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Thank you for the opportunity to speak before this committee. You have chosen to address issues relating to austerity at an opportune time as both our economic and our budget situations are in considerable flux and as a broad rethinking of reflexively austere policies is underway worldwide. In my testimony today I want to do three things:

First, I will characterize the economic and fiscal outlook. Second, I will reflect on the economics of austerity, arguing that too little of the policy debate in recent years has focused on the imperative of increasing economic growth which, in the short and medium term, goes back to issues relating to demand. Third, I will comment on some of what I see as policy priorities for the years ahead.

The Economic and Fiscal Outlook

I am increasingly optimistic about our economic recovery. Indeed, I believe our economic prospects now look as sound as at any time in the last 15 years. The late 1990s saw the emergence of a major stock market bubble which was followed by recession in 2001 and slow recovery giving rise to fears of deflation. Soon enough bubbles recurred, this time credit and housing markets, leading me to observe in 2006 and 2007 that again, “The main thing we have to fear is lack of fear itself.” In August of 2007, the financial crisis began with profound distress overtaking the economy in late 2008. Recovery since that time has been real if inadequately paced.

I think it is now reasonable to expect the pace of recovery to accelerate if sound policies are pursued. I base this judgment on a number of considerations.

- It appears that housing has decisively turned with home prices up at double digit rates nationwide over the last year and construction rising sharply. Given that the shortfall in housing construction during the post 2007 bust substantially exceeded the excess inventory created during the bubble period, robust housing demand should be with us for years to come. Strength in housing should also propel recovery through improvements in consumer balance sheets and increased demand for durable goods.

- The United States has the potential to benefit from a substantial renaissance in domestic energy production associated with shale oil, so called “tight oil” more generally and natural gas. It is very plausible that North America will be a net energy exporter by the end of the decade. Increased domestic energy production
will involve investment on a substantial scale approaching $100 billion, and
significant job creation, including in hard hit sectors, like construction, and in
struggling areas of the country, like Western Pennsylvania. Lower oil and natural
gas prices will likely lead to increased consumer spending and to some re-shoring
of manufacturing.

- There has been substantial improvement in household, corporate and financial
  institution balance sheets setting the stage for increased spending. Indeed it has
  been several decades since household wealth rose as rapidly as it has recently,
  with both the stock and housing markets providing support.

- While fiscal contraction at an excessive pace has been an important economic
  headwind since the Recovery Act began phasing out in 2011, most of this blow
  will have been absorbed by the end of this year, setting the stage for some
  acceleration in growth unless further policies that immediately reduce demand are
  enacted. By 2014, it is likely that government will not be a retardant on economic
  activity for the first time in 4 years.

These favorable aspects of the current situation are real. But optimism needs to be
tempered by two unfortunate features of the current situation:

First, the economy has suffered long term damage from the financial crisis and recession
of the last several years. Long term, unemployed workers have withdrawn, quite likely
permanently, from the workforce. Young workers coming out of school have had much
greater difficulty than usual getting on career ladders. Capital investment in new capacity
has been held back, as has corporate investment in research and development and the
establishment of new brands and product categories. Infrastructure investments on some
measures have not kept up with deterioration and obsolescence. It is sobering to
contemplate that the CBO estimate of the economy’s potential capacity after full cyclical
recovery in 2017 is now fully 7.2 percent or $1.2 trillion below the CBO’s 2007 estimate.

Second, there remain real risks to the recovery. The rest of the world, especially Europe,
faces major growth challenges. Increasing inequality acts to hold back spending. There
are some signs of froth reappearing in credit markets. Measures of confidence, while
improved, remain somewhat depressed and the possibility of geopolitical shocks can
hardly be discounted. Everything we know about the aftermath of financial crises from
the United States’ 1930s depression to Japan’s experience since 1989, suggests that
achieving a return to sustained real growth is very difficult and that premature
declarations of victory can be very costly.

Fortunately, relatively good economic news in recent months has been matched by even
better budget news. A combination of factors has led to substantial downward revisions
in projected budget deficits, to the point where the debt-GDP ratio is now expected to
decline through 2020. These factors include a stronger economy, a striking slowdown in
the growth rate of health care costs and enhanced revenue collections beyond what might
immediately be expected given economic performance. While there are no certainties,
experience suggests that favorable revisions in the budget outlook tend to be followed by further favorable revisions and vice-versa. It is therefore reasonable to judge that while the nation continues to face a serious long run fiscal challenge, the budget outlook is today far less grim than it appeared several years ago.

