The United States Should Grant the Federal Reserve Some Control over Counter Cyclical Fiscal Policy

By James Sly

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The Federal Reserve Needs New Tools to Manage the Economy

Fiscal policy can be a valuable tool in reducing the impact of recessions, and this tool is especially important right now, when the influence of monetary policy has become limited due to interest rates stuck near zero. That leaves the Federal Reserve with less powerful tools like quantitative easing (QE) to manage the economy during a downturn. In the 2008 crisis, QE successfully reduced long term interest rates, stabilized inflation as it was falling too low, and reassured investors that there was no need to fear a debt crisis, even as deficits were reaching unusually high levels. By itself, however, QE is not enough to completely offset the impact of a severe downturn, and this is where fiscal policy can play a useful role. If interest rates stay near zero over the long term, then central banks will need new tools to manage the ebbs and flows of the business cycle, and giving central banks some control over fiscal policy decisions is one strategy that the US should be experimenting with in order to help deal with this new world of persistently low interest rates.

Three Approaches to Determining Counter Cyclical Fiscal Policy

There are three general strategies for managing counter cyclical fiscal policy in a crisis. The first strategy is discretionary fiscal policy, which lets the legislative and executive branches work together to decide how much fiscal stimulus to enact once the downturn has already arrived. The second strategy has the executive and legislative branches pass automatic stabilizers before the recession hits, which links more generous fiscal stimulus to specific economic indicators, so that once the economy suffers, you can get new fiscal aid sent out without passing any new laws. The third strategy gives some control over fiscal policy decisions over to the central bank, which can then use its unique institutional structure to decide when fiscal stimulus is needed most.

Our current system relies heavily on discretionary fiscal policy to provide a unique response to each individual recession, though there are some automatic stabilizers built into our current system, like unemployment insurance (which automatically expands when unemployment goes up) and the tax system (which allows taxes to automatically decline as incomes decline). There are three main disadvantages to relying too heavily on discretionary fiscal policy. First, it takes a long time for Congress and the President to decide, negotiate, enact, and implement a unique policy response for each individual recession, and since this process does not begin until after the recession has already started, there can be a long lag time between the beginning of a recession and when the discretionary fiscal stimulus actually arrives. Second, the executive and legislative branches can become mired in partisan disagreements that can prevent the swift enactment of valuable fiscal stimulus, as has become obvious during this latest crisis, when the second round of fiscal stimulus was delayed for months even after the first round was passed quite quickly. Third, providing new fiscal stimulus is usually quite popular and reducing fiscal stimulus is often quite unpopular, so public pressure can make it difficult for the executive and legislative branches to reverse the fiscal stimulus once it has already been enacted, as happened with the 2001 Bush tax cuts.

Relying more on automatic stabilizers, rather than discretionary fiscal policy, will help avoid the harms of each of these three particular problems. As far as timing is concerned, automatic stabilizers affect the economy more quickly because they are negotiated and enacted well before the recession actually hits, and are specifically triggered to go into effect once the recession starts showing up in the economic data. Plus, enacting automatic stabilizers beforehand allows the bureaucracy to prepare their response in advance, which eliminates any delays in setting up the administrative infrastructure necessary to manage any new fiscal stimulus that gets enacted in the middle of a recession. As far as gridlock is concerned, there might be some partisan disagreement in getting the automatic stabilizers set up, but unlike discretionary fiscal policy, this option does not need to be negotiated in the middle of a recession, but can be enacted at any time in between recessions. Rather than be stuck with whatever distribution of power that is present in the middle of a crisis, the automatic stabilizers can be created when the level of gridlock is least severe and any delays in resolving disagreements between the two sides becomes relatively harmless as long as the economy stays strong during this time. Plus, when enacting the automatic stabilizers, policymakers do not know who will be in power when the next recession hits and the automatic stabilizers are triggered, which reduces concerns over giving the other party a big political win that helps them stay in power since it could be either party who benefits. As for the issue of reversing any new stimulus measures, automatic stabilizers can be designed to automatically trigger on when certain economic conditions are met, but also automatically trigger off as the economy recovers and the economic indicators improve. This reduces the need for the executive or legislative branch to enact unpopular laws to take away the stimulus just as the economy is recovering because they can just let the automatic triggers do the work for them.

Giving some control over counter cyclical fiscal policy to the Federal Reserve offers some benefits over automatic stabilizers. First, even though automatic stabilizers respond more quickly than discretionary fiscal policy, there are some lags in collecting and releasing critical data, so that the Fed often has some idea a recession is taking place before it even shows up in the data. This means that even if automatic stabilizers might be triggered a few months into a recession, giving the power to the Fed to decide on fiscal stimulus could get it done even sooner. The second advantage for giving power over fiscal policy to the Federal Reserve is that they have a reasonable idea of how severe a recession will be while the recession is taking place, while automatic stabilizers only know how severe the recession is until after it has happened. This means the Fed has the ability to adjust the size of the stimulus in real time to the needs of the recession, while automatic stabilizers can only realistically increase the stimulus until after the harm has already taken place. This requires automatic stabilizers to be designed to be more cautious at the beginning since you do not know at that point whether the recession will be limited or severe based only on the economic data available, while the Fed would likely be able to be more aggressive when a severe recession hits. The third advantage for giving the Fed some control over fiscal policy is that the Fed is run by a small non-partisan board filled with technocrats that historically has had little trouble reaching consensus since they often follow the direction of the chair. As with automatic stabilizers, there would be some resistance to initially granting the Fed some control over fiscal policy, but once the authority was granted, the Fed would have little trouble resolving differences in opinion and deciding on key stimulus measures, since institutionally that is exactly what they were designed to do. Finally, the Fed would also have little trouble reversing any fiscal stimulus, since they are largely protected from public pressure as an unelected independent agency with each member serving on the board for long terms, which was specifically designed to make it easy for them to make unpopular decisions to fight inflation with monetary policy. This structure would also make it easy for them to take away fiscal stimulus as well.

