

# **ECONOMIC POLICY AND THE CURRENT U.S. RECOVERY**

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## **Abstract**

This has been the worst recovery from a recession by the U.S. economy since the end of WWII. In this paper, it is noted that we have probably had the most peacetime expansionary monetary and fiscal policies ever. However, the results have been disappointing. The unemployment rate is still over 8%. At this stage in a recovery from a recession, it should normally be much lower. The empirical evidence indicates that permanent tax cuts rather than government spending are more effective than temporary tax cuts in stimulating the U.S. economy, but more permanent tax cuts were not pursued. In addition, the uncertain environment created by many of the economic policies has hurt the recovery.

## **Economic Policy and the Current U.S. Recovery**

### **Introduction**

This is the worst recovery from a recession for the U.S. economy since the end of WW II. Since the end of the recession in June 2009, the U.S. economy has been growing at about half the growth rate (2.4%) of all of the recoveries since WW II. In contrast, during the first eleven quarters of the expansion in the 1980's, the growth rate averaged 6.1% (**WSJ**, April 27, 2012). The U. S. economy has had more than three years where the unemployment rate has been above 8%. According to Mortimer Zuckerman (**WSJ**, July 23, 2012), under President Obama the official unemployment rate has averaged a record 8.8%.

The next part of the paper will discuss the type of economic policies pursued to enable the economy to recover from the recent recession. The policies used were considered to be more active and followed what are generally called Keynesian type policies. This is different than the type of policies followed during the "Great Moderation" (1985 - 2005) period which were considered for the most part to be more passive or less discretionary.

The third part of the article will present some of the empirical evidence that has been accumulated on the effect of the policies that have been pursued to help the economy recover from the recent recession. Why did these policies not lead to a more robust recovery for the U.S. Economy? The paper ends with some concluding remarks.

### **Economic Policies**

To combat the 2007 – 09 recession, the federal government instituted the most expansionary peacetime monetary and fiscal policies ever. In early 2008 a temporary \$117 billion tax-rebate program was passed. "In early 2009, the Obama administration requested and Congress passed the American Reinvestment and Recovery Act (ARRA), a roughly two-year fiscal stimulus originally estimated at \$787 billion, and later revised to \$862 billion. Of that total, roughly one-third was tax cuts, and one-third greater government purchases. The remaining third consisted of increased transfer payments to help those most directly affected by the recession, along with transfers to state and local governments (to help them avoid raising their own taxes and cutting their own outlays). While the tax cuts and aid to state and local governments took place relatively rapidly, the new government purchases were to be phased in over two years." (Hall and Lieberman, p. 349) As Gramm and Taylor have stated (**WSJ**, September 11, 2012), "Since mid-September of 2008, the Federal Reserve balance sheet has grown to \$2,814 billion from \$924 billion as it purchased massive amounts of U.S. Treasuries and mortgage backed securities. To finance those purchases the Fed increased currency and bank reserves (base money)." According to Arthur Laffer in a recent article (**WSJ**, August 5, 2012), total stimulus spending is \$4 trillion over the past five years if you add to the \$860 billion Obama stimulus

such items as TARP, the 2008 tax cut previously mentioned, add-ons to the agricultural and housing bills in 2007, “cash for clunkers,” additional mortgage relief subsidies, and Fannie Mae and Freddie Mac bailouts.

However, despite these expansionary policies, the results have been disappointing. For example, the recovery from the 81-82 recession (a similar recession in terms of length and severity) was much better despite the fact that the unemployment rate reached a higher level (10.8% in November 1982). The Obama Administration predicted that its fiscal policy would prevent the unemployment rate from rising above 8% and by now (2012) the unemployment rate would be 6%. Of course, this did not happen. The main question is why has this recovery not been as robust as the recovery of previous recessions? Is it because the recession was more severe or was it due to the wrong policies being pursued? Perhaps, it is some combination of these two factors.

