
Introduction: The Macroeconomics of Fiscal Policy

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It is hard to imagine a more opportune time for a volume on the macroeconomics of fiscal policy, since the last few years have seen government spending, taxation, and deficit financing move to the forefront of policy debates worldwide. In Japan in the 1990s, deflation and short-term interest rates that hovered near zero forced policymakers to turn to fiscal policy to stimulate the country's sluggish economy. For somewhat similar reasons, fiscal policy also played an important role in fostering the U.S. economy's recovery after the 2001 recession. Members of the European Monetary Union are also reconsidering the merits of maintaining the fiscal restraint required by their "Pact for Stability and Growth" as they seek ways to foster expansion after years of weak growth. At the same time, the discussion of fiscal policies has renewed attention to the effects of large sustained fiscal deficits on national savings, investment, interest rates, and the current account.

The effect of government expenditures, taxation, and debt on the aggregate economy is of immense importance, and therefore great controversy, in economics. A broad range of essential services is provided by governments, requiring the collection of taxes and fees. This book, however, covers only a subset of these issues, those associated with the macroeconomic aspects of fiscal policy. The authors of the chapters and commentaries included in this volume address questions such as: Should fiscal policy be used to help stabilize the economy and smooth business-cycle fluctuations? Do large government deficits harm economic activity? Has recent U.S. fiscal policy contributed to overconsumption by American consumers? And, how is U.S. fiscal policy related to the current account and international capital flows?

In this chapter, we provide a brief introduction to the important topics addressed by the subsequent chapters. We start with a general discussion of fiscal policy's potential effects on economic activity, in order to outline the main concerns and controversies related to the macroeconomics of fiscal policy. Following this discussion, we provide a brief description of how the chapters in this volume address the important issues pertaining to fiscal policy today.

1. How Does Fiscal Policy Affect the Macro Economy?

Fiscal policy affects aggregate demand, the distribution of wealth, and the economy's capacity to produce goods and services. In the short run, changes in spending or taxing can alter both the magnitude and the pattern of demand for goods and services. With time, this aggregate demand affects the allocation of resources and the productive capacity of an economy through its influence on the returns to factors of production, the development of human capital, the allocation of capital spending, and investment in technological innovations. Tax rates, through their effects on the net returns to labor, saving, and investment, also influence both the magnitude and the allocation of productive capacity.

Macroeconomics has long featured two general views of the economy and the ability of fiscal policy to stabilize or even affect economic activity. The equilibrium view sees the economy quickly returning to full capacity whenever disturbances displace it from full employment. Accordingly, changes in fiscal policy, or even in monetary policy for that matter, have little potential for stabilizing the economy. Instead, inevitable delays in recognizing economic disturbances, in enacting a fiscal response, and in the economy's reacting to the change in policy can aggravate, rather than diminish, business-cycle fluctuations. An alternative view sees critical market failures causing the economy to adjust with more difficulty to these disturbances. If, for example, consumers were to reduce their current spending in order to consume more in the future, producers, who would not know the consumers' future plans for want of the appropriate futures markets for goods and services, would see only an indefinite drop in demand, and this might encourage them, in turn, to reduce their hiring and capital spending. In this world, changes in fiscal and monetary policy

have greater potential for stabilizing aggregate demand and economic activity. How the economy reacts to fiscal policy depends on whether it is at full employment or operating below its full capacity.

Effects of a Tax Cut on Consumer Spending

To illustrate the importance of the difference in these two views for fiscal-policy stabilization, consider the effects of a cut in personal taxes—a classic countercyclical fiscal-policy action. Lower taxes, everything else being constant, increase households' disposable income, allowing consumers to increase their spending. The consequences of the cut—how much is spent or saved, and the response of economic activity—depend on the way households make their decisions and on prevailing macroeconomic conditions.

For example, whether the tax cut is perceived to be temporary or permanent will influence how much consumers save. A temporary cut when the economy is at full employment will alter households' lifetime disposable income relatively little, and so might have little effect on consumption. If the cut is, instead, perceived to be permanent, then households will perceive a larger increase in their lifetime disposable income and so will likely increase their desired consumption by much more than they would if they thought the cut were temporary.