The Federal Reserve's institutional structure also provides some disadvantages as well. Since the Fed is run by unelected non-partisan technocrats who are protected from political pressures, this also makes them an undemocratic institution, indicating that this option should only be used as a last resort when other options like discretionary fiscal policy or automatic stabilizers fail. In particular, the Fed should not be making policy with any important distributional considerations, since institutionally they are not set up to pick winners and losers in any major policy decision. As a result, the Fed's power should be limited to the counter cyclical part of fiscal policy decisions and any distributional aspect left to the legislative and executive branches, specifically so the Fed could remain an independent non-partisan institution over the long term.

Question #1 – What policies should the Fed have control over?

If policymakers decide they want to give some control over counter cyclical fiscal policy over to the Fed, then the first key question is what programs should they have some authority over? The Brookings Institution collaborated with the Washington Center for Equitable Growth to produce a multi-chapter report called Recession Ready: Fiscal Policies to Stabilize the American Economy, which detailed numerous ways automatic stabilizers could be built into government programs to assist with counter cyclical policy. This report has one chapter each on making direct payments to payment to individuals, providing additional aid to state governments through Medicaid, strengthening the counter cyclical impact of unemployment insurance, expanding SNAP benefits and eliminating work requirements during recessions, reforms to TANF programs to help families in difficult economic times, and using infrastructure spending on transportation to help offset any significant downturn in the economy. In theory, the Fed could be given partial control over all those programs, but as indicated earlier, the best approach is to do as much as you can with discretionary fiscal policy and automatic stabilizers and only use the Fed to fill in gaps which the other approaches miss.

When considering which policies the Fed should help control, the only policy that makes sense is direct payments to individuals. Direct payments offer the strongest counter cyclical effect, and can be scaled up to whatever amount necessary to offset any downturn. Plus, the Fed could be limited in the way it structures its direct payments so that each individual in the whole country, regardless of age and income, gets the exact same amount, which is not only philosophically the fairest way to distribute a windfall benefit, but also has an equal distributional impact for everyone so that the Fed would not need to pick any winners or losers. The direct payments provided during the latest pandemic indicates this would be a viable and popular way to do this, though there would probably be some pressure to create an income limit so the richest individuals get no benefit at all. This would upset the general principle that all people should benefit equally from any windfall gain, and would require the Federal Reserve to collect income data on all individuals getting the benefit, which would make the program much more complex and difficult to administer, while likely having only a limited impact on the overall cost. Recession Ready suggests that annual payments following the start of a recession could be triggered automatically through changes in the unemployment rate, and this would be highly useful to create a strong foundation, while the Fed could fill in gaps with lump sum or monthly payments between the annual payments triggered through these automatic stabilizers.

The other programs that could provide greater counter cyclical benefits are less attractive for the Fed to manage. Payments to state governments have become a heated and controversial flashpoint between the two parties, which the Fed would likely want to avoid, and this program could be easily done through automatic stabilizers, since states have rainy day funds to cushion any immediate impact from a recession, making any delays from the automatic triggers less harmful overall as long as states knew additional funding was going to arrive eventually. Unemployment insurance is also an important tool for counter cyclical fiscal policy, but this too could be done through automatic stabilizers, as long as the Secretary of Labor was given the ability to expand benefits themselves for a few months until the economic data caught up with the economic reality. SNAP, TANF, and infrastructure spending on transportation are all smaller programs with a more limited impact on the overall macroeconomy compared to direct payments to individuals, so that even if they each play a valuable role in fighting recessions, they are difficult to scale up enough to have the large scale macroeconomic effect the Fed needs to fight recessions. As a result, these programs can be modified through automatic triggers and probably do not need any role for the Fed to take over.

Question #2 – How should Congress oversee Fed decisions on counter cyclical fiscal policy?

Clearly, giving the Federal Reserve some control over fiscal policy would represent a major change to how fiscal policy is made, and Congress would not want to give up this power of the purse without including some mechanisms for oversight. The trick to creating an effective system of oversight is to balance the need for Fed autonomy so that they can make good decisions, while also giving the executive and legislative branches some role in the process to make sure the Fed does not abuse their power.

