

## Fiscal Policy Reconsidered

Alan S. Blinder



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Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

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**MAY 2016**

This policy proposal is a proposal from the author(s). As emphasized in The Hamilton Project's original strategy paper, the Project was designed in part to provide a forum for leading thinkers across the nation to put forward innovative and potentially important economic policy ideas that share the Project's broad goals of promoting economic growth, broad-based participation in growth, and economic security. The author(s) are invited to express their own ideas in policy papers, whether or not the Project's staff or advisory council agrees with the specific proposals. This policy paper is offered in that spirit.

**BROOKINGS**

# Abstract

For decades, economists looked to monetary policy, not fiscal policy, both when the economy needed stimulus and when it needed restraint. This clear preference rested on two beliefs: (1) that fiscal policy is too slow and too political, and (2) that monetary policy can always do the job by itself. Recent events have demonstrated that monetary policy might need help in a deep recession, and at least given hints that fiscal policy might be able to provide that help. This paper proposes a number of ways to speed up fiscal policy actions and, perhaps, to make them a bit less political.

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# Chapter 1. Introduction

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*Investors fret . . . that policymakers seeking to keep recession at bay have run out of ammunition. The good news is that more can be done. . . . The bad news is that central banks will need help from governments.*

—*The Economist*, February 20–26, 2016

The lengthy struggle to emerge from the Great Recession has led, among other things, to a serious rethinking of a previous verdict: that the job of *stabilization policy*—the deliberate manipulation of macroeconomic instruments to achieve full employment and low inflation—could and should be left exclusively to monetary policy. Fiscal policy, it had previously been concluded, was too slow, too clumsy, and too political to be relied upon. And besides, the Federal Reserve and other central banks were ready, willing, and able to do the job (Taylor 2000). In 1997 Martin Eichenbaum wrote, “*There is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible*” (236; emphasis added). It was not a new pronouncement. Five years later, in 2002, Martin Feldstein observed, “Monetary policy is . . . *generally accepted* as the policy of choice when it comes to . . . stimulating a weak economy” (153; emphasis added).<sup>1</sup> These were not idiosyncratic views. There really was such a consensus.

Now it is gone—or should be. The depth and suddenness of the Great Recession demonstrated that monetary policy

might not always be enough. It became clear that, under certain circumstances, the Federal Reserve, though *ready* and *willing*, might not be *able* to do the job by itself. In the realm of practical policy making, that realization led quickly to a burst of Keynesian fiscal policy in the years 2008–10. In the realm of economic thought, it should have led to a sharp reassessment of the previous verdict against fiscal policy—and to some extent it did (see, e.g., Auerbach, Gale, and Harris 2010). This paper is meant to push that reassessment further.

Concerns about the former consensus are not only of academic interest, however. As this paper is written, the federal funds rate, the Fed’s principal macroeconomic weapon, sits at just 38 basis points. Should the economy weaken, or slip into recession, that’s the maximum amount the Fed could cut the funds rate to stimulate the economy.<sup>2</sup> And it’s not much; previous easing cycles have generally pulled the funds rate down by 300–500 basis points. If easier money is insufficient to forestall an incipient recession, or even to limit the severity of one that has started, fiscal stimulus would be needed again. That’s the message in the epigram.

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## Chapter 2. The Benefits and Costs of Fiscal Stabilization Policy

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The basic ideas behind using stabilization policy to combat recessions are disarmingly simple. There are times when aggregate demand (the economy's appetite for buying goods and services) falls short of aggregate supply (the economy's capacity to produce goods and services), thereby leaving unemployed resources in general and unemployed workers in particular. When that occurs, the government can bolster demand by (i) spending more itself, (ii) reducing taxes so that households and/or businesses spend more, or (iii) reducing interest rates so that people and businesses spend more on interest-sensitive items like houses and automobiles. The last of these three options is called expansionary *monetary* policy and is not our concern here. The first two are called expansionary *fiscal* policy.

It seems obvious that raising government spending and/or lowering taxes will augment aggregate demand. The argument is not terribly different from saying that, if businesses decide to invest more, total spending in the economy will grow faster. But economists have long recognized at least three main factors that can undermine the otherwise-obvious case:

1. Raising the government budget deficit will presumably push interest rates up, and those higher rates will reduce, or “crowd out,” some interest-sensitive private spending—unless monetary policy prevents this from happening.
2. Once the government accumulates a lot of debt, its capacity to borrow even more may be limited, making (much) larger fiscal deficits (almost) out of the question. A weaker version of this idea has sometimes been used to argue that policies that lead to larger *future* deficits can be contractionary *now* if they raise long-term interest rates.
3. Hyperrational, farsighted consumers may perceive tax cuts as merely shifting their tax burdens over time. In other words, lower taxes today will be balanced by higher taxes tomorrow. If so, they will perceive no increase in long-run spendable income and hence have no reason to spend more.

Any one of these three factors could be important under the right circumstances. But:

1. While crowding-out might be severe in a strong economy with firms and households competing avidly for funds, fiscal stimulus is normally prescribed in weak economies, in which substantial crowding out is implausible. Besides, under such

conditions the central bank would probably prevent interest rates from rising.

2. Borrowing capacity has never been an issue for the U.S. government, whose debt securities are among the safest in the world. Even today, with the debt-to-GDP ratio higher than it has been for decades, Treasury borrowing rates are extremely low. The ability to borrow more is, however, a relevant constraint on fiscal policy in a number of other countries.
3. Ordinary people don't behave like the super-rational calculating machines envisioned by economic theory. The evidence (summarized later) says that they do react to tax cuts by spending more, even if the tax cuts are temporary.

Readers can draw their own conclusion. Mine is that the conditions that support the efficacy of expansionary fiscal policy are more likely to hold true than the conditions that undermine it—especially at times when such policies are actually under consideration. In fact, I would go further.

Think first about a recession so severe that, even after the central bank lowers its policy rate all the way to zero, it finds it still has not provided sufficient stimulus. That is precisely when monetary policy is most in need of assistance from fiscal policy. But it is also when fiscal policy is likely to be most powerful because interest rates will not rise.

Second, standard macroeconomic thinking holds that while aggregate demand rules the roost in the short run, aggregate supply—which is approximately unaffected by fiscal policy—rules in the long run. So the economy has what economists call “the natural rate property”: the effects of both fiscal and monetary policy on output dissipate over time, leaving output ultimately unaffected.

But suppose that view is wrong. Suppose a fiscal stimulus leaves a permanent imprint on output by augmenting aggregate supply—perhaps by pulling more people into the labor force, or by inducing more capital formation, or by encouraging more innovation and thus faster productivity growth. Then the beneficial effects of fiscal expansion will be permanent rather than transitory. Economists call that a case of “hysteresis,” meaning that the past leaves a permanent imprint on the present. Hysteresis bolsters the case for expansionary stabilization policy (Delong and Summers 2012).



For decades, U.S. economists have rejected hysteresis in favor of the natural rate hypothesis: that GDP eventually returns to its prerecession path no matter what. But suppose that consensus is wrong. Suppose a deep recession leaves permanent scars on an economy. Then stimulative fiscal or monetary policy that brings a recession to a quicker end will leave GDP (and also tax revenue) permanently higher than it otherwise would have been.

Data from the Great Recession suggest there may be something to this idea. Figure 1 shows real GDP from 1985 through 2015. The recession ended almost seven years ago, but these data give no sign whatsoever of returning to the pre–Great Recession trend (suggested by the purple line)—even though unemployment has almost returned to full employment. It looks, instead, like a permanent loss of GDP.

### THE EVIDENCE ON TAX POLICY

When it comes to using fiscal policy to give the economy a boost, many politicians think first—and some think only—about tax cuts. That’s not necessarily misguided thinking. But there are many tax rates that can be cut and numerous tax provisions that can be changed in ways that reduce tax liabilities. For example, the American Recovery and Reinvestment Act of 2009 (ARRA, or the “stimulus bill”) included a reduction in payroll taxes, a tax credit for buying a new home, an increase in the Earned Income Tax Credit, accelerated depreciation for businesses, liberalization of loss carryback provisions, and more.

