Comments on Fiscal Policy and its Interactions with Monetary Policy

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Some Important Factual context

- How has what governments do changed over time?
  - Large increases in spending, focused on transfers and social insurance
  - Large unfunded future “commitments” on autopilot
- From pre-Great Recession 37%, the publicly held debt to GDP ratio has more than doubled to 97.8% (end of 2024) and CBO projects that it will reach 118% by 2035 and continuing to increase thereafter; an alternative, perhaps more plausible, scenario has it rising even faster
  - To stabilize the debt to GDP ratio at 97.8% would require substantially curtailing spending growth and/or raising additional revenue
- Large fiscal deficits; simultaneous huge increases in debt/GDP almost everywhere;
- Post WWII U.S. history: Obama ran largest cyclically adjusted deficits, until Trump 1.0, until Biden, maybe Trump 2.0 risks taking the crown;
- U.S. fiscal trifecta on top of having the largest debt to GDP ratio since WWII: the urgent need for major defense spending increases (as well as a bigger bang for the buck); impending in a few years: Social Security and Medicare cliffs
- Many economists and policymakers have been surprised we haven’t had an overt fiscal crisis
  - The surge in inflation in 2021-2023 was at least partly due to the large increase in government spending as the economy approached full employment (Fiscal Theory of the Price Level?)
  - (Feldstein-Harberger) Many analyses have been of a closed economy, but it has turned out the the supply of capital to the U.S. has been for more elastic over a larger range then has been expected; we know eventually in must turn inelastic, if only because there must be an upper bound on the fraction of wealth that people are willing to hold in Treasuries and other dollar denominated assets
  - The present value condition, if binding, says nothing about when on that time path primary surpluses must take over and for how long
  - r<g? For successful continual rollover, there can not be a period of r>g that causes the debt to explode
  - U.S. is 40% of global equity and bond markets; can U.S. continue to offer high, safe and liquid enough returns?
  - Global reserve currency threatened?; 85% of currency transaction have the dollar on one side; will that gradually erode, a major global alternative emerge - it would have to have deep, liquid markets with narrow bid-ask spreads in options and futures markets;

- Economists have debated the effects of deficit-financed spending on short-run aggregate demand, the price level, long-run growth, and economic welfare since the classical economists.
- Does debt have real effects? Mundell, Modigliani; Buchanan; Tobin (e.g. TIPs); a quasi-consensus—call it the traditional view (TV)—has emerged.
- The TV posits that deficits and debt are acceptable, and even desirable
  - as a countercyclical device, via the automatic stabilizers; discretionary fiscal policy may be useful in a deep, long-lived recession at the zero lower bound (ZLB) on interest rates if it can be designed and implemented to help quickly at reasonable long-run cost;
  - to finance productive public investment;
  - for tax smoothing of large, temporary spending swings (e.g., World War II);
- The TV posits that the incidence of the debt falls primarily on younger generations, who will inherit a smaller capital stock, lower wages, and higher taxes. The equity of the intergenerational transfer from young to old varies with the rate of productivity growth.
- The TV posits that deficits and debt are economically harmful and, in the extreme, dangerous
  - as they crowd out private investment and reduce future income;
  - if they cause an upsurge increase in the price level, and perhaps a continued inflation
  - if they are big enough to cause elevated risk premia, expectations of inflation, depreciation of currency, capital flight, and/or a financial crisis.
- It is not just the budget position overall, but level and structure of government spending and of taxes, e.g. *productive* government investment versus transfers financing consumption; taxes on saving and investment versus consumption; and effective rates versus inframarginal; and expectations thereof.

