FRBSF ECONOMIC LETTER

Number 2002-26, September 6, 2002

The Role of Fiscal Policy

In recent weeks, a number of signs have appeared suggesting that the recovery of the U.S. economy from the recent recession is on a bumpy path. During the second quarter of 2002, real GDP grew at an anemic annual rate of barely over 1%, well below market expectations. Unemployment, after rising throughout 2001, has leveled off but has yet to show signs of declining. Adding some gloom to the general outlook, the stock market continued to drop through most of July and has remained volatile.

This sluggish economic performance comes despite substantial stimulus from both monetary and fiscal policy. Since January 2001, the Federal Reserve has reduced its benchmark policy interest rate, the federal funds rate, from 6.52% in September 2000 to a current level of 1.75%. Fiscal policy also has become more expansionary. The federal government budget has swung from a surplus of $236 billion in 2000 (2.5% of GDP) to a projected 2002 *deficit* of $157 billion (1.5% of GDP) as the government has increased expenditures and reduced taxes.

This active use of fiscal policy during a recession is somewhat unusual. During the last U.S. recession, in 1990, then President George H.W. Bush resisted attempts to use fiscal policy to stimulate the economy. In fact, his Council of Economic Advisers, in their February 1992 report, argued that increases in fiscal expenditures or reductions in taxes might hamper the economy's recovery. In contrast, during the current recession, both Congress and the President have supported increases in expenditures and tax cuts as ways to stimulate economic growth, culminating in the passage of the Economic Recovery Act in March 2002.

The current recession and the 1990–1991 recession offer contrasting examples of the use of fiscal policy, and they also highlight some elements of the longstanding debate in economics over whether fiscal policy can play a useful role in combating business cycle downturns. This *Economic Letter* discusses some of the issues involved in using fiscal policy to help stabilize short-run fluctuations in the economy.

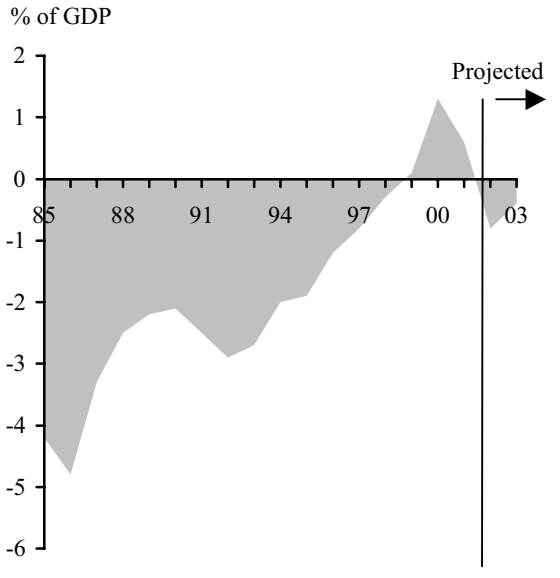
Automatic stabilizers and discretionary fiscal policy

As economic activity fluctuates, fiscal expenditures and taxes respond automatically in ways that stabilize the economy. For example, during an economic slowdown, government spending on unemployment benefits rises automatically as the unemployment rate rises. This increase in spending is automatic in that it does not require explicit actions by Congress or the President. Similarly, tax payments decline automatically when the economy goes into a recession. Auerbach and Feenberg (2000) have estimated that automatic tax stabilizers offset about 8% of the impact of an economic shock to GDP. While the automatic adjustments of federal spending and taxes work to stabilize the economy, not all automatic fiscal adjustments are stabilizing. State and local governments also see their tax revenues fall during recessions, but, because many of these governments must balance their budgets annually, they often must cut spending during recessions.

In addition to the automatic responses of fiscal policy, governments may make discretionary fiscal changes in the face of an economic downturn. Expansionary fiscal policy aims to boost demand and output in the economy either directly, through greater government expenditures, or indirectly, through tax reductions that stimulate private consumption and investment spending.

The standardized surplus provides a good way to measure these discretionary changes by correcting the actual budget surplus for changes due to the effects of automatic stabilizers. Figure 1 shows the standardized surplus based on the Congressional Budget Office's (CBO) April 2002 projections. It illustrates the swing in discretionary fiscal policy since 2000, with the standardized surplus falling from 1.3% of GDP in 2000 to a projected deficit of 0.8% of GDP for 2002. Legislated fiscal actions taken since January 2001 reduced the standardized

Figure 1
The standardized surplus



surplus by 0.5% of GDP in 2001 and will reduce it by a projected 1.2% of GDP in 2002.

