General Discussion: Is There a Role for Discretionary Fiscal Policy?

Chair: Stanley Fischer

Mr. Fischer: We will give Alan Auerbach a couple of minutes to respond. Alan, I'd like to interject one further comment. You say at the end of your paper that fiscal policy should be used with caution. Do you mean that it should not be used at all—which is what aggregate fiscal policy is, and that is what Marty seemed to be saying—or do you mean that it should be used in small doses?

Mr. Auerbach: I think the latter. I'm sympathetic to Marty Feldstein's argument about Japan—not necessarily for the detailed reasons he gave, but just because a prolonged slump is different from a ten-month recession. Implicit in what Marty was saying, is that a lot of the criticisms of the timing of discretionary fiscal policy don't really apply when, year after year, you are experiencing slow economic growth.

I'll respond selectively to the points raised by my discussants. Regarding Marty's recommendations for Japan for phased incentives for spending, either by consumers or investors, it is worth drawing a parallel to recent U.S. policy. Our stimulus package enacted in spring 2002 may turn out to be a coincidental indicator for the end of the recession; Marty and his friends on the business-cycle dating committee will tell us, probably in a couple of years. The stimulus package included a three-year (small by comparison to a big investment credit)

temporary investment incentive. It was temporary both for budget reasons and also as a way of giving an extra kick. I mentioned that policy in my paper. I also mentioned the fact that such temporary policies—this goes back to the first discussion of the dynamic inconsistency and the timing of investment incentives—can cause worries about what happens next time. If we move to a regime in which we say, "Whenever we think investment could be stronger, we'll have investment incentives, one worries that could be very destabilizing for investment on a going-forward basis. I would exercise caution in this instance even in Japan, as I would have exercised more caution in the United States than our government did.

I think Fumio Hayashi's point about the use of structural Vector Auto-Regressions (VARs), is important. I should have emphasized it more in the paper. The literature is very confusing and Fumio made the right distinction between innovations and discretionary fiscal policy in a structural VAR, which puts fiscal policy, monetary policy, output, and possibly other variables into a system of equations. The coefficients of the VAR are going to pick up both discretionary fiscal policy and automatic stabilizers. All they won't pick up—all that will be in the innovations—are things that we can't explain using either a policy rule or what is built into the tax code. That could be unpredictable changes in policy. It could also be things that have nothing to do with policy—a change in the income distribution, which causes tax revenues to go up, for example.

Some suggest interpreting the efficacy of policy by looking at the impact of innovations, as opposed to the impact of predictable policy, but it is hard to know what to think about the impact one sees from innovations because we don't really know what these innovations represent. To estimate the value of discretionary policy, which I presume would mean zeroing out the innovations in fiscal policy and also setting the fiscal coefficients to zero (i.e., saying the fiscal policy doesn't respond) you really have to believe the VAR. You have to believe that is the structural model of the economy and that when you change these coefficients, all of the other coefficients in the system are going to stay the same. I am skeptical about this. If one thinks about the effects of fiscal policy on investment, for example, looking simply at levels of

aggregate revenues does not produce a structural model for determining investment behavior. Therefore, we won't have invariant coefficients in this model if we start changing policy around in a big way.

Finally, let me address the issue of sustainability of policy, even if we have a past policy rule that says government policy tightens when we have larger debt, one can say that we are not on a sustainable path if we don't do that in the future. That's one interpretation of what I was saying in the paper. But I don't think we are necessarily in the same situation as we have been historically in the period for which these equations were estimated—particularly, if you look not at the reported primary surplus and the reported value of the government debt, but measures that take into account the very large implicit liabilities that we have now and are accruing very rapidly. It is not clear to me that our recent policy actions have had the characteristics described in the historical equations. Therefore, I am not sure that we are on a sustainable path, even taking account of the policy actions we are taking.

Mr. Fischer: Thanks very much. If I could just ask the people who comment or ask questions to keep them brief please. We will start with John Makin, Pam Woodall, Rob Dugger—the first three.