So far, we have been considering the effect of a tax cut on households' consumption expenditures with everything else held constant. However, lower taxes will increase the government's fiscal deficit. Suppose that the economy tends to remain near full employment and that households do not expect their disposable income to rise any higher than it would have risen without the change in fiscal policy. Even if the tax cut is long-lasting, many will conclude that future taxes will need to be higher than they otherwise would have been in order to retire the extra public debt resulting from the tax cut. In the extreme case, households will not feel that their disposable income has risen, because they have completely internalized the increase in the public debt arising from the tax cut, treating it as though it were equivalent to personal debt.

Yet even in the full-employment view, consumption might increase as a result of the tax cut if capital markets are imperfect. Consumers who are liquidity constrained, living from paycheck to paycheck, will likely

increase their spending even if they internalize the public debt. So the effect of the tax cut will depend on its incidence over different types of taxpayers. Consumption will also increase if the government can borrow at a lower rate of interest than the consumer.

However, consumption can increase more significantly when the economy is not at full employment and if the tax cut is seen as an instance of a continuing fiscal policy that stabilizes economic activity, or if the tax cut otherwise raises households' expected income by increasing the economy's future productive capacity. Although the tax cut entails an increase in public debt, higher current and future income diminishes the burden of servicing or repaying this debt. In this case, the tax cut is essentially an investment in a public good that redounds to the benefit of households.

Effects on Interest Rates, Capital Formation, and International Capital Flows

Over time, an increase in the budget deficit resulting from a tax cut will increase the public debt. That increase raises important issues concerning the long-run effects of the tax cut on interest rates, capital investment, and future economic welfare. The rich range of possible consequences makes this a very controversial and interesting topic.

Fiscal policies that increase the deficit will result in future taxes being higher than they otherwise would have been, but, depending on the policies' effects on incentives for investing in human or physical capital, they might also raise future living standards. Policies that absorb slack resources or foster investment might reduce government saving, as reflected in the greater budget deficit, while they increase total saving, as reflected in the greater rate of capital formation. This additional saving might be supplied by the increase in national income, or it might come from foreign sources. Policies that fail to raise income and investment not only reduce government saving, but also reduce total saving.

When the economy is at full employment and a tax cut today is expected to be offset by a tax increase in the future, as discussed above, lower taxes do not necessarily increase consumption spending. In this extreme case, the increase in the government's deficit will be matched by an increase in private saving. As a result, national saving, interest rates, and investment

spending will be much the same as if there had been no change in fiscal policy. If, instead, consumers spend much of their additional disposable income while the economy is already at full employment, personal saving will not rise sufficiently to offset the drop in public saving, interest rates will rise, and investment spending will decline, unless business saving (resulting from the additional consumption spending) or capital inflows from abroad increase sufficiently to make up the difference. If the economy is not at full employment, national income might expand as a result of the cut, providing additional income-tax receipts and saving, and thereby preventing a drop in national saving. In either case, a tax cut that increases the return on capital can increase business saving and attract, for a time, an inflow of foreign saving sufficient to maintain total saving and investment. If, however, fiscal policy depresses investment, then both the capital stock and economic output will be lower in the future than they otherwise would have been. The lower capital stock will tend to be accompanied by real interest rates that are higher than they otherwise would have been.

If capital inflows from abroad increase sufficiently to offset any drop in national saving resulting from a change in fiscal policy, then investment need not fall. In this case, the current account deficit, which is equal to the quantity of capital inflows from abroad, will increase at least enough to offset the increase in the budget deficit less the induced increase in private saving. The future levels of the capital stock and real output will not fall, but future domestic consumption will be reduced because an increased share of the return to capital will accrue to foreign nationals—unless the fiscal policy fosters a greater utilization of the stock of capital, greater capital formation, or greater net returns on capital to compensate for the outflow. The concurrent large budget and current account deficits that occurred in the early 1980s and again in the last few years have led many to believe that increases in the current account deficit would generally accompany large increases in the budget deficit, and gave rise to the term “twin deficits.”