This experience should be a useful caution to all of us involved in policy debates. While it is important to address long run issues, our visibility is limited. For example, the CBO publishes reports that analyze their five-year real GDP growth forecasts versus actual realized growth. Historically, the forecast error is 1.2% per year. To put that number in perspective, it implies that there is about a 1 in 4 chance of that our current estimates of real GDP in 2018 are off by more than a trillion dollars (7.4% of GDP). The error in 10-year projections would be significantly greater.

**The Economics of Austerity**

Both in the United States and abroad there have, in recent years, been fierce debates about budget policies and ideas around austerity and deficit reduction. These debates which are often framed in universal terms have often shed more heat than light. A prudent government must over time seek to balance spending and revenue collection in a way that assures the sustainability of debts. To do otherwise, leads to instability and needlessly slow growth, and courts default and economic catastrophe. Equally however, responsible fiscal policy requires recognizing that when economies are weak and movements in interest rates are constrained, as has been the case in much of the industrial world in recent years, changes in fiscal policy will have large impacts on economic activity that in turn will affect revenue collections and social support expenditures. In such circumstances, aggressive efforts to rapidly reduce budget deficits may actually backfire as a contracting economy offsets their direct benefits.

It is a truism that deficit finance of government activity is not an alternative to tax finance or to supporting one form of spending by cutting back on another. It is only a means of deferring payment for government spending and, of course, because of interest expenses increasing the burden on taxpayers. Just as a household or business cannot indefinitely increase its debt relative to its income without becoming insolvent, a government cannot either. There is no viable permanent option of spending without raising commensurate revenue. The meaningful choices involve the size of public activity and the timing of government spending and taxation.

It follows that in normal times there is no advantage to deficit policies. Public borrowing does not reduce ultimate tax burdens. It tends to crowd out private borrowing to finance growth and job creating investment and tends to foster international borrowing, which means an excess of imports over exports. Or the expectation of future tax increases may discourage private spending. While government spending, or tax cutting financed by borrowing, creates increased demand in the economy, the Federal Reserve can in normal times achieve this objective by adjusting base interest rates.
It was essentially this logic that drove the measures taken in the late 1980s and in the 1990s, usually on a bipartisan basis, to balance the budget. As a consequence of policy steps taken in 1990, 1993 and 1997, it was possible by the year 2000 for the Treasury to use surplus revenues to retire Federal debt. There is no question in my view that deficit reduction, and the associated reduction in capital costs and increase in investment, was an important contributor to the nation’s very strong economic performance during the 1990s when productivity growth soared and unemployment fell below 4 percent. Essentially, we enjoyed a virtuous circle in which reduced deficits led to lower capital costs and increased confidence, which led to more rapid growth, which further reduced deficits reinforcing the cycle.

As a Treasury official in the 1990s, I was proud to support and help implement these measures. The time will come again when deficit reduction should be the immediate first priority of budget policy.

But, in recent years, circumstances have been anything but normal in the United States and most of the industrial world. High levels of unemployment, low levels of job vacancies and deflationary pressures all indicate that the level of output is not constrained by what the economy is capable of producing, but by the level of demand. Moreover, with base interest rates at or close to zero, the efficacy of monetary policy is circumscribed. In the United States, GDP has been as much as a trillion dollars a year or more than $10,000 per family below its potential.

Under these circumstances, there is every reason to expect that changes in deficit policies will have a direct impact on levels of employment and output in a way that is not normally the case. Borrowing to support spending, either by the government or the private sector, raises demand and therefore increases output and employment above the level they otherwise would have reached. Unlike in normal times, these gains will not be offset by reduced private spending because there is substantial excess capacity in the economy, and cannot easily be achieved via monetary policies because base interest rates have already been reduced to zero. Multiplier effects operate far more strongly during financial crisis economic downturns than in other times.

