Fiscal Stimulus: A Recession Antidote?

President Bush recently presented an outline of a fiscal stimulus program for the U.S. economy. Government, business and policy leaders in Florida have also initiated discussions on a fiscal stimulus package for the state. Presidents since at least John F. Kennedy's time have employed fiscal stimulus to expand the economy or avoid an economic downturn. It is, therefore, an appropriate time to examine the potential merits and drawbacks of such policies.

Mounting and intensifying concerns about an economic recession in the nation and the state, respectively, have motivated the initial discussions about fiscal stimulus programs. The deepening housing market slump -- especially in Florida where the slump is of serious and significant proportions -- plunging housing prices, escalating home foreclosures, shaky consumer and business confidence, markedly higher oil prices, volatile stock markets and credit market gridlock are increasingly threatening to curtail consumer and business spending and tilt the national and state economies from slowdowns into outright contractions.

Fiscal stimulus programs are intended at a minimum to moderate and in the best case to prevent economic downturns. They are programs of increased government spending and/or tax reductions. Heightened government spending serves to directly raise economy-wide total demand, while tax reductions encourage household and business spending and also may improve incentives to expand the economy's productive capacity. Generally, the boost in government spending is supposed to be on a one-time basis. Permanent as well as temporary tax reductions have been included in fiscal stimulus programs.

Nationally, the size of the Bush Administration's fiscal stimulus initiative is targeted at approximately 1 percent of nominal GDP. This translates into a dollar amount of roughly $140 to $150 billion. Although specific details await Congressional approval, the program will likely emphasize individual tax rebates and temporary incentives to boost business capital expenditures.

In Florida, a coalition of business groups has recommended an economic stimulus program focused largely on a broad range of infrastructure investments. The program calls for either accelerating the timing or expanding infrastructure investments in areas where a well-defined need has been generally acknowledged. Infrastructure investments have been proposed for roads, affordable housing, schools, ports, water supplies, research and development along with tourism marketing. Importantly, the package advocates one-time as opposed to permanent expenditure changes. Moreover, it stresses that financing be obtained from existing Trust Funds where applicable, such as the Sadowski Affordable Housing Trust Fund, in order to minimize the strain on the state budget. If they are effectively and efficiently implemented these infrastructure investments have the potential to give the Florida economy a current boost as well as to stimulate longer-term growth.

So-called "multiplier" as well as "crowding out" effects accompany the initial injections of government spending and/or tax reductions. The climb in government spending, for example on legitimate infrastructure needs, leads to job growth as the firms awarded contracts hire new workers. Job gains are associated with rising incomes, which stimulates consumer spending. Business profits may also advance, inducing firms to make capital expenditures. The cycle repeats itself, albeit with diminishing returns, until the last dollar of...
additional income and profit are neither spent nor invested. The size and timing of the full effect, including multiplier effects, of the fiscal stimulus may vary considerably, but if a properly implemented $140 - $150 billion national program is enacted, then the total boost to GDP could be in the 4 percent range.

Crowding out effects, in contrast, work in the opposite direction to the stimulus associated with government spending and/or tax reduction programs. They arise as an improving economy leads to higher interest rates, which dampen business capital spending and consumer expenditures on interest-sensitive items. An important role for monetary policy emerges here. Accommodative monetary policy can temper crowding out, as long as it does not ignite inflationary concerns. This clearly appears to be the case at present. The timing of the Federal Reserve's most recent easing of monetary policy is occurring in conjunction with and, perhaps is tacitly being coordinated with, President Bush's fiscal stimulus program.

In principle, fiscal and monetary policy adjustments can help to stabilize the economy. What are the potential, practical pitfalls that might hinder the effectiveness of these adjustments? There are several potential drawbacks. First, there are time lags. A recognition lag exists between the time when a fiscal stimulus program is needed and when policy makers recognize the need for one. Fortunately, at both the national and state levels the recognition lag does not appear excessively long at present.

There is also a time lag between the recognition of the need for fiscal stimulus and the enactment of legislation authorizing the spending and/or tax reductions. The political process can be painfully slow at this stage, though currently there appears to be a bi-partisan sense of urgency at the national and state levels. Perhaps more importantly are the risks that enacted spending programs may not be consistent with legitimate functions of government, and that temporary tax reductions serve only to shift the timing of household and business spending. Short-term boosts to the economy may then occur at the expense of ineffective and unproductive new programs detracting from longer-term growth.

Finally, there is an implementation lag - the lapse of time between the passage of a fiscal stimulus program and when the additional spending and/or tax reductions start to affect jobs and incomes. In this regard, President Bush's emphasis on tax reductions versus government spending programs might be motivated by the view that the timing lag for fiscal stimulus tied to spending programs is longer than the lag for tax reductions. Nonetheless, recognition, enactment and implementation lags may be so long that the state of the economy may already have changed by the time fiscal stimulus starts to affect it.

Financing fiscal stimulus programs, especially at the state level where (fortunately) balanced budgets are constitutionally mandated, is a second potential pitfall. Higher federal government spending will increase the fiscal deficit leading to both more federal borrowing and the risk of crowding out private sector borrowing or the expectation of higher future taxes. In contrast, tax reductions may encourage investments in productive human and physical capital, setting the stage for stronger future growth.

Though infrequently considered as a source of financing, government efficiency and productivity gains can provide at least some of the resources to finance fiscal stimulus programs. The Bush administration's $150 billion package equals about 5 percent of planned federal outlays for the current fiscal year. With a federal budget approaching $3 trillion finding $150 billion of savings seems feasible. The same approach should hold true for Florida.

A third potential pitfall to fiscal stimulus programs, mentioned earlier, is new spending programs and/or enlargement of existing programs that are not legitimate functions of government. These are more than the "bridges to nowhere" programs; they are government ventures of
speculative -- if not dubious -- merit. Once started, ending such programs becomes politically difficult. Moreover, they may contribute to a political culture where governments pay less attention to their core functions and, instead, seek to become all things to all people.

Fiscal stimulus programs may help to stabilize a slowing economy and moderate the pain of recession. However, inevitable time lags must be overcome and financing must be found. An embedded culture of public sector productivity and efficiency is important here. Most importantly, fiscal stimulus programs should not open the door to questionable government ventures.

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