Great Depression II

Why It Could Happen and How to Prevent It

Laurence Seidman

This economist argues that fiscal and monetary stimulus likely saved us from a Great Depression. He explains clearly how and why Keynesian stimulus works, but he also argues that deficit spending cannot go on indefinitely. When the economy strengthens, that is the time to deal with government spending, not before. He offers a plan to do so.

GREAT DEPRESSION II SHOULD NEVER HAPPEN. Yes, the economy may periodically be hit by downward forces that cut aggregate demand and generate a recession. But in contrast to the 1930s, thanks to Keynesian analysis, we know what the federal government should do when a recession hits: raise aggregate demand back to normal by sufficiently cutting federal taxes, increasing federal cash transfers to households and state and local governments, and increasing federal purchases of goods and services. To finance the resulting deficit, the Treasury should sell bonds to the public, and the Federal Reserve should buy Treasury bonds from the public through its open

***LAURENCE SEIDMAN** is Chaplin Tyler Professor of Economics at the University of Delaware.*

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market operations—so indirectly the Treasury would be borrowing from the Fed. The magnitude of this combined fiscal/monetary stimulus should be set large enough to raise aggregate demand back to normal. As the economy returns to normal and confidence is restored, the combined fiscal/monetary stimulus can and should be gradually phased out.

Although Great Depression II should never happen, could it happen? During the 2008 recession there was a surge of opposition to enacting sufficient fiscal stimulus to fully recover from the recession. This surge, "like a fire bell in the night" (to use Thomas Jefferson's immortal phrase concerning the resurgence of the conflict over slavery during the debate over the Missouri Compromise of 1820), should "awaken and fill us with terror." We must now face the possibility, even likelihood, that fiscal stimulus of *sufficient* magnitude might not be enacted by Congress even in a severe recession.

It turns out that strong opposition to enacting sufficient fiscal stimulus is alive and well today, more than seventy years after John Maynard Keynes wrote his *General Theory* (1936) and more than sixty years after Paul Samuelson clearly explained it with a simple 45-degree-line diagram in the first edition of his introductory economics textbook (1948). The past two years show unmistakably that there is strong opposition to sufficient fiscal stimulus not only in Congress and the general public but also within the economics profession. Unless a new strategy for politically defeating this opposition is devised, Great Depression II could happen, either from the current recession or from a future one.

Many Economists Oppose Fiscal Stimulus

In the mid-1960s, three decades after Keynes's *General Theory* (1936), it seemed that a permanent change in the economics profession had occurred. From now on, it seemed, the overwhelming majority of economists would always respond to a recession by prescribing a combined fiscal/monetary stimulus large enough to raise aggregate demand back to normal.

The college economics textbooks of the mid-1960s explained this prescription by using a 45-degree-line diagram in which, at each level of Y (output) plotted horizontally, plotted vertically was the level of aggregate demand D (where $D = C + I + G$) that would be forthcoming from consumers, business firms investing in plant and equipment, and government purchasing goods or services. D was usually drawn as a straight line with a positive slope but flatter than the slope of a 45-degree line from the origin. The economy would move to output Y^* where the aggregate demand line intersected the 45-degree line, because if output Y was greater than Y^*, the height of the demand line (demand D) would be lower than the height of the 45-degree line that equaled output Y, so producers would cut production. If the aggregate demand line shifted down—for example, because consumers and businesses became anxious in response to a stock market plunge—the economy would move to a lower output Y^{**}, where the new lower aggregate demand line intersected the 45-degree line. Hence, a downward shift of the aggregate demand line would cause a recession.

The cure for the recession was obvious from the diagram. The government needed to shift the aggregate demand line back up to its normal position. Congress could do this by sufficiently cutting taxes or giving cash transfers to consumers so that they would raise C, which in turn would induce business firms to raise I, so that they could produce enough to meet the new consumer demand, and by raising government purchases G. Moreover, the Federal Reserve could reduce interest rates to encourage consumers and businesses to borrow and spend, thereby raising C and I. Thus, a combined fiscal/monetary stimulus of sufficient size could cure the recession.