The multiplier effects of each of these tax cuts differ. Mark Zandi and I (Blinder and Zandi 2015, Table 4) used the Moody’s Analytics model of the U.S. economy to simulate the effects of

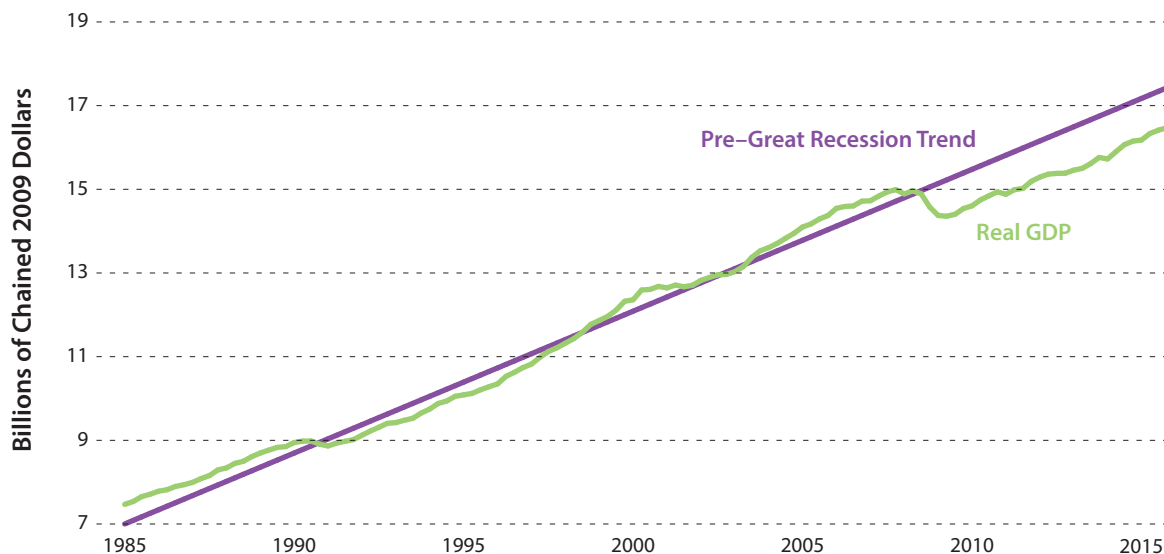
each of these policy changes and others on real GDP. Since multipliers are assumed to be larger when the economy has more slack, we ran separate simulations starting in either 2009:1 (a deep recession) or 2015:1 (a much healthier economy). Table 1 displays the estimates. Notice that the 2009:1 multipliers range from 0.25 (just 25 cents of GDP for each \$1 of tax cut) to 1.38—a very wide range. The clear message is that tax reductions are not all created equal. So if there is any concern with the size of the federal budget deficit, as there should be, there is a case for concentrating on tax cuts with bigger multipliers. Items like accelerated depreciation and loss carrybacks should not make the cut.

Let’s start where most policy discussions begin: with personal income tax cuts. The logic of using income tax cuts to boost aggregate demand is straightforward and seems unassailable: If you give consumers more disposable income, they will spend more. How could that be wrong? In several ways, but the one I want to deal with was mentioned earlier.

Suppose people are farsighted and skilled at complex calculations—unlikely assumptions, but useful as a starting point. Then a temporary reduction in income taxes to fight a recession will add little to workers’ lifetime spendable incomes, and hence will boost their consumption only slightly, undercutting the basic idea of using tax cuts to boost demand. As Hillel said, though in an admittedly different context, all the rest is commentary.

But the commentary is important. Suppose, for example, that households either can’t or won’t borrow and lend to “smooth” their consumption over time. Then they will spend less when their cash flows fall (e.g., in a recession) and more when

FIGURE 1.  
Real Gross Domestic Product, 1985–2015



Source: Federal Reserve Bank of St. Louis 2016; author’s calculations.

TABLE 1.

## Fiscal Multipliers for Various Tax Changes

Estimates of the one-year change in GDP for given reductions in federal tax revenue

	As of 2009 Q1	As of 2015 Q1
Refundable lump-sum tax rebate	1.22	1.03
Nonrefundable lump-sum tax rebate	1.01	0.69
<b>Temporary tax cuts</b>		
Child Tax Credit, ARRA parameters	1.38	1.17
Making Work Pay	1.3	1.03
Payroll tax holiday for employees	1.27	0.94
Earned Income Tax Credit, ARRA parameters	1.24	0.87
HIRE Act (job tax credit)	1.2	0.85
Payroll tax holiday for employers	1.05	0.79
Personal income tax cut	1.02	0.66
Housing tax credit	0.9	0.61
Accelerated (bonus) depreciation	0.29	0.23
Loss carryback	0.25	0.09
<b>Permanent tax cuts</b>		
Extend alternative minimum tax patch	0.53	0.44
Make dividend and capital gains tax cuts permanent	0.39	0.34
Cut in corporate tax rate	0.32	0.3

Source: Adapted from Blinder and Zandi 2015, Table 4.

their cash flows rise (e.g., after a temporary income tax cut). Economists call people like that “liquidity constrained” or “hand-to-mouth” consumers, and the evidence suggests there are a lot of them.<sup>3</sup> If millions of U.S. households are liquidity constrained, the overall impact of a temporary tax cut on spending is larger. But how much larger?

This issue first arose generations ago in the context of a temporary income tax increase designed to curb consumer spending in 1968. Arthur Okun (1971) was the first to study the episode, finding that the increase achieved its aim. Early studies of the 1975 tax rebate by Franco Modigliani and Charles Steindel (1977) and Otto Eckstein (1978) found sizable effects on spending, as did Okun. Subsequent work by me (Blinder 1981) and with Angus Deaton (Blinder and Deaton 1985) generated more mixed results, however.

This older time series literature asked whether consumers’ responses to *explicitly temporary* income changes are larger than predicted by theory. Most answers seemed to be yes. But, as Deaton and I (Blinder and Deaton 1985, 498) concluded, the time series data offer so few observations on temporary taxes that the “results are probably not precise enough to persuade anyone to abandon strongly held *a priori* views.”

A later strand of research posed a different, though related, question: Is the response of consumers to *easily predictable* income changes greater than theory suggests? The “rational expectations” approach to the consumption function, as initially developed in Robert Hall (1978), implies that easily predicted income changes should have negligible effects on consumption when they occur because households have already incorporated them into their spending plans. The literature that followed sought answers mainly in cross-sectional data, often utilizing what might be called natural experiments.

It began with a clever paper by Matthew Shapiro and Joel Slemrod (1995), who noticed that President George H. W. Bush conducted a curious tax experiment in 1992—an election year, of course. He reduced withholding rates by executive order beginning in March even though Congress had not cut income tax rates at all! As a consequence, taxpayers received temporarily higher cash flows from March through December 1992, to be balanced by larger tax settlements on April 15, 1993. That’s about as temporary and predictable as you can get. Yet nearly half of the respondents to a University of Michigan survey said they would spend most of their (very temporary) increases in take-home pay.<sup>4</sup>

In a similar vein, Jonathan Parker (1999) exploited the fact that a minority of workers hits the maximum earnings subject to Social Security payroll tax each year. For them, payroll tax payments fall abruptly to zero when their earnings reach that maximum, and then revert back to normal again on January 1st. Such easily predictable fluctuations in after-tax income should have no effect on spending by households who are not liquidity constrained. But Parker estimated a marginal propensity to consume of about 0.5 within three months.

Similarly, Nicholas Souleles's (1999) study of consumer responses to income tax *refunds*—another predictable source of cash—found that taxpayers spent most of their refunds. And in a subsequent study, Souleles (2002) found that, even though the phased-in Reagan tax cuts were preannounced and predictable, people did not spend their additional after-tax income until they had the money in hand.<sup>5</sup>

Chang-Tai Hsieh (2003), however, reported some puzzling findings for Alaskan families. Their spending seemed *not* to react to the relatively large and predictable annual payments from the Alaskan Permanent Fund (which comes from oil revenues), but *did* react strongly to relatively small and predictable income tax refunds. Could it be that consumers react strongly to small, predictable changes in income but not to large ones? Sounds odd, but some research in behavioral economics suggests it might be true.<sup>6</sup>

Johnson, Parker, and Souleles (2006) assessed spending from the 2001 tax rebate. This episode was interesting for two reasons. First, while widely described as a “rebate,” the 2001 tax cut was actually an early installment payment on a permanent tax-rate reduction. Second, for administrative reasons the checks were sent out on a randomized basis, which enabled Johnson, Parker, and Souleles to estimate sizable spending responses (e.g., about three-quarters of the rebate within six months) with considerable precision. In a subsequent (and similar) study of the one-time income tax rebates paid out in 2008, Parker et al. (2013) estimated that consumers spent about 50–90 percent of their stimulus payments (which averaged about \$900) within three months of receipt. Broda and Parker (2014) subsequently estimated similar spending propensities using an entirely different data set but a similar methodology based on date of receipt. Some years earlier, Shapiro and Slemrod (2009) had used survey responses to estimate that households would probably spend about one-third.

Taken together, these post-2008 studies yield results that are broadly consistent with the pre-2008 evidence: consumers seem to spend receipts from temporary income tax cuts rather quickly. Thus the overall message of the literature is quite consistent, pointing strongly toward the importance of liquidity constraints on consumption decisions.

The lessons for stabilization policy seem clear: Even *temporary* income tax changes can pack substantial punch, though perhaps not quite as much as permanent tax changes. And smaller tax

changes may have more “bang for the buck” than larger ones. Some tantalizing findings in behavioral economics even suggest that the name the government assigns to a temporary tax cut might matter. Calling it a “bonus” rather than a “rebate” looks to increase its impact on spending (Epley, Mak, and Idson 2006). Now that’s what I call cheap stimulus.

## THE EVIDENCE ON SPENDING POLICY

Just as with taxes, there is no such thing as “the” multiplier for federal spending; the multiplier depends on what specific type of spending the government increases. Table 2 displays several estimated multipliers from Blinder and Zandi (2015). The multipliers for defense or infrastructure spending are estimated to be just over 1.5 in a deep recession. But SNAP (formerly known as food stamps) has a larger multiplier (presumably because recipients are especially likely to spend the additional funds) and grants to state governments have a lower multiplier (presumably because they use some of the funds to reduce their deficits rather than to spend more). These differences, however, are not nearly as large as those that exist between alternative tax cuts in table 1.