Mr. Makin: I just wanted to comment on something that Alan and Marty alluded to: Is there a role for discretionary fiscal policy in an unusual cycle like the one we have seen in Japan and like the one we may be seeing in the United States? In that context, I would like to suggest that the notion that somehow raising taxes and reducing expected future deficits was the key to the expansion of the 1990s is certainly debatable, as Alan suggests, and perhaps a dangerous notion right now. Because among the criteria that Marty listed—and I am going to focus here on the United States—we do have weak demand growth; we do have inflation falling. Another thing that bears on the policy mix here is that we have weak global demand growth, so that aggressive monetary stimulation in the United States that caused the dollar to depreciate sharply might have the effect of exporting U.S. deflation, and it might be better to try to enhance demand growth with lower taxes. And, finally, pushing too hard with monetary policy at this point might miss the mark and create a bubble somewhere else. If

we look at the stylized facts during the last year in the United States—despite the fact that we did have tax increases in the 1990s—in fact, what has come to pass is that they have not led to smaller expected future deficits; deficits have gone up sharply. Simultaneously, consumption responded sharply and positively to the tax cuts that were enacted last fall. We had a surge of consumption in the fourth quarter and the first quarter of this year. And while all this was happening, nominal interest rates were going down by a 100 basis points, with that reduction in interest rates composed partly of lower expected inflation and lower real interest rates. The bottom line here—the lesson—is that there is a role for discretionary fiscal policy at this stage in an unusual cycle in the United States, as well as Japan, and that lower marginal tax rates would be very constructive, both in the short run and the long run.

Finally, Fumio, I would suggest that I too thought interest rates were too low in Japan. But actually, when I went back and looked at real interest rates, as our previous session suggests, real interest rates in Japan today are about where they have been on average during the past thirty years.

Mr. Fischer: Thanks, John. Pam Woodall, please.

Ms. Woodall: On this question of whether fiscal policy works, I wonder whether it is worth differentiating a bit more between the effectiveness in different countries, since we have an international audience here. Most of the work on fiscal policy effectiveness has actually been done in the United States. But there are good reasons for thinking that the effect elsewhere might be smaller. There are two recent studies on discretionary fiscal policy. One study is by Roberto Perotti, where he finds that fiscal multipliers are much larger in the United States than in smaller economies. There is also an IMF working paper that shows that in open economies where imports are more than 20 percent of GDP, fiscal policy has no impact at all on demand. Whereas, in relatively closed economies, which in this case would be America and Japan, it is effective. On the other hand, automatic fiscal stabilizers would actually be expected to have a bigger impact in Europe than in Japan or the United States because taxes and spending are a larger share of GDP. I just think it might be worth considering these differences a bit.

Mr. Fischer: Thanks, Pam. Rob Dugger.

Mr. Dugger: I think everyone is attracted to the interest in Japan because it is so distinct and always offers up the possibility of lots of lessons. I am drawn to the Hayashi-Prescott paper, which hasn't been given much attention. It wasn't mentioned at all or cited in the Ahern paper that the Board staff did. I am particularly drawn to the final conclusion of it where you observe that there seemed to be an allocation of fiscal spending to declining industries. That observation was affirmed by Ed Lincoln in his book. He talked a lot about the politics of the allocation of deficit spending. It seemed to me, Martin, that part of your suggestion about what to do with respect to Japan and a fiscal policy response seemed to have something to do with changing the allocation away from declining industries. So, it has something to do with the churning of an economy, the restructuring process of an economy. My question to the three panelists is: To what extent is "the preservation of a status quo distribution of sector support of declining industries"—a phrase that Ed and Fumio used in the conclusion of their paper—enhancing the churning of an economy? Is that a desirable goal in a fiscal policy response?

Mr. Fischer: Mickey Levy.

Mr. Levy: I have two comments on the way Alan Auerbach calculates whether fiscal policy changes are discretionary. You regress the full-employment budget surplus on lagged measures of the full employment GDP gap and rely on Congressional Budget Office (CBO) estimates of the gap. Historically, the CBO has always abided by a fairly rigid NAIRU model for economic forecasting. Whenever its NAIRU model fails to accurately forecast inflation, on an ex post, ad hoc basis, it changes its natural rate and estimate of the GDP gap to whatever fits the model. So, my question is: When we look back on how we estimate what is discretionary and what isn't, was it discretionary at the time? What was the estimated GDP gap at the time? Consider how we interpret the 1993 tax hikes. We all agree that during the 1990s there was a pretty persistent upward revision in forecast of estimated potential GDP. Were the Clinton tax hikes put in place at a time when the gap was negative, which in hindsight looks positive?

