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Recent Fiscal Policy and the Manipulation of Aggregate Economic Activity

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It is widely believed that public sector spending and investment can restore aggregate economic activity to efficient levels. But some policy responses are likely to be more successful than others. In particular, directly targeting frictions in capital, labor, and insurance markets arguably provides the best chances of improving welfare.

A substantial portion of recent fiscal policy is predicated on the idea that increased public sector spending and investment can restore aggregate economic activity to efficient levels by stimulating current consumption, current production, or both. Understanding the likely impact of stimulative fiscal policies is currently of considerable importance, in particular because a debate now exists on the effectiveness of the stimulus package enacted earlier this year, and as a result whether a second installment may be warranted.

In this *Economic Brief*, we make three points with regard to recent fiscal policies that have been enacted to deal with the recession. First, declines in measured output, employment, and consumption are not *necessarily* indicative of an inefficient response to economic fundamentals. Second, there are reasons to think that the current contraction in economic activity is indeed inefficiently large. This is likely due to certain specific market frictions present in labor, insurance, and capital markets. As a result, policies that target those frictions directly may have the best chances of improving welfare. Third, the extent to which recent fiscal policies directly address the frictions currently in play is mixed.

FINDING A PRODUCTIVE ROLE FOR POLICY FOLLOWING A DECLINE IN MEASURED OUTPUT

Before confronting the ideas mentioned above, it is worth a brief detour to first understand the source of economists' general enthusiasm for leaving unfettered the choices of individual households and firms interacting via competitive markets in which prices adjust to equate supply and demand. A key result of economic theory known as the "First Fundamental Theorem of Welfare Economics" asserts it is these prices — which both constrain and influence individual actors — that allow the economic decisions of self-interested households and firms to be entirely consistent with an efficient allocation of resources. By efficient, we mean: in ways that leave *no* gains from trade unrealized. It is this property that leads many economists to be wary of interventions in the economy that aim to improve aggregate outcomes by modifying the decisions of individual actors, such as firms, households, or even sectors of the economy. The real relevance of the First Welfare Theorem is not as a description of reality, but rather as a useful point of departure for policy analysis: It suggests that one generally needs to point to a missing or noncompetitive market in order to justify a given policy.

The preceding result implies that in a well-functioning competitive market system, the adjustments made by individuals and firms in response to a shock to economic fundamentals, even when they are contractionary, will be efficient. If something bad has happened to the ability of firms to produce output (say, a shock to the financial sector that hinders the allocation of labor and capital to their best uses), then each hour of labor becomes less productive. In this case, it makes little sense for firms to continue producing, or for workers to work, at previous levels. After a storm, for example, a fisherman may find that each hour spent in the boat produces less fish; an efficient response is for him to spend less time fishing (hire less labor) and more hours consuming leisure (or, perhaps working on boat maintenance and repair), given that the cost of leisure or other activities, measured in terms of fish foregone, has fallen.

THE NEED TO IDENTIFY FRICTIONS

The preceding example also makes clear that an efficient response to a shock does not mean that shocks themselves are good. Recessions clearly are associated with hardship, and it would clearly have been better if there had been no storm. Nonetheless, it may still be true that it is not possible for policy to improve welfare of some households without hurting others.

We make this point to argue that it is not sufficient to simply observe a fall in aggregates and conclude that policy action is warranted. To the extent that the downturn represents an efficient reaction to underlying declines in productivity, policy can at best help some households by hurting others. Moreover, if we cared only about measured aggregate economic activity, then any means of increasing it (for example, simply destroying capital equipment while subsidizing new investment) could technically "solve" the problem. But such policies, by not being directly targeted at the problems faced by households and firms, may not mitigate the actual hardship created by a decline in productivity. Therefore, finding a productive role for policy entails first asking whether there are frictions that make declining economic activity in response to the shock inefficiently large, and then crafting policy to address those frictions directly.

There are indeed good reasons to think that the current recession is characterized by significant inefficiencies. In particular, lower levels of employment, rather than reflecting a sensible scaling back of costly work effort in the face of lower productivity, likely reflect important frictions in capital, labor, and insurance markets.

THE (IN)EFFICIENCIES IN CAPITAL AND LABOR MARKETS

Frictions in capital and labor markets hinder the allocation of factors of production to their best uses. In the case of capital markets, the problems being faced by banks recently arguably have impeded their efforts to discover good investment projects, and then raise the resources to invest in them.

In the case of labor, work is allocated by a decentralized process. When one loses a job, regaining employment entails a costly search process. There is the risk that workers and firms cannot find each other, and even when they do, they may not find the match to be mutually beneficial. As a result, many workers may find that it takes long periods and sustained search effort to find a match that may entail moving or other disruptions.

