

Principles of Economics
Macroeconomics
Fiscal Austerity

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The Recovery Act: Overview

- Romer-Bernstein estimates ca. January 2009
 - A three-year output gap of \$3.6T
 - Even with interest rates at ZLB and TARP bailouts
- Romer-Bernstein were in line with private-sector forecasters
- Romer-Bernstein were optimistic
 - Things were much worse than they imagined...

The Recovery Act: Politics

- Romer-Bernstein multiplier μ of 2
- \$3.6T of output gap over 3 years requires a \$1.8T stimulus
- Political and Legislative Affairs view: any fiscal expansion number with a “1” in the trillions place is “non-planetary”
- NEC bid a \$900B fiscal expansion, said it would close half the output gap, and hoped Obama would do the math...
- Obama administration proposed an \$800B stimulus
- Obama administration got a \$600B stimulus (plus \$200B of ineffective Christmas-tree tax provisions)

The Recovery Act: Effectiveness

- Gabriel Chodorow-Reich et al. (2012) <<http://pubs.aeaweb.org/doi/pdfplus/10.1257/pol.4.3.118>>: Does State Fiscal Relief During Recessions Increase Employment? Evidence from the American Recovery and Reinvestment Act
- A cost per job-year of \$26,000... only about a quarter of the increase in employment was in the health sector, with another quarter in education and the other half in state and local government. In the context of our broader understanding of the costs and benefits of fiscal stimulus, state fiscal relief, in particular, may be a particularly low-cost means of supporting employment during a recession. Furthermore, the jobs increases were rapid, perhaps because “shovel-ready” projects were often not necessary; in many cases, state and local governments only needed to avoid cuts...