- It has been sharply questioned on analytical and empirical grounds, e.g. from Barro's revival of Ricardian Equivalence, in which government bond issuance decreases national saving, but is offset by increased private saving (perhaps through intergenerational transfers) to Blanchard's objections to the TV and his conclusion of no fiscal cost or welfare loss to debt increases.
- The conclusions from stylized analytical and macroeconometric models, estimated multipliers, structural vector autoregressions, and historical case studies analyzing fiscal policy depend upon assumptions on economic and fiscal conditions; the nature, timing, and financing of fiscal actions; the path of monetary policy; the degree of wage and/or price rigidity, including at the ZLB; the degree of forward-looking behavior by consumers and firms; etc.
- Modern research decisively rejects the simplified Keynesian notions of expenditure multipliers that are large and larger than tax multipliers, with little if any long-run cost.
- Evidence since the financial crisis suggests the following:
  - Present value expenditure multipliers are somewhat below one, and lower still with variable labor supply and capital stock; at their peak, multipliers at the ZLB initially, but rapidly declining, and potentially negative, a dampener, if either the increased spending is expected to last beyond the ZLB period or the debt/GDP ratio is high enough.
  - Estimated tax multipliers are considerably larger, especially for permanent rate reductions.
  - Multipliers are possibly larger in recessions and smaller, even negative, in expansions.
  - Multipliers for the 2009 stimulus bill were about 0.6; Ramey concludes that it should have relied "more on tax rate cuts and less on expenditure."
- Importantly, fiscal consolidations focused on spending reductions are more successful in improving the fiscal position and avoiding recession than those focused on tax increases.
- Given the implications for future taxes and or spending, it is important to merge estimates of short-run effects with a growth model. One study estimates a dollar of deficit spending costs the economy a sobering $3.40 in present value.

- Most analyses of the effects of deficits and debt utilize the government's intertemporal budget constraint—that the net present value of future primary surpluses must cover the current debt net of assets—and the debt dynamics difference equation:

$$(1) \qquad B_0 \leq \sum_{t=0}^{\infty} \frac{T_t - G_t}{(1+r)^t},$$

$$(2) \qquad d_t = \frac{1+r_t}{1+g_t} d_{t-1} + x_t,$$

Where x is the primary surplus, d is the debt ratio, g is the growth rate, and r is the maturity-adjusted net of tax Treasury rate

- If deficits decrease national saving and crowd out investment, future incomes will be lower. A rough estimate from a simple production function and an assumption on how much the debt substitutes for tangible capital: full crowding out, for example, results in a 15+ percent decrease over a generation. There is a range of empirical estimates of these effects. It is important to separate external from internal debt, where the substitution is on foreign portfolios. My own very rough estimate is the crowding out is about 50-60 cents on the dollar, the rest coming from increased private saving and foreign capital inflows.
- The International Monetary Fund estimated each 10 percent increase in the debt ratio lowered the growth rate 0.2 percent, which would lead to larger income losses.
- A main mechanism through which deficits and debt affect the economy, is by raising interest rates—estimates suggest 3–4.5 basis points per point of the debt/GDP ratio.

- Many attempts to bind future legislatures with fiscal rules have been implemented in recent decades with mixed results.
- Balanced budget (constitutional amendment?); Graham/Rudman/Hollings; Maastricht; paygo – a marginal balanced budget rule; balance budget over the business cycle; stabilize D/Y at “acceptable” level;
- Measuring budget position: cyclical adjustment; inflation adjustment; capital accounts; fiscal gaps, etc.
    - BTW tax brackets are now indexed with a superlative formula, but not benefits; measures of inflation have improved; frontier – putatively free goods

Some implications for monetary policy

- With low multipliers for expenditure, even lower for transfers which tend to form the bulk of "stimulus" spending, pressure on FED to deal with recession increases; this may not be a bad thing, given the ineffective and costly nature of most discretionary fiscal interventions.
- Longer-term, continued large primary deficits will put pressure on FED to monetize the debt; importance of fed quasi-independence.
- If pessimistic projections about growth potential are lowered even more because of the potential for growth to slow with major debt increases, macroeconomic stabilization will become more difficult; and international issues: global reserve currency status of dollar, policy coordination (swap lines in emergencies) may become more difficult to maintain.

- My Conclusion: large deficits and debt are risky; the harm they cause may be more like a slow-moving cancer than a heart attack; but when you have a pretty good idea that there are icebergs ahead, even if you are not sure how close, it is wise to steer clear, not continue or worse yet, speed up.