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Stimulus, Without More Debt

By ROBERT J. SHILLER

THE $858 billion tax package signed into law this month provides some stimulus for our ailing economy. With the unemployment rate at 9.8 percent, more will certainly be needed, yet further deficit spending may not be a politically viable option.

Instead, we are likely to see a big fight over raising the national debt ceiling, and a push to reverse the stimulus we already have.

In that context, here’s some good news extracted from economic theory: We don’t need to go deeper into debt to stimulate the economy more.

For economists, of course, this isn’t really news. It has long been known that Keynesian economic stimulus does not require deficit spending. Under certain idealized assumptions, a concept known as the “balanced-budget multiplier theorem” states that national income is raised, dollar for dollar, with any increase in government expenditure on goods and services that is matched by a tax increase.

The reasoning is very simple: On average, people’s pretax incomes rise because of the business directly generated by the new government expenditures. If the income increase is equal to the tax increase, people have the same disposable income before and after. So there is no reason for people, taken as a group, to change their economic behavior. But the national income has increased by the amount of government expenditure, and job opportunities have increased in proportion.

During the Great Depression, there was a debate about "pump priming" — about whether the government had to go into debt to stimulate the economy. John Maynard Keynes, who originated the Keynesian theory in 1936, liked to emphasize that the deficit-spending multiplier was greater than 1, because the income generated by deficit spending also induces second and third rounds of expenditure. If the government buys more goods and services and there is no tax increase, people will spend much of the income that they earned from these sales, which in turn will generate more income for others, who will spend much of it too, and so on.

In contrast, the balanced-budget multiplier theory says that there are no extra rounds of expenditure. You get just one round of spending — meaning that the multiplier is 1.0 — but sometimes that is enough.

Paul Samuelson, an economist at M.I.T., first drew national attention to the balanced-budget multiplier in 1943 , seven years after Keynes introduced his theory. The multiplier was an immediate consequence of the Keynes theory, but Keynes didn't articulate it himself.

Economists embraced this multiplier because it seemed to offer a solution to a looming problem: a possible repeat of the Great Depression after wartime stimulus was withdrawn, and when new rounds of deficit spending might be impossible because of the federal government's huge, war-induced debt.

It turns out that this worry was unfounded. The Depression did not return after the war. But in the early 1940s, economists justifiably saw the possibility as their biggest concern. Their discussions have been mostly forgotten because they didn't have much relevance for public policy — until now, that is, when we again have a huge federal debt and a vulnerable economy.

Of course, the balanced-budget theorem is only as good as its assumptions. Other possible repercussions could make its multiplier something other than 1.0. The number could be less, for example, if people cut consumption because of psychological reactions to higher taxes. Alternatively, it could be greater if income-earning people who are taxed more cut their consumption less than newly employed people increase their spending. We can't be sure what will happen.

Researchers haven't pinned down the deficit-spending multiplier either, even though that has been the focus of their efforts. In fact, a recent survey article on the effects of government stimulus by Alan Auerbach at the University of California, Berkeley, and two of his colleagues has found that "the range of mainstream estimates for multiplier effects is almost embarrassingly large." Last month, a Congressional Budget Office study revealed similar uncertainty. The trouble comes in estimating how people will react in generating those subsequent rounds of spending.

But the balanced-budget multiplier is simpler to judge: If the government spends the money directly on goods and services, that activity goes directly into national income. And with a balanced budget, there is no clear reason to expect further repercussions. People have jobs again: end of story.

What kind of jobs? Building highways and improving our schools are just two examples — as cited in 1944 by Henry Wallich, an enthusiast of balanced-budget stimulus who would later become a Yale economist and a Federal Reserve Board governor.

AT present, however, political problems could make it hard to use the balanced-budget multiplier to reduce unemployment. People are bound to notice that the benefits of the plan go disproportionately to the minority who are unemployed, while most of the costs are borne by the majority who are working. There is also exaggerated sensitivity to "earmarks," government expenditures that benefit one group more than another.

Another problem is that pursuing balanced-budget stimulus requires raising taxes. And, as we all know, today's voters are extremely sensitive to the very words "tax increase."

But voters are likely to accept higher taxes eventually, as they have done repeatedly in the past. It would be a mistake to consider the present atmosphere as unchangeable. It's conceivable that an effective case will be made in the future for a new stimulus package, if more people come to understand that a few years of higher taxes and government expenditures could fix our weak economy and provide benefits like better highways and schools — without increasing the national debt.

Robert J. Shiller is professor of economics and finance at Yale and co-founder and chief economist of MacroMarkets LLC.