Fiscal Policy: 
Time for the Renaissance of Keynesianism

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Abstract

Developments in macroeconomic theory and policy over the last thirty years or so downgrade substantially the role of fiscal policy. This is particularly the case with what has come to be known as the ‘New Consensus in Macroeconomics’. This contribution aims to consider this particular contention, and argue that fiscal policy deserves a great deal more attention paid to it than what the case has been in the past. More recent theoretical and empirical developments on the fiscal policy front are closely examined in this contribution. This examination reveals that these developments lead to the overall conclusion that fiscal policy is not as ineffective as argued by the ‘New Consensus in Macroeconomics’ proponents. Consequently a more positive attitude towards fiscal policy and its effectiveness should be forthcoming. The present contribution goes a step further and proposes the possibility of fiscal and monetary policy co-ordination. This is examined in this contribution to conclude that it deserves a great deal more attention and careful consideration than hitherto. The overall conclusion is then that discretionary application of fiscal and monetary policy in a co-ordinated and focused manner, as a tool of macroeconomic policy, deserves serious attention paid to it. In this sense and in view of the ‘great recession’, financial stability should also become part of this co-ordination. Fiscal policy is thereby restored to its proper upgraded role in terms of economic policy. It is, thereby, high time economics turned its attention to the renaissance of Keynesianism, appropriately accounting for the realities of today.

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1. Introduction

We examine in this paper the role of fiscal policy as a macroeconomic instrument of stabilization policy. This policy has been downgraded in recent economic policy discussions (for the details, see, for example, Arestis, 2007), although the empirical evidence on the effectiveness of fiscal policy is not always supportive of this view (see, for example, Arestis, 2008). We would, thus, suggest that although problems would always prevail on the policy arena, fiscal policy does not deserve to be so downgraded as in recent policy contributions. The complexity of the theoretical arguments and the difficulty of arriving at clear-cut empirical results notwithstanding, the analysis in this contribution suggests that fiscal policy can be an effective instrument of regulating the level of aggregate demand. This is particularly so when fiscal policy is properly co-ordinated with monetary policy. It is the case that co-ordination of fiscal and monetary policies is gaining a great deal of support.

The main thesis, therefore, of this contribution is that fiscal policy, as a tool of macroeconomic policy, deserves a great deal more attention paid to it than it has been in the recent past. This contribution, therefore, welcomes the question posed by the ex-IMF Managing Director, which is “What about fiscal policy?”; and it is also in full agreement with the answer provided, namely that “Under the old paradigm, fiscal policy was definitely the neglected child of the policy family. Its role was limited to automatic stabilizers – letting budget deficits move up and down with the cycle – and discretionary policy was regarded with deep suspicion. But fiscal policy had a Sleeping Beauty moment during the crisis – with monetary policy running out of steam, and with the financial system on its knees, the forgotten tool arrived to prop up aggregate demand and save the world from an economic freefall. We need to rethink fiscal policy” (Strauss-Kahn, 2011, p. 3). We examine carefully this proposition in what follows in our attempt to defend the thesis that fiscal policy is a powerful tool of macroeconomic stabilization. It is amazing actually that despite the use of fiscal policy following the crisis that emerged in August 2007, which saved the world from the second ‘Great Depression’ and ended with the ‘Great Recession’, full faith in fiscal policy is not there. In this sense the statement by Strauss-Kahn (2011), mentioned above, is very apt. This is precisely what is attempted in this contribution. But we go further, nonetheless, and argue that co-ordination of fiscal and monetary policies is both possible and desirable.

We begin by appraising the recent theoretical developments and empirical findings on the fiscal policy front in section 2. This is followed by a discussion of the role of fiscal policy in section 3. Finally, section 4 summarises the argument and concludes. We also discuss the neglected
but more recently resurrected arm of monetary matters, namely financial policy, which we argue should be the main focus of monetary policy. As such co-ordination of fiscal and monetary policies should also account directly for financial stability.