Tension Between Short-Term Stabilization and Long-Term Goals

In the discussion so far, it is apparent that there is a potential conflict between the use of fiscal policy to stimulate aggregate demand when the

economy is operating below potential in the short run and the use of policy to promote longer-run goals for national saving and capital formation to improve future living standards. When there are underutilized economic resources, fiscal stimulus can increase investment. But when the economy is operating near potential, an increase in the public debt might eventually depress private investment, unless the fiscal stimulus is reversed as the economy approaches full employment or the policy fosters capital formation and increases the supply of labor.

This tension between short-run stabilization and longer-run growth is prominent in the rest of this volume. The volume begins with a reconsideration of the role of fiscal policy in macroeconomic stabilization before turning to an analysis of longer-term concerns.

2. Overview of the Volume

This volume does not examine what the theory should say about the data, but rather explores what the data say about the theory. As is clear, different economic theories can justify almost any policy. The chapters in this book revisit the empirical evidence concerning the effect of fiscal policy on the economy. Is there evidence that fiscal policy can help to stabilize the economy? Has it done so in the past? And, finally, has it accomplished the long-run goals it should? Before the latter two questions can be answered, the first should be addressed.

Can Fiscal Policy Improve Macro Stabilization?

Countercyclical Fiscal Policy in Theory

Through the 1980s and 1990s, the predominant answer in the profession was a resounding “no.” Alan Blinder takes issue with that conclusion in “The Case Against the Case Against Discretionary Fiscal Policy.” Blinder reminds the reader that views on the use of discretionary fiscal policy as a tool for macroeconomic stabilization have undergone a sea change since the early 1960s, when the prevailing wisdom was that discretionary stabilization policy was effective and desirable for taming the business cycle, and that fiscal policy was the most important tool with which to conduct stabilization policy. Then, beginning in the late 1960s, theoretical and empirical work raised serious doubts about fiscal policy’s abil-

ity to accomplish countercyclical stabilization, while large deficits in the 1980s made it unlikely any would be attempted.

Blinder begins by reviewing the intellectual and policy developments that led to the diminished role of fiscal policy, and then turns his attention to a critical analysis of the arguments against the use of discretionary fiscal policy as a stabilization tool. After discussing the theoretical assumptions underlying Ricardian equivalence¹, Blinder evaluates the empirical research on this topic. He concludes that the weight of the evidence supports the view that both temporary and permanent tax changes do affect consumption spending.

Overall, Blinder finds the practical arguments against the use of discretionary fiscal policy to be more compelling than the theoretical arguments. Long lags in the formulation and implementation of appropriate stabilization policies are likely to be especially severe when the policy instrument is government purchases, leading Blinder to conclude that changes in taxes and transfers are more effective fiscal instruments for stabilization. Blinder suggests that institutional changes, such as placing short-run tax policy in the hands of a board of technical experts modeled after the Federal Reserve Board, might alleviate some of the practical aspects of using tax policy for stabilization.

Another suggestion Blinder makes is to improve the targeting of changes in taxes and transfers. If tax and transfer changes were better targeted at those households that are most likely to change their consumption spending in response to temporary changes in their disposable income, then fiscal policy would be more effective at influencing aggregate demand. Blinder cites the expansion of unemployment insurance benefits as an example of a fiscal policy that is well targeted for increasing consumption.

Blinder also suggests that future fiscal stabilization make greater use of opportunities to exploit intertemporal substitution. Examples of policies that exploit intertemporal substitution to temporarily stimulate aggregate demand are a temporary cut in sales-tax rates, which creates an incentive for consumers to purchase durable goods earlier than they otherwise would in order to avoid paying the tax, and a temporary investment tax credit, which provides an incentive for firms to accelerate the timing of new investment projects.

In the final analysis, Blinder concludes that monetary policy should be relied upon as the primary policy tool for macroeconomic stabilization, but that discretionary fiscal policy can play an important stabilization role under unusual circumstances. When a recession is unusually long or deep, or when short-term nominal interest rates approach zero, then it is appropriate to supplement monetary policy with fiscal stimulus.

