
Comments on Blinder's "The Case Against the Case Against Discretionary Fiscal Policy"

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Alan Blinder's outline of the history of ideas about countercyclical fiscal policy documents how events, academic fashion trends, and—possibly—the improved understanding of the economy have changed those ideas over time. I found his report useful, a reminder for most of us that, at any given time, the number of people who share the current consensus view on what is good macroeconomic policy is not a reliable indicator of the probability that that view is correct.

1. Evidence of Imperfect Optimization or Imperfect Markets

Blinder's paper goes on to survey evidence, some of it recent, that individual spending behavior departs significantly from the predictions of theories that assume complete markets and perfect dynamic optimization. That there are such departures is clear. Less clear are the reasons for the departures and the quantitative reliability of predictions based on them.

The Hsieh results [Hsieh (2003)] on the Alaskan Permanent Fund payments are particularly interesting. Here, in contrast to most of the other episodes that have been studied, the timing of the actual payments did not seem to matter much. The timing and size of these payments were more uniform across people and better publicized than in most of the other incidents studied. It is likely that when a payment or rebate is modest in size, many people don't expend the effort to determine in advance the size and timing of their own payment and adapt their spending patterns accordingly, even though they could do so fairly easily. But when

the size and timing are uniform, it is hard to escape that knowledge. Also, one can imagine personal loan companies developing a product—borrow now against your rebate, with repayment due the day after the rebate. Eligibility for the rebate would be far easier to check than the usual calculation of ability to pay. These considerations suggest to me that Hsieh's unusual results imply a need for caution in predicting the effects of formula-based, systematic, countercyclical fiscal policy. It could be that the more systematic and prompt such policy is, the smaller its effect on the timing of expenditures.

2. The Intertemporal Government Budget Constraint

In his paper, Blinder deals too casually with both private and public intertemporal budget constraints, perhaps relying on the arcane terminology of “transversality” to get the reader's assent to sweep these issues under the rug. Transversality is a fancy name for a simple idea: If you acquire wealth, you will, at some point, recognize that you are richer and will want to spend more. The same applies in reverse if you lose wealth or borrow money. The effects of wealth on spending are not necessarily immediate, but they can be quick; and they are not connected to maturity of the instruments in the spender's portfolio.

For exactly the same reason, public expectations of future deficits or surpluses can have effects *now*.

- If it seems clear that debt is going to be rolled over or even expanded indefinitely, the fact that it carries a 10-year term will not prevent it from generating a real shift in tax burden from current to later generations. This will have consequences for real savings and investment—*now*, not in the distant future.
- If it becomes a political axiom that taxes cannot be increased in response to growing government debt, that will generate inflationary pressure that the Fed cannot resist—*now*, not in the distant future.
- If, in the face of persistent deflation, monetary and fiscal policy are seen to be “committed” to maintaining in the future the growing real value of government liabilities, deflation becomes dangerous—*now*, not in the distant future.

3. 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." The extreme real business-cycle view that most fluctuation that we observe at business-cycle frequencies is efficient and that policy should not try to interfere with it remains a minority view. But, in contrast to both monetarists and Keynesians in the 1960s and 1970s, 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. For example, the end of the dotcom boom reduced the value of portfolios and required people to search for jobs outside that sector. Should we have tried to prevent completely, via changes in fiscal and monetary policy, the GDP and unemployment rate changes that were associated with these real reallocations?

4. "Discretionary" versus "Countercyclical"

Blinder's title refers to *discretionary* fiscal policy. But, in most of the text, this seems to be taken to be equivalent to *countercyclical* fiscal policy, and these are not the same thing. One can believe that fiscal policy needs to react to developments in the economy, and that the appropriate reactions are not best reduced to rigid rules. And one can do so without believing that the business-cycle phase or the growth rate of GDP is the only relevant economic index, or that the effects of fiscal policy on "aggregate demand" are the only relevant considerations in fiscal-policy changes at business-cycle frequencies.

5. The Case for Thoughtful and Vigilant Fiscal Policy

Despite my disagreement with some of the paper's implicit and explicit assumptions, I do agree that fiscal policy is important and should not simply be put on some kind of autopilot. However, my list of the

important types of contingencies to which fiscal policy should respond differs from Blinder's.

"Countercyclical" fiscal policy ought to be targeted at those aspects of fluctuations that seem likely to reflect incompleteness or distortions in markets. A good example is one that Blinder cites—recession-induced extensions of unemployment insurance (UI) benefits. UI offsets one kind of market failure, while inducing an incentive distortion of its own. When many have been thrown out of work by economy-wide developments, the balance of these factors shifts, so that extending benefits clearly makes sense. To the extent that this mitigates the decline in output, this is probably also efficient. Making such extensions automatic probably would make sense.

Investment tax credits (ITCs) are a different kind of example. We expect wide fluctuations in investment as opportunities arise and are exhausted, even without any market failure. Distorting these fluctuations with taxes surely would result in some inefficiencies. If we thought most fluctuations represented inefficiencies, or that we were constantly on the edge of a new great depression, the case for systematic cyclical ITCs might be strong, but otherwise the case is weak.

When a liquidity panic or a severe overinvestment cycle makes government paper attractive relative to private assets, the monetary and fiscal authorities need to keep this from developing into an accelerating contraction in real activity. The required policies are not complicated, but historically they have not always been understood. Because these conditions go with near-zero interest rates, the required actions always have at least a partially fiscal character, even if they are undertaken by the central bank. Deficit-financed public spending or transfer payments can be helpful, if the resulting increased debt is not seen as implying a corresponding future tax burden. The central bank can shore up the banking system or other institutions by freely discounting illiquid private assets like bank loans. Doing so has a fiscal dimension, however, as it generates a central bank balance sheet that could be subject to capital losses and negative net worth. A central bank with negative net worth that needs to combat inflationary pressures will need support, in the form of recapitalization, from the treasury.

If the government borrows now and makes it clear that taxes to finance the new debt will occur far in the future (or claims to believe they will never be necessary), “transversality” will make savings fall now. This immediate effect is the mechanism by which the tax burden is shifted to later generations. Calculations of how much shifting is going on, and how much would be fair, need constant updating, because they depend on long-run projections that will inevitably be updated regularly. Discussion of these issues and adjustment of policy in light of the discussion ought to be—but, of course, is not in fact—a central, “discretionary” component of fiscal policy.

6. Conclusion

Out of this list of caveats and quibbles, I end up agreeing in substance, though sometimes for different reasons, with most of Blinder’s direct policy recommendations.

- Countercyclical fiscal policy is not “normally” very useful.
- In sustained deflationary contractions, the fiscal policy vehicle must come out of the garage.
- Institutional innovation to replace or reform the European Stability and Growth Pact would be a good idea.

My main disagreement with the paper on direct policy issues concerns what I see as an omission. I would have put more emphasis on the need to guard continually against intergenerationally unfair crowding out.

References

- Hsieh, Chang-Tai. 2003. Do consumers react to anticipated income changes? Evidence from the Alaska Permanent Fund. *American Economic Review* 93(1) March: 397–405.