Two further considerations magnify these effects. As I noted earlier, sustained poor economic performance, in addition to reducing output and employment, adversely affects future economic performance. So, measures that support demand raise future, as well as present, output. Also, support for demand helps to stimulate the economy by offsetting contractionary, deflationary pressures.

In a study published last year in the Brookings Papers on Economic Activity, that I ask be included in the hearing record, Brad Delong and I made estimates suggesting that the effect of expansionary fiscal policies might well be to reduce, rather than increase, future debt burdens because of their positive economic impacts. These estimates remain the subject of substantial debate among economists and I would never want to suggest that policy should be driven by the results of a single study. Yet, I do think it is a fair
conclusion that once account is taken of the direct impact of budget policies on economic performance, their impact on debt burdens is greatly attenuated.

To illustrate: Consider the effect of the sequester in 2013. The sequester will impact the last 10 months of calendar year 2013. The CBO estimates that the sequester will, over this 10 month interval, reduce spending by $64 billion. With no other change, this would result in a reduction of $64 billion in the Federal debt, which is equivalent to reducing the debt/GDP ratio by 0.39 percent.

However, we must also consider the sequester’s effect on GDP growth. The CBO estimates that the sequester will reduce the GDP growth rate in 2013 by 0.6 percentage points. This stifling of growth actually increases the debt/GDP ratio through two effects: First, by reducing the GDP growth rate, the sequester reduces the denominator of the debt/GDP ratio. Second, lower GDP during 2013 means lower tax revenue, which increases the deficit.

We cannot ignore these spillover effects of the sequester onto the economy and onto tax revenue. When we account for these spillover effects, the CBO estimates imply that, the sequester will have a negligible effect on our debt/GDP ratio, at the end of the day.

These observations have strong implications for recent debates over austerity—debates that have reached a crescendo with recent controversies over the work of my Harvard colleagues Carmen Reinhart and Ken Rogoff. I have attached a commentary reflecting my views on their work.

More important than arguments over their data and statistical procedures is the simple observation that the impact of debts and deficits will vary with economic circumstances and the further point that while high levels of debt can retard economic growth, increases in borrowing can enhance economic growth by mitigating downturns. This has the additional impact as I have already noted of raising future potential output.

International comparisons tend to confirm the view that excessively rapid fiscal consolidation has adverse impacts on economic performance.

In Figure 1, we see that countries that pursued harsher austerity policies in recent years also had lower real GDP growth. In Figure 2, we see the difference in unemployment in the US and Eurozone. In 2009, the US and Eurozone had almost the same unemployment rates. In the interim, the Eurozone pursued far harsher austerity policies. Today, the gap in the unemployment rates between the US and Eurozone is 4.6 percentage points.

Naturally, I would be remiss if I did not caution that correlation is not the same as causation. And there are many different ways of processing these data. However, in the face of these data it is difficult to credit claims that more rapid fiscal consolidation is likely to accelerate economic growth.
Figure 1: Growth vs Austerity

Caption: Austerity = Average Change in (Cyc Adj Primary Balance)/(Potential GDP)

Figure 1 (alternate version): Growth vs Austerity
Caption: Austerity = Average Change in (Cyc Adj Primary Balance)/(Potential GDP)

Figure 2: US vs Eurozone unemployment
Policy Going Forward

The foregoing analysis suggests several important principles regarding US fiscal policy in the years ahead.

First, it would not be desirable to undertake further measures to rapidly reduce deficits in the short run. Excessively rapid fiscal consolidation in an economy that is still constrained by lack of demand, and where space for monetary policy action is limited, risks slowing economic expansion at best and halting recovery at worst. Indeed, there is no compelling macroeconomic case for the deficit reduction now being achieved through sequestration, as the adverse impacts of spending cuts on GDP more or less offset their direct impacts in reducing debt. An ultimate judgment on sequestration should therefore depend on a view about the merits of the expenditures being cut back in providing public benefit. I think it is unlikely that aside from the macroeconomic argument, which is dubious, that policymakers would adopt the sequestration cuts simply on grounds of efficient public expenditure though this is not at root an economic judgment.

Second, while uncertainties are great and progress has been made, the United States does face an unsound long run imbalance between forecast expenditures and revenue collections. Spurring growth is the best way to reduce this imbalance. Indeed a 1 percent increase in the growth rate of GDP maintained for 10 years would reduce cumulative deficits by more than $3 trillion. Accelerating growth should be a central aspect of budget debates going forward.