It is true that in the mid-1960s there were prominent dissenting economists—for example, monetarist Milton Friedman and public-choice theorist James Buchanan. Friedman (1962) contended that the economy would recover from a recession on its own as long as the Federal Reserve kept the money supply from contracting. He opposed fiscal stimulus as unnecessary to cure a recession and also as ineffective. He especially opposed "temporary" government spending because he believed it was likely to become permanent. Buchanan opposed deficit spending in a recession because he contended that it would impose a burden on future generations. Moreover, he feared that Keynesian doctrine would undermine fiscal discipline because politicians would use it as an excuse to increase government spending, thereby leading to a dangerous surge in government indebtedness.

In the decades since the mid-1960s, the prescription of fiscal stimulus to combat a recession has gradually lost support within the economics profession. There are at least two reasons for this loss of support: the resurgence of classical economics, and doubts about the practical implementation of fiscal stimulus.

First, classical macroeconomics has staged a comeback, led by Robert Lucas, Thomas Sargent, Robert Barro, and Edward Prescott. According to the new classical economists, the economy automatically recovers quickly from any recession; hence, government intervention is unnecessary, and fiscal stimulus would generate harmful government indebtedness.

New classical economists have resurrected an old classical/monetarist argument to "prove" that fiscal stimulus cannot increase aggregate demand. They ask: "Where does the money come from when the federal government borrows to finance its spending increase or tax cut?" They argue that the federal government must borrow the money from the private sector, which consequently cuts its spending by the same amount as the fiscal stimulus increases spending so that aggregate spending in the economy stays constant. This argument seems convincing to a portion of the economics profession and the general public.

Keynesians reply that even if money in the economy remains constant, there is a flaw in the classical/monetarist argument. The classical economist simply *assumes* that the cut in private sector spending equals the increase in spending due to the fiscal stimulus. This is not obvious and, in fact, is extremely doubtful in a recession, when the private sector has reduced its propensity to spend the money that it holds. The classical economist simply assumes that there is a fixed ratio of aggregate spending to the money in the economy. A crucial Keynesian insight is that the ratio of aggregate demand for goods to money in the economy rises in a boom, when the private sector is optimistic, and it falls in a recession, when the private sector is pessimistic. Hence, in a climate of pessimism, money lent from the private sector to a government that spends it on fiscal stimulus is likely to increase aggregate spending.

Moreover, the fiscal stimulus draws more money into the economy because, as explained above, the federal government indirectly borrows from the Federal Reserve to finance the fiscal stimulus. But, replies the classical/monetarist economist, then it is the increase in money that increases spending, and there is no need for fiscal stimulus.

The Keynesian responds that how money enters the economy is crucial. If there is no fiscal stimulus drawing it in, then money can enter the economy only through the Federal Reserve's open market operations, in which the Fed buys Treasury bonds and pays with new money. This method of injecting money into the economy may have little impact on spending when a pessimistic private sector is unwilling to borrow and spend despite near-zero interest rates. This is now called the "zero-bound problem" confronting monetary policy in a recession, but in his 1948 first edition (and subsequent editions) Samuelson said it best:

> In terms of the quantity theory of money, we may say that the velocity of circulation of money does not remain constant. "You can lead a horse to water, but you can't make him drink." You can force money on the system in exchange for government bonds . . . but you can't make the money circulate against new goods and new jobs. . . . You can tempt businessmen with cheap rates of borrowing, but you can't make them borrow and spend on new investment goods. (1948, 353–54)

In contrast to classical economists, who assume automatic recovery, other economists doubt that fiscal stimulus would be implemented competently and appropriately by Congress. These economists judge that congressional politics would generate long delays in enacting fiscal stimulus in response to a recession, would fill any stimulus package with wasteful pork-barrel projects distorted by parochial and special-interest politics, and would also prevent the termination of fiscal stimulus after the recession was over. They therefore conclude that monetary stimulus alone should be relied on to combat a recession.

The 2008 recession, however, demonstrated the inadequacy of sole reliance on monetary stimulus to combat a severe recession. The Federal Reserve cut the federal funds rate from about 5 percent in mid-2007 to nearly 0 percent in late 2008. Yet the economy continued to suffer from inadequate aggregate demand for goods and services, evidenced by the huge 6 percent gap in 2009 between actual and normal GDP (the GDP that would be generated if the unemployment rate were normal). Some supporters of sole reliance on monetary stimulus maintained that not all monetary weapons had been tried. They urged the Fed to aggressively buy long-term government bonds and even long-term corporate bonds in a direct attempt to bring down long-term interest rates, the rates most important to business firms contemplating borrowing to finance investment in plant, equipment, and technology.