One option is to enforce a 1 year time limit on any new fiscal stimulus initiated by the Federal Reserve at which point they would need approval from the legislative and executive branches. This gets a bit tricky to determine when the Fed does one time payments, or multiple changes to monthly benefits, and can easily lead to restrictions that prevent the Fed from responding appropriately to a double dip recession. Another option is to enforce a limit on the maximum benefit the Fed can provide, but there would be pressure to set a relatively modest limit initially, which would prevent the Fed from going very big very fast in the most severe recessions, which is exactly one of the most important benefits to giving power over fiscal policy to the Fed. Ideally, any maximum limit would be set very high, so that the Fed could determine what policy would be most appropriate, and then the executive and legislative branches could eventually decide whether or not this policy should continue. The best way to do this would be simply to appropriate a designated pot of money that the Fed could uses as it likes to provide direct payments to individuals, as long as each person received the same amount, and then once the money runs out the Fed would have to return to Congress in order to get more funds. If the Fed only needs to do small amounts of stimulus, there would be little need for oversight, but if the Fed decides to go big, then the executive and legislative branches would likely want to a say in this policy much sooner, which is exactly what providing a fixed pot of money would do.

If this particular oversight mechanism were used, policymakers would probably want to create three different pots of money for the Fed to distribute, which would each have its own level of oversight from Congress and the President. In this option, the executive and legislative branches could set aside $500 billion that the Fed could use as it wanted on direct payments to individuals with no input from the other branches of government. Then when this money runs out, another $500 billion would become available for the Fed to spend on these programs, but this money could be blocked by a vote in Congress and a rejection from the President. To avoid gridlock, the executive and legislative branches would only be able to block the funds if the House, Senate, and President all agreed to deny it, and any divided vote among those institutions means the Fed would gain access to those funds. If the Fed used up all these funds, then a third $500 billion would become available, but only if the House, Senate, and President all explicitly approved these new funds, and any divided vote would fail to release this new money. This would be similar to having Congress and the President pass an entirely new law, but perhaps the legislation that grants the Fed this new power over fiscal policy could force an up or down vote on releasing this pot of money, rather than requiring a whole new law to be passed, which would speed up the legislative process and make it less likely to get caught up in other unrelated disputes.

This tiered strategy to providing funds that the Fed could use for direct payments would give them a lot of flexibility to do small amounts of stimulus, while also providing enough funds to go big if necessary quite quickly. The first pot of $500 billion could be used to pay for a $1,000 stimulus check to everyone in the country, as well as an additional monthly benefit or second smaller payment. If the Fed wanted to do more than that, then Congress and the President would have the chance to block them, but only if all of them agreed they needed to be blocked. This would likely give the Fed enough funds to get through a major recession, even if there was a divided government, making it less likely that fiscal stimulus would get caught up and blocked in a partisan dispute. If the Fed wanted funds for a future recession, presumably after it used up the first two pots of $500 billion in the current recession, then they would have to go back and get approval from the House, Senate, and the President, much like passing a new law, but ideally with just an up or down vote on this particular issue. This requirement to go back for more money from Congress would encourage the Fed to spend the money they did have wisely, since if they did abuse their power then they could easily lose this spending authority in future recessions. A similar tiered structure could be used to provide oversight on direct payments triggered by automatic stabilizers, where perhaps the first payment could only be blocked by the Fed, the second annual payment could be blocked if the House, Senate, and President all voted against it, and the third annual payment and beyond would only be approved if the House, Senate, and President all agreed to approve it.

Conclusion

With the persistent trend of declining interest rates that leaves central banks with fewer tools to manage the economy, the Federal Reserve is going to need new strategies and policy levers to ensure they can offset the negative impacts of any downturn. As discussed in this memo, giving the Federal Reserve some control over fiscal policy is one attractive option, that if done well can improve the execution of counter cyclical fiscal policy by speeding up the response, avoiding gridlock, and making it easier to reverse the stimulus once the recession is over when compared to purely discretionary measures enacted in the midst of each crisis. Relying more on automatic stabilizers can realize some of these gains as well, but offering more power to the Federal Reserve over these decisions can fill in some of the gaps that automatic stabilizers cannot, especially since the Fed often knows how severe a recession will be before it shows up in the economic statistics.

Clearly, our current system is far from perfect, and by utilizing automatic stabilizers more heavily and allowing the Fed to make some direct payment to individuals, this combined approach would allow policy to react more swiftly and more strongly. This in turn could make recessions less severe, reducing the pain of the downturn that does result, and providing the foundation for a stronger recovery since there is less ground to make up. This last crisis has shown how direct payments to individuals can be quite effective and popular, and now we just need the Federal Reserve to get on board with granting them new powers over fiscal policy. Once the Fed realizes that the US might be stuck in a low interest rate environment long term, and that the executive and legislative branches of government cannot be relied on to do the job themselves effectively, perhaps they will come around and seek these new powers themselves, especially since it can be argued that these tools would be effective even if interest rates rise well above zero in the future, because of the long policy lags of changing interest rates even under normal circumstances. The world has taught us over these last 15 years that interest rates can fall near zero and stay there for a surprisingly long period of time, and giving the Fed some control over counter cyclical fiscal policy needs to be seriously considered as a way to adapt to these new economic circumstances.

References

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