In his comments, Olivier Blanchard agrees with Blinder that fiscal policy can be effective in stimulating aggregate demand and output in the short run. However, he offers the caveat that recent empirical evidence examining the effect of fiscal stimulus on output is mixed, and he believes that caution is warranted. Blanchard agrees with Blinder on the virtue of exploiting intertemporal substitution in formulating a fiscal stimulus, and, like Blinder, believes that temporary investment tax credits and temporary decreases in consumption tax rates deserve further attention and development.

Christopher Sims points to what he sees as an important omission in Blinder's evaluation of fiscal stabilization: that fiscal stimulus may exacerbate "intergenerationally unfair crowding out." Fiscal stimulus increases the budget deficit and public debt, and Sims notes that if the public believes that any tax increases needed to finance the debt will occur only in the distant future, then savings will fall *now* and the tax burden will be pushed onto future generations. Of course, if one wishes to increase aggregate demand, then a short-run increase in consumption is desirable. However, Sims believes it is important to pay attention to the consequences for intergenerational equity of using fiscal policy for stabilization purposes.

Sims adds a number of other caveats to Blinder's analysis. Sims thinks that one reason that countercyclical fiscal policy went out of fashion is the growing popularity of the view that at least a portion of the fluctuation in economic activity associated with the business cycle is part of a necessary reallocation of resources. However, the fluctuation also partly reflects market failure, and Sims believes that fiscal policy may be useful in offsetting the inefficient aspects of the fluctuation. As an example, he cites a policy also supported by Blinder: recession-related extensions of unemployment insurance benefits.

Blanchard, Blinder, and Sims agree that judicious use of countercyclical fiscal policy can be effective in some circumstances, particularly when monetary policy is less flexible, as when interest rates are already very low. The obvious next question is whether fiscal policy has been used in such a prudent manner.

American Fiscal Policy in Reality

Alan Auerbach attempts to answer this question by analyzing the evolution of American fiscal policy over the post-World War II era. Over this period, Auerbach notes that federal spending net of interest has been a relatively constant fraction of GDP since 1962, whereas there have been substantial shifts in the composition of spending, with entitlement spending growing and defense spending shrinking relative to GDP. Similarly, the composition of tax revenue has changed, with payroll taxes growing in relative importance. In discussing the behavior of the budget deficit, Auerbach highlights the sharp increase in the deficit that has occurred since 2000, but he emphasizes that it is still smaller in relation to GDP than the deficit of the mid-1980s.

Auerbach next illustrates how fiscal policy has helped to stabilize the economy over this period. He presents econometric results that indicate that both tax and expenditure policies respond countercyclically, with tax revenue decreasing and expenditures increasing in response to an increase in the gap between actual and potential GDP. Auerbach's measures of policy change are constructed to be independent of the automatic stabilizing effects of the fiscal system, and are designed to capture only the revenue and expenditure changes associated with explicit policy actions. The empirical analysis also shows that fiscal policy responds to budget conditions, with an increase in the budget surplus leading to a reduction in revenue and an increase in expenditures.

Auerbach links deviations from the estimated econometric relationships with specific historical events. For example, the 1993 Clinton tax increase is associated with a larger increase in revenue than the econometric results would predict, and the 2001 and 2003 tax cuts are associated with larger-than-predicted drops in revenue.

Auerbach attempts to put the recent fiscal deficit into historical context and then attempts to project the previous stabilization propensities

into the future. Once the implications of the increasing importance of spending on Social Security, Medicare, and Medicaid are included, the picture becomes fairly grim, with a large gap between spending and tax revenue looming in coming decades. While the long-run fiscal problem is familiar to many, more surprising is Auerbach's finding that the change in the nature of the public sector will result in decreased responsiveness of future spending to changes in economic and budget conditions than has been the case in the past. Auerbach's econometric results indicate that discretionary spending responds more strongly to economic and budget conditions than does spending on social insurance. So, overall spending will become less responsive as social insurance benefit payments come to constitute a larger proportion of total spending.