You need to reassess how we distinguish between what was perceived of as discretionary at that time. Associated with that is Marty Feldstein's proposal for Japan that we reduce marginal tax rates and increase the value-added tax. If that is neutral with respect to the budget deficit, it would show up as not a discretionary fiscal policy change, based on the way you assess what is discretionary or not, even though we know it could have a significant impact.

Similarly, in the United States, the Tax Reform Act of 1986, the CBO budget scorekeeped as revenue-neutral, even though it significantly changed marginal tax rates and incentive. According to your measure, the tax legislation would not be considered as discretionary, even though it stands out as very discretionary.

Mr. Fischer: Thanks, Mickey. Larry Meyer is next please.

Mr. Meyer: Alan, you started off with a very interesting observation. You said that some of us might find surprising your result that discretionary fiscal policy has become increasingly activist over time. I was surprised.

That does raise a question about how a researcher should respond when the data seem to disconfirm his or her priors. Of course, you had an interesting phrase, "But that is what the data show." So, the question is what to do?

You have a perfectly reasonable approach. When the data disconfirm your views, you change your views. Some of my former colleagues will attest that I'm a little bit more stubborn in my priors. So, my first inclination would be to reassess the methodology and question the data. Another reason for doing this is actually the Romer-Romer paper this morning. They told us, convincingly I think, that ideas matter for policy. But, in my view, you seem to contradict this result. It seems to me that during the latter period, ideas changed and became increasingly skeptical about the effectiveness of discretionary activist fiscal policy. At the beginning of the Reagan Administration there was a clear disavowal of short-term stabilization policy, and that has continued. More focus was on long-run supply-side, tax policy, worrying about deficits,

etc. So, the question is, why do your data show differently? It seems to me that the problem is that you fail to really look at the intent of the changes. This follows up on some of the points that Mickey was raising.

You note this a little bit in your paper as one of the limitations. But I think it is a very important one. So, how do you look at the Reagan tax cut of 1981-1982? Is that activist stabilization policy? I always refer to President Reagan as an accidental Keynesian. That was a policy that was proposed and implemented for other reasons. It was timed fortuitously. When you take that into account, you might have a different view about activist fiscal policy. Maybe it helps to understand your other result—that activism doesn't translate into success. If the motivation for these changes was not active stabilization policy, then it is very reasonable that about half the time they should be well-timed and half the time they should not be from the perspective of stabilization policy.

Mr. Fischer: Thanks, Larry. The last comment is from Glenn Hubbard, and I am very sorry, but time is up after that.

Mr. Hubbard: My first comment echoes something that Larry just said. The paper left me with a sense of unease. Some of the uneasiness comes with the technical thing, which I won't go into, of how the CBO incorporates spending in its forecasts.

More substantively, the distinction Larry made is not second order but first order. There is a big difference between discretion generally and stabilization policy. Think of three major tax changes in the past couple of decades—the Reagan tax cuts, the Clinton tax increase, and President Bush's tax cut. None of those was adopted with stabilization policy in mind. Two of those shared a common view about decreasing marginal tax rates and effects on economic growth. Another held that increasing marginal tax rates would increase economic growth. But none of those was about stabilization policy. That is important because you then can't really evaluate those policies in this framework. They weren't intended for stabilization, and I would think the more standard public finance analysis of what the effects are of these policies on investment or labor supply or growth would be the better way to go.

The third point I'd like to make is that I agree with you, Alan, wholeheartedly on the notion of the need for more clarity in this idea that raising taxes or increasing primary surpluses in a country like the United States increases economic growth. I think that is a relatively thin reed. I would encourage you to think hard about the second point about micro-estimates of growth from cutting tax rates. The burden is also on the other side to get at micro-estimates of raising them.

Mr. Fischer: Thanks, Glenn. We will now ask the people on the podium to respond briefly.

