Commentary: Is There a Role for Discretionary Fiscal Policy?

Martin Feldstein

Alan Auerbach has given us a valuable paper loaded with new empirical research on the macroeconomics of fiscal policy. I agree with his basic conclusion that there is "little evidence that (the effects of discretionary fiscal policy) have provided a significant contribution to economic stabilization, if, in fact, they have worked in the right direction at all." I, therefore, concur with his support for the earlier conclusion of Romer and Romer (1994) about the general superiority of monetary policy as a tool for macroeconomic stabilization.[1]

Although Auerbach's evidence is innovative and impressive, he recognizes that it confirms views that are now well-established and widely held in the profession. Even economists who did not consider themselves to be monetarists came to this conclusion on the basis of their own research. I recall studies in the 1970s by Otto Eckstein and also by the Office of Management and Budget of the Carter Administration that concluded that the timing of previous discretionary fiscal policies had actually been destabilizing. In 1983, as the economy was pulling out of the recession and Congress was pressing for a new fiscal stimulus, I testified as CEA chairman that a congressional call for a fiscal stimulus might be one of the best coincident indicators of an economic upturn.

It is surprising, in light of all of this, that Auerbach finds (in table 2) a substantial and statistically significant use of discretionary fiscal policy in the Clinton years, as reflected in the response of changes in discretionary fiscal policy to the lagged GDP gap during the years of the Clinton Administration, although not in the previous eight years of his sample (i.e., in the presidency of George H.W. Bush and the second term of President Ronald Reagan.)[2]

But despite the general presumption against discretionary "counter-cyclical" fiscal policy that Auerbach's research supports, I believe that there is one important condition when discretionary fiscal policy can play a positive role: in a sustained downturn when aggregate demand and interest rates are low and when prices are falling or may soon be falling. This situation is of more than theoretical interest since it describes Japan's current condition and some analysts believe may also be relevant to the United States and Germany.

In discussing the case for discretionary fiscal policy in this context, I will also emphasize that an expansionary fiscal policy need not increase the full employment deficit. More specifically, changes in fiscal incentives may be more useful than traditional fiscal policies that increase budget deficits and work through income effects alone.

The case against discretionary fiscal stabilization policy

To explain why discretionary fiscal policy may be appropriate in the special case that I have identified, it is useful to begin by reviewing the widely accepted case against using discretionary fiscal stabilization policy under most circumstances when a change in aggregate demand is desired.

This general consensus against discretionary fiscal policy is a really remarkable reversal from the Keynesian view of appropriate policy that prevailed in the 1960s and even in the 1970s. The basic view at that time was that a shortfall of aggregate demand could be and should be reversed by a cut in taxes or an increase in government spending. The economics profession has now rejected that prescription for three basic reasons.

First, the powerful multiplier effect assumed in the early textbook Keynesian models was dramatically reduced when economists recognized that the marginal propensity to save out of temporary tax cuts is likely to be relatively high and that the increase in money demand that accompanies an economic expansion causes a demand-reducing rise in interest rates.

Second, more recent analyses summarized in Giavazzi and others (2000) have shown that tax reductions or expenditure increases can actually depress economic activity. One important way in which this can occur is by raising long-term interest rates as bond investors react to the fear of future deficits.[3]

Third, the combination of fiscal policy lags (recognition lags, implementation lags, and lags in the effect of spending and taxes on aggregate demand) and the substantial uncertainty about the magnitude of the economic response to fiscal changes increase the risk that well-intentioned fiscal policy will be destabilizing, a point emphasized many years ago by Milton Friedman (1953). With the average recession lasting just eleven months from peak to trough, it takes remarkably good luck to add fiscal stimulus at just the right time.

Reacting to the low fiscal multiplier by a more vigorous fiscal policy, i.e., a larger tax cut or spending increase, is unsatisfactory for two reasons. First, it would leave the economy with a permanently larger national debt. Although early Keynesians dismissed the burden of the debt with the argument that "we only owe it to ourselves," James Meade later taught us that even a domestically held national debt is a burden because of the dead-weight loss associated with the taxes needed to pay the interest on the debt. Second, the larger the fiscal policy change is, the more likely it is to destabilize total aggregate demand by adding (or subtracting) a large stimulus that is imperfectly correlated with the underlying shortfall (or excess) of demand.