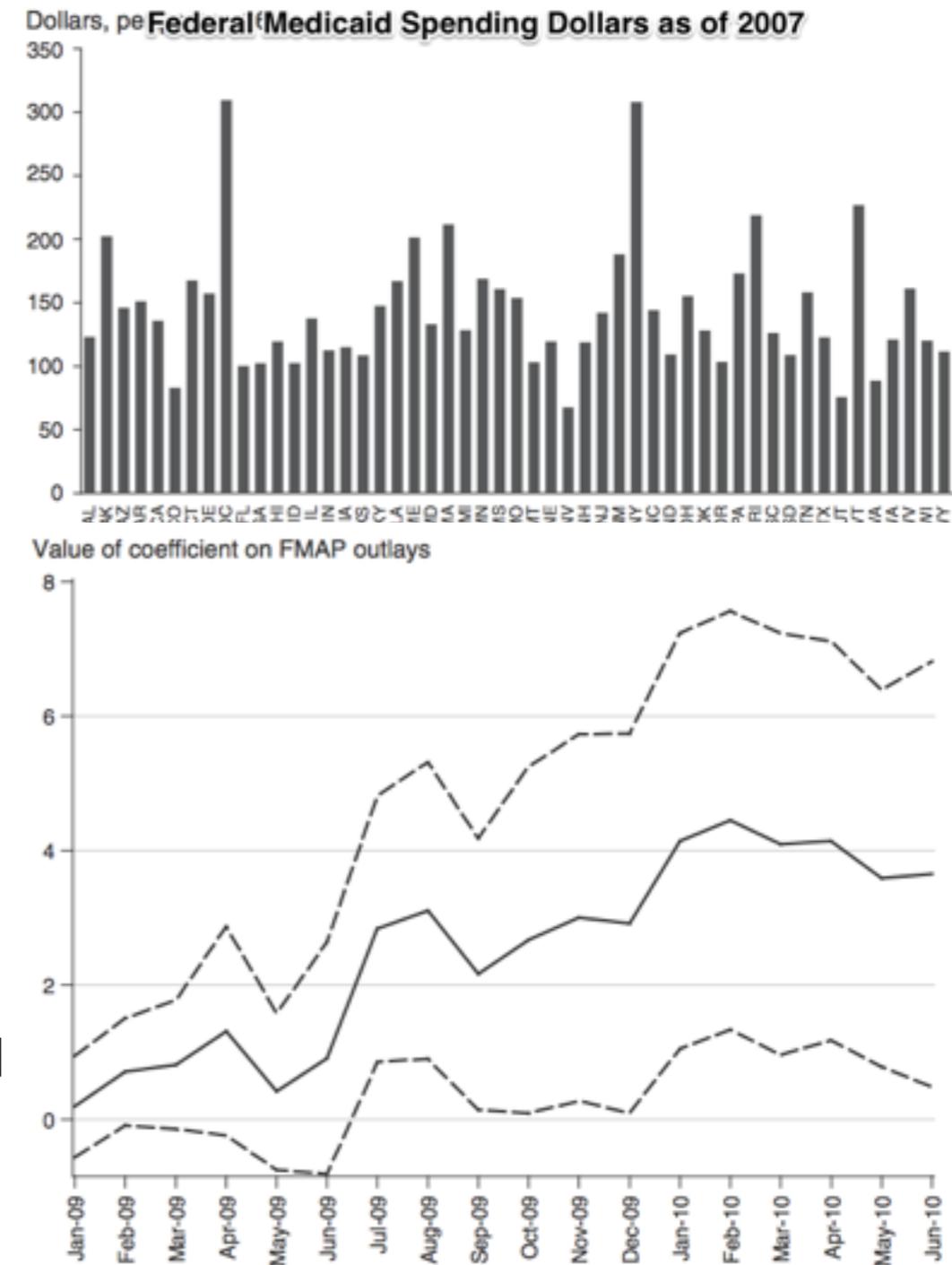


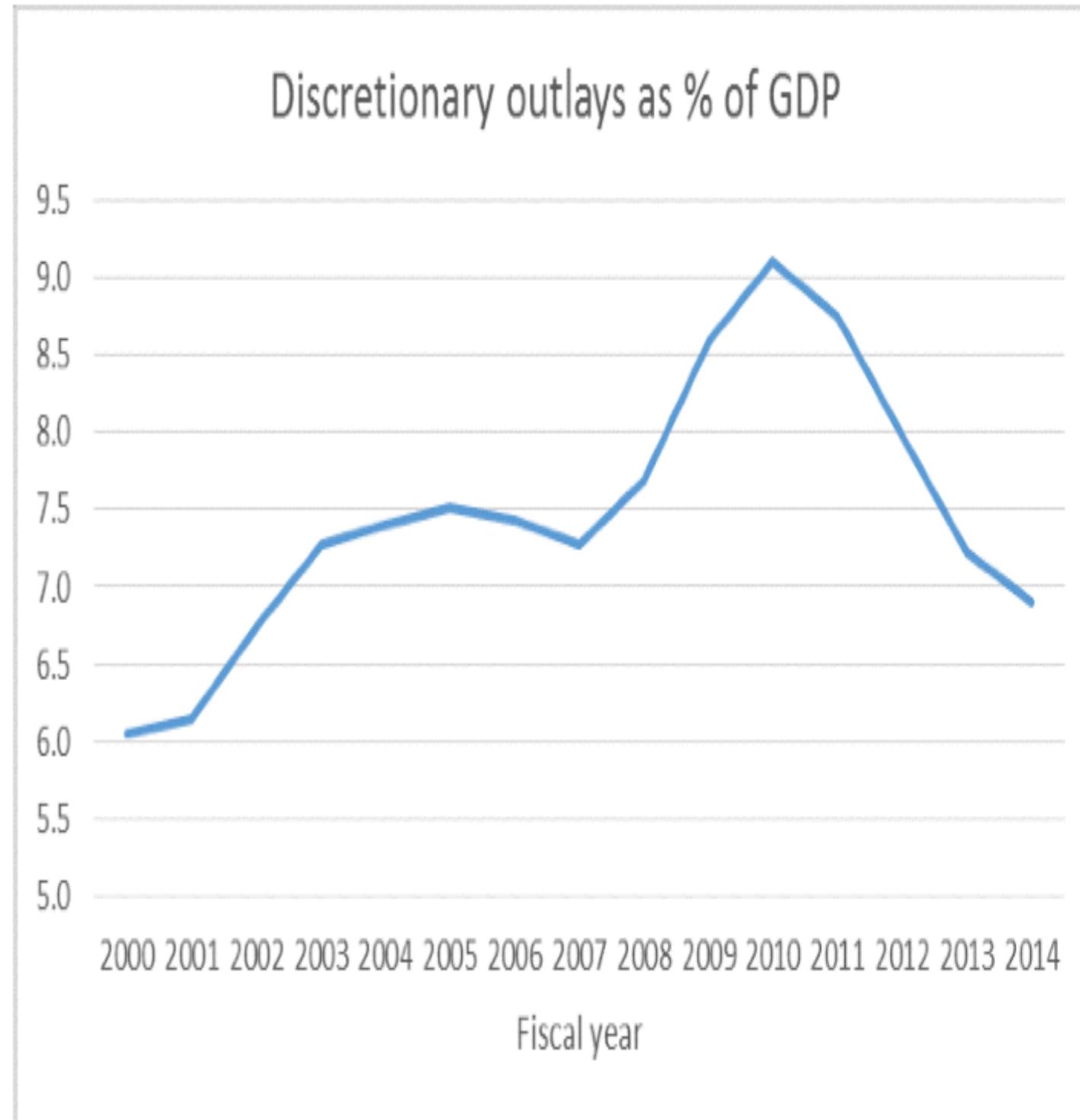
FIGURE 3. TOTAL NONFARM SECOND STAGE COEFFICIENTS

