

Practical Stabilization Policy in the 21st Century

By MARTIN EICHENBAUM*

Macroeconomists widely agree on four key propositions. First, excluding anticipated inflation effects, monetary policy is neutral in the long run. At best, the long-run Phillips curve is neutral. More likely, that curve slopes the wrong way, with high inflation rates associated with low economic growth rates. Second, monetary policy isn't neutral in the short run and can help the economy adjust to shocks. Third, persistent, high inflation is almost always a fiscal phenomenon.¹ Fourth, counter-cyclical fiscal policy *can* be a useful tool for stabilizing aggregate economic fluctuations.

The last proposition contrasts sharply with the mainstream view about fiscal policy in 1997, the last time the AEA convened a panel about core beliefs in macroeconomics.² At that time, there was a consensus about *not* using fiscal policy as a stabilization tool.

I. Some remarks about monetary policy

There is a clear tension between the two roles of monetary policy, summarized by the first two propositions above. As a practical matter, policymakers have

* Northwestern University and NBER; eich@northwestern.edu.

¹This statement should not be viewed as an endorsement of the fiscal theory of the price level. Sustained deficits lead to a loss of central banks' independence and the monetization of those deficits. Also, inflation can be driven by the failure of Ricardian equivalence in heterogeneous agent New Keynesian models. In principle, monetary policymakers could generate inflation by giving in to the time consistency problem pointed out by Kydland and Prescott (1977). A good argument can be made that they did so in the 1970's. That said, most monetary policymakers are now accurately aware of the problem and have avoided succumbing to the Kydland and Prescott type of time inconsistency trap.

²Besides myself, the other panel participants were Olivier Blanchard, Alan Blinder, John Taylor and Robert Solow. They should not be held responsible for my view of the consensus.

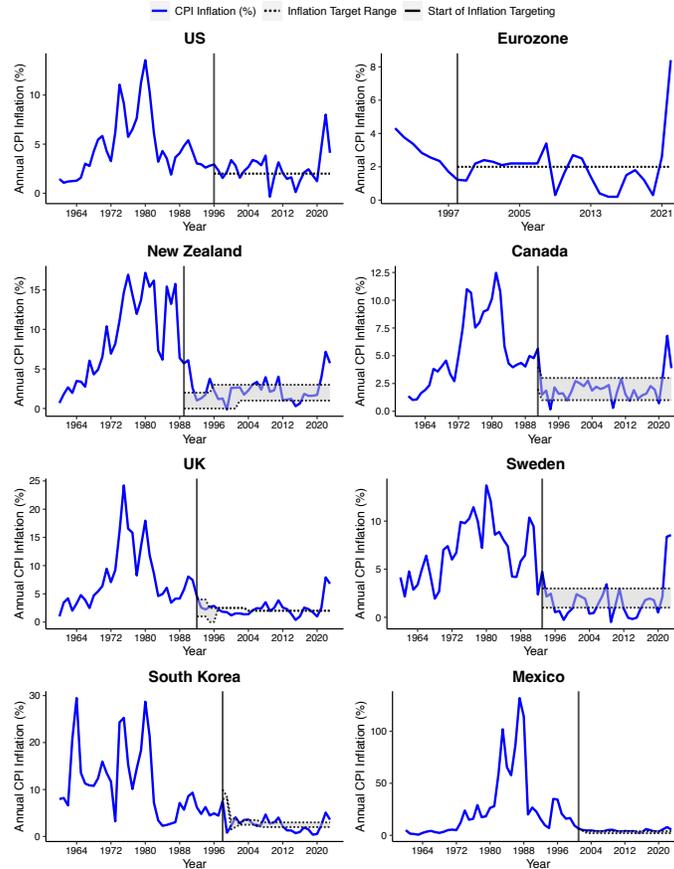
resolved the tension by adopting what they call flexible inflation-targeting regimes centered around a 2% target level. The flexible part is well characterized by some form of a Taylor rule in which a central bank raises the policy rate when inflation exceeds 2% and lowers the policy rate when output is below its potential level.

The following figure displays the inflation experience of eight countries. The vertical line in each figure is drawn at the time when the country committed to a nominal-inflation targeting regime. The success of nominal inflation targeting is remarkable.

An important shortcoming of the current flexible inflation-targeting regime is that it is time-inconsistent. For various reasons, including policy errors, inflation may exceed target levels for a substantial period. If the central bank is serious about achieving its average inflation target, it must undershoot target inflation for a prolonged period. New Keynesian (NK) business cycle models imply that being aggressive on the downside is not time-consistent: if actual inflation is already 2%, why engineer a prolonged slowdown in economic activity? In practice, monetary policymakers let by bygones be bygones. So, we are operating under an asymmetric inflation-targeting regime. Forward guidance suffers from the same time inconsistency problem as strict average-inflation targeting. That may explain why it had limited success. In contrast, some forms of fiscal policy don't suffer from time inconsistency.