2. Recent theoretical and empirical developments

2.1 Prolegomena

The impact of fiscal policy on aggregate demand and economic activity depends heavily on the theoretical model and its assumptions about the real world where the policy is implemented. In the old macroeconomic models with sluggish prices, fiscal policy has positive demand implications. Expansionary fiscal policy adds to aggregate spending, and allows demand-constrained firms to sell more output, thereby increasing income and employment. The inflexibility of prices due to mark-up pricing makes output demand determined. Prices adjust gradually and they follow cost-push increases in wages as captured in some versions of the Phillips-curve type of specifications. The fiscal policy multiplier is positive, although its size can be affected by a number of factors, of which the main ones can be briefly summarised: productive capacity close to full use; higher interest rates from anticipated central bank interest rate changes that may crowd-out private demand; fiscal policies that may cause the central bank to implement higher interest rates, reflecting higher risk premia; currency depreciation in a flexible exchange rate open economy; composition of the fiscal measure, where government spending is thought to be more effective than tax changes. These factors are likely to produce a positive, but small, fiscal policy multiplier.

The more recent development of what has come to be known as ‘New Consensus Macroeconomics’ (NCM), which has been used extensively not merely by academic economists but also by central banks around the world, views fiscal policy differently. Prominence is given to the factors that weaken fiscal policy. In particular, emphasis is given to the ‘rational expectations’ of economic agents concerning their future income and wealth, thereby producing demand-side and supply-side effects. All these effects so weaken fiscal policy that it is rendered ineffective as a macroeconomic stabilisation instrument (see, for example, Arestis, 2008, for a summary and critique; see, also, Taylor, 2000, for an exception amongst the proponents of the NCM who support the ineffectiveness of fiscal policy). The rationalization of this proposition relies essentially on three assumptions in addition to ‘rational expectations’ as just mentioned: that households optimize intertemporally, that households are not subject to any liquidity constraints, and that households are able to anticipate
intertemporal financial constraints (see Hemming, Kell and Mahfouz, 2002, for a survey of both the theoretical arguments and the empirical findings). In Hemming, Kell and Mahfouz (op. cit.) the empirical evidence reviewed is not in favour of using fiscal policy as a stabilization instrument.

There have also been further views recently, which support fiscal austerity. Alesina and Parotti (1995) and Alesina et al. (2006), for example, argue for fiscal austerity being expansionary in both the short and the long run. However, recent IMF (2010a) findings on fiscal policy contradict these results. Actually, there is a significant difference in terms of the terminology employed. While the Alesina and Parotti (1995) and Alesina et al. (2006) use a cyclically adjusted measure for budget deficits, IMF (2010a) uses a policy-driven measure. As Baker (2010) correctly points out a cyclically adjusted budget deficit does not accurately distinguish between endogenous and policy-driven changes in fiscal policy. The IMF (2010a) policy-driven changes in fiscal policy show that fiscal policy is more effective under government expenditure financing rather than taxes. Clearly, this is a result that is consistent with standard Keynesian analysis. This result is supported by Jayadev and Konczal (2010), who are also critical of the Alesina and Ardagna (2009) results, which are not dissimilar to the ones obtained in Alesina and Parotti (1995) and Alesina et al. (2006).