This was a severe recession compared to some of the other post WWII recessions. As Gwartney, Stroup, Sobel, and Macpherson (GSSM) have stated (p. 231), “The rise and fall of stock prices prior to and following the 2008-2009 recession were not substantially different than for the earlier business cycles. But, this was not the case for housing prices. As Exhibit 10 shows, the increase in housing prices during the expansion prior to 2008 recession and subsequent decline that began more than a year before the recession were far greater than those of earlier business cycles. The housing price decline accompanying the 2008-2009 recession was more than 35 percent, about three times the average of the recessions of the past four decades.” Another serious problem was the ratio of household debt to disposable income. In 2007 it reached 135% which was more than twice what it was in the mid-1980s (GSSM, p. 623).

Historically speaking, there usually is a strong recovery from a deep recession. As Edward P. Lazear notes (**WSJ**, June 13, 2012), “based on the historical evidence... robust recoveries follow severe recessions.” Even though a housing bust makes a recovery more difficult, Robert Barro observed in a recent study by Jose Ursua (**WSJ**, June 4, 2012), “after factoring in the estimated impact of the typical housing bust, Mr. Ursua found that the US. Growth rate since 2009 should have averaged a little over 4% rather than the 2.4% we’ve experienced.” In addition, John B. Taylor in his Blog on August 3, 2012 presents some evidence in support of a strong recovery from a deep recession. As Taylor states, “Some say that recoveries from deep U.S. recessions—or from financial crises—are usually slower, but this is simply not true.” He presents some graphs that shows how the recovery from three deep U.S. recessions (1981-82, 1907, and 1893-94) was robust. As Michael Bordo states in a recent paper (**WSJ**, September 27, 2012): “In a recent working paper for the National Bureau of Economic Research, Joseph Haubrich of the Federal Reserve Bank of Cleveland and I examined U.S. business cycles from 1880 to the present. Our study not only confirms Friedman’s plucking model but also shows that deep recessions associated with a financial crises recover at a faster pace than deep recessions without them.”

The above comments indicate that some of the recent economic policies the U.S. government has been following could be hurting our growth rate and, therefore, slowing the recovery from the recession. Several economists seriously questioned the discretionary fiscal policies used by the Obama and Bush Administrations. For example, Robert Barro (**WSJ**, January 22, 2009), found that the multiplier associated with peacetime government spending was “insignificantly different from zero.” In a similar manner, Gary S. Becker and Kevin M. Murphy “believe a multiplier well below one seems more likely.” As Robin Blade and Michael Parkin state in a recent textbook (p. 401), “The mainstream view is that Keynesians over-estimate the multiplier effects of fiscal stimulus and that these effects are small, short-lived, and incapable of working fast enough to be useful. Among the leading economists who advance this view are Robert J. Barro (Harvard University), the 1995 Nobel Prize Winner Robert E. Lucas Jr. (University of Chicago), and John B. Taylor (Stanford University).”

### **Empirical Evidence**

Overall, the stimulus does not appear to have been very successful. As noted above, we have had the worst recovery from a recession since WW II despite the fact that we have had highly stimulating monetary and fiscal policies. Of course, the argument could be made that it could have been worse without these policies. For example, the Congressional Budget Office (CBO) presented evidence that the AARA at least prevented about 2 million more jobs from being lost and kept the unemployment rate from rising to 10.6% (It rose to 10.1%). (Hall and Lieberman, 2013, p. 351).

Much of the empirical work on the government spending multiplier indicates that it is less than one and has not been very effective stimulating the U.S. economy. For example, this is presented in studies by Robert Barro (**WSJ**, August 23, 2011, and May 9, 2012), Michael J. Boskin (**WSJ**, December 1, 2010), and John F. Cogan and John B. Taylor (**WSJ**, December 9, 2010). The CBO noted that the government purchases multiplier had a low estimate of 1 and a high estimate of 2.5 (Hall and Lieberman, p. 351). A paper in the FRB of San Francisco's **Economic Letter** (June 19, 2009) reviewed some of the recent studies on the multiplier. The tax multiplier was greater than 1 and the spending multiplier was less than 1. John B. Taylor in his Blog on April 16 notes a recent multi-author paper on the impact of the stimulus that supports his view. William A. McEachern reviews some of the studies on government spending and tax cuts in his recent textbook (p. 589) and makes this summary statement, “Thus, the studies suggest that tax cuts seemed to have more of an impact on the economy than spending increases, and of those studies that estimate a spending multiplier, the average was less than one.”