Third, the highest priority in terms of structural reforms to reduce future deficits should be attached to measures that would be desirable even in the absence of prospective deficits. Candidates here include steps to control the growth of health care costs and tax reform. Careful international studies suggest that the excess of US health care costs over foreign costs are more related to a given procedure costing more in the US than to more procedures being performed in the US. This suggests an emphasis on improving approaches to purchasing care rather than on curbing consumer demand for medical assistance. There are a number of features of the tax code that both cost the government revenue and make the economy less efficient. These include corporate tax provisions that support the shifting of economic activity and accounting income to tax havens, subsides that favor particular industries over others, and measures that create an economic bias towards risky financial transactions. Sound loophole-closing tax reform offers the prospect of increased revenues, increased incentives for productive economic activity through lower rates, and increased government revenues.

Fourth, attention should be devoted to measures that reduce future deficits by pulling expenditures forward to the present when they have the additional benefit of increasing demand. It is important to recognize that just as increasing debt burdens future generations, so also does a failure to repair decaying infrastructure, or to invest adequately in funding pensions, or in educating the next generation burdens future generations. Wherever it is possible to reduce future public obligations by spending money today, we should take advantage of this opportunity especially given the very low
level of interest rates. In particular, a major effort to upgrade the nation’s infrastructure has the potential to spur economic growth, raise future productive capacity and reduce future deficits. It should be a high priority.

Thank you very much for the opportunity to speak with you today. I look forward to your questions.
Senator Coons

Question 1:
I’m concerned about the long-term unemployed. Economic data shows that short-term unemployment (those who have been unemployed for 14 weeks or less) is down near the levels observed in the 1991 and 2001 recoveries. However, those unemployed for 27 weeks or more is still very high. As of the end of April, 4.4 million Americans, or 37 percent of the unemployed, had been without a job for 27 weeks or longer.

Can you describe austerity’s impact on the long-term unemployed?

Additionally, what policy measures would make the most impact in reducing the rate of long-term unemployment?

RESPONSE: I share your concern about the long-term unemployed. The relevant scholarship makes clear that the longer a person has been unemployed, the more difficult time he/she has finding a new job. This is the source of the hysteresis effect I referenced in my testimony, and this is just one of the reasons why measures to promote demand and accelerate recovery are important not only for the short run, but also for the long run. A number of experiments have been performed to test unemployment insurance as a tool to promote reemployment. These experiments should be carefully evaluated, and consideration should be given to unemployment insurance reform to promote reemployment. There is also a case for careful consideration of tax credits along the lines of the payroll tax break for new hires proposed by Senator Schumer and Senator Hatch in 2010 to provide employers an incentive to hire the long-term unemployed.
Senator Coons

Question 2:
Manufacturing is critically important in the United States. The sector makes up 12% of our economy, while providing high quality jobs.

According to the Bureau of Labor Statistics, from 2000 to 2009, 6 million factory jobs were lost in the United States. Over the last three years, we’ve seen a rebound, with the US adding more than 500,000. Yet, government spending is slowing the recovery in manufacturing. This week, the Institute for Supply Management’s factory index fell to 49, its lowest level since 2009. A level of 49 indicates a contractionary phase for the sector.

According to Bloomberg News and several analysts, the low level is the result of slow corporate spending and government spending cutbacks.

Can you comment on the impact of austerity on manufacturing?

Additionally, what types of policy measures would promote continued recovery in manufacturing?

RESPONSE: In any economy, the performance of manufacturing is sensitive to the overall performance of the economy. Hence, measures that impede economic growth are likely to also impede the manufacturing sector.

I believe the core policy measures that would promote continued recovery in manufacturing are policies that promote US competitiveness. As such, a case can be made for corporate tax reform and measures that promote innovation such as increased federal support for R&D. Additionally, policies that support low cost energy such as those that encourage the development of renewables and fossil fuel resources, as well as measures to increase the skills of our workforce (by improving primary and secondary education, increasing access to higher education, and working to ease the transition from school to work) would augment our nation’s competitiveness and consequently benefit the manufacturing sector.
Senator Coons

Question 3:
The rest of the world is catching up to the United States in private sector investment in research and development. We know that investing in R&D boosts productivity and can lead to the creation of new products, services, and sectors. Yet, federal support of private sector R&D should be improved.