The problem of lags

The chief argument against using discretionary fiscal policy to combat recessions emphasizes the long lags involved in changing fiscal policy in the U.S.. The recent U.S. experience illustrates this problem. Evidence appeared in late 2000 that the economy was slowing. Congress did pass a tax cut in 2001, but this was part of President Bush's legislative agenda before any hint of an economic slowdown. It took Congress until March 2002 to pass the Economic Recovery Act to provide further stimulus to the economy. In contrast, when signs emerged in December 2000 that the economy had slowed, the monetary policymaking committee of the Federal Reserve was able to convene a quick telephone meeting and to start cutting interest rates in January 2001.

Most postwar recessions in the U.S. have been short, lasting on average just under 11 months. By the time a fiscal program is starting to boost business and consumer demand—that is, after policymakers recognize that economic growth has slowed, propose a fiscal package, debate it, pass it, and send it to the President for his signature—the economy is already likely to be recovering. For this reason, discretionary fiscal policy in the U.S. is generally viewed as too unwieldy for dealing with the typical, mild recessions experienced in recent decades.

Figure 2 shows the contribution of automatic stabilizers and discretionary fiscal changes to the total change in the fiscal surplus (figures for 2002 are based on the April CBO projections). A positive value means that the surplus has increased (the deficit has shrunk) and therefore represents a contractionary shift in the budget; a negative value represents a more expansionary policy. During the recessions in 1970, 1974–1975, and 1990–1991, almost the entire shift to a larger deficit was the result of automatic stabilizers at work. In contrast, in the current recession both automatic and discretionary fiscal policy changes have worked to reduce the surplus. Notice, however, that the automatic stabilizers began to work in 1999, while the major shift in discretionary fiscal policy did not occur until later, when the economy had already entered a recession.

The role of future fiscal policy

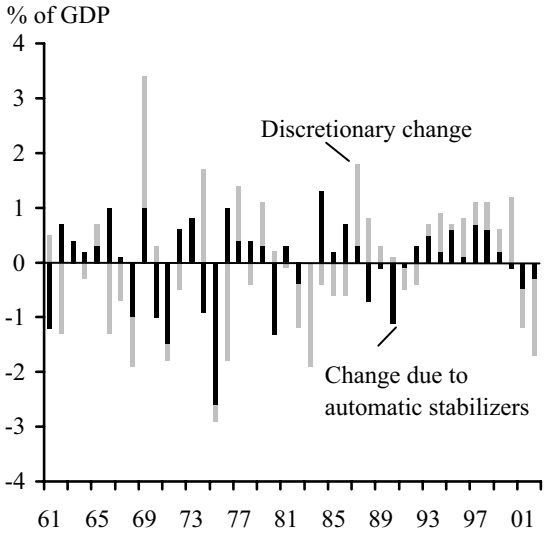
Expectations of future fiscal actions, and not just current expenditures and taxes, also can affect the economy. The distinction between current changes in spending or taxes and expected future changes is important because households and firms consider future economic conditions, as well as current conditions, in making their spending decisions. The impact of a change in fiscal policy today will depend on how it affects individuals' expectations about future government spending and taxes.

A tax cut, for example, leaves more disposable income in the hands of households. If the tax cut is viewed as temporary, though, it may have a much smaller effect on household spending than a permanent tax cut would. In contrast, some temporary tax changes can have larger effects on spending than permanent changes. For example, an investment tax credit that temporarily lowers the cost of investment projects can lead firms to schedule their spending to take advantage of the tax credit. Both current and future fiscal actions must be considered in assessing the impact of fiscal policy on the economy.

Can fiscal expansions be contractionary?

When expectations of future fiscal policy are important, "expansionary" fiscal policy—an increase in government spending, for example—may actually be contractionary. For example, if a government is already running a large deficit, spending increases might lead financial markets to question the solvency of the government or to expect that taxes will need to be raised in the future. This can cause

Figure 2
Changes in the federal surplus



Note: Data for 2002 based on April CBO projections.

long-term interest rates to rise, restraining current investment spending and negating the expansionary effects of the government spending. This argument was made by the President's Council of Economic Advisers (CEA) at the time of the 1990–1991 recession. In the 1992 *Economic Report of the President* (p. 25), the CEA argued that

> …an attempted stimulus that abandoned, or was perceived to abandon, serious discipline on the growth of future spending or on the reduction in the multiyear structural deficit probably would produce a substantial rise in interest rates. That would offset a large portion of the direct stimulus in the short run and would leave the economy thereafter with a higher cost of capital, which would be detrimental to investment necessary for long-run growth.