Although such a direct attempt to reduce long rates might help, it is doubtful that it would be enough in a severe recession like the 2008 one. Monetary policy relies on stimulating loans. But every potential borrower knows that a loan is supposed to be paid back. If business firms forecast weak demand for their products, then even a 0 percent long-term interest rate will not induce much borrowing by firms. If consumers are worried about their own job security, even a 0 percent interest rate will not induce much consumer borrowing.

There is a crucial difference between fiscal stimulus in the form of tax cuts or cash transfers and monetary stimulus. A recipient of a federal tax cut or federal cash transfers correctly takes it for granted that the money does not have to be paid back. Thus the recipient generally spends some of it, uses some of it to pay down debt, and saves the rest. By contrast, any potential borrower takes it for granted that any borrowing must be repaid. Monetary stimulus can lower interest rates, but if potential borrowers fear that they will not be able to repay a loan, they will not borrow, and there will be no additional spending. The crucial difference between fiscal and monetary stimulus, therefore, is whether the money must be paid back.

Of course, classical economists like Robert Barro insist that tax cuts and transfers will have to be paid back when future taxes are increased to repay the government debt and that "rational," forwardlooking individuals, firms, and state and local governments will all recognize this and will therefore *entirely* save all tax cuts or transfers to prepare for the coming repayment they must make. Hence, say classical economists, fiscal stimulus in the form of tax cuts or transfers will *not* boost spending by households, firms, or state and local governments. But, reply Keynesians, there is absolutely no empirical evidence that transfer recipients actually *think* "I'd better entirely save this tax cut or transfer in order to be ready to make the coming repayment to the government." There is a lot of empirical evidence that people (other than classical economists) do not think this way about what to do with tax cuts or cash transfers. Just ask them, and listen to what they say. It is an incredible indictment of the economics profession that it has let classical economists like Barro get away with this key assumption in the face of overwhelming empirical evidence that the assumption is false.

Over the past four decades most textbooks on introductory economics, intermediate macroeconomics, and especially graduate-level macroeconomics have given less and less attention to the use of fiscal stimulus to combat a recession. Some textbooks have taught students that the economy tends to recover automatically on its own. Other textbooks have focused on the use of monetary stimulus to counter a recession. Many economics Ph.D. programs completely ignored the possible role of fiscal stimulus in combating a recession. Emerging from these Ph.D. programs, newly minted economics professors naturally either ignored or commented negatively on the use of fiscal stimulus to combat a recession in their undergraduate economics courses. Students emerging from these college economics courses had a much more negative view of the use of fiscal stimulus to combat a recession than students who emerged from college economics courses in the mid-1960s.

This erosion of support for fiscal stimulus within the economics profession has had a dramatic impact on Congress and the general public. In the mid-1960s, advocates of fiscal/monetary stimulus could tell doubters in Congress that the overwhelming majority of economists prescribed a combined fiscal/monetary stimulus to cure a recession.

Today, advocates of fiscal stimulus can no longer make that claim. Congressional opponents of fiscal stimulus know that there are many prominent macroeconomists, including several Nobel Prize winners, who oppose fiscal stimulus to counter even a severe recession.

Since 2001, despite the skepticism of many economists, there has been an attempt to revive fiscal policy to counter recessions. When the 2001 recession began, I joined other Keynesian economists in calling for a revival of fiscal policy (Seidman 2001) and was encouraged when Congress enacted some fiscal stimulus (including a tax rebate) in the summer of 2001. It was also encouraging that the new chairman of the Federal Reserve, Ben Bernanke, had stated in speeches and writings prior to becoming chairman in 2006 that he supported fiscal stimulus as well as monetary stimulus to combat a severe recession (Seidman 2006a). In 2008 and 2009 Congress twice enacted a fiscal stimulus package.

Although these fiscal stimulus packages, together with financial rescues and monetary stimulus, averted Great Depression II in 2009, it was clear by mid-2009 that the packages were too small to generate a recovery strong enough to bring the unemployment rate back to normal by the end of 2010. In mid-2009, therefore, Keynesians began pressing for the enactment of another large fiscal stimulus package to strengthen the recovery. At this critical point, the Keynesian effort to achieve sufficient fiscal stimulus hit a political brick wall. Despite new evidence in mid-2009 of how severe the recession had been and how weak the recovery was, Congress refused to enact another large fiscal stimulus package. The economy was now on its own. It might have enough strength to eventually recover fully. That remained to be seen. But Congress was not about to provide any more fiscal stimulus.