RESPONSE: We need to make the R&D credit permanent and simpler. Moreover, according to the GAO, over half of the credit goes to firms with $1 billion or more in receipts. Meanwhile, the most innovative startups are shut out of the R&D credit (because they lack an income tax liability). This creates a big policy gap: according to the Kauffman Foundation, startups create the most net new jobs in the United States.

Could you comment on the importance of the research and development credit?

Additionally, could you comment on the importance of making the credit accessible to highly innovative, early-stage companies?

I support the continuation of the R&D tax credit. However, as you note, there is room for improvement with respect to federal support of private sector R&D, particularly given the abuse of the credit by some firms looking to reduce their tax liabilities. I would favor the exploration of provisions which would extend the ability to carry forward unused R&D credits as a way of helping early stage companies. However, I believe it is important to be prudent when extending the R&D credit to avoid certain kinds of abuses where the credit is taken in cases that do not relate to the research and development of new products.
Senator Coons

Question 4:
It’s been more than 70 days since the Senate passed our budget, but we still need to reconcile it with the House of Representatives’ budget for it to become a forceful resolution – a budget resolution – that drives the decisions of the Congress. It is important that we do that because it has been several months since sequestration began. All of us, as Senators, are hearing from our home states the very real, very human impact of these across-the-board spending cuts that have begun to really bite.

The sequester exists because of a lack of political will to come together, to resolve a fundamentally different vision between the Senate and the House enacted in our respective budgets. This sequester exists because we haven’t come together, across the House and the Senate, in the way that for 200 years or more this Congress has done, when we pass a bill and when the House passes a bill, it’s supposed to go to conference for reconciliation, resolution, and ultimately passage.

Dr. Summers, in your experience in the executive branch, can you comment on whether you’ve seen something like this before?

Additionally, can you comment on the sequester’s dampening of impact economic growth?

RESPONSE: The CBO has estimated that the sequester will reduce the GDP growth rate in calendar year 2013 by 0.6 percentage points. As I described in my prepared remarks, the negative impact of the sequester on economic growth substantially offsets the sequester’s attempt to lower the debt/GDP ratio through two channels: first, by reducing the GDP growth rate, the sequester reduces the denominator of the debt/GDP ratio. Second, lower GDP during 2013 means lower tax revenue, which increases the budget deficit. When we account for these spillover effects, the CBO estimates imply that, the sequester will likely have a negligible effect on our debt/GDP ratio, at the end of the day, while causing imposing significant human costs.

The CBO estimate seems to be a reasonable assessment of the impact of the sequester on aggregate growth. Beyond this aggregate impact, there are clearly
troubling sectoral impacts, like the impact on Head Start, on national security spending, and on programs like Meals on Wheels. I very much hope that it is possible to move to a more rational approach to containing deficits. Containing deficits is important to our country’s future; however, I do not believe the sequester is the best means to achieve this end.
Senator King

Question 1:
There is a clear need for immediate federal investment in America’s aging infrastructure networks. In your testimony, you suggested that Congress take advantage of current low interest rates to fund medium and long-term projects, such as sustained federal investment in infrastructure, that would reduce future debt burdens. Along with low interest rate levels, what other factors create today’s low opportunity cost for federal investment in infrastructure?

RESPONSE: As mentioned in my written testimony, I too believe the moment is ripe for investment in American infrastructure. Since this investment would reduce our future infrastructure obligations today, we should take advantage of this opportunity, especially given the very low level of interest rates. In addition to low capital costs, the relatively high rates of unemployment (particularly among the less-skilled and those in construction) and the low materials cost associated with economic slack make investment in infrastructure attractive at this time. A major effort to upgrade our nation’s infrastructure can help spur economic growth, raise future productive capacity, reduce unemployment, and lower future deficits.
Senator King

Question 2:
In today’s hearing, you proposed that lawmakers should consider embarking on a 10 year program of renewed investment in infrastructure, with the understanding that the revenues to pay for it would kick in at some point that was “macro-economically appropriate.” Please elaborate on what macroeconomic triggers you believe would provide appropriate thresholds and how you believe this proposal could generate sustained federal investment in our nation’s infrastructure networks.

