

COMMENTS

COMMENTS ON ALAN AUERBACH RECEIVING THE HOLLAND AWARD*

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IT IS A DISTINCT PLEASURE TO CONGRATULATE ALAN on an extremely well-deserved award. We have all learned so much from Alan's research on so many topics. I am honored to be part of this forum. Alan has been a wonderful coauthor, a valued adviser and mentor, and a good friend to me over the years.

I have been asked to discuss Alan's work on fiscal policy and related topics (not including Auerbach-Kotlikoff research, which Larry will discuss). Even given those constraints, however, I will not have space to cover Alan's voluminous contributions to many topics in public finance, such as dynamic revenue estimation and forecasting, budget windows and budget rules, and other issues. I will limit my comments to his contributions to long- and short-term fiscal policy, and even there, I do not have the space to cover all of his contributions.

Before turning to those issues, let me add that, in my view, one of Alan's defining traits is his ability to think comprehensively – he sees connections where others do not, he can create a coherent framework where others have failed. (Another defining trait is his dry sense of humor.) If, for example, your null hypothesis is that Alan walks around with a dynamic, overlapping generations, multisector, open economy model with transversality conditions all in his head, the evidence would not let you reject the null.

In fiscal policy, some examples of thinking comprehensively come to mind quickly. Some of these examples will seem obvious in retrospect. However, the mark of good economics (and hence a good economist) is that observations may seem obvious ex-post, even if they were not obvious ex-ante to people at the time.

For example, during tax policy discussions leading to the 2001 tax cut, Alan emphasized that one could not discuss the effects of a permanent tax cut without specifying the financing. Obviously, this notion comes out of serious consideration of the government's budget constraint. However at the time, it was not obvious to many participants,

especially in the policy sphere. In subsequent work (Auerbach, 2002a), Alan showed that, indeed, alternative methods of financing have a first-order impact on the long-term growth effects of a tax cut.

As a second example, I turn to Alan's numerous talks and presentations about tax reform. Although there is a standard analytical dichotomy between revenue-neutral structural tax reform and changing the level of revenues collected by the government, Alan has persistently emphasized that the issues are not separate. Indeed, structural tax reform is all the more important as we consider raising revenue levels because deadweight loss rises as a function of the marginal tax rate and equity and simplicity issues become even more important as the tax system grows in size.

These types of connections see past the narrow, and often arbitrary, confines of seemingly well-defined issues and established common wisdom. Alan's strength in making these connections has been a great contribution to both the research world and the public policy debate.

LONG-TERM BUDGET OUTLOOK

Long-Term Fiscal Policy Objectives

One of the most difficult aspects of long-term fiscal policy is determining precisely what policy should try to achieve. As Alan has written recently (Auerbach, 2008), it should be an obvious point that fiscal policy should have rational objectives, but this point is often neglected: he has described the usual process of determining deficit targets as "not unlike spontaneous generation." Ideally, Congress would determine deficit targets by rationally considering the potential long-term objectives and their tradeoffs (such as intergenerational equity, fiscal sustainability, and economic performance) and weighting them by importance; yet in practice, few targets are designed with foresight or consistency of objective.

Auerbach (2008) notes that there is no simple formula for how to compute the ideal trajectory, nor

*2011 Holland Award recipient, Alan Auerbach, did not prepare a written statement for his acceptance of the award.

is there a single measure of the economy's fiscal situation that best addresses all issues. Rather, a collection of forward-looking measures, presented in conjunction with an assessment of their dependence on particular assumptions, can provide far more information than short-term deficit targets alone. Even so, care must be taken in the presentation of these measures to ensure that their multiplicity helps and does not hinder policy makers, that they provide a clear message regarding the desirability of particular fiscal policy paths.

Fiscal Gap Estimates

Through development and estimation of the fiscal gap, Alan has done significant public service to help clarify the enormity of the fiscal shortfall facing the country. In Auerbach (1994), Alan laid out the foundations of the fiscal gap. At that time, neither the CBO nor the GAO issued regular reports of the long-term budget deficit; while there was general understanding that Social Security and Medicare faced long-term shortfalls, there was little evidence on the government as a whole.

Auerbach (1994) developed the concept and measure of the fiscal gap — which can be expressed in different ways, including as the present value of projected primary budget deficits or as the permanent and immediate increase in revenues or reduction in spending (as a share of GDP) the federal government would need in order to have a future debt-to-GDP ratio equal to the current ratio. The gap clearly defines the size of the needed policy response under different scenarios. He provided plausible bounds using different assumptions: an optimistic scenario, where only the change in demographics drives the growth of mandatory spending, and a pessimistic scenario, where health care entitlement spending grows faster than GDP (as it has historically). At the time, Auerbach (1994) estimated that the U.S. had a fiscal gap of between 3.8 and 6.4 percent of GDP over an infinite horizon.

Since then, the official CBO budget baseline has become less and less useful as a guide to realistic budgetary outcomes. This is not a criticism of CBO; rather, it is a statement about legislators' increased use of temporary tax and spending provisions and the maintenance of increasingly incredible assumptions about policy. Since 2000, Alan and I have published what amount to "shadow" budget projections every year. We have taken the CBO baseline, which is more or less a mechanical projection of current law, and adjusted it for plausible

policy alternatives over the next 10 years (see, for example, Auerbach and Gale, 2000; 2011). For example, we assume that history is a good indication of the future: that Congress will not allow Medicare provider payments to decrease, the AMT to capture increasing numbers of middle-class Americans, or the "temporary" Bush and Obama tax cuts to expire. These 10-year projections then form the basis of alternative long-term fiscal gap estimates. Auerbach and Gale (2011) shows that the long-term fiscal gap has grown since Alan's original estimate: the needed fiscal adjustment over an infinite horizon is between 3.7 and 7.5 percent of GDP under CBO's baseline scenario and between 6.5 and 10.3 percent under our extended or "current policy" scenario. The variation depends heavily on projections of per-capita health care spending growth, whether current tax cuts are extended, and whether the AMT is adjusted.