II. Fiscal Policy

The old consensus about fiscal policy as a stabilization tool has broken down. In this section, I discuss some of the reasons for the change.



A. Observations from periods where the ZLB period was binding

The zero lower bound (ZLB) on the nominal interest rate was binding from late 2008 to late 2015 and from April 2020 to the beginning of 2022. As a result, policymakers put more weight on fiscal policy. Whether or not we will see frequent episodes of binding ZLB constraints remains to be seen. Prudence requires that we take this possibility seriously and design appropriate fiscal stabilization policies.

B. Fiscal policy: theoretical considerations

In principle, there is nothing monetary policy does that fiscal policy can't do. [Correia et al. \(2013\)](#) consider the efficacy of fiscal policy in a class of models where people have rational expectations and don't face liquidity constraints. They show that state-contingent tax rates on consumption,

labor income, and capital income are a perfect substitute for monetary policy when the ZLB isn't binding. Even better, tax policy can be used when the ZLB is binding to achieve the same allocations that monetary policy would support if the ZLB weren't binding. Depending on the time path of taxes, this form of fiscal policy may be time inconsistent. For example, consider putting consumption on sale by lowering consumption taxes now and promising to raise them in the future. When we reach the future, would it be optimal to raise consumption taxes? In many models, it would not. Moreover, political considerations may prevent policymakers from raising taxes in the future. Like forward guidance, this fiscal policy may have limited success because of time inconsistency problems.

[Wolf \(2025\)](#) provides a general condition on consumer behavior ensuring that any path of inflation and output that is

implementable via interest rate policy is also implementable through time-varying uniform transfers. His results cover standard heterogeneous agent NK (HANK) models with occasionally binding constraints.

Like [Correia et al. \(2013\)](#)-type tax schedule policies, complex, dynamic schedules of transfers may be time inconsistent. Of course, one-time transfers are, by construction, time consistent. But even then, political pressure may induce repeated transfers once a precedent is set. In this sense, even discretionary one-time transfers are subject to a politically induced time inconsistency problem.

Changes in government spending provide one alternative to a complicated tax regime. Moreover, there is a great deal of research showing that under rational expectations, government spending is particularly powerful when the ZLB is binding (see, for example, [Eggertsson and Woodford \(2003\)](#) and [Christiano, Eichenbaum and Rebelo \(2011\)](#)).

1. LIMITATIONS ON PEOPLES' UNDERSTANDING OF GENERAL EQUILIBRIUM FORCES

To review the sensitivity of fiscal policy to limitations on peoples' sophistication, I focus on my work in which people are dynamic-level- k thinkers (see [Bianchi-Vimercati, Eichenbaum and Guerreiro \(2024\)](#)). This specification captures the view that people do not understand the dynamic general equilibrium effects of aggregate shocks to the economy or changes in government policy. By dynamic, I mean that people become more sophisticated over time. This work is closest to [Farhi and Werning \(2016\)](#) who analyze the *fiscal-multiplier puzzle*. They show that the lower the level of cognitive sophistication in the economy, the lower is the government-spending multiplier.

The intuition for the previous result is as follows. Despite peoples' cognitive limitations, they understand that higher government spending implies increased taxes. Other things equal, this negative

wealth effect leads to a decrease in consumer demand. However, other things equal, higher government spending implies an increase in the demand for labor. In equilibrium, this effect leads to an increase in current and future income. Under reasonable conditions, the less sophisticated people are, the less they take into account those positive general equilibrium effects. So, lower levels of cognitive sophistication imply lower values for the government spending multiplier.³

What about tax policy? Following [Correia et al. \(2013\)](#), [Bianchi-Vimercati, Eichenbaum and Guerreiro \(2024\)](#) consider a policy of lowering an ad-valorem tax on consumption as soon as the ZLB binds and then slowly raising that tax to its pre-shock level. This policy puts consumption "on-sale" while the ZLB binds. As it turns out, the stimulative power of tax policy is *undiminished* under *dynamic k-level* thinking. As under rational expectations, there always exists a time path for consumption taxes that supports the flexible price allocation.

The basic intuition for the robustness of tax policy is as follows. Suppose the government announces a time path for current and future tax rates. Then, people incorporate these rates into their personal consumption-savings decisions and substitute consumption to dates when the tax rate is lower. This basic force is operative regardless of any general equilibrium considerations. So, the policy boosts consumption demand and supports flexible price allocation when the ZLB binds, irrespective of whether people understand the general equilibrium effects of tax policies.