Both Keynesian theory and commonsense thinking suggest that fiscal multipliers should be larger—probably much larger—in economies with a lot of idle resources (such as in the Great Recession) and smaller—probably much smaller—in economies with few idle resources (such as during wars). That is true in the Moody’s model that underpins tables 1 and 2. Auerbach and Gorodnichenko (2012), Fazzari, Morley, and Panovska (2014), Dell’Erba, Koloskova, and Poplawski-Ribeiro (2014), and others have offered econometric evidence in support of this hypothesis. Ramey and Zubairy (2014) find no evidence that fiscal multipliers are greater during periods of slack, but their econometric procedure relies exclusively on shocks to military spending.

Since estimated multipliers depend on the specific types of spending involved, let’s consider some prominent examples, beginning with grants to states, which played such a prominent role in the 2009 fiscal stimulus. Prior to the ARRA, as Auerbach, Gale, and Harris (2010, 147) noted, “There is surprisingly little evidence on the countercyclical effects of federal transfers to states.” The few studies they cited date back to the 1970s. But recent research by Gabriel Chodorow-Reich et al. (2012), James Feyrer and Bruce Sacerdote (2011), and Daniel Wilson (2012) finds strong spending effects from, for example, the highway grants and additional federal reimbursements under Medicaid that the ARRA provided. (More on this in chapter 5.) It should be noted, however, that grant programs that send money to states should come with serious maintenance-of-effort strings attached. We want states to spend the money, not just to deposit the federal cash into their rainy-day funds.

Another promising set of ideas is exemplified by the so-called Cash for Clunkers program, though it may be hard to replicate

TABLE 2.

## Fiscal Multipliers for Various Spending Changes

Estimates of the one-year change in GDP for increases in government spending

	As of 2009 Q1	As of 2015 Q1
Temporary increase in SNAP (formerly food stamps)	1.74	1.22
Temporary federal financing of work-share programs	1.69	1.13
Extension of unemployment insurance benefits	1.61	1.01
Increase in defense spending	1.53	0.87
Increase in infrastructure spending	1.57	0.86
General aid to state governments	1.41	0.58
Low Income Home Energy Assistance Program (LIHEAP)	1.13	0.55

Source: Blinder and Zandi (2015), Table 4.

beyond automobiles.<sup>7</sup> The basic idea behind Cash for Clunkers is to provide a subsidy to owners of old gas guzzlers who trade them in for newer, less-polluting models. If that was the goal, the Cash for Clunkers program promulgated by the U.S. government in the summer of 2009 was very successful.<sup>8</sup> Congress originally budgeted a mere \$1 billion for the program, a paltry sum that was exhausted within a few *days!* Congress then appropriated another \$2 billion to extend the program, but even that money lasted less than two months. We will never know how many Americans would have availed themselves of the program if it had lasted some reasonable length of time—say, six months. But the mad rush into auto dealerships certainly suggests that the program could have induced a lot more sales.

What was the secret sauce that made Cash for Clunkers so powerful? I believe there were two key ingredients—both worth repeating if possible.

One was the huge assist it got from private industry. Sensing a terrific selling opportunity, the automobile industry advertised the program aggressively. If you were living in America during the lifespan of Cash for Clunkers in 2009, you could hardly have missed the saturation advertising on radio, TV, and in the newspapers—none of which was paid for by the U.S. Treasury. One chronic problem that often besets new government programs is low initial take-up rates because eligible individuals either don't know about the program or are hesitant to dip their toes into unfamiliar waters. Thanks to the avalanche of private-sector advertising, neither was a problem for Cash for Clunkers. Businesses acting in their own self-interest gave the U.S. government a highly visible hand.

The second secret to the success of Cash for Clunkers was putting cars on *temporary* sale. Just as department stores and auto dealers try to stampede people into their stores by offering low prices for limited periods of time, Cash for Clunkers' finite lifetime was designed to hasten peoples' scrappage decisions. They had to get to showrooms before it was too late. It is true that all those

“clunkers” would have been scrapped eventually, so the program could be—and was—criticized for “just” shifting spending forward in time (Mian and Sufi 2012). But doing so was exactly one of the program's central ideas. Indeed, one of the central ideas of stabilization policy in general is to give spending a boost *when the economy needs it*. Furthermore, in the particular case of Cash for Clunkers, it is notable that the sharp July–August 2009 spike in new car sales was not followed by a sales “valley” when the program ended (see Gayer and Parker 2013 or Romer and Carroll 2010).

All that said, the 55-day duration of the program—less than half the originally proposed duration—severely undercut its effectiveness (Gayer and Parker 2013). For one thing, the number of months by which new car sales were advanced wound up being far too short. To make a real dent in a recession, we need car sales pulled forward by, say, three to six months; instead, the program may have pulled September car sales into August. Second, the program's short duration enabled automakers to meet much of the surge in demand out of inventory rather than by increasing production (Copeland and Kahn 2013). Third, as mentioned earlier, the program ended before most Americans had a chance to use it. There is a general lesson here, too: It is hard for Congress to get the details right.

While Cash for Clunkers was a spending program, it has clear analogies on the tax side. For example, the tax credit for first-time home buyers, which was used three times to fight the Great Recession, shared the second critical attribute of Cash for Clunkers. Prospective house buyers knew the credit was scheduled to expire at a certain date. So they were incentivized to move home-buying plans forward in time. On the other hand, neither banks wanting to grant new mortgages (were there any at the time?) nor builders wanting to sell more houses (there were plenty) seem to have engaged in the massive advertising campaigns that were so helpful to Cash for Clunkers.



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## Chapter 3. Discretionary Fiscal Policy: The Evolution of Events and Ideas

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**T**imes change. When I was introduced to macroeconomics as a Princeton University freshman in 1963, discretionary fiscal policy was the new, new thing. The appropriate role for monetary policy was often said to be “accommodating” fiscal policy—a gerund that, curiously, survives to this day. Thus many people probably thought that Walter Heller, then chairman of President Kennedy’s Council of Economic Advisers (CEA), had more influence over stabilization policy than William McChesney Martin, then chairman of the Federal Reserve Board. Indeed, it was said that Kennedy remembered that *Martin* was in charge of *monetary* policy only because both words began with M (Stein 1969, 4).<sup>9</sup>

By the 1980s attitudes had pretty much reversed. Virtually every discussion of stabilization policy by economists—whether abstract or concrete, theoretical or practical—was about monetary policy. By 2002 Robert Solow could lament, accurately, “Serious discussion of fiscal policy has almost disappeared.” It never crossed anyone’s mind that Glenn Hubbard, then chairman of the CEA, was more influential than Fed chairman Alan Greenspan.

The sharp revision of the extreme fiscalist views of the 1960s was certainly appropriate. But perhaps the pendulum swung too far. Let’s look back at the history of thought on fiscal policy since its birth in 1936.

### THE TRIUMPH OF KEYNESIANISM: 1936–66

During the long pre-Keynesian period, most economists and most governments viewed what we now call recessions as unfortunate but inevitable hallmarks of market capitalism that would eventually cure themselves without government intervention. *The General Theory* (Keynes 1936) changed all that remarkably and quickly, and the following three decades witnessed what Herbert Stein (1969) called *The Fiscal Revolution in America*.

Keynes’s ideas, which emphasized fiscal over monetary policy, probably because interest rates were near zero during the Great Depression, spread like wildfire. The early editions of Paul Samuelson’s path-breaking textbook, *Economics: An Introductory Analysis* (first edition: 1948), explained the use of both fiscal and monetary policy but clearly emphasized the former. Mindful of potential political delays, Richard Musgrave (1959) promoted the idea of “formula flexibility,” whereby Congress would pre-legislate both the form of and the trigger for tax or expenditure

changes—thereby converting discretionary policy into automatic stabilization. Others advocated maintaining a backlog of spending projects “on the shelf” to use when cyclical conditions warranted. While these ideas were subsequently discarded, some may merit a second look.

The first *deliberate* use of fiscal policy in the United States was the Kennedy–Johnson tax cuts of 1964 and 1965, which were judged to be a resounding success. From a modern perspective, one can only marvel at the unabashed optimism exuded by Heller (1966) in his memoir on the New Frontier. He wrote that both monetary and 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.” To do so, fiscal policy must become “more activist and bolder,” and “rely less on the automatic stabilizers and more on discretionary action” (Heller 1966).<sup>10</sup> Was there ever a stronger encomium to fine tuning?

### THE CONSENSUS CRUMBLES: 1967–77

It didn’t last long. The first blow was the Vietnam War, which piled heavy government spending atop an economy that was already at full employment. President Johnson overrode the counsel of his Keynesian advisers by insisting on prosecuting the war without either trimming Great Society spending or raising taxes; it would be guns *and* butter for LBJ (Okun 1970, especially chapter 3). The predictable—and, in fact, widely predicted—result was an overheated economy. Soon inflation was on the rise, and Keynesian economics was being accused, unjustly given what Johnson’s Keynesian advisers had urged, of being inherently inflationary.

That charge received apparent support from both the world of ideas and the world of real policy. On the intellectual front, Milton Friedman (1968) and Edmund Phelps (1968) challenged and subsequently demolished the notion that there was a durable long-run “Phillips curve” tradeoff between inflation and unemployment. Aiming to keep unemployment below its “natural rate,” they argued, would drive inflation ever higher.

On the policy front, the beginnings of the death knell for activist fiscal policy came when the much-delayed 1968 income tax surcharge failed to curb the Vietnam-induced inflation (Eisner 1969; Okun 1971). The two-and-a-half year delay in getting the

tax hike enacted illustrated just how painfully long the lags in policy formulation could be.<sup>11</sup> In a world in which recessions typically lasted less than a year, and an entire business cycle took about four years, such long policy lags made fiscal stabilization a dubious proposition.