Auerbach notes that the official budget deficit does not capture changes in future liabilities associated with social insurance programs and that this could make a difference in policy decisions. The econometric results show that fiscal-policy decisions are responsive to the budget deficit, and, therefore, the way the deficit is defined may well influence which policy proposals are adopted. The 2000 budget would have shown a substantial deficit, rather than a surplus, if the incremental liabilities associated with the social insurance programs had been incorporated into the official deficit measure, and Auerbach speculates that Congress would have been less likely to pass the 2001 tax cut if the official deficit had been defined in this way.

In reviewing the history of the major fiscal-policy changes of the past four decades, James Duesenberry finds that actual fiscal policy generally has not been good stabilization policy. Duesenberry advocates adoption of fiscal policies that avoid the potential conflict between long-term objectives and short-term stabilization that has proven to be problematic in the past. To address this problem, he would like to see greater use of semiautomatic fiscal stabilizers, such as an extension of unemployment benefits when a prespecified trigger point is reached, along with a goal of balancing the budget at full employment.

Douglas Elmendorf agrees with Auerbach's overall conclusions, but he believes that fiscal policy in recent decades is best described as consisting of two major episodes of dramatic deficit increases, the tax cuts early in the Reagan administration and the tax cuts in the George W. Bush

administration, along with a period between these episodes of incremental adjustments toward restoring balance to the budget. Elmendorf agrees with Auerbach regarding the importance of the way in which we frame choices about fiscal policy. He advocates balancing the budget excluding Social Security and Medicare on average over the business cycle, and reforming the social insurance programs to achieve long-term solvency.

Fiscal Policy and Long-Run Financing

The Early Reagan Era: A Sea Change

So far, the discussion of fiscal policy has concentrated on stabilization policy. However, fiscal policy since the 1980s has been dominated by concerns about long-run financing. As Elmendorf points out, the deficits that resulted from the tax cuts early in the Reagan administration were a major factor driving fiscal policy for many years afterwards. C. Eugene Steuerle, W. Elliot Brownlee, Rudolph Penner, and Van Doorn Ooms provide four perspectives on fiscal policy in the early part of the Reagan era.

Steuerle's essay sets the stage with a review of post-war fiscal policy, with an emphasis on the three major tax cuts of the period: those of the Kennedy-Johnson, Reagan, and G.W. Bush administrations. Of these three sets of tax cuts, the Kennedy-Johnson cuts are the smallest, and the G.W. Bush cuts are the largest. After evaluating and applying a variety of measures, Steuerle concludes that the G.W. Bush tax cuts are the largest fiscal stimulus in the nation's history, excluding those accompanying world wars.

Turning to the question of the sustainability of the three tax cuts, Steuerle notes that sustainability was not really an issue when the Kennedy tax cuts were passed. The tax system was not yet indexed to inflation, so revenue grew as long as there was nominal income growth. And, with Social Security not yet mature, and Medicare and Medicaid not yet enacted, expenditures were largely discretionary and relatively easy to adjust. By the 1980s, the situation had changed. Tax brackets were inflation indexed starting in 1985, and a larger proportion of federal expenditure was devoted to entitlements. As a result, the deficits resulting from the 1982 Tax Act were quite persistent, and several rounds of legislated policy changes were required to restore fiscal balance. The

fiscal environment had changed still more by 2001 because of the growing share of federal expenditures devoted to entitlements and other mandatory spending. This factor, along with a likely slowdown of tax-revenue growth as the baby boomers retire, makes the recent tax cuts unsustainable.

Brownlee, Ooms, and Penner each examine the fiscal policymaking process in the early Reagan years that produced these unsustainable tax cuts. Although the three authors approach this subject from different perspectives, several common themes are evident. One is that the tax cuts embedded in the 1981 Economic Recovery Tax Act (ERTA) turned out to be larger in real terms than originally intended. All three authors note that fiscal policymakers did not anticipate that monetary policy would be as effective in quickly lowering the rate of price inflation as it turned out to be. Because indexing of tax brackets and exemption amounts was not implemented until 1985, the “bracket creep” that accompanied inflation tended to increase tax revenue as a share of GDP. The ERTA tax cuts were formulated, in part, to compensate for the “bracket creep” that was expected to accompany inflation in the 1981-to-1985 period. Because “bracket creep” was much smaller in magnitude than had been anticipated, some of the reduction in real tax revenue resulting from ERTA was essentially accidental.