The Bob Rubin Question...

- What if we are wrong today? What actions will we, two years from now, wish that we had taken today to preserve our ability to recover?
- Apparently not a question ever asked inside the Oval Office...
- Or inside the Obama Treasury...
- Obama, 2010 State of the Union Address:
 - There are projects like that all across this country that will create jobs.... But the truth is, these steps won't make up for the seven million jobs that we've lost.... The only way to move to full employment is to lay a new foundation for long-term economic growth.... It's time to get serious... serious financial reform... encourage American innovation... export more... invest in... skills and education... step up refinancing.....
 - Our efforts to prevent a second depression have added another \$1 trillion to our national debt..... So tonight, I'm proposing specific steps to pay for the trillion dollars... freeze government spending for three years... go through the budget, line by line, page by page, to eliminate programs that we can't afford and don't work....
 - I've called for a bipartisan fiscal commission, modeled on a proposal by Republican Judd Gregg and Democrat Kent Conrad. This can't be one of those Washington gimmicks.... The commission will have to provide a specific set of solutions by a certain deadline...

The Consequence...

- Obama protests that he wanted long-run cost control, not short-term austerity...
- But that's not what he got...
- How different might things have been?



The Puzzling Politics of the Obama Administration...

- Obama wants very much to be the reasonable centrist between Pelosi and Reid on the one hand and the Republicans on the other...
- A critical component of both Pelosi's and Reid's members want to be the reasonable centrist between the Republicans and the Kenyan Muslim Socialist...
- The moderate Republicans all bought into the Gingrich line...