Monetary policy is, therefore, generally accepted as the policy of choice when it comes to reducing aggregate demand or stimulating a weak economy.

Monetary policies to counter deflation

But what should be done in an economy in which the existing level of demand may cause low inflation to become deflation, despite low existing interest rates, or in which prices are already falling, despite very low interest rates?[4]

A widely cited Federal Reserve study by Ahearne and others (2002) points to the Japanese experience in the 1990s and suggests that when inflation is very low and demand is weak, monetary policy should be pursued very aggressively—going beyond the interest rate cuts that would normally seem appropriate for that combination of inflation and unemployment.[5] Their reasoning, in brief, is that deflation can imply high real interest rates, even if the nominal interest rate is reduced to a near-zero level. Such high real rates would push the economy deeper into recession and cause an even faster decline of prices. They conclude that to avoid this vicious downward spiral, it is important to cut interest rates sharply while inflation is still positive if there is a danger that it may evolve into deflation.

They argue, in effect, that with low interest rates, low inflation, and weak demand, the risks to the economy are asymmetric. If demand continues to decline, prices might start falling and produce a condition that an expansionary monetary policy cannot correct. In contrast, if the expansionary monetary policy turns out to have been unnecessary, the result will be a higher rate of inflation that can later be brought down by a tighter monetary policy.

I do not favor this approach for two reasons.[6] First, the "hyperexpansive" monetary policy might cause an asset price bubble in securities and real estate markets or an excessive decline of the exchange rate as well as a more rapid increase in the prices of goods and services.[7] The adverse effect when the asset price bubble later collapses or the exchange rate rises might be severely destabilizing. An excessively easy monetary policy is a dangerous tool.

Second, it may also be an unnecessary tool. Discretionary fiscal policy could be used in these circumstances either to prevent the economy

from slipping into deflation or, if deflation occurs, to bring it back to price stability.

Since I began by pointing out the difficulties of using discretionary fiscal policy under normal circumstances, let me comment now on why it might be effective and appropriate in the deflationary situation of the type that Japan is now experiencing. First, the dampening effect of increased short-term interest rates caused by an induced rise in money demand can obviously be offset in this case by a monetary policy that holds short rates constant. Moreover, the problem of lags and uncertainty is not relevant when we are considering a long-term situation of depressed demand, like that in Japan, rather than the traditional business-cycle downturn that lasts less than a year.

Fiscal expansion without budget deficits

The final common objection to using discretionary fiscal policy is the possible contractionary effect on current demand of an increase in the current or expected future deficit. It is important, therefore, to emphasize that an expansionary fiscal policy need not involve a rise in the full-employment deficit if its expansionary impact is achieved by increasing the private *incentive* to spend. A fiscal policy can be expansionary if it has a positive substitution, effect even if there is no income effect. Indeed, a fiscal incentive that succeeds in increasing economic activity can actually reduce current and future budget deficits.

To be specific, I will now give two kinds of examples of discretionary targeted fiscal incentives that I believe could stimulate economic activity in a situation characterized by low demand, low inflation, and low interest rates.

Offsetting the effect of low interest and inflation
rates on business investment

Because tax rules do not distinguish between nominal and real interest rates, a fall in inflation with a constant real interest rate causes the real net-of-tax interest rate to rise. Even when inflation is zero or

positive, a decline in inflation rate causes a higher real net-of-tax inter-
est rate. One way to offset this and maintain the same incentive to
invest is to modify the depreciation rules or the investment tax credit.

   More formally, the real interest rate (r_n) is related to the nomi-
nal interest rate (i), the tax rate (τ) and the rate of inflation (π) by
$r_n=(1\text{-}\tau)i–\pi$. A change in inflation that does not alter the real interest
rate ($r = i–\pi$) implies $di/d\pi$=1 and, therefore, $dr_n/d\pi = –\tau$. Consider,
for example, the implication if the real interest rate is 4 percent and the
relevant tax rate is the corporate rate of $\tau = 0.35$. If the inflation rate
is 4 percent, the nominal interest rate is 8 percent, and the real net-of-
tax interest rate is 1.2 percent $[0.65(0.08) – 0.04 = 0.012]$. If the infla-
tion rate drops to zero, the nominal interest rate drops to 4 percent but
the real net-of-tax interest rate more than doubles, going from 1.2 per-
cent to 2.6 percent $[0.65 (.04) = 0.026]$.