Alesina and Ardagna (2009, p. 50) conclude that fiscal adjustments based on spending cuts accompanied by tax cuts are most successful. They also suggest that the results obtained in their study are relevant to the current US fiscal position of high-debt-to-GDP ratio. However, Jayadev and Konczal (2010) argue that “The overwhelming majority of the episodes used by A & A did not see deficit reduction in the middle of a slump. Where they did, it often resulted in a decline in the subsequent growth rate or an increase in the debt-to-GDP ratio. Of the 26 episodes that they identify as ‘expansionary’, in virtually none did the country a) reduce the deficit when the economy was in a slump and b) increase growth rates while reducing the debt-to-GDP ratio” (p. 1). They go on to conclude that “there is little evidence provided by A & A that cutting the federal deficit in the short-term, under the conditions the United States currently faces, would improve the country’s prospects. It may even make the United States’ situation far worse” (p. 1; A & A in the quotes stands for Alesina and Ardagna, 2009). Another recent study by Gravelle and Hungerford (2010) reinforces the results of Jayadev and Konczal (2010) and argues that the A&A propositions “are generally inconsistent with the mainstream view of fiscal policy where short-term multipliers for spending decreases are negative and also tend to be larger in absolute value than those for tax cuts” (p. 9). Gravelle and Hungerford (op. cit.) also argue that “Most of the fiscal adjustments in advanced economies identified by Alesina and
Ardanga were neither successful nor expansionary. Furthermore, most of their successful fiscal adjustments took place during fairly favorable economic conditions” (p. 10; see, also, Baker, 2010).

There are other studies that question the unfavourable empirical evidence on fiscal policy; see, for example Van Aarle and Garretsen (2003). Studies have actually produced results that are contrary to the propositions of the NCM on the issue of the effectiveness of fiscal policy (Hjelm, 2002). Indeed, there have been studies that advocate greater emphasis on fiscal policy as a key economic tool in macroeconomic stabilization; and that fiscal policy is more effective than previously thought (Allsopp and Vines, 2005; Gravelle and Hungerford, 2011; Krugman, 2005; Leith and Wren-Lewis, 2005; Wren-Lewis, 2000). An important, and more recent, statement on fiscal policy has been made by an IMF publication (Spilimbergo et al., 2008), where it is argued that in view of the ‘great recession’ “a fiscal stimulus should be timely (as there is an urgent need for action), large (because the drop in demand is large), lasting (as the recession will likely last for some time), diversified (as there is uncertainty regarding which measures will be most effective), contingent (to indicate that further action will be taken, if needed), collective (all countries that have the fiscal space should use it given the severity and global nature of the downturn), and sustainable (to avoid debt explosion in the long run and adverse effects in the short run). The challenge is to provide the right balance between these sometimes competing goals - particularly, large and lasting actions versus fiscal sustainability” (p. 2).

We suggest that all these contributions should be seriously taken on board. We explore these more recent contributions in what follows.

### 2.2 The theoretical premise of NCM fiscal policy

The NCM approach combines the optimising general equilibrium framework with short-run nominal price stickiness. Fiscal policy can have demand implications if it affects the expectations of economic agents concerning their future income and wealth (demand-side effects). It could also have supply-side effects to the extent that it influences labour market efficiency and labour supply along with the competitiveness of the economy. The latter effects, in their turn, can affect the non-accelerating inflation rate of unemployment (NAIRU). Still there are the ‘institutional aspects of fiscal policy’, which relate to uncertainty and political considerations. Furthermore, agents in this theoretical framework are expected to be forward looking and not be liquidity constrained; they are assumed to form ‘rational expectations’ in terms of how future developments in government budgetary policies and public finances will affect their lifetime income and wealth.
The assumption of 'rational expectations' along with the acceptance of the Ricardian Equivalence Theorem (RET), implies that expectational and wealth effects might outweigh the Keynesian type of multiplier effects. An increase in government deficit, for example, which is perceived as permanent by agents, would imply an increase in the future tax burden and a permanent decrease in their expected income and wealth. Agents would decrease their current consumption and save more in anticipation of lower future income. Higher lump-sum taxes would decrease household and worker wealth. It is the case that the initial increase in public spending generates a larger decrease in current consumption. Labour supply would decrease as a consequence of the negative wealth effects and so would production. The latter comes about in view of the expected increase in future taxes, which induces expectations of lower production as a result of the distorting effects of higher taxation. There are also other supply-side effects in that the increase in public employment reduces private sector labour supply, exerting an upward pressure on wages, which decreases the present discounted value of the future stream of profits. This affects investment adversely. The latter is also affected by higher interest rates in view of the increased deficit (the usual crowding-out effect). What we labelled above as 'institutional aspects of fiscal policy' are important to the NCM thesis (Hemming, Kell and Mahfouz, 2002). The relevant arguments can be briefly summarised. Model uncertainty, in that longer and more uncertain lags prevail than it was thought previously; there is the risk of pro-cyclical behaviour in view of cumbersome parliamentary approval and implementation; increasing taxes or decreasing government expenditure during upswings may be politically unrealistic, and this may very well generate a deficit bias; spending decisions may be subjected to irreversibility, which can lead to a public expenditure ratcheting effect; and there may be supply-side inefficiencies associated with tax-rate volatility.