RESPONSE: A ten-year program of renewed investment in infrastructure would by definition represent a sustained investment commitment. Appropriate macroeconomic triggers would likely involve some combination of the unemployment rate, inflation rates, and perhaps the level of medium-term interest rates. Triggers built on variables like these would be appropriate and further rigorous study can aid in estimating the specific numerical threshold.
Senator Murray

Question 1:

Question: Many of my colleagues have said that deep spending cuts will lead to stronger economic growth. In fact, they argue that the reason we aren’t growing faster is because we are spending too much right now. As support for this argument, they point to academic studies by Harvard economists and the IMF.

This is contrary to what I understand mainstream economic theory to say. While the economy is still weak, further contraction in government spending would seem to be a drag on growth. I understand your recent work has shown that the bang-for-the buck of fiscal policies is actually much higher when the economy is weak, as it is now.

Could you comment on this argument for “expansionary austerity”? The idea that the more we cut the faster our economy will grow.

RESPONSE: As your question suggests, fiscal policy likely has a greater impact in environments like the present, where we have substantial slack in the economy and very low interest rates. Under other circumstances, it is possible that reductions in government spending could lead to economic expansion. However, these “other circumstances,” involving high capital costs and potential for export growth to a strong world economy, are distinct from the circumstances we are in today.

IMF researchers concur with this opinion and they now believe that observers have underestimated the size of fiscal multipliers, in the current environment. By underestimating the fiscal multiplier, observers have also underestimated how damaging austerity is to an economy, at a time like the present. In the IMF’s World Economic Outlook (October 2012), Chief Economist Olivier Blanchard notes that “The main finding, based on data for 28 economies, is that the multipliers used in generating growth forecasts have been systematically too low since the start of the Great Recession… This finding is consistent with research suggesting that in today’s environment of substantial economic slack, monetary policy constrained by the zero lower bound, and synchronized fiscal adjustment across numerous economies, multipliers may be well above 1.”
Senator Sessions

Question 1:
Dr. Summers, your recent article in the Washington Post says that Austerity would hurt U.S. jobs and economic growth. While you admit that deficit financing is not sustainable you say that, "... the effects of contractionary fiscal policies might actually increase debt burdens because of their negative economic impacts." You however fail to distinguish between public growth and private growth. Further, you fail to distinguish between the type of contractionary policy, increasing taxes versus reducing spending. Do you feel that these two choices yield different results?

Dr. Valerie Ramey says that while increased government spending increases employment but "virtually all of the effect is through an increase in government employment, not private employment," and that private spending likely falls as government spending increases. This argument is bolstered through her research and the work done by other economists.

Can increases in government spending cause crowding out of both private investment and private employment? Leading to depressed economic activity in the short term and causing increased debt hindering long term growth.

RESPONSE: These are much debated matters among economists where the empirical evidence can be read in different ways. Professor Ramey is a respected scholar who has done important work. However, I read the evidence differently than she does. Because of differences in initial conditions across different countries and different US regions, there are surely differential impacts of government spending and taxation. However, the nature of these differences depends on the precise form of expenditure policy and taxation policy. I regard the CBO’s estimate of the effect of the American Reinvestment and Recovery Act as being broadly reasonable. The CBO found that for calendar year 2012, the American Reinvestment and Recovery Act “raised real GDP by between 0.1 percent and 0.8 percent” and “increased the number of people employed by between 0.2 million and 1.1 million.”
Senator Sessions

Question 2:
Economists have debated the effect of the government multiplier and if the multiplier is less than one because of the effect of government spending on private investment, specifically crowding it out. Economists agree that sound fiscal balances and restraint of government spending are advantageous in the long run. However, it is often argued that government spending is beneficial in the short run. How beneficial government spending is in the short run is the question. Do you believe that crowding out exists and that private investment can be hindered by excessive government spending in the short run?

And, if you feel that the government multiplier is greater than 1, despite crowding out, at what point do we stop sacrificing the long term in favor of the short term?