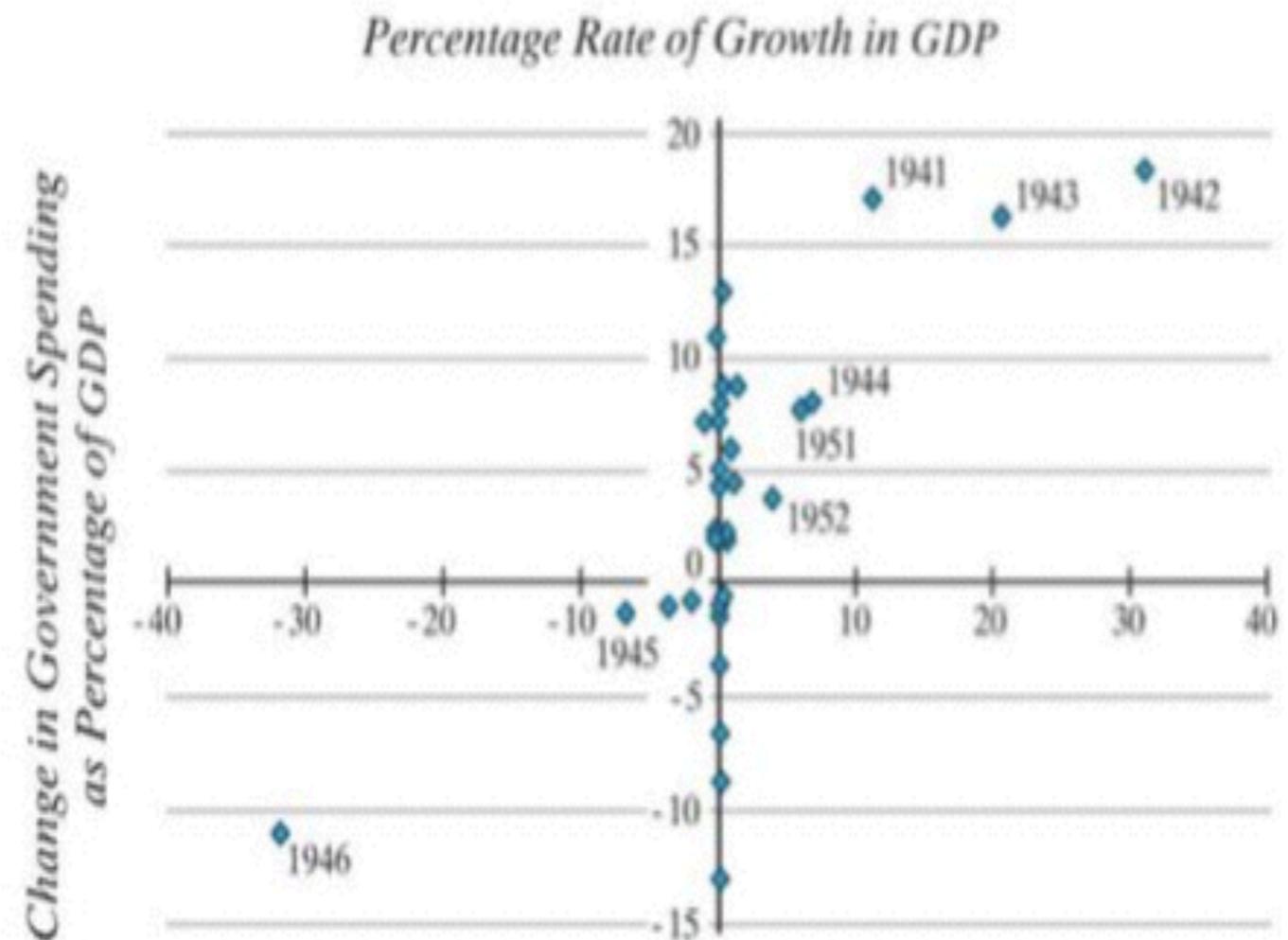
In Our Framework...

- $Y = \mu[(G - c_y T) + c_0 + (c_w W(r) + I(r) + X(r))]$
- $r = i + E(\Delta i) + \rho - E(\pi)$
- The belief that austerity would be expansionary is a belief that a bigger deficit:
 - Would raise $E(\Delta i)$
 - Would raise $\rho - E(\pi)$
 - Would keep the Federal Reserve from raising i

But Is There Any Evidence for Expansionary Austerity?