Keynesians Must Take National Debt Seriously

Ever since early Keynesians prescribed fiscal stimulus for a recession, others have objected because of concerns about its impact on the national debt. That concern is as strong today as ever. In Congress and among the citizenry, concern about the national debt is perhaps the major obstacle to enacting sufficient fiscal stimulus to combat a severe recession. This concern was an important reason that Congress kept the fiscal stimulus package of February 2009 under $800 billion despite estimates from Keynesian macroeconometric models that a much larger fiscal stimulus would be needed to bring unemployment down to normal by the end of 2010. Concern about debt has kept Congress from enacting another substantial fiscal stimulus package.

The traditional reaction of many (not all) Keynesians has been to dismiss the concern about national debt as uninformed, a vestige of old-fashioned classical economics that modern Keynesian analysis has rendered obsolete, and based on false analogies between households and business firms, on the one hand, and the national government, on the other. Perhaps the earliest and most articulate Keynesian exponent of this view was Abba Lerner, who contrasted modern Keynesian "functional finance" with old-fashioned "sound finance" and argued that we owe most of the national debt to ourselves (1944/1970, 1951).

Even if Lerner were correct that concern about the national debt is misguided, it is clear after seven decades that, despite the efforts of many Keynesians, a majority in Congress, the public, and the business and financial community continue to worry about the impact of fiscal stimulus on the national debt. As Keynes said in other contexts, the actual opinions and psychology of the public, whether ill or well informed, must always be taken into account in designing effective public policies.

If many financial investors around the world and many American consumers and business managers worry about a rising U.S. government debt as a percentage of GDP, then that worry must be taken into account in designing economic policy. Traditional Keynesians have always insisted that a realistic view of how people actually think and behave is essential to getting policy right—this insistence on realism has been at the core of the Keynesian critique of the new classical economics with its unrealistic assumption that everyone holds "rational" expectations and that workers promptly accept wage cuts needed to "clear" labor markets.

Suppose it is realistic to expect many financial investors, in response to a rising U.S. debt-to-GDP ratio, to reduce their demand for U.S. government bonds because they worry that a default may be possible. This would raise bond interest rates and the government's interest burden on its debt. Suppose it is realistic to expect many American consumers to become alarmed about rising national debt and to cut their consumption and save more to prepare for a future they view with alarm. Suppose it is realistic to expect many American business managers to cut their investment spending on plant and equipment and save more for the same reason. Then Keynesians should be the first to agree that the widespread fear of rising debt—whether valid or not—will cause a plunge in aggregate demand that results in a severe recession. If all financial investors, consumers, and business managers thought like Abba Lerner, this would not happen. But many do not think like Lerner, and Keynesians must design policy accordingly. It is just as mistaken to assume that everyone in the economy actually thinks like Abba Lerner as it is to assume that everyone in the economy actually thinks like Robert Lucas or Robert Barro.

Keynesians should therefore draw this conclusion: "People have worried about national debt for seven decades despite efforts to get them to stop worrying when we prescribe fiscal stimulus. We had better assume they will keep worrying, and see if we can devise a way to get sufficient fiscal stimulus in a recession while addressing their worry about national debt." Rather than attempting a thorough analysis of whether concern about national debt is economically valid, I will go directly to the urgent practical task of designing a strategy that can persuade a majority of the public and Congress to support sufficient fiscal stimulus despite their concern about national debt.

But before I do, let me make a few brief comments about the national debt. First, when the economy is in a severe recession, even a large fiscal stimulus generates only a small rise in debt as a percentage of GDP because, in response to the stimulus, real GDP rises nearly as much as debt (Seidman and Lewis 2009). Second, after the economy is at full employment, continuing a large fiscal stimulus would generate inflation if the Federal Reserve does not offset the fiscal stimulus with tight monetary policy or would generate high interest rates if the Fed implements tight monetary policy to prevent inflation. High interest rates crowd out private investment, and high interest rates on government bonds raise federal spending on interest to bondholders, thereby either crowding out other federal spending or requiring an increase in taxes. Third, even if U.S. federal debt were bought and held only by Americans so that we "owed it to ourselves," future American taxpayers would be burdened when they had to pay higher taxes to finance interest payments to American bondholders. Thus, there would be a net burden on the future American taxpayers who are not holders of U.S. bonds—hence, on the vast majority of future citizens. Fourth, today roughly half of U.S. government bonds are held by foreigners, not Americans, so half of U.S. debt is owed to "them," not "us."