   The incentive effect on business investment of the decline in infla-
tion is, of course, more complicated because the fall in inflation also
increases the present value of the nominal depreciation allowances.[8]
This offsetting effect is more important for some types of assets than
for others, depending on the life of the asset and the depreciation rules.
In the extreme, inventory investment (for a firm that uses last-in-first-
out inventory accounting) is depressed by lower inflation because
there is no offsetting change in the value of depreciation to balance the
rise in the real net-of-tax interest rate.

   If the net effect of the lower inflation is to reduce the overall incen-
tive for business investment, the depressing effect on aggregate
demand can be offset by a suitable investment tax credit. This is true
even if the inflation rate is negative.

Stimulating demand by households and businesses in Japan

   Japan has now experienced a decade of stagnation with growth rates
that are far less than Japan's potential and with several years of declin-
ing prices. Although the short-term interest rate is essentially zero, the
real rate is positive and could rise if the rate of deflation increases. The
large existing budget deficit (a primary deficit of about 5 percent of

GDP) and the excessive national debt (a national debt that exceeds 140 percent of GDP) make additional fiscal deficits potentially counter-productive. In this context, I have previously discussed two targeted fiscal policies that could increase aggregate demand without increasing the size of the budget deficit (Feldstein, 2001).

The first option would raise consumer spending. The government of Japan has said for some time that it wants to reduce its reliance on the income tax and increase its reliance on its value-added tax. The Japanese government could announce that it will raise the current 5 percent value-added tax by 1 percent per quarter and simultaneously reduce the income tax rates to keep revenue unchanged, continuing this for several years until the VAT reaches 20 percent. This revenue-neutral policy would imply consumer prices rising at the rate of 4 percent per year. This tax-induced inflation would give households an incentive to spend sooner, rather than waiting until prices are substantially higher. And yet, it would not change the size of the structural budget deficit.

The second such revenue-neutral-targeted incentive policy could encourage business investment by a Japanese government announce-ment that it was instituting a large investment tax credit—say, 30 per-cent—paid for by an increase in the corporate income tax and that the investment tax credit rate would decline by 5 percentage points per year until it was eliminated (with corresponding revenue-neutral reductions in the corporate tax rate.) Companies, like the consumers in the previous example, would have a substantial incentive to spend sooner before the net price of investment goods rises. A similar declin-ing tax credit could be applied to investment in business structures and residential housing.

In summary, an expansionary fiscal policy based on a revenue-neu-tral structural incentive may be more productive and less risky than an excessively easy monetary policy as a way of dealing with a defla-tionary situation or one that could become deflationary.

This case for using discretionary fiscal policy in any country assumes, of course, that a political agreement can be achieved for legislative action in a timely enough fashion. If partisan conflict prevents this, the

central bank would have to weigh the consequences of a potentially
excessive monetary easing—including the consequences for security
and real estate markets and for the exchange rate—against the risks
of deflation.

Additional comments on Auerbach's paper

Let me conclude with a few additional specific comments on the
Auerbach paper.

Measuring the fiscal stimulus

Auerbach discusses the difficulty of measuring the discretionary
fiscal stimulus and makes a good case for using the Congressional
Budget Office measure of policy changes, rather than changes in the
full-employment surplus. To the extent that the stimulus is given by a
change in the budget deficit, the Auerbach decision is probably a good
one. But it is too limited a measure of fiscal stimulus. It is possible to
stimulate demand without any change in the budget deficit by chang-
ing incentives to spend through a change in relative prices. The invest-
ment tax credit is the most obvious example of this. Although an
increase in the investment tax credit does cause a decline in tax rev-
enue, the incentive effect is greater than would be achieved with an
equal lump sum cut in taxes. It is difficult to know how to interpret the
Auerbach regressions of the effect of the GDP gap on discretionary
fiscal stimulus policy when it omits the use of these incentive policies.