It should be noted that the main theoretical property of RET is the irrelevance of the government’s financing decisions vis-à-vis taxes and debt. For example, a fiscal expansion prompts expectations of future fiscal contractions regardless of the way financing is undertaken. Private savings increase to compensate for the reduction in government saving, in the expectation of future tax increases, with the multiplier effect of the fiscal expansion brought to zero in the limit (Barro, 1974).

Mankiw and Weinzierl (2011) employ a typical NCM model to show that fiscal policy cannot replace monetary policy under normal circumstances. Only after monetary policy has exhausted its potential, should fiscal policy be employed. But even in this case the model "does not point toward conventional fiscal policy, such as cuts in taxes and increases in..."
government spending, to prop up aggregate demand. Rather, the fiscal policy that maximizes welfare aims at incentivizing interest-sensitive components of spending, such as investment. In essence, optimal fiscal policy tries to do what monetary policy would if it could” (p. 33). When non-Ricardian, rule-of-thumb, households are allowed in the model the authors “find that the description of the equilibrium closely resembles the traditional Keynesian model, but the prescription for optimal policy can differ substantially from the textbook answer” (p. 4).

In effect, the NCM model downgrades fiscal policy, but it upgrades monetary policy. We further discuss this role of fiscal policy in what follows in this contribution. We focus on recent developments, and show that this theoretical construct entails a number of assumptions, which may or may not be validated in the real world. This makes it imperative that we also look at the extent of these assumptions being empirically validated.

2.3 Recent theoretical developments

Recent developments on the effectiveness of fiscal policy conclude that incorporating additional realistic assumptions to the theoretical model of the NCM type implies favourable results for fiscal policy. The most important of which can be succinctly and briefly summarized (see, for example, Botman and Kumar, 2006). Overlapping generation models in the tradition of Blanchard (1985) and Weil (1989), which enable the relaxation of the Ricardian equivalence assumption, is probably the most important one. Under such circumstances, a short-planning horizon by households is evident so that intertemporal smoothing of consumption is not possible. This implies that even temporary changes in fiscal policy affect household decisions to consume and work.

Another assumption is that of liquidity-constrained households, consistent with the evidence that even in developed countries up to a third of households do not have sufficient access to financial markets (Botman and Kumar, 2006). Under such circumstances, changes in fiscal policy that affect household disposable income would have significant real effects. Similarly, when firms are credit constrained (Aghion et al., 2005) fiscal policy can have positive effects on productivity growth through enhancing firms’ ability to finance ‘innovative investment’. Still another feature is the endogenisation of labour supply and capital accumulation. Since they are affected by after-tax real wage and after-tax rate of interest, respectively, changes in fiscal stance, as they affect after-tax real wage and the rate of interest, can have real effects.1

It is also important to recall the distinction between closed and open economies. The reason is that in the latter case, trade balance and
exchange rate changes could have an impact on domestic activity in a way that the value of the fiscal policy multipliers could be affected. For example, expansionary fiscal policy could cause a trade imbalance, which depreciates the exchange rate under a flexible exchange rate regime - in the case of a fixed exchange rate regime the exchange rate could of course be contained. At the same time, if higher interest rates ensue, capital inflows emerge, which are bound to contain the currency depreciation. On the whole reported open economy multipliers are weaker, but certainly not negative, than in the case of a closed economy. This is due to fiscal stimulus leaking abroad partially; how much would depend on a number of factors that relate to the openness of the economy as noted above. Still, though, open economy multipliers favour fiscal policy (Gravelle and Hungerford, 2011).