NUBAR Plus Sufficient Fiscal Stimulus with a Terminator

I recommend that Congress enact NUBAR, which stands for "normal unemployment balanced budget rule," as soon as possible, plus a sufficient fiscal stimulus package with a "terminator."[1]

Under NUBAR, every year (starting with the budget that Congress plans during 2012 for the fiscal year 2013) Congress would be required to enact a planned federal budget that the Congressional Budget Office (CBO) estimates would be balanced next year if the economy's unemployment rate is "normal" next year.

"*Normal*" would be defined as *the actual average over the preceding decade.* There would therefore be a small automatic change every year in the numerical value of the normal unemployment rate as the ten-year average is recomputed. In this article 6 percent will be used for numerical illustrations. Thus, "normal" does not imply "socially optimal"—it is simply the average of what has actually occurred over the past decade.

Also as soon as possible, Congress should enact a temporary fiscal stimulus package of sufficient magnitude so that the CBO estimates it would reduce the unemployment rate to normal (6%) by the end of 2012. The fiscal stimulus package should contain a *terminator* that phases down the stimulus as the unemployment rate declines toward 6 percent. For each tax cut and spending component of the fiscal stimulus package, Congress should enact a terminator clause that reads: "The amount specified for this program is authorized if the unemployment rate (*U*) exceeds 9 percent; if *U* is between 8 percent and 9 percent, the amount authorized is cut 25 percent; if *U* is between 7 percent and 8 percent, the amount authorized is cut 50 percent; if *U* is between 6 percent and 7 percent, the amount authorized is cut 75 percent; and if *U* is below 6 percent, the amount authorized is cut 100 percent (the program is terminated)."

The deficits that must be brought under control are the large projected future deficits, not the temporary deficits caused by the recession itself or the temporary fiscal stimulus enacted to combat it. It is not enough for the president, senators, and representatives to promise that, when the future arrives, they will address the budget deficits. What financial markets and the general public want to see now is that Congress is willing every year, starting with the fiscal 2013 budget, to enact a planned budget that CBO technicians estimate would be balanced next year if the economy has a normal unemployment rate that year.

For more than half a century, economists across the political spectrum have recommended that Congress adhere to a full-employment balanced budget rule (FEBAR) and thereby enact a planned budget every year that technicians estimate would be balanced next year if the economy is at "full employment" next year. NUBAR is the same rule, except it avoids a debate over what is "full employment" by using the "normal" unemployment, defined as the average of the preceding decade, instead of "full employment."

A key objection to enacting temporary fiscal stimulus programs is the fear that they will turn out to be permanent, not temporary. This objection can be met, however, by attaching an automatic terminator to every fiscal stimulus measure. Any program with a terminator attached is automatically ended after the unemployment rate returns to normal.

If Congress enacts a NUBAR statute by the end of 2011, Congress would be required to adopt a planned budget by October 1, 2012, for fiscal year 2013 (which begins October 1, 2012) that CBO estimates would be balanced in 2013 if the unemployment rate is normal (6%) in 2013. How would NUBAR work in practice if it is enacted by the end of 2011?

One month before the beginning of fiscal year 2013 (on September 1, 2012), the CBO would provide a NUBAR estimate for the 2013 fiscal year. The CBO would estimate the labor force in 2013 and use it to estimate total employment in 2013 if the employment rate is 94 percent. From its estimate of total employment and the total capital stock in 2013, the CBO would estimate total output (GDP) and total income if the unemployment rate in 2013 is 6 percent. Given total income and current tax law, the CBO would estimate total tax revenue; and given current authorizations and appropriations for all federal spending programs, the CBO would estimate total federal spending in 2013. The difference between estimated spending and estimated tax revenue would be CBO's estimated 2013 deficit on the assumption the unemployment rate in 2013 is 6 percent. The CBO currently makes all these estimates except that it tries to forecast the employment rate of the economy in the coming fiscal year and makes all its estimates using its forecasted employment rate. CBO would continue to do this, but for the purpose of NUBAR, CBO would also make all the same estimates on the assumption of a 94 percent employment rate in 2013.