Brownlee, Ooms, and Penner also highlight that the larger-than-expected deficits following ERTA produced a bipartisan effort to craft new policy measures to reduce future deficits. At the same time, fiscal policy was largely abandoned in favor of monetary policy as the primary tool of countercyclical stabilization. The initial round of new tax increases was passed while the economy was still in the midst of a deep recession, but the perceived problems associated with the budget deficits outweighed any concerns about the effects of the tax increases on aggregate demand.

Government Financing in the Long Run

The deficits that emerged in the 1980s were unprecedented in a peacetime economy. These deficits raised serious concerns about the long-run financing of government spending. Benjamin Friedman focuses on the long-run implications of fiscal-policy choices. Friedman notes that the

economic implications of a budget deficit depend critically on whether it is transitory or persistent. Although fiscal stimulus might be beneficial in the short run when resources are underutilized, the long-term effects of persistent deficits are undesirable. Friedman presents econometric evidence, based on data from 1959 to 2003, indicating that increases in the deficit exhibit considerable persistence, but fade over time. Deficits (measured relative to GDP) tend to start decreasing a year after their initial increase, with the reversion half complete after three years (although the half-life is a little longer than four years when the data are restricted to the post-1980 period). Controlling for prior movements in economic output and inflation, which might be associated with either automatic stabilizers or discretionary fiscal stabilization, shortens the half-life of the persistence in the deficit to a little under two years. The persistence of increased deficits cumulates into an increase in the ratio of public debt to GDP. Friedman's estimates indicate that an increase in the debt-to-GDP ratio also decays over time, but with a half-life of over 20 years.

Because fiscal policy exhibits considerable persistence, it has the potential for inducing substantial long-run economic effects. And this brings us, once again, to the Ricardian equivalence controversy. Although Friedman acknowledges the difficulty of resolving this controversy econometrically, he points to a sign of consensus in two recent studies that find that a one-percentage-point increase in the expected debt-to-GDP ratio increases expected future real interest rates by about 3 to 5.8 basis points. This is sizable, and Friedman points out that if interest rates increase by 4 basis points per percentage-point increase in the debt-to-GDP ratio, then the increase in government debt between 1981 and 1993 would have increased real interest rates by nearly a full percentage point. He notes that an increase in real interest rates of that magnitude implies a substantial decrease in the economy's equilibrium capital-output ratio.

Friedman questions why public discussion of fiscal policy focuses on the economic effects of deficits, while economic theory implies that it is the debt-to-GDP ratio that matters. Given the identity that investment must equal the sum of private saving plus government saving plus financial inflows from abroad, a change in the deficit (government saving) may require substantial changes in investment or capital inflows from abroad unless private saving offsets the change in government saving.

Friedman presents econometric evidence that, after controlling for the effects of GDP growth and inflation, an increase in the budget deficit leads to a decrease in the rate of private investment that lasts for five quarters. Although he acknowledges that it is hard to distinguish econometrically between the effects of deficits and the effects of expected increases in the debt-to-GDP ratio resulting from persistent deficits, Friedman also notes that because portfolio adjustment is costly, it is theoretically plausible that budget deficits will have crowding out effects on investment that are independent of the deficit-induced increase in the debt-to-GDP ratio.

Barry Bosworth provides a different interpretation of deficit persistence. In his view, the deficits of the 1980s and early 1990s were reversed mainly by good luck rather than by intentional policy. Absent the run of good luck in the 1990s, especially the high rates of productivity growth and the low unemployment rate, the 1980s' deficits might have proven to be even more persistent.