We examine in the sub-section that follows immediately some of the empirical aspects and further developments.

2.4 Empirical developments

2.4.1 Evidence on Ricardian vs non-Ricardian behaviour

An interesting recent study on the possible effects of government spending on private consumption in the case of the euro area is Coenen and Straub (2005). The novelty of this study is that it attempts to resolve the contradiction between the typical predictions of the NCM type of theoretical models, which conclude that government expenditure has a strong negative effect on consumption, with that of the empirical literature that concludes on a positive or at least not significantly negative effect on consumption of a government expenditure change. The study concludes that the evidence does not validate the predictions of the relevant theoretical models. In view of this finding, Coenen and Straub (op. cit.) proceed to study further the Mankiw (2000) argument that models that attempt to study the effects of fiscal policy should allow for two types of households. One type of households (the ‘Ricardian’ households) are those that behave in an optimizing, fully forward manner, by trading in asset and other markets and are, thus, able to smooth consumption over time; these households hold expectations about the future, which are essentially consistent with the assumptions of the models in question.

Another type of households (the ‘non-Ricardian’ households) follow non-optimizing simple rules of thumb (they do not optimize intertemporally or intratemporally), cannot and do not participate in asset markets, and they merely consume their net-of-tax disposable income; their expectations of the future, therefore, need not be consistent with the assumptions of the models in question. There is actually empirical evidence that sup-
ports the contention that a significant proportion of consumers and firms are actually non-Ricardian in that they are not forward-looking or their behaviour is constrained. Many households have little wealth, or are financially constrained, to be able to undertake intertemporal consumption smoothing; an observation that is supported by survey-based evidence (HM Treasury, 2003; Campbell and Mankiw, 1989; Mankiw, 2000).

Coenen and Straub (2005) also rely on a study by Gali et al. (2004), where a model is put forward that allows for the coexistence of non-Ricardian and Ricardian households and their interaction with firms that change prices infrequently and a fiscal authority that issues debt to finance part of its expenditure. This study concludes that calibrating such a model provides support to the contention of a positive impact of government expenditure shocks on consumption. The study by Coenen and Straub (2005) proceeds to include both Ricardian and non-Ricardian households in an extended version of the euro area stochastic dynamic general equilibrium model developed by Smets and Wouters (2003), and also employs Bayesian inference methods. The presence of non-Ricardian households is crucial. The quantitative impact of government spending on consumption is higher as compared to the benchmark case without non-Ricardian households.

Nonetheless, the chance of government expenditure crowding-in consumption is rather small in view of the relatively low share of non-Ricardian households assumed in the study. However, the possibility of crowding-in is strengthened once it is recognized that the presence of non-Ricardian households and their behaviour can have significant effects on that of the Ricardian households. To the extent that the increase in consumption of non-Ricardian households following a budget deficit, impacts on the income stream of the Ricardian households, then crowding-in becomes a distinct possibility.

An interesting and relevant point made in the Wren-Lewis (2000) study is that even with the Ricardian Equivalence assumption there are aspects of fiscal policy that are effective, a point strengthened by a subsequent contribution as in Kirsanova et al. (2009). The presence of cost-push shocks makes the point clearly. In view of the fact that cost-push shocks cannot be eliminated by monetary policy, fiscal policy by contrast is useful not so much through its influence on aggregate demand, as much as “through its impact on key relative prices” (p. F489).