Now comes a key question: Suppose the planned 2013 budget as of September 1, 2012, shows a NUBAR deficit? NUBAR would then prescribe an automatic *X* percent across-the-board adjustment in all planned spending programs and all taxes to achieve a planned balanced budget. If the planned budget as of September 1 is estimated by the CBO to have a NUBAR deficit, then on October 1 all planned spending programs would be reduced by *X* percent and all taxes would be increased by *X* percent. The CBO would be instructed to calculate the numerical value of *X* that would achieve a planned balanced budget.

A NUBAR statute enforced by the across-the-board *X* percent adjustment would keep federal debt as a percentage of GDP relatively low. If the economy is hit with a severe recession, this low debt percentage would enable Congress to enact a large fiscal stimulus without alarming financial markets or the general public. Moreover, a crucial feature of NUBAR is that it would permit as large a fiscal stimulus as necessary to fully combat a severe recession as long as the fiscal stimulus package contains a terminator. When the CBO makes its NUBAR evaluation of the planned budget, any fiscal stimulus package with a terminator would be ignored because it would have no effect on next year's budget if next year's unemployment rate is normal.

Should There Be a Federal Capital Budget Exempt from NUBAR?

Should Congress establish a federal capital budget to fund specific capital projects by borrowing instead of taxes—a capital budget that is exempt from NUBAR? The establishment of a federal capital budget has often been proposed, and the pros and cons have been debated, but the issue would become more pressing if Congress were to enact a NUBAR statute.

On the one hand, most economists agree that a large share of federal spending is an investment in physical, human (education or health), or knowledge capital. On the other hand, if an exempt capital budget were established under NUBAR, advocates of particular spending programs would argue that their program is an investment and therefore belongs in the exempt capital budget. Advocacy for inclusion would sometimes reflect merit but sometimes also reflect special-interest politics.

Financial markets appear primarily concerned about how much debt a government has incurred relative to GDP. In the financial press, countries are often ranked by the ratio of government debt to GDP without any analysis of the assets—physical, human, and knowledge capital—that have been obtained by issuing the debt. Perhaps financial markets should look at these assets as well as a government's debt in deciding whether to purchase a government's bonds. But if financial markets ignore these assets, then a government must worry about the debt it incurs regardless of what the debt finances. Thus, despite the fact that many government programs are investments, concern about the reaction of financial markets calls for limiting exemptions under NUBAR.

Perhaps the most sensible approach would be to establish a commission of capital budget experts to review the criteria for inclusion used by state and local governments and private business firms, to propose criteria for inclusion in a federal capital budget under NUBAR, and to illustrate the proposal by showing which items in the current federal budget would be included and which would be excluded. The commission would present arguments for and against establishing a federal capital budget under NUBAR. Guided by the commission's report, Congress would then decide whether to establish a federal capital budget under NUBAR and, if so, establish the criteria for inclusion.

Keynesian Fiscal Stimulus Includes Tax Cuts as Well as Government Spending

Many conservative opponents and many liberal supporters of Keynesian fiscal stimulus incorrectly agree on one thing: "Keynesian fiscal stimulus means government spending, not tax cuts." Both are wrong. From the beginning, most Keynesian economists have emphasized that both tax cuts and government spending (cash transfers or government purchases) increase aggregate demand, $C + I + G$. Liberals and conservatives, of course, have different long-run agendas for the federal government: Liberals want higher spending on social insurance programs and accept higher taxes that are progressive to finance these programs, while conservatives want lower spending on social insurance programs and lower taxes, and they want taxes to be proportional, not progressive. But these agendas should not confuse the issue about Keynesian fiscal stimulus.

Once again, let us go back to Samuelson's first edition of his introductory economics textbook in 1948. He wrote:

> In addition to public-works expenditures and welfare expenditure, countercyclical compensatory fiscal policy can also rely on cyclically timed tax policies. . . . Even without Congress changing any laws, it turns out that governmental tax collections fall off when national income falls off. . . . This is a powerful factor stabilizing the whole economy and moderating the business cycle. . . . Even this is not all. Congress can also change tax rates. . . . Those who believe in countercyclical compensatory fiscal policy argue that the time to reduce tax rates is in depression, when over-all purchasing power is too low. (1948, 413–14)

The Kennedy administration in the early 1960s witnessed an internal debate between two Keynesian economists, Walter Heller and John Kenneth Galbraith. Heller and Galbraith agreed that a tax cut and a government spending increase were each a Keynesian fiscal stimulus that would raise aggregate demand. For various reasons, Heller argued for a tax cut and Galbraith for a spending increase. Of course, today supply-side, anti-Keynesian conservatives (for example, the editorial writers of the *Wall Street Journal*) claim the Kennedy tax rate cut worked because it induced more supply of labor and capital, not because it stimulated demand. But Heller's argument for the tax cut was Keynesian: It would lift aggregate demand. Keynesian economist Arthur Okun later did a study from which he concluded that the tax cut worked because it raised aggregate demand.