Theoretically, then, contractionary spending may increase demand, and expansionary spending may decrease demand. But is there any evidence to suggest such outcomes might occur in practice? The answer, it turns out, is yes. Alesina, Perotti, and Tavares (1998) find that deficit reductions are more likely to be expansionary if they involve cuts in government spending on government wages and transfers. Such cuts may signal a decline in permanent government spending and therefore create expectations of lower future taxes. In contrast, deficit reductions achieved through tax increases do seem to be contractionary.

Interactions with monetary policy

Both fiscal and monetary policies affect aggregate demand. But because discretionary fiscal policy changes in the U.S. are often difficult to enact in a timely fashion, automatic fiscal stabilizers and discretionary monetary policy are commonly viewed as the primary policy tools for macroeconomic stabilization. However, there are situations in which monetary policy might be unable to stimulate the economy, and discretionary fiscal policy would be needed to combat a recession. In the face of a recession, central banks reduce interest rates, but no central bank can lower interest rates below zero. If interest rates fall to zero, as occurred in the U.S. during the Great Depression and in Japan in recent years, monetary policy may be unable to stimulate the economy further, and discretionary fiscal policy would be needed to expand the economy.

Conclusions

Automatic fiscal stabilizers help moderate economic fluctuations. The contribution discretionary fiscal policy can make in combating economic recessions is more debatable. The long lags that typically characterize major changes in fiscal policy weaken the role discretionary policy can play during the relatively short recessions the U.S. has experienced. In some cases, the direct impact of current fiscal spending and taxation may be reduced or even offset as households and firms react to the expectation of future fiscal actions. While the situation would differ should the U.S. economy suffer a major economic downturn or should the Federal Reserve's benchmark interest rate reach zero, monetary policy and automatic fiscal stabilizers remain the first line of defense for ensuring short-run economic stability.

Carl E. Walsh
Professor, UC Santa Cruz,
and Visiting Scholar, FRBSF

References

Alesina, Alberto, Roberto Perotti, and José Tavares. 1998. "The Political Economy of Fiscal Adjustments." *Brookings Papers on Economic Activity* 1998(1), pp. 197–248.

Auerbach, Alan J. and Daniel Feenberg. 2000. "The Significance of Federal Taxes as Automatic Stabilizers." NBER Working Paper No. 7662 (April).

U.S. President. 1992. *Economic Report of the President* (February).

ECONOMIC RESEARCH

FEDERAL RESERVE BANK

OF SAN FRANCISCO

P.O. Box 7702
San Francisco, CA 94120
Address Service Requested

PRESORTED
STANDARD MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

Printed on recycled paper
with soybean inks

Index to Recent Issues of *FRBSF Economic Letter*

DATE	NUMBER	TITLE	AUTHOR
3/15	02-07	Predicting When the Economy Will Turn	Loungani/Trehan
3/22	02-08	The Changing Budget Picture	Walsh
3/29	02-09	What's Behind the Low U.S. Personal Saving Rate?	Marquis
4/5	02-10	Inferring Policy Objectives from Policy Actions	Dennis
4/19	02-11	Macroeconomic Models for Monetary Policy	Rudebusch/Wu
4/26	02-12	Is There a Credit Crunch?	Kwan
5/3	02-13	House Price Dynamics and the Business Cycle	Krainer
5/10	02-14	Deposit Insurance Reform—When Half a Loaf Is Better	Furlong/Kwan
5/17	02-15	Off-Site Monitoring of Bank Holding Companies	Krainer/Lopez
5/24	02-16	Searching for Value in the U.S. Stock Market	Lansing
5/31	02-17	Reforming China's Banking System	Moreno
6/14	02-18	Country Crises and Corporate Failures: Lessons for Prevention...	Glick
6/28	02-19	Towards a Sovereign Debt Restructuring Mechanism	Spiegel
7/5	02-20	Productivity in Heart Attack Treatments	Gowrisankaran
7/26	02-21	Trends in the Concentration of Bank Deposits: The Northwest	Laderman
8/2	02-22	Using Chain-Weighted NIPA Data	Jones
8/9	02-23	Technical Change and the Dispersion of Wages	Trehan
8/16	02-24	On the Move: California Employment Law and High-Tech Development	Valletta
8/23	02-25	Argentina's Currency Crisis: Lessons for Asia	Spiegel