The surplus reaction function

The surplus-reaction function that Auerbach estimates relates the
change in the full-employment budget surplus to the GDP gap and the
level of the budget surplus. I have already commented on Auerbach's
evidence on the relation of discretionary policy to the GDP gap. His
regressions also show that changes in discretionary fiscal policy are
inversely related in a substantial and significant way to the past level
of the actual budget surplus.

A larger budget surplus causes legislated changes in taxes and

spending that reduce the surplus, while a larger budget deficit has the opposite effect. The recent out-of-sample experience is consistent with this estimated relation. Looking ahead, it implies that the current and projected budget deficits will induce fiscal contractions to shrink future deficits.

The Auerbach estimates also have important implications for the proposals to shift a portion of Social Security payroll taxes out of the budget and into personal retirement accounts. If the relation estimated by Auerbach continues to hold, these personal retirement accounts and the associated rise in the off-budget surplus would cause an increase in national saving.

Automatic stabilizers

Auerbach's analysis of automatic stabilizers implies that each dollar decline in GDP induces an offsetting rise in the fiscal deficit of 35 cents. Although this relation is estimated for the nation as a whole, it probably applies also to individual states and regions. If so, a one-dollar decline in the GDP of New England induces an offsetting decline in the net taxes (i.e., taxes net of transfers) paid from New England to Washington of about 35 cents.

This offsetting fiscal stimulus helps the United States to operate with a single monetary policy, even though there are regional differences in cyclical shocks. There are, of course, no similar transfers from the individual nations of Europe to a central European fiscal authority to cushion the effects of the European single monetary policy.

The long-run fiscal situation

Auerbach is, of course, correct to emphasize the seriousness of the long-run fiscal situation. As a practical matter, he is also correct that the long-run budget deficits will not disappear because of growth alone. But his specific arguments, based on equation 4 in his text, are less convincing. While the real rate of return on capital exceeds the economy's rate of economic growth, the same is not true of the real interest rate on government debt, the relevant interest rate in equation

4. Moreover, the primary surpluses also depend on the rate of economic growth because the elasticity of tax revenue with respect to GDP exceeds one. If the ratio of government spending to GDP remains constant as the economy grows, the budget deficit would eventually disappear because of this more rapid growth of tax revenue with existing tax rules.

In fact, though, we cannot grow our way out of budget deficits because government spending also rises more rapidly than GDP. Even without new spending legislation, this will happen in the future under current law because of the aging of the population, raising pension benefits under Social Security, and increasing health outlays under Medicare. Supplementing existing payroll taxes with small amounts of saving in personal retirement accounts would make it unnecessary to raise the future payroll tax rate. A similar plan could limit the future tax cost of Medicare. We cannot grow our way out of the future Social Security and Medicare deficits, but we can save and invest our way out of the problem.

Endnotes

[1] It might be useful in this context to distinguish between "deliberate" discretionary stabilization policy (i.e., aimed at cyclical stabilization) and the incidental effect of fiscal changes done for other reasons. The tax cuts enacted in 1981 and in 2001 were both planned during the earlier election campaigns to improve long-term incentives but happened to play a positive but unintended stabilization role.

[2] I am not surprised that Auerbach cannot distinguish separate effects of the GDP gap on revenues and expenditures. During the Clinton years, the line between revenue changes and expenditure changes was substantially blurred by an increased use of tax rules to achieve expenditure goals, e.g., the child care credit and the expanded earned income tax credit.

[3] This impact on long-term interest rates is different from the IS-LM model of the effect of money demand on short-term interest rates that Auerbach emphasizes. A very small current budget deficit may have little contemporaneous direct effect on demand, but might cause such a large increase in the expected future deficit, and therefore in the long-term interest rate, that current demand actually falls, lowering the short-term interest rate. This possibility of the changing shape of the yield curve reconciles the

"popular" view that a budget deficit can reduce demand through higher interest rates with the traditional IS-LM analysis. Elmendorf and Reifschneider (2002) show that this effect can be quantitatively important, although in the empirical rational-expectations model that they examine it is not important enough to make a fiscal "stimulus" contractionary. The actual effect depends, of course, on the extent to which market participants extrapolate current deficit increases into the future. Evidence of the positive effect of expected future deficits on long-term interest rates is presented in a recent paper by Canzoneri and others (2002).