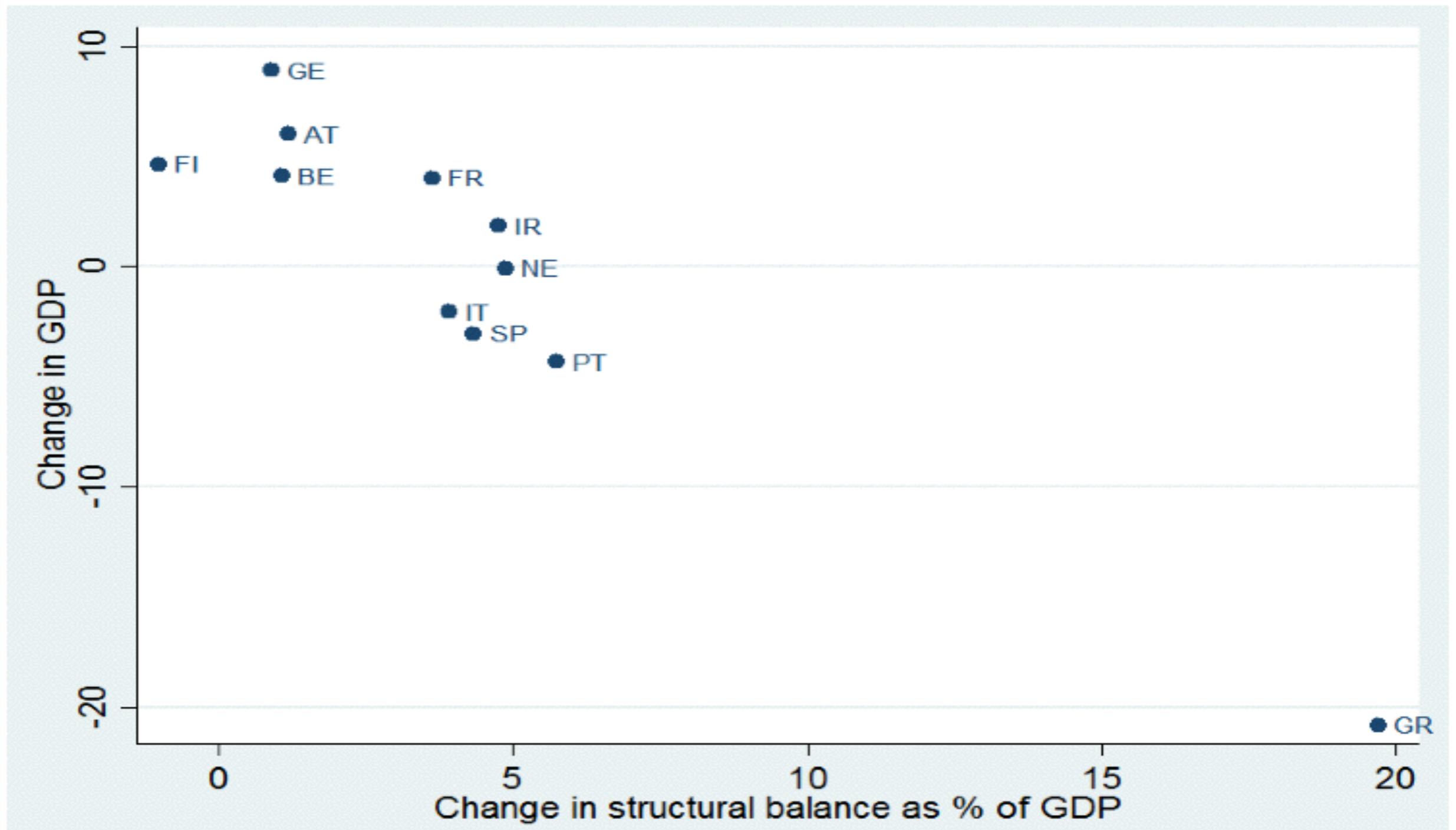
- **NO**
- And there is a lot of evidence against it...
- In World War II and in the Korean War the U.S. economy slammed up against capacity constraints...

