Fiscal Policy: Alive and Well

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Document date: December 08, 1997
Released online: December 08, 1997

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For a long time now, "fiscal policy" has been defined as dead. The conventional wisdom is that politicians have tired of thinking about fine-tuning the economy through tax and expenditure policy, while economists often argue that the nation's macroeconomic position should be regulated almost entirely through monetary policy. Like all conventional wisdom, however, this bit of lore is often misleading and sometimes wrong. The recent economic success of the United States at least relative to many of our industrial partners, is due partly to the adoption of a more restrained fiscal policy through the 1990s. By eventually turning around the growth in the nation's debt relative to national income, this fiscal policy also gave monetary authorities greater leeway in their attempts to influence short-term interest rates and the money supply. Failure to understand the vital role of fiscal policy could easily lead to harmful future legislative activity.

To make sense out of fiscal policy, we must distinguish, first, between long-run and short-run fiscal policy and, second, between automatic and discretionary fiscal policy. Long-run fiscal policy generally determines how the government pays for what it buys and can often be followed by looking at the level of the nation's debt, ideally relative to its potential gross domestic product. Higher deficits inevitably lead to higher levels of debt or money supply in the economy, thus affecting the Federal Reserve in its principal activity—the making of money and the purchases or sales of government bonds. Higher debt also means that more interest has to be paid on that debt, thereby reducing the share of revenues available to meet other purposes.

Over the past 15 years or so, long-term fiscal policy was given a lot of attention, mainly by those who sought to lower the deficit. Fiscal policy was not only alive and well, it dominated the political process over this period. It became defined in terms of deficit reduction, as budget agreement after budget agreement attempted to cut back on the large deficits that loomed in the future.

Well, then, some might argue, at least short-run fiscal policy has been discarded. Activist fiscal policy—the attempt to regulate the economy through changes mainly in taxes and sometimes in expenditures—often has been associated with the early postwar Keynesian era, from about 1945 to the late-1970s, when tax cuts were used to stimulate the economy. The criticisms of this policy were many: in particular, Congress would gladly enact the tax cuts when necessary, but not the tax increases, and by the time that Congress took action, the need for stimulus or dampening was usually long past. Economists and politicians both came to believe that monetary authorities would have greater independence and be less politicized. In particular, they could adjust the money supply more quickly in the case of an emergency.

These last arguments all made sense, but they were incomplete. In point of fact, short-run fiscal policy is also very much alive, but most of it operates as automatic, rather than discretionary, policy. When economic output and income rise at a very fast rate, revenues to the government swell at the same rate or even faster. When economic output falls, so do government revenues. Meanwhile, payments in some programs such as unemployment compensation would expand to meet needs in a declining economy. Suppose the economy expands at a 3.5 percent rate for a year, as opposed to a more normal rate of 2.5 percent. That extra 1 percentage point in the growth rate by itself will make federal, state, and local revenues swell by about $25 billion annually over and above what they would have been. Suppose, on the other hand, that a significant downturn lowers the growth rate of the economy to minus 1.0 percent from plus 2.5 percent. Then revenues to government fall by almost $100 billion annually, while expenditures under programs like unemployment compensation, food stamps, even social security (people start retiring earlier) increase.

Given the size of these automatic adjustments, congressional and presidential actions during a slowdown are often of only minor consequence on the economy—whether they are timely or not. Given the sheer size of modern government, short-term macroeconomic policy is driven mainly by the automatic adjustments in tax and expenditure policy and the discretionary actions of the monetary authority.

While short-term discretionary fiscal policy may have only a modest role, however, there is still a case to be made that it should be sensible. Maybe other influences are dominant, but that doesn't mean that it can be ignored entirely. That's sort of like arguing that if a person's income is determined primarily by how hard she works, she needn't worry about how she spends her money.

Neither expenditure nor tax policy exists to serve macroeconomic policy; instead, they are the means through which the government affects individual lives—hopefully for the better. Most expenditures today are social expenditures, which means generally they are designed to meet needs in society. Needs are more likely to be greater during a downturn and lesser when there is an upswing in the economy. What this implies is that from a "micro" or individual level—forget about macroeconomic policy for a second—well-designed expenditure and tax policy should put more money in the hands of taxpayers when times are bad and less when times are good. In effect, there is a micro-basis for expenditure and tax policy that operates counter to the economic cycle. It may turn out that automatic adjustments work more quickly than discretionary ones, but often only discretionary actions are able to take account of new and unanticipated problems.

Good fiscal policy requires that the nation's debt be kept modest and certainly not rise in good times faster than the economy. It demands the retention and sometimes enhancement of automatic stabilizers. Finally, it recognizes that expenditure and tax policy do not exist in a vacuum, but should respond to changes in relative needs in the economy.

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