Bosworth sides with those who emphasize deficits over the debt-to-GDP ratio as the more important area of concern. He believes that the impact of the public debt needs to be evaluated in the context of how it arose. Public debt that is accumulated during a period of economic slack has a lower economic cost than debt accumulated when resources are fully employed. But when deficits run during recessions are combined with those run during a boom into a single measure of the stock of public debt, that context is lost.

Deficits can be viewed as a transfer of income between generations. Susanto Basu offers a known framework for making decisions about such transfers. Basu notes that underlying the concerns of Friedman and many others regarding the long-term economic consequences of persistent budget deficits is an implicit moral judgment that it is unethical to promote current living standards at the expense of the economic welfare of future generations. Basu believes we should base our normative analysis of fiscal policy on rigorous thinking, rather than just on implicit judgments regarding which policies are desirable. Application of Rawls's theory of distributive justice might lead one to accept deficits that reduce the welfare of future generations if the future generations were certain to be better off than we are at present. But the same principles that lead one to favor redistribution toward relatively poor generations would

also lead one to favor redistribution toward those who are disadvantaged within any given generation. So, distributive justice does not seem to provide justification for policies that reduce taxes on those currently wealthy, with the consequence of creating persistent deficits that reduce the economic welfare of future generations.

Why Has the United States Suffered Persistent Deficits Since 1980?

Another way to put Basu's question may be to ask whether the United States is, in some sense, overconsuming? Deficits are equivalent to government dis-saving, and so an increase in the deficit will result in decreased national saving, unless private saving increases enough to offset the drop in government saving. The combination of a personal saving rate that fell precipitously during the 1990s and the reemergence of large U.S. federal budget deficits in the early 2000s brings up the question of whether the United States is prone to saving too little and consuming too much.

Jean-Philippe Cotis, Jonathan Coppel, and Luiz de Mello tackle this question in their chapter. As Basu made clear in his comments on Friedman's chapter, the answer to this question depends on the normative criteria that one adopts. Cotis, Coppel, and de Mello take as their normative benchmark the notion from economic growth theory that, in the steady state, aggregate consumption should grow at the "natural rate," the sum of the rate of technical progress and the growth rate of the labor force. An example of an economy that is prone to overconsumption in this context would be one where private saving does not increase by an amount sufficient to return consumption growth to the natural rate following a shift into persistently larger fiscal deficits.

Cotis, Coppel, and de Mello present econometric evidence that the high rate of consumption growth in the United States in recent years can be explained as the result of increases in wealth and income, as well as decreases in interest rates. So, in this sense, households do not seem to have been overconsuming relative to normal behavior.

Capital inflows from abroad allowed the high rate of consumption growth and the declining rate of personal saving in the United States during the late 1990s to be accompanied by a high rate of investment. The rate of investment fell sharply in the early 2000s at the same time that the federal budget position went from a substantial surplus to a large and

seemingly persistent deficit. Capital inflows have continued, but Cotis, Coppel, and de Mello caution that it will be difficult to return investment to its steady-state rate without an increase in the national saving rate. Econometric results they present suggest that private saving in the United States generally does not increase to offset the effects of increased budget deficits. Combined with the prospect of even larger budget deficits in the relatively near future as spending on social insurance benefits increases, this suggests the need for changes in public policy aimed at increasing national saving.

Willem Buiter points to the difficulty of answering the question of whether the United States consumes too much and saves too little. Insufficient understanding of the need to provide for their retirement consumption, and overestimation of how much of their retirement needs will be provided by government programs, may lead U.S. households to save at suboptimally low rates. On the other hand, the high rate of productivity growth in the United States simultaneously makes saving for the future less compelling and increases the attractiveness of the United States as a destination for foreign investment, arguably the driver of the large U.S. current account deficit. Buiter believes that the United States is in a relatively advantageous position regarding its external liabilities, which are mostly either real liabilities, such as equity and real estate, for which there is essentially no default risk, or dollar-denominated debt, the value of which can be reduced by inflation.