2.4.2 Further empirical evidence

Blanchard and Perotti (2002) employ the Structural VAR (SVAR) approach in studying the quantitative impact of fiscal policy. They argue that this approach is superior to those that utilise large-scale economet-
ric models or reduced-forms. Large-scale econometric models "postulate rather than document an effect of fiscal policy on activity" (p. 1), while the reduced-form approach registers the effect of a summary statistic of fiscal policy, and yet no theory suggests this is pertinent. The SVAR approach is argued to be more appropriate in the study of fiscal policy simply because, unlike monetary policy for example, decision and implementation lags imply that there is no response of fiscal policy to economic activity. So that fiscal shocks can be identified and their dynamic effects on economic activity can be traced through the SVAR approach. Blanchard and Perotti (op. cit.) employ post-war US data along with SVAR to conclude that spending multipliers for consumption and output are anything between one third and unity.

However, Perotti (2005) and Mihov (2003), using VAR-based evidence, argue that after 1980 the effectiveness of fiscal policy weakened substantially in the US. Three explanations of this change have been put forward. One relates to the financial liberalization era, which took place at the time. The increasing asset market participation enabled households to smooth consumption in the desired way, thereby influencing the impact of fiscal policy. Another explanation refers to the increasing use of monetary policy since the 1980s in relation to the pre-1980s. It is true that a considerable change has taken place in the way the nominal interest rate is adjusted in response to expected inflation; monetary policy has been more hawkish ever since the 1980s. And a third explanation emphasizes the change in the degree of deficit financing, which has assumed more persistence post-1980. These explanations imply that while fiscal policy has a strong and persistent effect on economic activity, this is less significant and persistent post-1980. Bilbiie et al. (2006) attempt to throw light on the empirical support of the three explanations just summarized. They conclude that increased asset market participation accounts for some of the change, while the degree of deficit financing is crucial. But the key quantitative factor is, in their empirical findings, the increasing use of monetary policy post-1980. But complementarity of the three factors is also emphasised.

The study by Gravelle and Hungerford (2011) provides a summary of fiscal policy multipliers of a number of studies. They conclude that “multipliers of 1.0 to 2.5 for government spending and transfers to the states for infrastructure, and 0.7 to 1.8 for transfers to the states for other purposes” (p. 6) are evident. Furthermore, “For direct transfers to individuals (who have low incomes) the multipliers were between 0.8 and 2.1. Payments to retirees (largely Social Security beneficiaries) were 0.3 to 1.0. For taxes, tax cuts for lower- and middle-income taxpayers (mainly those claiming the making work pay tax credit) were 0.6 to 1.5, while the increase in the
alternative minimum tax exemption for higher-income individuals was 0.2 to 0.6. Business tax cuts, mostly of a cash flow nature, were 0.0 to 0.4” (p. 6).

2.4.3 Counter-cyclical vs pro-cyclical assumptions

There is the further argument that the experience of a number of countries, especially developing, suggests that fiscal policy is in practice pro-cyclical rather than counter-cyclical there. This means that budget deficit, as percentage of GDP, increases in booms, but decreases in recessions. This is contrary to the counter-cyclical case where the budget deficit, as a share of GDP, decreases during booms but increases in recessions (Kaminsky et al., 2004; Alesina and Tabellini, 2005). The pro-cyclical argument applies particularly to the discretionary changes in fiscal policy, but would not apply in the case of the operation of the automatic stabilisers, which provide a counter-cyclical component of fiscal policy. Persson and Tabellini (2000) and Alesina and Tabellini (2005) resort to a political agency problem to explain it. In countries where voters lack significant information, and are faced with corrupt governments that use parts of government revenue for unproductive public consumption, pro-cyclical fiscal behaviour is possible. Voters demand higher utilities for themselves, especially so under booming conditions. They are not irrational; they merely lack full information of the ability of the government to satisfy their demands without creating budget deficits. The government is forced to borrow to satisfy voter demands, for otherwise there is the fear of future electoral losses. The more corrupt the country is, the more pro-cyclical behaviour may be observed. In fact, pro-cyclical behaviour is mainly observed in countries with widespread corruption. Where governments are subject to ‘check and balances’, voters would not impart pro-cyclical to fiscal policy. Alesina and Tabellini (op. cit.) note that pro-cyclicality can only materialise in democratic regimes. In a dictatorship where corruption may be thriving, voters cannot influence fiscal decisions and thus pro-cyclical would not be observed.