Furthermore, Robert Eisner (1969) raised an important intellectual conundrum. Activist use of tax policy for stabilization purposes seemed to call for *temporary* changes in income taxes. But if workers make consumption decisions based on their expected lifetime (or “permanent”) income, these temporary tax changes may have little impact. The so-called permanent income hypothesis therefore implies that temporary tax changes should have only small effects on consumer spending.

These dual failures seemed to be replicated in the opposite direction during the deep recession of 1974–75, when first President Nixon and then President Ford failed to recommend antirecessionary policies until it was too late. Then the temporary nature of the 1975 tax *cut* undermined its effectiveness (Blinder 1981). On the bright side, however, Congress acted speedily in 1975, demonstrating that policy lags could be short.

Long policy lags, weak effects of temporary tax changes, the absence of a long-run Phillips curve tradeoff between unemployment and inflation, and the famous Lucas (1976) critique all conspired to produce a backlash against Keynesianism, and fiscal stabilization fell deeply out of favor.<sup>12</sup> Its nadir may have come when President Carter’s call for a short-term fiscal stimulus in 1977 was swiftly rejected by Congress—an event that would be repeated 16 years later under President Clinton.

## HUGE DEFICITS CROWD OUT STABILIZATION POLICY: 1981–2001

President Reagan’s massive tax cuts pushed fiscal stabilization policy even farther into the background. The cuts, which were justified by supply-side economics, not by Keynesian thinking, ushered in an era of chronically large federal budget deficits. Those deficits, in turn, fostered a dramatic change in discussions of the federal budget—away from stabilization policy and toward deficit reduction no matter what. This newfound devotion to fiscal prudence grew so extreme that, in 1985, Congress passed the Gramm-Rudman-Hollings Act, which called for automatic budget cuts if spending caps were exceeded, regardless of the state of the business cycle. Thus, had this act actually been followed, it would have short-circuited even the automatic stabilizers. Five years later, when the economy slipped into a recession, no politician suggested fiscal stimulus. In fact, taxes were *increased* as part of the 1990 deficit-reduction package.

Things went even farther after the 1992 election. President Clinton’s original budget proposal combined a substantial long-run deficit reduction program with a small, short-run fiscal stimulus—a strategy of one step backward, five steps forward.<sup>13</sup> But this two-pronged strategy proved to be too clever by half.

Congress quickly rejected the stimulus part, but passed, albeit barely, a deficit-reduction package larger than the one Clinton had proposed.<sup>14</sup> Thus Clintonomics turned out to be about fiscal prudence: first reducing the deficit, then balancing the budget, and finally building a sizable surplus.

The fact that the Clinton boom began shortly after Congress passed a deficit *reduction* package gave rise to some revisionist thinking—some of it serious, some of it muddled—on even the *sign* of the fiscal-policy multiplier. Among politicians and the media, the notion that raising taxes and/or cutting spending would *expand* (rather than contract) the economy took hold rapidly and uncritically—with seemingly little thought given to exactly how this was supposed to happen. In the bat of an eyelash, the idea that reducing the budget deficit (or increasing the surplus) was the way to “grow the economy”—even in the short run—came to dominate thinking in Washington, in the financial markets, and in the media. Such thinking was, of course, profoundly anti-Keynesian.

In the academic world, some earlier theorizing by Stephen Turnovsky and Marcus Miller (1984) and Olivier Blanchard (1984) was dusted off to explain how a credible reduction in *expected future* budget deficits could increase aggregate demand today. Their basic idea was that getting investors to believe that the national debt would be lower in the *future* would reduce long-term interest rates *today*. Their models did not claim that a reduction in the *current* budget deficit would be expansionary. Still, the Turnovsky-Miller-Blanchard analysis offered a theoretically coherent explanation of the Clinton boom. (There were many incoherent ones.) Few people stopped to ask whether the lessons of those glory years could be generalized. Janet Yellen and I were one exception (Blinder and Yellen 2001, 23), concluding, “This is not a formula that can be repeated at will.”<sup>15</sup>

## THE REMARKABLE BUSH II YEARS

It is hard to know how to characterize fiscal policy under President George W. Bush. The ideas that eventually morphed into the tax cuts of 2001–3 began as campaign promises in the boom year 1999, when the rationale was that the government had no business running budget surpluses and should instead return the extra money to the people. But when the economy slowed in 2000 and sagged in 2001, fiscal stimulus became appropriate.

In terms of fiscal history, three remarkable things happened during the Bush presidency. First, while the tax cuts of 2001–3 were *not* originally recommended for stabilization purposes, the Bush administration quickly adopted the traditional Keynesian rationale (among others) when the economy slumped. Without skipping a beat, both political parties and most of the press jettisoned the Clinton-era view that deficit *reductions* paved the way to faster short-term growth and returned to the older Keynesian notion that *increasing* the deficit did so—apparently without noticing the inconsistency.

Second, the political consensus in favor of fiscal stimulus formed so quickly and decisively that both the 2001 and the 2003 tax cuts were enacted in a matter of months, thereby demonstrating once again that policy lags could be quite short, even with a divided Congress.

Third, yet another old Keynesian idea rose like Lazarus from the tomb of discarded doctrines. As the Fed lowered the federal funds rate toward 1 percent and the economy still did not revive, economists began to express concern that nominal interest rates could not be reduced below zero—a trap that had already ensnared the Bank of Japan and would later ensnare many other central banks. Briefly, the problem is this: once the central bank reduces its overnight interest rate to zero, it is left with only unconventional monetary weapons, which are weaker.

Thus, to a significant degree, we came full circle during the Bush II presidency: belief in fiscal stimulus resurfaced, Congress showed that fiscal policy lags could be short, and skepticism about the efficacy of monetary policy returned. This is a world Walter Heller would have recognized.

## THE GREAT RECESSION AND THEREAFTER

The fiscal response to the Great Recession began with income tax rebates in 2008—which revived decades-old academic discussions of whether temporary income tax cuts packed much punch (reviewed earlier). But the main fiscal stimulus came just a month into the Obama administration, when the ARRA passed. Unlike the 2008 Bush tax cuts, which had garnered substantial Democratic support, the ARRA's journey through Congress was starkly partisan. Republicans successfully bargained for a number of changes (mainly business tax cuts), and yet voted against the bill almost to the man and woman.<sup>16</sup>

The debate over the stimulus—which continued long after the bill was passed, as Republicans sought to repeal it—was noteworthy in several respects. First, it was quick. Despite all the acrimony, the bill passed Congress less than a month after President Obama and congressional leaders proposed it. Of course, it helped that fiscal stimulus had been discussed during the campaign and the transition. That said, the policy lag was very short.

Second, the debate was extremely partisan—unlike many previous fiscal policy episodes. That was due, in part, to the bill's large size—about 5 percent of GDP—and consequent effects on the budget deficit.<sup>17</sup> But much of the partisanship stemmed from the bill's *composition*: Roughly speaking, tax cuts accounted for about one-third of the stimulus while higher spending accounted for about two-thirds.<sup>18</sup> Republicans were unhappy with that mix; they wanted the vast majority of the stimulus, maybe all of it, to come from tax cuts. President Obama and the Democrats had other priorities, including spending more on health care, the environment, and infrastructure. They nonetheless gave ground by accepting several business tax cuts they did not want.

In February 2009 and thereafter, the U.S. government thus *practiced* Keynesian demand stimulus on a grand scale, while parts of it (especially the Republican minorities in both houses) increasingly *preached* anti-Keynesianism. This disjuncture didn't last long. Even before the Democrats were routed in the 2010 elections, deficit reduction was becoming the fiscal order of the day—despite an unemployment rate near 9 percent. Fiscal rhetoric and fiscal actions were coming into alignment again, though both went in the wrong direction.

The federal budget deficit, which had peaked at a frightening 9.2 percent of GDP in FY2009 and was still a yawning 8 percent of GDP in FY2011, plummeted to just 2.7 percent of GDP (near its historic average) by FY2014—a drop of 5.3 percentage points in just three years. CBO (2016, table C-2) estimates that 4.5 percentage points of that decline was *structural*—that is, not attributable to the strengthening economy. A fiscal contraction averaging about 1.5 percent of GDP per year in a still-weak economy seems perverse. If the weighted-average multiplier was just 1.0, it was enough to lop roughly 1.5 percentage points off the average growth rate over those three years. Keynesians were not pleased, but few could be found in the U.S. government.

The absence of any recent need for fiscal stimulus makes it hard to know what attitude toward fiscal policy prevails today. What we do know is that growth slowed late in 2015 and early in 2016, and many observers feared this might mark the beginning of something worse. Financial markets started fretting over what the Fed would be able to do if the economy needed stimulus again. But few talked about using *fiscal* stimulus. It was *déjà vu* all over again.

## LESSONS FROM THE GREAT RECESSION

The Great Recession taught us several important lessons. One of them is that the view that monetary policy will always have enough fire power to do the job is wrong. Here's how I concluded a 2004 paper on fiscal policy (Blinder 2006, 54):

*Under normal circumstances, monetary policy is a far better candidate for the stabilization job than fiscal policy. It should therefore take first chair. . . . However, there will be occasional abnormal circumstances in which monetary policy can use a little help, or maybe a lot, in stimulating the economy—such as when recessions are extremely long and/or extremely deep, when nominal interest rates approach zero, or when significant weakness in aggregate demand arises abruptly. To be prepared for such contingencies, it makes sense to keep one or more fiscal policy vehicles tuned up and parked in the garage, and perhaps even to adopt institutional structures that make it easier to pull them out and take them for a spin when needed.*

No such tune-up was made, of course, and the Great Recession brought about all the contingencies I had described.