Robert Barro also had this comment about the multiplier in a recent text (2008, p.401): “The Keynesian multiplier is an interesting theoretical result. However, economists have not verified empirically the existence of a multiplier. For example, we found in Chapter 12 that it was difficult to document in the U.S. data even a positive effect from government purchases  $G$ , on real GDP,  $Y$ . The positive relation was clear only for the temporary expansions of  $G$  during

major wars. Moreover, even in these cases, the response of  $Y$  was less than the increase in  $G$ ; that is, the multiplier was less than one.”

Robin Blade and Michael Parkin in their textbook (p. 413 ) show how automatic stabilizers rather than discretionary stimulus spending did most of the work limiting job losses. For example, the Obama Administration claimed that the stimulus spending could create 650,000 jobs by the end of the summer in 2009. Since each employed person can produce \$100,000 in real GDP, 650,000 workers would produce \$65 billion in GDP. By October 2009 only 20% of the stimulus totaling \$787 billion had been spent. This is about \$160 billion. Therefore, if \$160 billion of government outlays produced \$65 billion of GDP, the multiplier would be 0.4 ( $65/160=0.4$ ). This, of course, is consistent with the majority of the other studies that concluded that the government spending multiplier is less than 1.

Arthur B. Laffer in a recent paper (**WSJ**, August 5, 2012) presents a table “which shows increases in government spending from 2007 to 2009 and subsequent changes in GDP growth rates. Of the 34 Organization for Economic Cooperation and Development nations, those with the largest spending spurts from 2007 to 2009 saw the least growth in GDP rates before and after the stimulus. “ This included the U.S. with spending up 7.3% and a lower growth rate that was down by 8.4%. In a related study, Tim Knox and Ryan Bourne (**WSJ**, May 24, 2012), presents evidence showing “that other things equal, countries with small governments and tax burdens grow faster.” To be more specific, Knox and Bourne note that “countries whose governments tax and spend less than 40% of GDP have grown more quickly than big-government countries.”

### **Concluding Remarks**

As indicated in the body of the paper, the evidence that federal government stimulus spending has been helpful in helping the U.S. economy recover from the recent recession is far from conclusive. There is better evidence that permanent tax cuts would have been better (Alesina, **WSJ**, September 15, 2010). This is also noted in the paper by Michael Boskin (**WSJ**, December 1, 2010).

In a recent economics text, GSSM (2013, pp. 311 – 313) discuss some reasons why monetary and fiscal stimulus failed to provide a strong recovery from the recent recession. First, much of the stimulus spending was temporary. Second, much of the spending was politically allocated and not very effective. Third, the concern over the large and growing net federal debt discouraged spending. Finally, a large amount of what Robert Higgs (2006) calls “regime uncertainty” was created. This is the uncertainty created by policy changes by the government. TARP, The Patient Protection and Affordable Health Care Act, AARA are all examples of

government programs that create an environment of uncertainty. Some recent evidence that supports this kind of uncertainty was given by Baker, Bloom, and Davis (2012).

One reason Fed policies may not have been very effective was that the large increase in the reserves of the banking system raised concern about future inflation and price stability. Also, the lower interest rates did not encourage more investment spending because of the uncertainty created by fiscal policy and the regulatory environment. In addition, high debt levels discouraged consumption. The low interest rate policy enabled the federal government to raise the level of debt without total interest rate cost increasing very much. Therefore, this made running deficits easier.