In noting the importance of the interest rate effect of fiscal policy, I don't wish to imply that I support the claim that the Clinton Administration raised economic growth by its 1993 tax increase. The rise in growth rates in the second half of the 1990s was dominated by the effect of exogenous improvement in productivity associated primarily with information technology. It was this growth that produced the extra tax revenue and that eventually eliminated the budget deficit. The 1993 tax rate changes were not large enough to produce the observed reduction in budget deficits, even if those lower rates had no adverse effects on taxable incomes.

[4] There is, of course, no problem with low interest rates and low inflation or even deflation if there is also a healthy positive rate of growth. There is no reason, in theory, why such a combination is not possible or even, as Milton Friedman (1969) argued, preferable. Although his argument ignored the revenue consequences of negative inflation in an economy in which the taxation of capital income is not indexed for inflation, a more complete analysis might still imply that the optimal inflation rate is negative. My own analysis of the benefits of price stability (Feldstein, 1998, 1999) assessed the effect of reducing true inflation from 2 percent to zero (i.e., reducing measured inflation from about 4 percent to 2 percent) but did not derive an optimal inflation rate and assumed that the real long-term growth rate is independent of the choice among low inflation rates.

[5] Although their emphasis is on monetary policy, they note the advantage of combining very easy monetary policy with fiscal expansion.

[6] There is also the question of whether monetary policy is really ineffective when the price level is falling. Although there is a lower bound on interest rates, implying a positive real interest rate, a rapid increase in the base money supply achieved by buying long-term assets and foreign exchange might still be able to stimulate the economy. However, lower long-term nominal rates may still leave positive real rates if deflation is rapid and a sharp decline in the exchange rate might create adverse "beggar thy neighbor" effects on other economies that should be avoided.

[7] Ahearne and others (2002) acknowledge that excessively easy money may cause an overshooting of asset prices and exchange rates.

[8] See, for example, the discussion in Feldstein (1999).

References

Ahearne, Alan, and others. "Preventing Deflation: Lessons from Japan's Experience in the 1990s," *International Finance Discussion Papers*. Washington: Board of Governors of the Federal Reserve System, June 2002.

Auerbach, Alan. "Is There a Role for Discretionary Fiscal Policy?" in *Rethinking Stabilization Policy* (Federal Reserve Bank of Kansas City, August 29-31, 2002), Papers and Proceedings, pp. 109-150.

Canzoneri, Matthew, and others. "Should the European Central Bank and the Federal Reserve be Concerned about Fiscal Policy?" in *Rethinking Stabilization Policy*, (Federal Reserve Bank of Kansas City, August 29-31, 2002), Papers and Proceedings, pp. 333-390.

Elmendorf, Douglas, and David Reifschneider. "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," *National Tax Journal*, forthcoming.

Feldstein, Martin. "The Costs and Benefits of Going from Low Inflation to Price Stability," in C. Romer and D. Romer, eds., *Monetary Policy and Price Stability*, Chicago: Chicago University Press, 1998.

_____. "Capital Income Taxes and the Benefit of Price Stability," in M. Feldstein, ed., *The Costs and Benefits of Achieving Price Stability*. Chicago: Chicago University Press, 1999.

_____. "Japan Needs to Stimulate Spending," *The Wall Street Journal*, July 16, 2001.

Friedman, Milton. "The Effects of a Full-Employment Policy on Economic Stability: A Formal Analysis," in M. Friedman, *Essays in Positive Economics*. Chicago: Chicago University Press, 1953.

_____. "The Optimum Quantity of Money," in M. Friedman, *The Optimum Quantity of Money and Other Essays*. Chicago: Aldine, 1969.

Giavazzi, Francesco, and others. "Searching for Nonlinear Effects of Fiscal Policy," *European Economic Review*. (June 2000), pp. 1259-1289.

Romer, Christina, and David Romer. "What Ends Recessions?" in S. Fischer and J. Rotemberg, eds., *NBER Macroeconomics Annual*. 1994, pp. 13-57.