The particular tax rate cuts proposed by President Reagan in 1981 and President Bush in 2001 gave many more dollars to high-income households than to middle- and low-income households and were consequently opposed by liberals on distributional grounds. It is crucial to recognize, however, that taxes can be cut in a way that gives more dollars to middle- and low-income households than to high-income households. The tax rebate of 2008 and the income tax withholding cut of 2009 that implemented President Obama's Making Work Pay Tax Credit (which constituted nearly a third of the February 2009 $800 billion fiscal stimulus package enacted by Congress) excluded high-income households from receiving rebates or withholding cuts by containing an income-related phaseout.

Thus, the debate over Keynesian stimulus should not be about government spending versus tax cuts. Both are a Keynesian stimulus. Liberals who believe in Keynesian stimulus want the spending and tax-cut components to favor middle- and low-income households, while conservatives who believe in Keynesian stimulus want less spending and more tax cuts, with the tax cuts giving the most dollars to high-income households. Congressional liberals and conservatives who believe in Keynesian fiscal stimulus in a recession should sit down and negotiate a compromise fiscal stimulus package that can win the required votes in the House and the Senate.

Is a Tax Rebate an Effective Component of Fiscal Stimulus?

Keynesian fiscal stimulus consists of government spending (purchases or cash transfers) and tax cuts. But doubt has been raised about one kind of fiscal stimulus: a tax rebate. In February 2008 Congress enacted an economic stimulus package that included a tax rebate for households. The U.S. Treasury mailed checks to households in May, June, and July. Most single individuals received $300 plus $300 per dependent child, while most married couples received $600 plus $300 per dependent child. For example, a family of two parents and three children received $1,500. The rebate amount phased in for low-income households and phased out for high-income households.

Did the 2008 rebate stimulate consumer spending? In two widely cited *Wall Street Journal* op-eds, Martin Feldstein (2008) and John Taylor (2008) asserted that the rebate failed. In their influential *American Economic Review* articles (May 2009), John Taylor and Martin Feldstein analyzed U.S. Bureau of Economic Analysis (BEA) National Income and Product Accounts (NIPA) aggregate time-series data and concluded that the rebate failed to stimulate consumer spending. The Taylor/Feldstein conclusions from the BEA aggregate data about the 2008 rebate contrast with two studies that use individual household micro data to study the impact of the 2008 rebate (Parker et al. 2010; Sahm et al. 2009). Both studies conclude that the rebate had a significant effect on the spending of a typical household receiving the rebate.

Parker et al. (2010) report on their study of the effect of the 2008 rebate on consumer expenditure using micro data—consisting of individuals' reports of the dollar amounts of their recent consumer expenditures—from the Consumer Expenditure Survey conducted by the U.S. Bureau of Labor Statistics. They write:

> Using special questions added to the Consumer Expenditure Survey, we measure the response of household spending to the economic stimulus payments (ESPs) disbursed in mid-2008. We find that, on average, households spent 12–31 percent of their stimulus payments on non-durable goods during the three-month period in which the payments were received. Further, there was also a substantial and significant increase in spending on durable goods, particularly autos. Improving on previous research, these spending responses are estimated with precision using only variation in the timing of ESP receipt.