Something that is discussed quite frequently by both major political parties is the creation of jobs. According to Okun's Law, there is an inverse relationship between real GDP growth and the unemployment rate. If real GDP falls by 2%, the unemployment rate increases by 1% (Greg Mankiw, 2010). This means, for example, if we could increase the real growth rate of GDP by 4%, we could reduce the unemployment rate by 2%. If we review the recovery of previous recessions in this area, this appears to be quite possible. One study noted that by increasing the time an unemployed worker could receive unemployment benefits to 99 weeks increased the unemployment rate by three-fourths of a percentage point (2009). Therefore, a way to reduce the unemployment rate by about  $\frac{3}{4}$  % is to change the 99 weeks of unemployment compensation to the previous level. In a more recent paper, Robert Barro (2010) noted that the unemployment rate could have been as low as 6.8% rather than the 9.3% rate at that time if unemployment benefits had not been extended to 99 weeks.

Another item that would be helpful to economic growth would be real tax reform. The Obama Deficit Commission noted how we could do this and lower all marginal tax rates. As noted above, permanent tax cuts are better than temporary tax cuts because they would encourage more real economic growth.

As most economics textbooks state, the three basic macroeconomic goals for the U.S. economy are economic growth, full-employment, and price stability (e.g., Hall and Lieberman). With price stability we seem to be doing reasonable well at this time; however, in the areas of economic growth and full-employment, we are lagging. Some studies indicate that much of the unemployment is due to inadequate demand rather than structural problems (e.g., Lazear, **WSJ**, September 3, 2012). Therefore, to lower unemployment we need to increase real economic growth. As noted above, real tax reform could help. In addition, lowering unemployment benefits back to the original 26 weeks would help. Also, we should reduce uncertainty. For example, this could be lessened by reducing government regulations.

John Taylor presents a plan in a recent book (2012, Norton) that reduces government spending over time to 19  $\frac{1}{2}$  percent. Taylor states (p. 118 – 119), "Lower government spending as a share of GNP is not associated with higher unemployment. For example, when government purchases

of goods and services came down as a share of GDP in the 1990s, unemployment didn't rise. In fact it fell. And the higher level of government purchases as a share of GDP since 2000 has clearly not been associated with lower unemployment. Though correlation does not prove causation, it is hard to see what plausible third factor could reverse this correlation. .." Taylor also notes that because his budget plan would reduce the uncertainty about government spending policy and the possibility of higher taxes, it would increase investment spending. As Taylor states ( p. 119), "Higher private investment would lower unemployment. Again, while correlation does not itself prove causation, when private investment is high, unemployment tends to be low. In 2006, investment—business investment plus housing investment—as a share of GDP was high, at 17 percent, and unemployment was low, at 5 percent. By 2010, private investment as a share of GDP was down to 12 percent, and unemployment was up to more than 9 percent. In the year 2000, investment as a share of GDP was 17 percent while unemployment averaged around 4 percent."

In some ways, it is interesting to compare the "Great Depression" with the recent recession. This paper indicates that the reason we have not had a strong recovery from the recent recession could be due to some of the government policies we have pursued. Cole and Ohanian make this argument for the lack of a strong recovery from the "Great Depression." (**WSJ**, February 2, 2009):

Why wasn't the Depression followed by a vigorous recovery, like every other cycle? It should have been. The economic fundamentals that drive all expansions were very favorable during the New Deal. Productivity grew very rapidly after 1933, the price level was stable, real interest rates were low, and liquidity was plentiful. We have calculated on the basis of just productivity that employment and investment should have been back to normal levels by 1936. Similarly, Nobel Laureate Robert Lucas and Leonard Rapping calculated on the basis of just expansionary Federal Reserve policy that the economy should have been back to normal by 1935.

So what stopped a blockbuster recovery from ever starting? The New Deal. Some New Deal policies certainly benefited the economy by establishing a basic social safety net through Social Security and unemployment benefits, and by stabilizing the financial system through deposit insurance and the Securities Exchange Commission. But others violated the most basic economic principles by suppressing competition, and setting prices and wages in many sectors well above their normal levels. All told, these antimarket policies choked off powerful recovery forces that would have plausibly returned the economy back to trend by the mid-1930s.

When FDR reversed these policies in the late 30s, the economy started to recover.

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