Once policy makers recognize that conventional monetary policy—that is, lowering the overnight interest rate—might be insufficient to forestall or cure a severe recession, they have two basic choices. One is to push monetary policy in unconventional directions. The other is to deploy fiscal policy.

Keynes had taught us that discretionary fiscal policy can support an economy suffering from a downturn, and standard fiscal stimulus measures for combating recessions had been in policy makers’ playbooks since the Great Depression. We have also long understood that the appropriate size of any stimulus program depends on the magnitude of the decline in economic activity. Furthermore, fiscal multipliers are probably larger, maybe much larger, when interest rates won’t rise. So when severe recessions, if not indeed depressions, threatened many countries in 2008 and 2009, nation after nation dusted off that old playbook and deployed fiscal stimulus—in some cases on a large scale.

Nonetheless, America’s big stimulus program, the American Recovery and Reinvestment Act of 2009 (ARRA), remains controversial to this day. Some critics have argued that the conclusion that the ARRA created lots of jobs is built into the structure of the Keynesian models used to appraise it. One way to address this criticism is to look *ex post* at particular components of the stimulus and ask whether they really stimulated spending or employment. Several papers have done precisely that, and have found that actual responses closely align to those forecast by the macroeconomic models.

For example, Feyrer and Sacerdote (2011) assessed the effectiveness of stimulus spending by comparing outcomes in states that received different amounts of ARRA money. When making such geography-based assessments, it is crucial to deal with reverse causation—that is, states that were hit harder by the recession received more stimulus money than states that fared comparatively well. Failing to account for that fact would systematically underestimate the effects of the stimulus. Feyrer and Sacerdote (2011) make such an adjustment, and find that the impact of fiscal stimulus measures on employment depended on the type of stimulus. Specifically, they estimated that federal education grants to states created hardly any jobs. Excluding those, however, the rest of the stimulus created jobs at approximately the rate that macro models suggest. Wilson (2012), which focused on Medicaid grants (that the federal government deliberately made fungible) and highway funds across states, found broadly similar results, as did Chodorow-Reich et al. (2011).

A paper by Timothy Conley and Bill Dupor (2013) is the main exception to the finding that cross-sectional studies based on actual data give roughly the same assessment of the stimulus’ effects as simulations of macro models. They find strong positive effects of ARRA spending on public-sector employment but small or even negative effects on private-sector employment. Han Tran (2015), who obtained starkly different results, speculates that one reason may be that, unlike most other studies of stimulus

spending, Conley and Dupor (2013) scale ARRA spending by state government spending (which was directly affected by the ARRA) instead of by state population or state GDP.

All that said, criticisms of specific tax and spending policies included in the ARRA based on low “bang for the buck” merit serious attention. I will argue in chapter 5 that well-targeted tax breaks and transfers to persons, such as more SNAP benefits and unemployment insurance (UI), can help the economy strongly and quickly. But they may not be sufficient. So in a long and deep recession, spending programs that take longer to implement, such as infrastructure projects, might be needed. Thus the appropriate list of fiscal palliatives depends on the expected length of the recession, which is devilishly hard to forecast.

Finally, a lesson not learned, but one that perhaps we should learn: fiscal and monetary policy interactions may be very large, meaning that fiscal stimulus substantially enhances the power of monetary stimulus and vice versa. For example, in estimating the impacts on real GDP of all the antirecessionary policies promulgated by the U.S. government from 2008 onward, Zandi and I (Blinder and Zandi 2015) found strong impacts of the combination of fiscal and monetary stimulus for the two years of greatest policy impact, as shown in table 3.

**TABLE 3.**  
**Estimated impacts on real GDP**

In billions of 2009 dollars

	2011	2012
Fiscal stimulus only	+ 485	+428
Monetary/financial stimulus only	+888	+ 920
Both together	+2,101	+2,118

Source: Author’s calculations from numbers in Blinder and Zandi 2015.

In each year, fiscal and monetary actions were estimated to have raised real GDP about \$2.1 trillion higher than a baseline without any stimulus. Of that large sum, the estimated impact of fiscal stimulus *alone* averaged \$450 billion per year and the impact of all the monetary and financial policies together averaged \$900 billion per year. Notice that those two contributions add up to only about 65 percent of the total. The rest—something around \$750 billion per year—was accounted for by positive interactions between the two sets of policies.

That there are positive interactions between monetary policy and fiscal policy has been well known for generations, though these are very large. There is, therefore, a strong case for using a “two-handed” policy approach to fighting a big recession.



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## Chapter 4. The Proposals: Tax Policy

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As we saw in chapter 2, temporary reductions in personal income taxes do work, in the sense that they boost aggregate demand, but their “bang for the buck” is reduced somewhat because of their temporary nature. Are there tax cuts that are actually *more* powerful when they are made temporary? The answer is possibly *yes* if the tax cut creates incentives for what economists call “intertemporal substitution”—that is, for moving spending through time. Temporary changes in investment tax credits (ITCs), value-added taxes (VATs), and sales and excise taxes are prime examples.

### TAX CUTS THAT ARE MORE POWERFUL WHEN TEMPORARY

The underlying idea is simple. Consider, as an example, a one-year reduction in a sales tax or VAT, after which the tax rate will return to normal. A tax cut like that puts goods “on sale” for a year, which should induce consumers to advance some spending from next year to this year. But such incentives may not have powerful effects. The scholarly evidence suggests rather little intertemporal substitution in broadly defined consumption.<sup>20</sup>

The United States has no VAT, and sales taxes are the province of the states. So the main intertemporal tax policies that have actually been used in the United States are the ITC and other investment incentives. The ITC was invented in 1962 for explicitly Keynesian reasons. Between then and its abolition as part of the Tax Reform Act of 1986, the ITC was suspended or repealed twice and had its rates readjusted twice—often for cyclical reasons.<sup>21</sup> Economic theory strongly suggests that the credit should be more powerful when it is enacted on a temporary basis. Indeed, as Robert Lucas (1976, 30) put it in a famous paper, “The whole point . . . of the investment tax credit is that it be viewed as temporary, so that it can serve as an inducement to firms to reschedule their investment projects.”

Several econometric appraisals of the effectiveness of the ITC gave it mediocre reviews, however.<sup>22</sup> One reason may be

that the ITC was never made *marginal*; instead, it was always applied to every dollar of qualified investment—most of which would have been done anyway. Economists in the 1992 Clinton campaign had persuaded the candidate to propose a marginal ITC as a low-cost way to provide fiscal stimulus. (Disclosure: I was one of them.) But the idea was quickly scrapped in 1993 when business lobbying overwhelmed economic logic. It remains a good idea whose time may one day come.

The 2002 tax cut bill included a provision that offered accelerated (called “bonus”) depreciation—originally for just 18 months. The idea was exactly the same as that behind a temporary ITC: to put investment goods “on sale” for a short time. Indeed, House and Shapiro (2008) emphasized the temporary nature of bonus depreciation as the key to its estimated strong effects. That same idea was echoed

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recently by Eric Zwick and James Mahon (2016) in a more comprehensive study of several bonus depreciation episodes. It is also noteworthy that Zwick and Mahon found much stronger effects on investment spending by small firms and by firms that appear to be liquidity constrained. That last finding echoes findings about consumer reactions to temporary income tax changes: liquidity constraints enhance the power of policies that augment cash flows.<sup>23</sup>

In the event, bonus depreciation was subsequently extended several times, and in 2015 was made a “permanent” feature

of the tax code—enacted until 2019, and who will bet that Congress will let it lapse then? Thus, ironically, we may have destroyed the usefulness of bonus depreciation as a countercyclical tool by making it permanent.

Put this story together with the fate of the marginal ITC, and you have two clear examples of what I suspect is a general theorem of political economy: *Business tax cuts artfully designed by economists for maximum bang for the buck will be altered by lobbyists to achieve maximum revenue loss instead.* The reasons are clear. Business lobbyists don't care about "bang" but care deeply about getting more "bucks" for their clients, and lobbying almost always overpowers economic logic. Sadly, this theorem should make us wary of using investment incentives for cyclical stimulus.

Fortunately, other creative ideas exploit intertemporal substitution in consumption, rather than investment. For example, Martin Feldstein (2001) once suggested temporarily suspending Japan's VAT, and following that by an increase two years later. The idea was to create incentives for consumers to buy now rather than later. The same idea was behind a suggestion I made during the debate over the 2001 stimulus package in the United States (Blinder 2001). The U.S. government has neither a VAT nor a general sales tax, but 45 of the 50 states have the latter. So I suggested that the federal government offer to replace the lost revenue of any state that would agree to cut its sales tax for the next twelve months. Given the low rates of sales taxation in the United States and

the modest degree of intertemporal substitution suggested by econometric studies, this policy would likely have a moderate impact on consumption.

If there is an appetite for going farther with automaticity, we could resurrect another old idea: formula flexibility—that is, writing into law triggers for temporary tax cuts (and also triggers for ending them) so that, say, income tax rates would be reduced automatically by pre-specified amounts whenever some cyclical indicator (e.g., the unemployment rate) reached some danger point and then restored to normal when that same indicator returned to something more normal. The evidence summarized earlier suggests that such automatic, temporary income tax cuts should have sizable effects on consumer spending.