The Twin Deficits

Buiter raises the question of the ultimate cause of the capital inflow: Was it high returns to investment in the United States relative to the rest of the world, or low saving in the United States? In an attempt to answer this question, the volume concludes with a section considering the relationship between the current account deficit and the government budget deficit. Edwin Truman's essay provides an overview of the relationship between the two deficits, along with a discussion of their economic implications. Truman observes that, although the current account and fiscal deficits are linked through the saving-investment identity, they are not analytical or behavioral twins. The concurrence of large fiscal and current account deficits in the early 1980s gave rise to the "twin deficits" label, but Truman notes that the deficits do not generally move in the same direction.

Truman cites a consensus that neither deficit is sustainable at its current size relative to national output. Noting that the fiscal deficit is more directly controlled by policy than is the external deficit, and that it is also likely to have more serious adverse consequences for national economic welfare, Truman advocates efforts to reduce the fiscal deficit.

Jeffrey Frankel compares the two twin-deficit periods, the early 1980s and the early 2000s, with a focus on how increases in the budget deficit are split between reductions in investment and increases in the current account deficit. Confirming the results of earlier research by Martin Feldstein and Charles Horioka [Feldstein and Horioka (1980)] that there is a strong correlation between national saving and investment, Frankel presents regression estimates that suggest that roughly half of the changes in national saving are financed by changes in the current account, with the rest financed by changes in investment.

Catherine Mann highlights the point that the composition of fiscal deficits matters. A large portion of the fiscal deficits of recent years is due to tax cuts that have boosted consumer spending, which, in turn, has contributed to widening the trade and current account deficits. Mann also stresses that there is a negative feedback loop relating the two deficits. Continued foreign purchases of the Treasury securities issued to finance the fiscal deficit will increase the interest income flowing to the foreign holders, thereby increasing the current account deficit.

Alice Rivlin agrees that the twin deficits of the 1980s were related. She also believes that the only politically feasible way to reduce today's current account deficit is to solve the fiscal imbalance. Rivlin reviews options that she and Isabel Sawhill recently developed for closing the fiscal deficit. Rivlin emphasizes that it is possible to balance the federal budget over a 10-year period, but that the only politically feasible way to do so entails both expenditure limitations and tax increases. Political agreement about exactly how to reduce expenditures and increase taxes will be difficult and may require budget rules similar to those used in the late 1980s and early 1990s.

3. Concluding Comments

Although there is clearly a diversity of opinion regarding what constitutes appropriate fiscal policy evident among the contributors to this

volume, several common themes emerge. There is widespread agreement that, although monetary policy is the primary instrument for macroeconomic stabilization, fiscal policy can potentially play a stabilizing role, particularly in relatively severe downturns and in periods when inflation is very low. Concern about lags and political motives in fiscal-policy decision-making is evident, and there is considerable interest in the further development of semiautomatic or rule-based fiscal stabilizers that might help to circumvent some of the practical problems associated with using fiscal policy for stabilization purposes.²

There is a clear tension between using fiscal policy for short-term stabilization and pursuing fiscal policy conducive to long-term growth. Deficits tend to be persistent over time, indicating that a fiscal expansion initially adopted with a stated stabilization goal may eventually crowd out private investment. Again, semiautomatic, rule-based fiscal stabilization policies would help to address this problem.

Several of the contributors expressed concern about current U.S. fiscal policy. The looming increases in social insurance benefit payouts will amplify the magnitude of the deficits in the relatively near future, and the increasingly dominant position of entitlements in the composition of federal expenditures has reduced policymakers' latitude to make short-run budget adjustments. The large current account deficits and rapidly deteriorating net international investment position of the United States may also limit the ability of the United States to accommodate future deficit increases without a higher degree of crowding out of private investment. Although there is significant support for the limited use of fiscal stimulus for stabilization purposes under appropriate circumstances, the consensus seems to be that this is a time for fiscal tightening.

Endnotes

1. Ricardian equivalence is described by Blinder in the following way: On the assumption that the pure permanent income hypothesis with perfect foresight holds, so that only the present value budget constraints matter, consumer spending will be unaffected by what amounts to a pure shift in timing.
2. The recent volume by Seidman (2003) is devoted to this topic.

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