Alesina and Tambellini (2005) employ data on 87 countries over the period 1960 to 1999 to test the counter-cyclical and the pro-cyclical assumptions. They conclude that in the OECD countries fiscal policy is counter-cyclical, while in 36 out of 64 non-OECD countries pro-cyclical is confirmed. The 36 countries are essentially Sub-Saharan African and Latin American countries, thereby supporting the political agency phenomenon in the case of these countries. They also depend on the nature of the tax system and on the expenditure system - a progressive tax and social security system would aid counter-cyclical budgets whilst a regressive system would point in the other direction. It is also shown that credit constraints impose obstacles to developing country governments
to borrow the desired amounts, but it does not appear to be as a significant variable of pro-cyclicality as the political agency variable.

These results, however, may very well reflect the fact that developed and developing countries are subject to different shocks (see Gali and Perotti, 2003; Perotti, 2007; Gopinath, 2004; and Rigobon, 2004; the latter two studies rely on Kaminsky et al., 2004). Utilizing a sample of industrialized countries and developing countries, Gali and Perotti (2003), Gopinath (2004) and Rigobon (2004) confirm this observation. They find that there is significant difference in the cyclical behaviour of fiscal policy in the two groups of countries. This they interpret as a consequence of the different shocks to which the two types of economies are subjected. Lane (2003) also confirms the difference just referred to but suggests that the capability to implement fiscal control procedures is positively correlated with the level of development (measured by output per capita). This implies that richer countries enjoy less pro-cyclical government spending. Further factors to explain the difference in cyclicality are attributed to political and institutional considerations. For example, Talvi and Vegh (2005) argue that political distortions are important in the relevant explanation. They suggest that running budget surpluses is costly because they create pressures to increase public spending. In view of this, a government that faces large fluctuations in the tax base will find it optimal to run pro-cyclical fiscal policy.

A final comment on the issues discussed in this sub-section is that the terminology used should be very clear (see, also, Kaminsky et al., 2004; Perotti, 2007). For otherwise there could be ambiguity over the notions of counter- and pro-cyclical fiscal policy. When budget outcomes are expressed as percentage of GDP, changes in the deficit or surplus might be ambiguous. For example, when growth is low the budget deficit as a percentage of GDP could be increasing; even if in absolute terms it is decreasing. It is for this reason that whenever the focus is on the potential contribution of fiscal policy to aggregate demand is at issue, it is better that the absolute amount is utilized to avoid such confusion.

It is clear from the discussion so far that fiscal policy does have a significant role to play in macroeconomic stabilization. This conclusion leads to the question of the precise role of fiscal policy as a stabilization instrument of macroeconomic policy. We discuss this issue in section 3.

3. What role for fiscal policy?

It clearly follows from the discussion so far that recent contributions, both theoretical and empirical, provide strong support to fiscal policy as an instrument of stabilization policy. Furthermore, it is important to point out that co-ordination between fiscal and monetary policies should be
seriously considered. This is vital in that monetary policy reaction can play a key role in the effectiveness of fiscal policy. For example, in the case of fiscal expansion the output response is considerably higher and more persistent when there is monetary accommodation. Clearly, then, when monetary and fiscal policies are consistent so that their impact on aggregate demand is cumulative, and not offsetting, the overall impact is higher than otherwise. When co-ordination is not present, risks may arise in that the impact of one policy forces the other to adjust, thereby limiting its margin of manoeuvre and desirable design, as well as its effectiveness.