However, replacing discretion with automaticity in that way would probably be a hard sell to Congress, which guards its taxing power zealously—especially its ability to dish out goodies by cutting taxes. In reality, members would retain the power to override automatic tax cuts or tax hikes by passing legislation, so it's really more like changing the default option than like relinquishing power. Perhaps some analog to fast-track authority for fiscal policy could be devised, e.g., a formula that would put a tax-cut bill on the House and Senate floors for an up-or-down vote without amendments. We have, after all, seen Congress relinquish some of its authority over military base closings and trade agreements in a similar fashion.

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# Chapter 5. The Proposals: Spending Policy

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## INFRASTRUCTURE SPENDING

As mentioned earlier, the idea of using timely variations in expenditures on public works to smooth cyclical fluctuations dates back to the early Keynesian days and makes good theoretical sense. After all, recessions are times when many labor and capital resources are left unused by the private sector. Why not put them to work in the public sector?

An important case in point arose after the great housing bust. Hundreds of thousands of skilled construction workers were out of work, and the government's borrowing rates were extraordinarily low. That seemed to make it an ideal time to repair America's ailing infrastructure. The 2009 stimulus bill provided for some of that, but, for the most part, we let the opportunity slip by. History will, I believe, judge that error harshly.

That said, there are several plausible objections to using public works as a countercyclical tool. First, the lags in the political process before new spending projects are authorized by Congress can be lengthy. Then still more time elapses between legal authorization and the actual expenditure of funds. The legislative lags could conceivably be shortened by having a queue of projects pre-authorized, pre-appropriated, and sitting "on the shelf" ready to go when the cyclical need arose—as some of the early Keynesians suggested generations ago. But I, for one, have a hard time imagining the U.S. Congress doing anything like that. Think, for example, about the political difficulty of delaying some well-publicized new bridge while everyone waits for a recession.

Furthermore, most spending on infrastructure will actually be performed by state and local governments, which may be less than fleet-footed due to infrequent budgeting sessions; perhaps more importantly, they may find themselves hesitant to spend when strapped for funds during a recession. In this regard, something like the Obama administration's Build America Bonds that offered a 35 percent subsidy on interest costs instead of the usual tax exemption may provide a helpful incentive (Puentes, Sabol, and Kane 2013)—especially if the offer comes with a termination date. As the U.S. Department of the Treasury's (2011) report on the Build America Bonds program noted, "Many state and local governments appear to have accelerated the timing of financings of needed public

capital projects in 2010 in anticipation of the scheduled expiration of the program on December 31, 2010" (6).

But even if all the political delays could somehow be eliminated, the slow natural spend-out rates of most infrastructure projects remains a serious handicap—except when recessions are very long and deep. For example, out of each \$1 appropriated for highway expenditures, the CBO estimates that barely more than a quarter is spent within the first year (Elmendorf 2009). Accelerating the pace of spending on public works beyond its "natural" rate could be inefficient and wasteful, maybe even dangerous. Would you want to drive over a bridge that was built in haste?

To my mind, these objections add up to two main conclusions. First, the lengthy lags involved in major infrastructure projects cast serious doubt on their suitability as stabilizers in garden-variety recessions. Pre-authorized road repairs (e.g., filling potholes) and similar work look like better infrastructure candidates. Such repair work often can wait for a recession; it can also be started and completed in short order. Second, however, spending on traditional large infrastructure projects (bridges, tunnels, schools, etc.) may be an appropriate countercyclical tool when the period of slack is expected to last a long time, as was the case during the Great Recession.<sup>24</sup> Furthermore, unless the infrastructure projects consist mainly of "bridges to nowhere," society will be left with something valuable at the end. So perhaps we should not toss infrastructure spending out the stabilization policy window just because spending will outlast the recession.

## COUNTERCYCLICAL GRANTS

There are, however, other types of spending that work faster. For example, well-designed grants from the federal government to state and local governments can prevent cuts in government spending—which is just as important as spending more. Remember that when a recession pulls down tax receipts, the federal government can, should, and normally does let its deficit rise—that's an important automatic stabilizer. But few state and local governments have that luxury. Most are required to balance their budgets, which forces them onto a contractionary fiscal diet at just the wrong time.<sup>25</sup>

If the federal government can use grants to state and local governments to mitigate or prevent such ill-timed fiscal contractions, it can reduce the severity of recessions. That, in fact, was the main idea behind including so many such grants in the ARRA. Notice also that if grants-in-aid are pre-legislated, the extra money starts flowing automatically.

Something analogous happens now with Medicaid, for example. Federal grants to cash-strapped states help those states maintain spending in a cyclical downturn. In the case of Medicaid, the cost-sharing formula between the states and the federal government is adjusted periodically to account for differential income growth by state, but is not explicitly cyclical. Making it cyclical might be a good idea.

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### CONSUMER-DIRECTED DISCRETIONARY POLICY

The Cash for Clunkers program is an example of a class of temporary policies aimed at boosting consumer spending. Can the U.S. government replicate this experience in future recessions? I don't see why not—with cars. The harder question is: Can we find other products for which the incentives, and especially the advertising blitz, would be as powerful as they were for Cash for Clunkers? Houses are one potential example, but the relatively atomistic nature of the home-building industry makes it hard to imagine a massive advertising campaign like the one that made Cash for Clunkers so successful. Other big-ticket durable goods include home appliances, computers, or smart phones. But cars may be unique.

### TARGETED TRANSFER PAYMENTS

Another idea suggested by the empirical literature is targeting countercyclical changes in taxes and transfer payments on the people most likely to be liquidity constrained. To some extent, that means targeting such changes on low-income households, who are more likely to be living hand to mouth. There are two drawbacks, however.

First, the suggested remedy is strikingly asymmetric. When the economy needs stimulus, targeting income tax reductions and increases in transfer payments disproportionately on the poor serves both stabilization and distributional objectives admirably. But when the economy needs restraint, targeting income tax hikes or cuts in transfers on the poor seems repugnant. This may not be a practical problem, however, because while the concept of countercyclical fiscal policy is symmetric, the practice is not: Congress virtually never tightens fiscal policy to slow down a boom.<sup>26</sup> Making such changes in transfers *automatic* and *temporary* might be one way out.

Second, income is an imperfect indicator of who is and is not liquidity constrained. In principle, a large negative income shock would be a better indicator of who is constrained—which leads naturally to the idea of varying the generosity of UI benefits cyclically. After all, most people who are collecting UI have recently suffered a severe drop in earnings. If they are striving to maintain their previous consumption levels, they are probably liquidity constrained.

Extending UI benefits during times of high unemployment has indeed become standard operating procedure in the United States. The Extended Benefits program under UI provides for an additional 13 or 20 weeks of jobless benefits (beyond the usual 26 weeks), and is triggered *automatically* when a state's insured unemployment rate rises above 5 percent.<sup>27</sup> And Congress often enacts additional *discretionary* increases in UI coverage during and after recessions. During the Great Recession, for example, federal outlays on unemployment compensation soared from \$32 billion in FY2007 to a peak of \$157 billion in FY2010 and then fell back to \$32 billion by FY2015 (OMB n.d., table 8-5). That rise of \$125 billion *per year* was a notable fiscal stimulus. Normally, the federal government covers half the cost of Extended Benefits, but it paid the entire bill in the aftermath of the Great Recession.

The UI automatic stabilizer could be significantly expanded. The Obama administration recently proposed an increase in the Extended Benefits program under which the federal government would pay 100 percent of the cost of up to 52 additional weeks of benefits, in four 13-week tiers, for states experiencing rapid job-losses or high unemployment (The White House 2016). The reformed program would presumably replace the large discretionary component of federally funded unemployment benefits that Congress typically disburses during and after recessions.

A second idea along those same lines is temporarily rebating part of the payroll tax, which was done as part of the ARRA in 2009.<sup>28</sup> Here the numbers are potentially quite large since annual payroll tax receipts run over \$1 trillion a year. Indeed, payroll taxes are the largest tax paid by most Americans (U.S. Department of the Treasury 2016).

There are two possible weak points in this idea, however. One is targeting. If the payroll tax rate is reduced, even upper-middle and high-income households, many of whom are not liquidity constrained, will benefit. So perhaps it would be better to cut the payroll tax only on, say, the first \$40,000 or \$50,000 of earnings. A second problem is that cutting the payroll tax reduces the flow of revenue into the Social Security Trust Fund, which is already out of actuarial balance. For this reason, the 2009 legislation actually took the revenue from income tax receipts, not from payroll tax receipts—as did the 2011 and 2012 temporary reductions in payroll tax rates.

### FEDERAL CREDIT PROGRAMS

Deborah Lucas (2016) has recently called attention to the hitherto-neglected countercyclical role of federal credit programs, which subsidize various sorts of borrowing. While

these programs range over a bewildering variety of activities, housing subsidies delivered through the Federal Housing Administration (FHA), Fannie Mae, and Freddie Mac are the largest by far. Lucas observes that disbursements under federal credit programs displayed little cyclical fluctuation until the Great Recession, typically fluctuating in the 2–3 percent of GDP range, but then soaring to over 10 percent of GDP in the distressed financial conditions of 2009. She estimates that the subsidy value of those disbursements reached \$71 billion in 2010, and that this money probably had high bang for the buck—rivaling the stimulative impact of the ARRA.