Mr. Feldstein: I will just comment about two things that have been raised. One is this question of how one measures or even thinks about fiscal policy. The traditional way, of course, has been in terms of some kind of change in the size of the full employment deficit. It is very important always to think about the incentive effects of the fiscal policy. That is certainly not new. The investment tax credit is a good example of something in which the expected impact is very different from the revenue loss associated with it. Another example is changes in marginal tax rates. In thinking about discretionary fiscal policies, it is important to think about policies that are aimed at changing incentives, as well as policies that simply change the amount of cash in people's pockets.

One of the puzzles in Alan's paper is that he found the discretionary policies during the Clinton years. Here, the data do seem to speak pretty loudly that there is this relationship between changes in discretionary budget changes and the lagged GDP gap. It may be coincidental, as Larry Meyer, I suppose, would argue, but the data certainly do seem to say that. Then, he doesn't find a clear breakdown when he tries to look at that same question separately in terms of taxes and expenditures. That is a kind of puzzle. But I don't think it is a very deep puzzle, because one thing we saw during that decade was a movement away from literal expenditures as a way of achieving expenditure goals. So, we saw an increase in welfare in the form of an expanded earned income tax credit and a number of other special provisions during that decade which were done through the tax system so that they resulted in lower taxes rather than increases in spending.

Mr. Fischer: Thanks. Fumio, any last comments?

Mr. Hayashi: What we did in Hayashi-Prescott is that we can explain the Japanese drop in the 1990s by the supply side, which is the productivity slowdown in the 1990s and the 10 percent decrease in hours worked that took place around 1990. Those two factors do a very good job of explaining that great recession in the 1990s. Now in that model, which is a standard real business-cycle model, there is government expenditure. It does something, but very minor compared with the supply-side considerations. In particular, our model cannot explain this 1997 drop in GDP when the government tightened its fiscal policy, but still our model can explain the trend of the whole 1990s. Suppose that Kuttner and Posen are right and the fiscal multiplier is huge. Should we engage in fiscal easing now in Japan? I am not sure. All those public works expenditures will go to subsidizing inefficient industries, and that is going to aggravate the supply-side program. So, I am not sure that I would recommend what Marty has been recommending on the fiscal side.

Mr. Fischer: Thanks, Fumio. Alan?

Mr. Auerbach: Just a few comments. First, on the issue of the relative efficacy of fiscal policy in smaller countries like EU countries, we would expect the effects to be smaller, just like we would expect the fiscal policy in Arkansas to have a smaller effect on GDP in Arkansas. It is a fairly obvious point. But it is an interesting observation, given that with the move to the euro there has been a move in the focus from monetary policy to fiscal policy to counter shocks in individual countries. Yet, as countries become more open, we also expect the multipliers to spill over into other countries and, therefore, for fiscal policy to be less effective too. The answer we have in the United States is that we have a central government. That is something that needs to be thought about in the European context as well.

As to the issue of declining industries and fiscal policy, thankfully, we in the United States have not really had is fiscal policy targeted toward industries—leaving aside things like steel tariffs, which have been getting a lot of publicity but aren’t that significant. Obviously,

one's attitude about discretionary fiscal policy would be even more negative if the policies tended to take the form of being targeted toward industries that are declining.

As to how one should interpret regressions, it depends on how much of a Bayesian you are and how strong your prior is. Even if the *t*-statistics are significant, for equations estimated over a short period, a few anomalous events can give you significant coefficients and poor out-of-sample predictions. There is no quarrel with that. But, during a long enough sample period, if people say they are doing one thing and the data tell us they are doing something else, we should believe what the data are telling us. An example is 2001. The tax cut was not put forward explicitly for cyclical reasons, but I do recall discussions about it being an insurance policy in case we needed some stimulus. There could be several factors at work and cyclical factors might play a role in policy choices, even when not being emphasized.

Finally, as to using CBO data or other similar data to measure stimulus—this relates to the first point I made in my presentation—it is very hard to measure discretionary fiscal policy. There can be changes in baselines that, because of changes in the perceived policy, actually don't represent legislated changes. Or, there can be legislated changes that are going to occur during a period of five years, which nobody thinks are actually going to be sustained and, therefore, don't really represent a policy change. In either case, it is difficult to analyze the effects of discretionary fiscal policy.

Mr. Fischer: Thanks, Alan, and to the discussants.