2. RICARDIAN EQUIVALENCE: SENSITIVITY TO OTHER LIMITATIONS ON CONSUMER SOPHISTICATION

The most obvious reason that Ricardian equivalence doesn't hold was enunciated

³See [Angeletos, Lian and Wolf \(2024\)](#) and [Woodford and Xie \(2022\)](#) for different but related ways of imposing limitations on households' sophistication that break Ricardian equivalence.

by Ricardo himself: most people don't understand or internalize the government's intertemporal budget constraint in their decisions. Consistent with Ricardo's views, [Bianchi-Vimercati, Eichenbaum and Guerreiro \(2024\)](#) break Ricardian equivalence by assuming that the least sophisticated people in the economy don't understand the government budget constraint. The net result is that government debt affects aggregate demand and output.

In all likelihood, [Bianchi-Vimercati, Eichenbaum and Guerreiro \(2024\)](#) understate the previous effect's quantitative strength because they assume that only the least sophisticated people suffer from 'fiscal illusions.' Using survey methods, [Eichenbaum, Guerreiro and Obradovic \(2025\)](#) find that people *generally* suffer from such illusions.

3. RICARDIAN EQUIVALENCE: LIQUIDITY CONSTRAINTS

The most common way of breaking Ricardian equivalence is to assume that a subset of the population faces binding liquidity constraints and incomplete markets. Different perturbations of this idea lie at the heart of the exploding literature on HANK models. There is also a rapidly expanding empirical literature documenting the prevalence of liquidity constraints and a high marginal propensity to consume out-of-liquid wealth in a subset of the population. I refer the reader to [Auclert, Rognlie and Straub \(2024\)](#), [Ganong et al. \(2024\)](#), [Kaplan, Moll and Violante \(2018\)](#), and the references therein.

[Auclert, Rognlie and Straub \(2024\)](#) argue that once HANK models are disciplined with the available microeconomic evidence on MPCs, the theory predicts a very sizable multiplier for deficit-financed deficits. The intuition is that when Ricardian equivalence doesn't hold, the negative wealth effect associated with a rise in future taxes is mitigated. That force interacting with liquidity-constrained consumers who have very high marginal propensities to consume generates a large multiplier, even

when the ZLB constraint is not binding.

III. Practical fiscal stabilization policy

A practical fiscal stabilization policy meets Lawrence Summers' test of being 'timely, targeted and temporary.'⁴ I would add 'time consistent' to this list. A program of asymmetric automatic stabilizers meets the amended Summers test.

The key idea is that changes in traditional stabilizer programs and tax rates would kick in and kick out automatically when an easy-to-measure and simple-to-communicate macro variable hits a pre-specified target, e.g., a moving average of the unemployment rate.⁵

Automatic stabilizers have two important advantages. First, they are tied to economic conditions, triggering benefits when needed and phasing them out when they are no longer required. So they can be *timely* and *transitory*. Second, they can be *targeted* at high MPC people. Legislated *asymmetric* stabilizers have three important advantages. First, there are important adverse effects associated with many automatic stabilizer programs and limited benefits during normal times. But the benefits rise dramatically as economic conditions worsen. So, it makes sense to invoke changes in automatic stabilizers only when we hit a pre-defined macro trigger. Second, firms and subnational governments would be more likely to factor expanded legislated benefits into their decisions than the possibility of expanded discretionary stabilizers. The more confident people are that they will get expanded benefits in a severe recession, the less they build up socially counter-productive precautionary savings. Third, because they would be implemented by law, automatic asymmetric stabilizers would be less subject to politically induced time inconsistency problems.

⁴Summers, Lawrence, January 2008, Fiscal Stimulus Issues, Testimony before the Joint Economic Committee.

⁵See [Bardóczy and Guerreiro \(2023\)](#) and [McKay and Reis \(2016\)](#) for analyses of state-contingent unemployment benefits in HANK models where all people have rational expectations.

IV. Conclusion

Competing forces can substantially affect the effectiveness of fiscal and monetary policy. For example, deviations from rational expectations that limit peoples' understanding of general equilibrium effects make the government spending multiplier smaller. Frictions like liquidity constraints or information constraints that break Ricardian equivalence make that multiplier larger. In empirically plausible models, the latter effects may overcome the former effects and place government spending on a more equal footing with tax policy or transfers. Finally, different stabilization policies are subject to different time inconsistency problems. We have not yet systematically evaluated the quantitative importance of the different forces at work. So, it is premature to take a firm stand on the optimal mix of stabilization policies. But surely there is some role for fiscal policy.

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