Moreover, what is arguably most problematic about declines in employment is that the adjustment of labor input comes in very uneven ways: Employers tend to engage in layoffs rather than make an equivalent cut in hours across the board. For a variety of reasons, most jobs in the data are clustered around either 20 or 40 hours per week. For example, fixed costs in labor use, both on the employer's side (for instance, training) and the worker's side (for instance, commuting costs) will tend to make both parties unwilling to consider wider mixes of hours. If instead firms could adjust to the shock by making *all* workers take an individually small reduction in their labor hours, recessions would be less problematic for households: Most could still afford necessities, make their mortgage payments, keep their children in daycare, and suffer relatively little disruption to their lives. This is the main reason we talk about recessions: A distinct subset of the workforce faces a rather severe adverse outcome while there is no major change for the rest of the workforce.

THE (IN)EFFICIENCY OF PRECAUTIONARY SAVINGS

The absence of a smoothly functioning labor market, the uneven nature of individual labor market outcomes, and the conspicuous absence of direct private market insurance against unemployment will all persuade consumers to be prudent and scale back consumption when recession adds uncertainty to their future prospects. Put differently, households facing the risk of unemployment will wish to increase "precautionary" savings as a form of private insurance to reduce the effects of uncertainty. Indeed, at the aggregate level, the national savings rate has surged to the highest point in at least a decade.

It is crucial to recognize that the increase in precautionary savings is a prudent decision on the part of each individual consumer, and thereby does not immediately warrant policy intervention. However, to the extent that the increase in savings arose from a need to overcome frictions in both labor markets and insurance markets, it is possible that households' increased precautionary savings could lead, in the aggregate, to an inefficiently large reduction in aggregate consumption. In turn, such a decrease may itself contribute to additional employment declines, further adding to the labor market uncertainty faced by households.

The preceding suggests there may be a role for policy. However, it also suggests that productive policies will likely be those which directly address the specific frictions in capital, labor, and insurance markets that make the observed decline of aggregate consumption inefficiently large.

The existing policy responses in capital and insurance markets both constitute efforts to directly address clearly identified frictions. In the case of capital markets, the Federal Reserve's and the Treasury's various financing facilities created over the last two years constitute efforts aimed directly at addressing these frictions. As for insurance markets, fiscal policy routinely, including in the current downturn, buttresses the public safety net through policies such as extended unemployment insurance and health insurance for laid-off workers. Such efforts seem productive.

However, several additional efforts to address labor market frictions have been very indirect. Government spending stimulus attempts to address the frictions in labor markets by encouraging hiring in other, government-sponsored areas. In particular, some sectors of the economy will receive production subsidies, which in turn will increase demand for labor in these areas. The presumption in this approach is that such an increase in demand will make job finding easier, and will attenuate the increase in precautionary savings.

The preceding responses do not directly address the fundamental labor market frictions themselves. No attention is given to improving the ways in which firms and workers match with each other, or to mitigating any of the features of labor markets, such as fixed costs, that seem to preclude the smooth adjustment of labor hours. In turn, current spending-based stimulus, while it may marginally increase the probability of a laid-off worker regaining employment, will also likely draw employed workers away from other productive uses — further hindering efficient resource allocation.

We think a more promising approach would be to expand the provision of unemployment insurance and related safety net programs. There is already a rich infrastructure in existence for the delivery of both. Such an approach would directly address the hardship faced by households who have lost employment, and simultaneously temper the need for precautionary savings, thereby attenuating the likelihood of inefficiently large drops in consumption and further employment declines. An additional benefit of this approach is that it could improve the matching process between employers and workers by reducing the extent to which a displaced worker must accept the first available opportunity. Moreover, if policy were redirected toward this approach, resources currently devoted to indirect policy responses could be applied instead to ramp up monitoring efforts to address the increased moral hazard associated with any expansion in the social safety net (in this case, to make sure that recipients continue to search for new employment).

CONCLUSION

Sound justification for fiscal policies that attempt to manipulate economic activity should be provided in advance by those proposing such policies. Identifying that aggregate economic activity has fallen, even if severely, is a necessary but not sufficient condition for enacting a given policy to address that decline.

Recent fiscal policy appears interested in addressing declines in aggregate employment and consumption via public spending. In this *Economic Brief*, we argue that fiscal stimulus is not likely to be successful in addressing this problem. If the decline in labor and capital hours in this current downturn is efficient, such policies will necessarily be welfare reducing. If, instead, the current decline in activity is a result of frictions in labor, capital, or insurance markets, which appears to be the case currently, a successful policy must be targeted specifically and directly at these frictions. Many recent fiscal policy actions, however, do not seem to deal pointedly with such frictions. We think a more fruitful approach would be to leverage the existing unemployment insurance and social safety net infrastructure to better insure the unemployed while more strictly monitoring their job search efforts. ▪

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