Importantly, most of the increased disbursements came automatically. Congress did not pass major new laws, with the exception of some changes to FHA programs. Rather, when private-sector mortgage finance cratered, federally backed lending rose to fill the huge gap. Given the aforementioned difficulties with increasing the role of transfer payments as automatic stabilizers, this is an important insight. The idea of using federal credit programs—whether automatic or discretionary—as countercyclical tools merits further thought. However, given the relative size of the various programs, most of the benefits will go to housing.



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## Chapter 6. Questions and Concerns

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### *Can we shorten the policy lags involved in fiscal stimulus?*

I have mentioned several times the classic political problem with using discretionary fiscal policy to mitigate recessions: the wheels of Congress grind slowly, when they grind at all. At one level, this is an insuperable difficulty; it's built into our constitutional system of checks and balances, which is one reason many economists gave up on fiscal policy decades ago. But while we can't eliminate the problem, can we at least find ways to mitigate it by shortening the policy lags?

Maybe. One clear route would be to rely more on automatic stabilizers—that is, on taxes that fall and expenditures that rise automatically as the economy weakens. We already have many such items in the federal budget. Income tax, payroll tax, and sales tax revenues all rise and fall automatically as the economy cycles from booms to busts, with no need for congressional action. Unemployment benefits, SNAP, and other safety net provisions also move in the right direction cyclically. We can make automatic stabilization stronger.

### *Other than unemployment insurance and Medicaid grants-to-states, what other spending programs are good candidates for automatic stabilization?*

The Supplemental Nutrition Assistance Program, formerly known as food stamps, might be one excellent choice. There is a lot of money in SNAP (about \$74 billion in FY2015), and incremental funds are likely to be spent quickly by families who are, quite literally, living hand-to-mouth. According to Bernstein and Spielberg (2016, 10), an astonishing 97 percent of SNAP benefits are redeemed within a month. Yet SNAP seems always to be on Republicans' wish list for budget cuts, making bipartisan agreement on more-generous SNAP benefits unlikely.

### *For how long should stimulus be provided?*

One important lesson from the most recent economic recovery is that fiscal policy should not swing from stimulus back to austerity prematurely. We should have learned that lesson in 1937–38, and the Japanese reminded us again in 1997 when they raised their consumption tax too soon. Yet the U.S. government moved to fiscal consolidation too quickly after 2010. One possible rule of thumb, suggested by Zandi and

me (Blinder and Zandi 2015), might be to withdraw stimulus only once the unemployment rate falls to within 1 percentage point of full employment—and is declining. Perhaps some other cyclical indicator would work better, but the basic idea is that policy makers should defer deficit reduction until a self-sustaining expansion is well under way.

### *It has been argued that government spending could actually be “job-killing.” Is this likely?*

No. Some Republicans attacked the spending portions of the 2009 fiscal stimulus package as “job-killing government spending.” It was an odd, and profoundly anti-Keynesian, verbal construction. Raising federal purchases means either that the government hires workers directly onto its own payroll or that it buys more goods and services from private businesses, which in turn raise their payrolls. Critics might legitimately object to any particular spending program as excessive, misguided, inefficient, or whatever. But how can more spending “kill” jobs? Furthermore, with so much slack in the economy, fiscal multipliers were probably unusually large at the time, certainly not *negative*.

### *Specifically, can unemployment insurance destroy jobs?*

There is a well-known downside to providing more-generous UI benefits: the disincentive effects on job seeking and job acceptance. That is, for example, why we keep the UI replacement rate well under 100 percent. The optimal level of UI benefits balances such disincentive effects against the benefits of supporting aggregate demand when the economy is weak. Notice, importantly, that this balance shifts in the direction of higher UI benefits when the economy slumps and jobs become harder to find.

### *Are fiscal multipliers really quite small?*

Estimated fiscal multipliers seem to depend on the methods used to estimate them. The methodology behind tables 1 and 2 was once standard: simulate a large-scale model of the U.S. economy, both with and without the policy of interest, and take the differences as estimates of the policy effects. Such estimates clearly depend on the details of the model used to generate them, so different models give different answers. This is why CBO, for example, uses a variety of models.

But Keynesian macro models like the Moody's model fell out of favor in academia (though not in policy-making circles) decades ago. In consequence, many economists now prefer so-called "reduced-form" estimates that do not depend on any particular macro model but, allegedly, allow the data to speak for themselves. Doing so is easier said than done, however, because the investigator must still decide which variables to control for statistically and which to ignore.

Empirically, the reduced-form methodology tends to produce smaller multipliers than big structural models do. Why is less clear. One reason may be that reduced-form estimates tend to be dominated by large increases in defense expenditures due to wars—which also happen to be periods of full employment.

### *What about helicopter money from the Federal Reserve?*

Lately, there has been a lot of loose talk about "helicopter drops" of money, prompted by the fact that the Federal Reserve has nearly run out of instruments to fight the next recession—whenever that might come. The term "helicopter drops" is a (bad) metaphor for increasing government transfer payments and financing them by creating money rather than by additional Treasury borrowing. They are highly expansionary for the simple reason that expansionary monetary and fiscal policy *together* is more powerful than either one separately. The loose talk, however, imagines that the central bank can do a "helicopter drop" on its own. It can't. The Fed has no authority to raise transfer payments: that's the prerogative of Congress. And, should Congress go down that path, it should ensure that the higher transfer payments are well-targeted on liquidity-constrained households, not sprinkled randomly as if by a helicopter.

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# Chapter 7. Conclusion

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The *theoretical* arguments against using fiscal policy as a stabilization tool turn out to be pretty thin gruel. But the *practical* and *political* arguments seem more daunting, particularly in the absence of major institutional change. Countercyclical variation in, say, public works spending is fine in theory, but does not appear to be either sensible or workable. Changes in taxes and/or transfer programs are far more suitable for stabilization purposes, but current institutional arrangements leave you wondering about prospects for success. Nor do any of the institutional changes that would make successful fiscal stabilization more achievable seem likely to be adopted by Congress. You can see where the old conventional wisdom—just rely on monetary policy—came from.

Unfortunately, recent events make that attitude look dangerous. Remember, the traditional case *against* using fiscal policy to prevent or shorten recessions rested on two main pillars:

- I. Fiscal policy is superfluous because monetary policy can always do the job.
- II. Sensible fiscal policy is impossible because Congress is too slow and too political.

We now understand that Pillar I is demonstrably false. Furthermore, close encounters with the lower bound on the federal funds rate are likely to be far more frequent in the future than they have been in the past, owing to the legacy of low inflation and low interest rates. We also have seen many examples demonstrating that Pillar II might be incorrect. Congress can move quickly, and in the right direction, when a recession hits. In short, the case against fiscal policy has collapsed, making it worthwhile to think about what economists and political leaders can do to make fiscal stabilization a more useful and effective tool.

Education is a good place to start. Students learn in Economics 101 that lower taxes and/or higher levels of government spending can mitigate recessions by boosting aggregate demand. That simple Keynesian idea should be no more controversial today than Darwinian natural selection or global warming. (Two disheartening analogies, I'll admit.) Furthermore, pursuit of countercyclical fiscal policy is not, and should not be viewed as, a "left-wing" idea. For example,

conservative politicians who are intent on shrinking the government can favor tax cuts when aggregate demand needs a boost and spending cuts when aggregate demand needs restraint.

That said, the fiscal policy toolbox could stand some refurbishment—and that has been the focus of this paper.

First, we could—and, I'd argue, should—strengthen automatic stabilization by making more grants-in-aid to state and local governments and to individuals (e.g., SNAP benefits and Medicaid grants) increase automatically (or *more* automatically) when the economy sags. Second, bringing back the decades-old idea of "formula flexibility," either in government purchases or in tax rates (or both), might also be worth a try. More generally, ways to take some of the politics out of fiscal policy—for example, via the "fast-track" procedure sketched above—would speed the process up.

Third, the so-called "bang for the buck" of fiscal policy could be enhanced by concentrating on policy instruments with high multipliers, such as tax cuts and transfer payments targeted on liquidity-constrained households. Doing so is especially important when there is concern over the size of the budget deficit and/or the national debt. Business tax cuts seem far less promising owing to the political theorem enunciated earlier: lobbyists will emphasize "bucks" over "bang."

Fourth, the appropriate mix of stimulative fiscal policies depends on the length and depth of the recession. Fast-acting tax cuts and increases in transfer payments to households make the most sense in short, shallow recessions. Infrastructure spending is an important part of the fiscal armory against long, deep recessions. The problem here is painfully obvious: economists are not very good at forecasting the length and depth of recessions. Still, some cases are obvious. For example, it was clear by February 2009 that we were in for a whopper.

Fifth, expansionary fiscal policies work best when accompanied by expansionary monetary policies—and the converse is also apparently true. While this insight is hardly original, economists may have underestimated its importance. I certainly did until I saw the results from the Moody's model summarized in chapter 3. It is a topic crying out for further research.



Sixth, where possible (and I fear the range of applicability may be narrow) “cash-for-clunkering” a program would help enhance both its speed and power. By this I mean creating some benefit (a lower tax or a higher subsidy) that is explicitly temporary and, if possible, heavily advertised by private businesses. At the very least, purportedly countercyclical investment incentives should always be made temporary, rather than undermining their efficacy (and raising their budgetary costs) by making them permanent, as Congress is wont to do.