SHORT-TERM ECONOMIC STIMULUS

It is remarkable that Alan, the public finance economist who has done the most to analyze and examine long-term fiscal policy issues, is also the public finance economist who has done the most to analyze and examine short-term fiscal policy issues. In a series of papers, Alan has examined both automatic and discretionary fiscal policy.

Automatic Stabilizers

Auerbach and Feenberg (2000) showed that the role of the tax system as an automatic stabilizer had not changed much from the early 1960s through 1995. Its effectiveness at stabilizing aggregate demand peaked in 1981, due to high inflation causing bracket creep, but more interestingly, its effectiveness in 1995 was about equal to what it was in 1966. This is surprising in a sense because the highest statutory marginal income tax rate was 70 percent in 1966 and had fallen to 39.6 percent by 1995; economists typically think that a more progressive tax system is a better automatic stabilizer.

Auerbach and Feenberg (2000) reveal that the answer to this puzzle can be found in changes in the distribution of income and in the composition of taxes, including increases in the payroll tax and the addition of the earned income credit. They calculated that by 1995, "one-sixth of the overall tax response is attributable to the payroll tax" and that while the tax response for the top income quintile has decreased over time, the response for the rest

of the income distribution has risen “because of the rising payroll tax and, in the second and third quintiles, the EITC.” In other words, “because payroll taxes are concentrated almost entirely among the group [deemed] to be liquidity-constrained, almost all of the tax change resulting from a shock to income [in that group] translates into a change in consumption.” In addition, Auerbach and Feenberg noted that automatic stabilization could work on the supply side: for example, when output falls, those for whom income declines see their marginal tax rates decrease, which should encourage greater labor supply. This also serves to constrain booms because when income rises, the higher marginal tax rates should discourage labor supply. The supply-side stabilization is achieved through “incentive effects of marginal tax rates, rather than through changes in tax payments. Moreover, the temporary nature of the change in income, which works against the effectiveness of demand-side stabilization, reinforces the supply-side impact.”

Auerbach (2009) updated the earlier estimates and showed that, over the previous decade, changes in tax policy have reduced the effectiveness of the tax system as an automatic stabilizer, that the “strength of automatic stabilizers has been weakened over time by the indexation of the individual income tax and reductions in marginal tax rates.” In fact, “the sensitivity of taxes to income during the period 2003-2007 was lower than at any time since the 1960s.”

Discretionary Policy

I have had the pleasure of writing two survey papers with Alan about what the profession knows about economic stimulus (Auerbach and Gale, 2009; Auerbach et al., 2010). Our major conclusion was that the state of the economic stimulus literature was not “shovel ready” for policy implications.

Alan has also made original contributions in two key areas about discretionary fiscal policy. First, in a series of papers, he has analyzed “how the practice of discretionary fiscal policy has changed over time,” specifically whether its use has increased over time. In Auerbach (2002b; 2003), he used policy changes as reported by the CBO to show that the 1990s were relatively quiet regarding activist policy. In Auerbach and Gale (2009), we showed that this was because the underlying forces that drove short-term fiscal policy responses were muted. Policy makers simply did not have reasons to intervene, given how well the economy was

doing. In the last decade, though, the reasons for interventionist policy had returned and resulted in several different stimulus acts – in 2001, 2003 and 2008. According to our model, the 2009 stimulus bill was “not only the largest” policy response, but it was “also predicted to be.”

Second, in two papers with Yuriy Gorodnichenko, Alan provided new evidence on the role of fiscal stimulus on the economy. Using U.S. data, Auerbach and Gorodnichenko (2010) found that the economic effect of government purchases depends on prevailing economic conditions; large multipliers can be achieved during recessions and when interest rates are low while under different conditions the multipliers may be much smaller. They also note that the timing of additional government spending is critical for countercyclical policies to be effective because “the size of the multiplier tends to change relatively quickly as the economy starts to grow after reaching a trough.”

Auerbach and Gorodnichenko (2011) extend the methodology to other OECD countries. In the world financial crisis of 2008, many OECD countries instituted fiscal stimulus to counteract the global meltdown and the subsequent recession. The paper shows that across OECD countries, the effectiveness of discretionary fiscal policy depends on underlying economic conditions at the time of the stimulus. Multipliers “of government purchases are larger in recession, and controlling for real-time predictions of government purchases tends to increase the estimated multipliers of government spending in recession.”

The findings in both papers are consistent with the theoretical arguments in old Keynesian models and raise questions about whether the new Keynesian literature, “which suggest that shocks to government spending, even when increasing output, will crowd out private economic activity,” models the economy well when the interest rate is at the zero bound.

CONCLUSION

I hope this discussion conveys at least some of the depth and breadth of Alan’s contributions to fiscal policy analysis. His work has been both fundamental and lasting, based on common sense and uncommon rigor. The bad news is that, given the problems the economy currently faces in the short-run and long-run, his work is just as relevant today as it was when it is written. The good news is

that scholars and policy makers can count on Alan to continue to provide new and important insights on the major fiscal policy issues going forward.

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