FISCAL POLICY IN THE U.S.: LESSONS FROM 2001

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Who would have thought it? After two decades during which government economic activity has been under attack, even on the retreat, there is a renewed and vigorous interest in fiscal policy in the United States. This is partly because of the serious events of 2001 which reminded us of the value of government, but it is also due to the recession which has highlighted government's role in stabilizing market economies.

Aided by the smooth workings of automatic stabilizer mechanisms, such as the progressive income tax, the huge on-budget surplus disappeared. This has helped dampen the recession's impact, and spotlighted the virtues of tried and trusted Keynesian principles of mobilising government money to stabilize the economy. When interest rates were higher, recessions could be fought by lowering them, which immediately reduced debt service burdens. In particular, families could refinance their mortgages with lower, more affordable rates, thereby freeing up disposable income. Now that inflation and interest rates are both down, monetary policy has less room for manoeuvre, increasing the need for alternative mechanisms to combat demand slumps.

Automatic stabilizers are one channel through which fiscal policy can help combat recessions; discretionary fiscal policy is another. Here, the record of 2001 is less sanguine. Though presented as immediate fiscal stimulus, the spring 2001 individual tax cut was in fact little more than a back-loaded tax redistribution to the wealthy. Thus, 47.1% of the benefits go to the top 5% of income earners, and because many of the provisions are phased in over the next ten years, it significantly worsens the long-term fiscal outlook. Good discretionary fiscal policy should provide immediate stimulus by getting money to those who will spend it, and it should sunset when recovery begins. The spring 2001 tax cut largely failed both of these tests.

Another area where policy failed was unemployment insurance (UI), which was held hostage to demands for corporate tax relief. UI is perhaps the single most effective instrument of fiscal stimulus, in that it reaches those who need income most and who will spend it all. Moreover, as the unemployed are often geographically concentrated, unemployment insurance helps dislocated communities. Finally, it sunsets – as counter-cyclical policy should – when the unemployed find new jobs. Yet, despite these clear benefits, action on UI was blocked by political demands for corporate tax relief. In some instances, these corporate demands contained little stimulus value in that they rewarded old investments already in place. In other instances, they gave little stimulus given their cost. Thus, the proposed investment tax credit made no attempt to target marginal investment spending, and instead rewarded all investment spending including that which would have taken place with or without the tax credit.

Public infrastructure investment is another are where policy can be strengthened. The September terrorist attacks did prompt some increased spending in the form of re-building assistance and defence and security expenditures. But more is needed. Infrastructure spending can be effective as a jobs generator, and it can also help address long unfilled needs and enhance future productivity. Finally, another useful fiscal policy for speeding recovery is federal aid for states. Since many states are subject to balanced budget rules, downturns lead to pro-cyclical cutbacks in state spending, making matters worse. Federal aid for states can mitigate this consequence of state budget rules. If the recession continues in 2002, such aid should be a focal point of federal fiscal policy action.

Thankfully, the era of fiscal repair to resolve unsustainable deficits is over. Looking ahead, government should renew its commitment to the principles of a good tax system – sufficiency, fairness, efficiency, and economic stability. Unfortunately, many of the discretionary changes in U.S. tax policy in 2001 failed these principles. The tax cut was unfair because it was skewed towards the richest 1% of the population, and its phased in design promises to so reduce future revenue streams that there will be insufficient resources to meet America's public service and infrastructure needs. This suggests that policy makers should repeal the 2001 tax cut. However, this will be a difficult message to craft. On one hand fiscal stimulus may still be needed if the recession continues. Yet on the other hand, and superficially in contradiction, the 2001 tax cut should be repealed because it undermines the long run fiscal outlook and provides minimal fiscal stimulus.