Their conclusion in the 2008 rebate is similar to their conclusion in a separate article on the effect of the 2001 tax rebate, using the same kind of micro data:

> Using questions expressly added to the Consumer Expenditure Survey, we estimate the change in consumption expenditures caused by the 2001 federal income tax rebates and test the permanent income hypothesis. We exploit the unique, randomized timing of the rebate receipt across households. Households spent between 20 to 40 percent of their rebates on nondurable goods during the three-month period in which their rebates arrived, and roughly two-thirds of their rebates cumulatively during this period and the subsequent three-month period. The implied effects on aggregate consumption demand are substantial. Consistent with liquidity constraints, responses are larger for households with low liquid wealth or low income. (Johnson et al. 2006, 1589)

Claudia Sahm, Matthew Shapiro, and Joel Slemrod (2009) evaluate the impact of the 2008 tax rebates using a survey of individual households about what they say they "mostly did" with their 2008 rebate—the Reuters/University of Michigan Survey of Consumers, which is a nationally representative monthly survey based on about 500 telephone interviews. They write:

> In summary, the survey results suggest that roughly one-third of the rebate income was spent in 2008 and that the spending response was concentrated in the first few months after receipt. (2009, 2)

Their result is consistent with what they found a few months earlier (Shapiro and Slemrod 2009) in their study in which they asked households what they *intended* to "mostly do" with their 2008 rebate. Based on the answers about intent, Shapiro and Slemrod estimated that the typical rebate recipient intended to spend about one-third of the rebate in the near future.

In summary, according to the micro data studies of the 2008 rebate, the typical rebate recipient spent between one-third and two-thirds of the rebate within half a year of receiving the rebate.

In a recent paper, Ken Lewis and I (2010) reexamine the BEA aggregate time-series data used by Feldstein (2009) and Taylor (2009). We consider two alternative hypotheses: (1) the Taylor/Feldstein hypothesis that the rebate had little or no effect, and (2) the hypothesis that the rebate had half the effect of ordinary disposable income.

After analyzing the same data used by Feldstein and Taylor, we come to the following conclusions. First, we do *not* go to the other extreme and claim that the data show that the rebate definitely worked. We find that the data *do not show* that the rebate failed and, instead, show that there is a high probability that the true rebate coefficient is positive. Moreover, the hypothesis that the rebate has half the impact of ordinary disposable income cannot be rejected. Thus we find that analysis of the BEA aggregate time-series data is consistent with the conclusion from the micro-data studies that the 2008 rebate stimulated consumer spending.

Preventing Great Depression II

Great Depression II could happen. Yes, there is a Keynesian remedy—a combined fiscal/monetary stimulus of sufficient magnitude—that could prevent it. But that remedy may not be enacted by Congress because of concern over the national debt. To prevent Great Depression II, Keynesians must overcome the public's concern over the national debt so that the Keynesian remedy will actually be enacted by Congress.

The best way to overcome the concern over the national debt is

NUBAR. Congress should enact a normal unemployment balanced budget rule statute. Under NUBAR, every year Congress would be required to enact a planned federal budget that the Congressional Budget Office estimates would be balanced next year if the economy's unemployment rate is normal (6%) next year. If Congress submits a planned budget that CBO estimates has a NUBAR deficit, NUBAR would then prescribe an automatic *X* percent across-the-board adjustment in all planned spending programs and all taxes to achieve a planned balanced budget; all planned spending programs would be reduced by *X* percent, and all taxes would be increased by *X* percent to make the planned budget comply with NUBAR.

Moreover, any fiscal stimulus package must contain a *terminator* that phases down the stimulus as the unemployment rate declines toward 6 percent. For each tax cut and spending component of the fiscal stimulus package, Congress should enact a terminator clause that reads: "The amount specified for this program is authorized if the unemployment rate (*U*) exceeds 9 percent; if *U* is between 8 percent and 9 percent, the amount authorized is cut 25 percent; if *U* is between 7 percent and 8 percent, the amount authorized is cut 50 percent; if *U* is between 6 percent and 7 percent, the amount authorized is cut 75 percent; and if *U* is below 6 percent, the amount authorized is cut 100 percent (the program is terminated)."

A NUBAR statute enforced by an automatic across-the-board *X* percent adjustment in planned spending and taxes would keep federal debt as a percentage of GDP relatively low. When a severe recession hits, this low debt percentage would enable Congress to enact a large fiscal stimulus without alarming financial markets or the general public. Moreover, as long as the fiscal stimulus package contains a terminator, NUBAR would permit as large a fiscal stimulus as necessary to fully combat even a severe recession.

NUBAR plus a terminator is no guarantee against Great Depression II. But with NUBAR plus a terminator attached to any fiscal stimulus package, there is a reasonable chance that there will be enough votes in Congress during a severe recession to enact sufficient fiscal stimulus to prevent Great Depression II.

Note

1. This proposal was presented in Seidman 2003 and 2006b.

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