

Blinder-Sims: Role of Fiscal Policy

Blinder – begins with a nice review of the history of activist fiscal policy (i.e. stabilization policy).

1963: Discretionary Fiscal Stabilization Policy was all the rage. Appropriate role of monetary policy was to “accommodate” monetary policy.

Blinder: “Multiply by -1 and you have a capsule summary of the conventional wisdom today” (this was written over about two years ago).

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Forget about the 4 assumptions that Blinder makes – look at Figures 2.1(a,b).

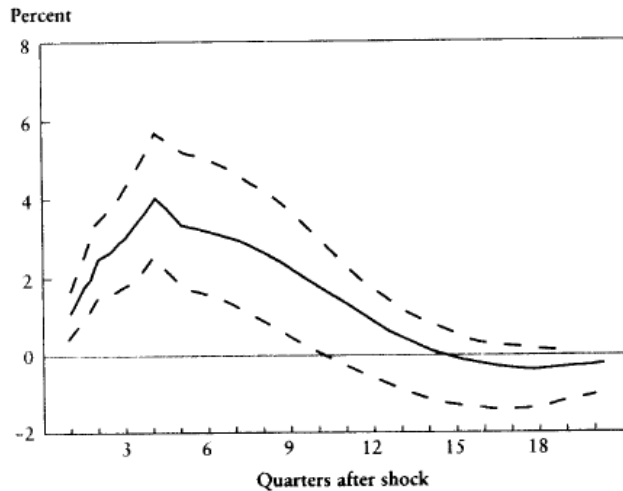


Figure 2.1(a)
Response of real GDP to a one-shot tax reduction. *Source:* Blanchard and Perotti (2002, Figure IV).

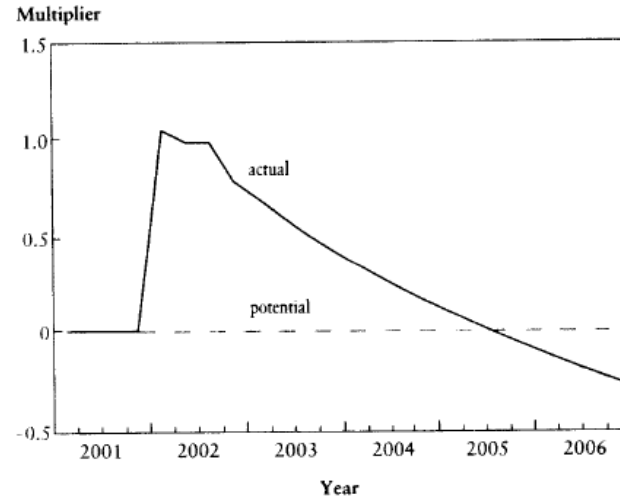


Figure 2.1(b)
Response of real GDP to a sustained rise in government purchases. *Source:* Elmendorf and Reifschneider (2002, Figure 11).

Note estimate of the “fiscal multiplier” is around 1. But appears that fiscal policy has important and persistent effects on GDP. So why do economists think that it is useless?

Thinking about Fiscal Policy: Four Episodes

1. The Triumph of Keynesianism: (1936-1966)

Kennedy-Johnson tax cuts of 1964-65 marked the first deliberate use of fiscal policy in U.S. history and were judged to be a success.

Walter Heller (economist) wrote in his memoir: Fiscal policy had “to be put on constant, rather than intermittent, alert” in order “to provide the essential stability at high levels of employment and growth that the market mechanism, left alone, cannot deliver.”

2. The Consensus Crumbles: (1967-1977)

Theoretical challenges: Milton Friedman and Edmund Phelps demolished the notion that the Phillips curve represented an exploitable tradeoff.

Empirical challenges: 1968 tax surcharge did not control inflation. Took 2.5 years to implement. And permanent income hypothesis implies that temporary changes in income tax should have small effects on consumption demand.

3. Huge Deficits Crowd Out Stabilization Policy (1981-2001)

Large tax cuts resulted in large (peacetime) deficits. So emphasis of fiscal policy was on reducing deficits rather than stabilization policy.

Theoretical developments: The 1986 NBER conference volume, *The American Business Cycle: Continuity and Change* did not include a chapter on fiscal policy. In its place was a long essay by Robert Barro on the “tax smoothing hypothesis.”

4. New Era Since 2001 (until 2007)

Hard to summarize: Bush tax cuts initially promoted as fair since tax revenues were historically high (remember Auerbach article). But then the recession soon changed this to: tax cuts are needed to stimulate the economy – back to activist fiscal policy.

4. New Era Since 2001 (until 2007) - continued

Theoretically: the “liquidity trap” reared its ugly head. As the Fed Funds rate gets to zero, traditional monetary policy loses its power. Now fiscal policy, for all its flaws, starts looking attractive.

Blinder presents a nice discussion about Ricardian equivalence and the associated assumptions necessary for it to hold. He also reviews some evidence that a significant number of households are liquidity constrained. (Sims states that evidence is not conclusive.)

But Note: Blinder states that the transversality condition does not put much restriction on present economic activity.

Sims criticizes Blinder for playing loose and fast. For instance, if, due to political concerns, taxes cannot be increased in response to growing government debt, that will generate inflationary pressure that the Fed cannot resist...NOW.

The Main Theoretical Argument against Fiscal Policy:

Ricardian Equivalence

Blinder does not find this persuasive.

The case against fiscal policy is primarily practical:
the problem of timely implementation:

Outside Lags: The effects on the economy are inherently longer than those from monetary policy.

Example: Increase spending on health care. But this sector already has low unemployment and it takes time for labor to flow from sectors with high unemployment (e.g. construction) to this sector.

Inside Lags: Lags associated with actual spending.

Example: Increased spending on infrastructure. Bridges take planning and it makes sense to spend money wisely. And of course political struggles also impede the spending process.

Blinder:

So my overall conclusion runs something like this. Under *normal* circumstances, monetary policy is a far better candidate than fiscal policy for the stabilization job. It should, therefore, take first chair. Nothing in this paper is intended to dispute this piece of conventional wisdom. That being said, however, there will be occasional *abnormal* circumstances in which monetary policy can use a little (or maybe a lot) of help in stimulating the economy – for example when recessions are extremely long and/or extremely deep, when nominal interest rates approach zero, or when significant weakness in aggregate demand arises abruptly.

Sims basically agrees with Blinder.

But asks the important questions: Is the Business Cycle
Bad?

“Missing from among the paper’s list of reasons why countercyclical fiscal policy is out of fashion is one of the most important: increasing acceptance of the idea that ‘all that cycles is not market failure.’...most macroeconomists now probably do accept the idea that enough of observed cyclical fluctuation is associated with necessary resource reallocations that it does not make sense to use costly policies simply to counteract every deviation of growth from trend.”

Fiscal Policy Recap

Know the following:

1. Intuition for Ricardian Equivalence.
2. Intuition for Tax Smoothing Hypothesis.
3. Definition of Ramsey Problem.
4. Derive Intertemporal Budget constraint – Govt. and household.