Finally, we need to find ways—which are probably more political than economic—to discourage politicians from pulling the plug on expansionary fiscal policy prematurely. We made that mistake in 1937, to devastating effect. We made it again in 2011–14, and it slowed the recovery. As things stand now, I see no reason to think we won’t make it again the next time.

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# Author

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## Alan S. Blinder

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Alan S. Blinder is the Gordon S. Rentschler Memorial Professor of Economics and Public Affairs at Princeton University. He is also Vice Chairman of the Promontory Interfinancial Network, and a regular columnist for *The Wall Street Journal*.

Dr. Blinder served as Vice Chairman of the Board of Governors of the Federal Reserve System from June 1994 until January 1996. In this position, he represented the Fed at various international meetings, and was a member of the Board's committees on Bank Supervision and Regulation, Consumer and Community Affairs, and Derivative Instruments. He also chaired the Board in the Chairman's absence. He speaks frequently to financial and other audiences.

Before becoming a member of the Board, Dr. Blinder served as a Member of President Clinton's original Council of Economic Advisers from January 1993 until June 1994. There he was in charge of the Administration's macroeconomic forecasting and also worked intensively on budget, international trade, and health care issues. During the presidential campaigns of 1992, 2000, 2004, and 2016, he was/is an economic adviser to Bill Clinton, Al Gore, John Kerry, and Hillary Clinton. He also served briefly as Deputy Assistant Director of the Congressional Budget Office when that agency started in 1975, and testifies frequently before Congress on a wide variety of public policy issues.

Dr. Blinder was born on October 14, 1945, in Brooklyn, New York. He earned his A.B. at Princeton University in 1967, M.Sc. at London School of Economics in 1968, and Ph.D. at Massachusetts Institute of Technology in 1971—all in economics. Dr. Blinder has taught at Princeton since 1971, and chaired the Department

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Dr. Blinder is the author or co-author of 20 books, including the textbook *Economics: Principles and Policy* (with William J. Baumol), now in its 13th edition, from which well over two and a half million college students have learned introductory economics. His latest book, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead*, was published in January 2013 (Penguin Press). He has written scores of scholarly articles on such topics as fiscal policy, central banking, offshoring, and the distribution of income. He also appears frequently on PBS, CNBC, CNN, Bloomberg TV, and elsewhere.

Dr. Blinder was previously President of the Eastern Economic Association and Vice President of the American Economic Association. He is a member of the board of the Council on Foreign Relations, a member of the Economic Club of New York, the Bretton Woods Committee, and the Bellagio Group, and a former governor of the American Stock Exchange. Dr. Blinder also serves on academic advisory panels for the Federal Reserve Bank of New York and the Hamilton Project.

He has been elected a Distinguished Fellow of the American Economic Association, and a member of the American Philosophical Society, the American Academy of Arts and Sciences, the American Academy of Political and Social Science. Dr. Blinder and his wife, Madeline, live in Princeton, NJ. They have two sons, Scott and William, and two grandsons, Malcolm and Levi.

## Acknowledgments

The author is grateful to William Gale, Diane Whitmore Schanzenbach, and participants in The Hamilton Project author's conference for valuable suggestions; and to Greg Nantz for excellent research assistance. Parts of this paper rely heavily on ideas expressed, and in some places words written, in Blinder (2006) and Blinder and Zandi (2015). Finally, I am grateful to both The MIT Press and the Center on Budget and Policy Priorities for permission to reprint previously published materials.

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# Endnotes

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1. In fairness, Feldstein did note that the preference for monetary over fiscal policy should perhaps be reversed when interest rates were very low. Years later, he advocated the use of fiscal policy to fight the Great Recession.
2. Some interest rates, such as the rate the Fed pays banks on their reserve balances, can be pushed into negative territory—as many central banks, but not the Fed, have done.
3. See, for example, Dogra and Gorbachev (2016), who estimate about 20 percent of U.S. households were liquidity constrained in 2007. Amazingly, that is about the same share as estimated originally by Hall and Mishkin (1982). Later, Campbell and Mankiw (1990) estimated that 50 percent of U.S. consumers were liquidity constrained. See also Kaplan, Violante, and Weidner (2014), who show that it is not only poor people who live hand to mouth.
4. A similar subsequent study of the so-called income tax rebate of 2001 by the same authors (Shapiro and Slemrod 2003) found that only 22 percent of respondents said they would spend most of it.
5. This last finding echoed what Deaton and I (Blinder and Deaton 1985) had found 17 years earlier.
6. See Chambers and Spencer (2008). Under “mental accounting,” large changes in income may prompt reconsideration of spending plans while small changes do not.
7. Disclosure: I was one of the earliest advocates of Cash for Clunkers. See Blinder (2008). The official name of the program Congress enacted was the Car Allowance Rebate System (CARS).
8. Success from the point of view of increasing spending on new automobiles. Production is another matter (discussed subsequently). Importantly, the program was not particularly well-structured as an environmental policy.
9. I was astonished to find that the index of Heller’s (1966) book contains not a single reference to Martin. He didn’t matter?
10. The quotations come from pages 9, 68, 69.
11. Johnson’s advisers urged a tax hike on him as early as late 1965 (Okun 1970). LBJ resisted until the middle of 1967, when he recommended a temporary income tax surcharge. Congress then took about 18 months to enact one.
12. The Lucas (1976) critique holds that a policy change may itself affect the economic relationship (in this case, the Phillips curve) that it seeks to exploit. Less widely recognized is that this critique implies that deployment of government policy instruments *might* change the behavior of households and businesses *in important ways*. To the extent that the Lucas critique is quantitatively important, it must be the case that stabilization policy is indeed substantially affecting household and business behavior.
13. Disclosure: I was part of President Clinton’s economic team, as a member of his Council of Economic Advisers.
14. Something similar happened years later when President Obama tried, unsuccessfully, to pair some small fiscal stimulus with budget cuts in the future.
15. Just one example of our reasons: Interest rates must be high when the deficit reductions start.
16. The bill garnered three Republican votes in the Senate and none in the House.
17. Note that about 10 percent of the ARRA came from extending the Alternative Minimum Tax (AMT), which was sure to happen anyway, and thus should not be construed as stimulus.
18. Much of that was not *federal* spending, however; the stimulus included substantial increases in grants to state and local governments.
19. The volume was published in 2006, but the conference took place in 2004.
20. See Hall (1988), who studied spending on nondurable goods, and M. T. Sumner (1979), who found little evidence that temporary changes in Ontario’s retail sales tax had a strong impact on consumer spending.
21. See Chirinko (1999), which is a useful source of information on the ITC.
22. See Auerbach and Hassett (1991), and Chirinko (1993) for a survey.
23. Here’s another possible analogy, suggested by behavioral economics: maybe calling the acceleration of depreciation allowances a bonus enhanced its effects on investment spending.
24. For example, infrastructure grants under the awkwardly named TIGER (Transportation Investment Generating Economic Recovery) program were still being made in 2015.
25. For evidence, see, e.g., Poterba (1994).
26. The last time Congress enacted a tax *increase* aimed squarely at *reducing* aggregate demand for stabilization purposes was in 1968. Monetary policy, which is not decided upon by politicians, is much more symmetric.
27. A state’s *insured* unemployment rate runs well below its total unemployment rate. No mechanical relationship connects the two, but 5 percent is a high insured unemployment rate.
28. I refer, specifically, to the Making Work Pay provision of the ARRA, which provided a refundable tax credit of up to \$400 for working individuals and up to \$800 for married taxpayers filing joint returns in 2009 and 2010. This was followed by a 2 percentage point payroll tax holiday in 2011 and 2012, which ended in January 2013.

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## Highlights

The lengthy struggle to emerge from the Great Recession has led to a serious rethinking of a previous verdict: that the job of stabilization policy in a downturn could and should be left exclusively to monetary policy. As a result, a new recognition of the importance of fiscal policy to mitigate recessions has emerged. In a new Hamilton Project policy proposal Alan S. Blinder of Princeton University reassesses the role of fiscal policy and proposes a series of reforms and best practices to guide the use of fiscal policy during the next recession.

## The Proposal

**Target tax cuts.** On the tax side, Congress would: make income and business tax cuts temporary; encourage states to implement temporary sales tax cuts (with revenue losses reimbursed by the federal government); and make tax cuts automatic to reduce the lag time between recessions and stimulus.

**Target government spending.** On the spending side, Congress would: expand automatic stabilizers such as the Supplemental Nutrition Assistance Program (SNAP) and unemployment insurance; administer grants to states and municipalities; and increase infrastructure spending—with a focus on shovel-ready projects. Congress would also establish bond programs similar to Build America Bonds to make it easier for states to finance new developments. Additionally, Congress would deploy consumer-directed discretionary programs similar to the Car Allowance Rebate System, known as Cash for Clunkers, for large durable goods such as cars, home appliances, and computers.

## Benefits

Underutilized labor and capital resources, which constitute the slack in a weak economy, stand to benefit the most from these proposals. Targeted spending will create new opportunities for workers and businesses. Tax cuts will benefit individuals and businesses and encourage additional consumption and investment following the downturn. Expanded automatic stabilizers will help the newly unemployed and provide support to those households struggling to make ends meet. Stimulus spending will help states balance their budgets without resorting to massive cuts in services. Importantly, the benefits of the stimulus will be greater when implemented closer to the onset of the downturn, and the stimulus will yield the greatest boost to output if allowed to extend until the economy is well on its way to recovery.



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