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The Problem with Fiscal Policy

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There are signs that the US recession has run it course and that the aggressive interest rate reductions of the last year have done their job. Nevertheless, the continuing spate of job losses has brought with it pleas that the US Congress should enact some combination of tax reductions and spending increases to cushion the blow. The problem is that fiscal policy is made by politicians, and that is why it is usually better to leave it alone.

The natural response to calamities is to turn to government policymakers for help. When it comes to recessions, the central bank is on the front line. One aspect of monetary policymakers' task is to ensure the stability of economic activity. Unlike almost all other government actions, interest rates can be changed literally overnight and speedy actions are more effective. The trouble is that monetary policy is a very blunt tool for fighting recessions because everyone's interest rate is changed while only a modest number of business and consumer decisions are affected.

Over the past 50 years we have come to think of fiscal policy as an equally important source of stimulus during a general slowdown. People turn to their elected officials for help, demanding that they set things right with new programs that bring some combination of lower taxes and higher government spending.

It is important to distinguish the increases in payments to the unemployed and lower income tax bills that automatically stabilize the economy from discretionary fiscal policies put in place once the economy has slowed. The first are an important fixture in every modern economy; the second can work as well, too.

But just because something can work, it does not follow automatically that it will or that it is the right thing to do. There are two fundamental defects with discretionary fiscal policy. First, it is slow. Second, it is almost impossible to do sensibly. Look at a few facts.

Most recessions are short, lasting a year or less. The longest recession in the US after the Second World War lasted 16 months. Furthermore, because data are only available with several months lag, a recession is often half way through before there is consensus that a recession has started.

Timing presents a considerable challenge. I know of no government that has an agreed upon economic stimulus legislation waiting to be implemented. In fact, given both the shifting

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environment and the changing cast of characters, such a thing is both economically undesirable and politically inconceivable. Instead, someone has to write new legislation every time a recession comes along. This takes several months even under the best of circumstances. In the US, serious Congressional efforts to pass stimulus legislation began only after September 11, and are still not complete even though there are signs that the economy has already hit bottom.

As if that were not enough, policies take time to have any impact. Even after legislative action is complete, changes in taxes do not increase individual consumption or corporate investment immediately. By the time the spending starts, the chances are the coming boom will be in full swing.

The main problem is with the substance of economic stimulus packages. Economists do not write economic stimulus packages, politicians do! And fiscal stimulus is one place where economics and politics collide. Economists prefer policies that focus attention on getting a few important people to do something they were not planning to do while avoiding paying for others to do what they would have done anyway. Temporary incentives to spur investment and income tax reductions for the less well-off who will spend what they get are good examples. Politicians, by contrast, look for programs that reward the largest number of people possible in order to win support and ensure re-election.

The Bush administration's decision to try to sell a capital gains tax reduction as part of their anti-recession program is a particularly egregious example of an expensive proposal that will have virtually no impact on the problem at hand. I guess reducing the tax burden on some wealthy people when they chose to sell appreciated stock might lead them to buy a few more Mercedes and BMWs, but I'm not exactly sure what it has to do improving the prospects for short-run economic growth. The proposal to cut the taxes big companies paid on past profits is another.

I do not hold opportunism against elected public officials, but we all need to recognize that it exists. We elect politicians to do things that are popular. Economic slowdowns, when some people are suffering and the rest are worried, play to their worst instincts.

All of this means that discretionary fiscal policy is a poor stabilization tool. While economically sensible stimulus legislation can be designed, economists have to realize that it will not be enacted. Instead, our suggestions will be used to justify cures that are often worse than the disease.

The proper role for fiscal policy is to focus on building solid foundations for long-term growth. This means creating structural tax and spending policies that encourage investment, innovation and hard work. Stabilization policy should be left to the central bankers, who have both the ability to act quickly and the independence not to pander to the masses. When a recession comes, fiscal policy should do nothing