RESPONSE: The importance of crowding out depends on whether or not interest rates have risen significantly. There is no evidence that, given the current liquidity trap circumstances, government spending has had a significant impact in raising capital costs and crowding out investment. My prepared testimony describes the difference between the current economic environment and other environments like in 1993, where crowding out is important. Today’s environment is distinctly different from that of the 1990s. Today, high levels of unemployment, low levels of job vacancies and deflationary pressures all indicate that the level of output is not constrained by the economy’s capacity, but instead by the level of demand.

IMF researchers now believe that observers have underestimated the size of fiscal multipliers, in the current environment. By underestimating the fiscal multiplier, observers have also underestimated how damaging austerity is to an economy, at a time like the present. In the IMF’s World Economic Outlook (October 2012), Chief Economist Olivier Blanchard notes that “The main finding, based on data for 28 economies, is that the multipliers used in generating growth forecasts have been systematically too low since the start of the Great Recession… This finding is consistent with research suggesting that in today’s environment of substantial economic slack, monetary policy constrained by the zero lower bound, and synchronized fiscal adjustment across numerous economies, multipliers may be well above 1.”

[ QUESTIONS 3–5 WERE NOT DIRECTED TO PROFESSOR SUMMERS. ]
Senator Sessions

Question 6:
Critics have suggested that austerity in Europe has not worked. Their argument is that many European countries have entered (or prolonged) a recession after engaging in austerity measures.

Based on past testimony, it seems that the type of fiscal consolidation determines how a country will weather austerity. What types of fiscal consolidation are going on right now in Europe? And what might we expect from those consolidation efforts moving forward? Do you feel that a change in the structure of their austerity measures may yield different results?

RESPONSE: It is difficult to generalize across Europe. But, in general, in environments with very low interest rates and excess capacity (like Europe today), I would expect that either tax increases or spending cuts are likely to be contractionary. The exact impact will vary across countries. As seen in the figures of my prepared testimony, more austerity is associated with worse economic outcomes. This general pattern has been confirmed by other researchers, including the IMF, using alternate methodologies.
Question 7:
When the UK began their austerity program they initially rolled out higher tax cuts before they instituted significant spending reform. By their own admission they feel they should have instituted spending reform first and limited the size of tax increases. Further, IMF economists have shown that nations that raise taxes suffer twice as much than nations that cut spending. Do you believe that this lesson is one that should be considered for the United States?

RESPONSE: It is always desirable to have lower rather than higher marginal tax rates, all else equal. However, in a demand-constrained economy like that of the UK, I believe that the primary issue is the level of aggregate demand. In circumstances like those the UK currently faces, either tax increases or spending cuts reduce aggregate demand.

The IMF does study the difference between cutting expenditure and increasing tax revenue. In particular, IMF researchers note that “it appears that the difference in monetary policy responses accounts for much, though probably not all, of the difference in output performance” (IMF World Economic Outlook, October 2010). However, today, interest rates are extraordinarily low. Hence, the IMF’s conclusion suggests that, in today’s environment, the two types of austerity may not be that different (in their negative impact on economic growth).
[Question: During the closing moments of the June 4 session, in responding to questions from Senator Wyden, Professor Summers promised to submit something in writing with a longer list of growth-promoting programs.]

RESPONSE: Thank you for the opportunity to discuss potential programs to promote growth of our nation’s economy. As I described in my prepared remarks, a 1 percent increase in the growth rate of GDP maintained for 10 years would reduce cumulative deficits by more than $3 trillion. Hence, I agree on the importance of economic growth.

As also discussed in my prepared testimony, I agree tax reform has substantial potential benefits. Furthermore, if we can identify specific special interest subsidies that should be scaled back, supporting middle class families through increasing the standard deduction and reducing the marginal tax rate are proposals that merit further study.

Additionally, a sustained commitment to infrastructure investment, improving our primary and secondary school systems and increasing access to higher education, and promoting exports by reducing trade barriers with other countries and enforcing our trade laws are examples of other policies that will help stimulate economic growth.

A number of factors make now an especially good time to re-invest in America’s future. Not only can the government borrow at extraordinarily low interest rates, there is also substantial excess capacity in the economy. Re-investment in our public infrastructure and schools can help spur economic growth, raise future productive capacity, reduce unemployment (particularly amongst construction workers), and lower future deficits.