GOVERNMENT SPENDING AND GROWTH, 1929-1962

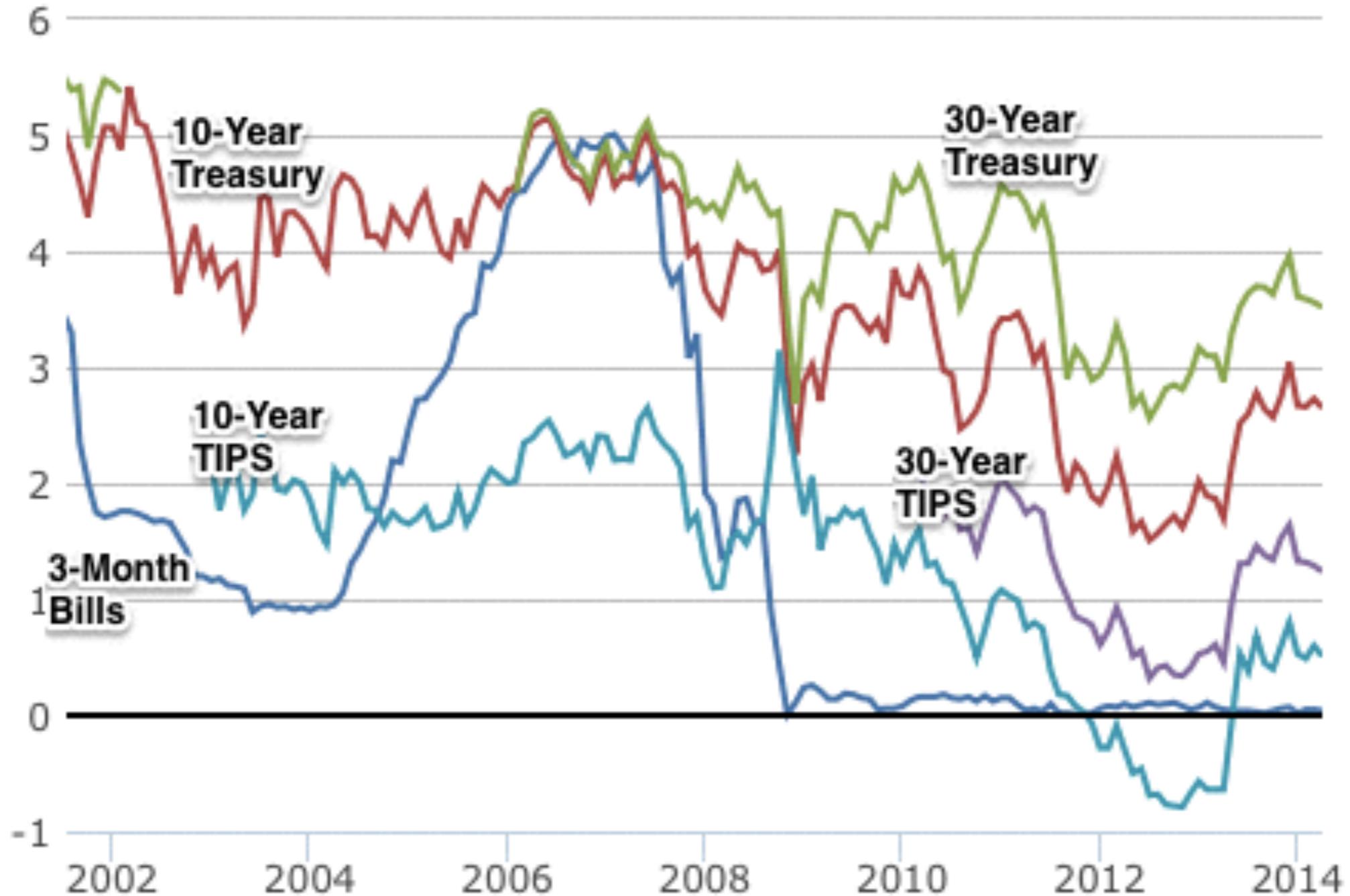


Source: Bureau of Economic Analysis

And Paul Krugman Looks at Europe



Current U.S. Treasury Interest Rates



Debt?

UK: Public debt as % of GDP



US Debt to GDP