This conclusion is strengthened by more recent findings, which are based on the value of the fiscal multipliers under conditions of co-ordination between fiscal and monetary policy. Eggertsson (2006), utilizing a calibrated model not dissimilar in substance to the NCM, concludes that under fiscal and monetary policy co-ordination fiscal multipliers are higher than when no policy co-ordination prevails. Indeed, they are bigger than those found in the traditional Keynesian literature. In fact, the fiscal multipliers reported in Eggertsson (op. cit.) under fiscal and monetary policy co-ordination are 3.4, in the case of the real spending multiplier, and 3.8, in the case of the deficit spending multiplier. When there is no policy co-ordination, i.e. when the central bank is ‘goal independent’, the real spending multiplier is unchanged, while the deficit spending multiplier is zero. This large difference in fiscal multipliers in relation to those where no co-ordination is present, is explained by the expectations channel, which is very much emphasized in the Eggertsson (op. cit.) study. This channel works via inflation expectations. Fiscal expansion increases expectations about future inflation, real rate of interest is reduced (provided the central bank collaborates with the fiscal authority) and spending is stimulated. Expectations of future income also improve, thereby stimulating spending further. This result is particularly important in view of much recent theory and practice that see fiscal policy better divorced from monetary policy. This contribution would suggest that macroeconomic stability is the joint responsibility of the monetary and fiscal authorities. Potentially destabilising behaviour by one authority can be offset by an appropriate stance of the other authority.

Perhaps more importantly the monetary authority can trade off some inflation for lower unemployment. Under such circumstances, a fiscal stimulus increases inflationary pressures (or at least reduces deflationary pressures), which with a monetary authority that keeps constant nominal interest rates, lowers real interest rates, thereby giving rise to further increases in consumption and investment expenditures. Furthermore, lower real interest rates cause real exchange rates to depreciate, which can
also play a role in stimulating aggregate demand. Freedman et al. (2009) provide examples of this co-ordination, utilising the IMF's macroeconomic DSGE model, which features non-Ricardian households, to conclude that "the multipliers of a two-year fiscal stimulus package range from 1.3 for government investment to 0.2 for general transfers, with targeted transfers closer to the upper end of that range and tax cuts closer to the lower end. In the presence of monetary accommodation ... multipliers are up to twice as large, as accommodation lowers real interest rates, which in turn has a positive effect on corporate balance sheets and therefore on the external finance premium" (p. 26).

A study that also utilizes a DSGE model reached similar conclusions (Davig and Leeper, 2009). In this study the initial part of the 'great recession' is studied, when "monetary and fiscal policy have reacted jointly in an effort to stimulate aggregate demand. A long line of research emphasizes that separating monetary and fiscal policies overlooks policy interactions that are important for determining equilibrium" (p. 2). Based on this premise the study adopts the usual DSGE assumptions along with interest rate and tax Markov-switching policy rules for the US. Government expenditure is treated as an exogenous variable. Davig and Leeper (op. cit.) conclude that "With the calibrated model in hand, we simulate the impacts of the government spending component of the American Recovery and Reinvestment Act of 2009 under alternative monetary-fiscal regimes. When monetary policy is active and fiscal policy is passive, the fiscal stimulus creates a modest expansion in output and it raises inflation and real interest rates, while government debt and taxes rise substantially and persistently. On the other hand, passive monetary policy and active fiscal policy generate an appreciably larger boom in output and consumption, and a significantly larger run-up in inflation, while rapidly reducing the real value of government liabilities" (p. 5). Clearly, co-ordination of the two policies provides stronger results than otherwise.

Co-ordination of fiscal and monetary policy does not imply that the respective authorities need to lose their 'independence'. For example, this cooperation need not mean that central bank independence is reduced. As long as the fiscal and monetary authorities have a common objective, for example maximization of social welfare, this need not imply that the two authorities should lose their 'independence' (Eggertsson, 2006). This is not dissimilar to Wren-Lewis's (2000) proposal for delegating fiscal actions to an independent body, outside the government. This could take the form of a 'fiscal regulator' with two objectives: to advise on short-run discretionary action and to supervise the long-run sustainability of the government finances. It is argued that in the case of the UK the Bank of England Monetary Policy Committee (MPC), alongside monetary policy,
can play such a role. This is paramount in this view, given the requirement of proper co-ordination of fiscal and monetary policies (Wren-Lewis, op. cit., p. 104). A number of studies have proposed delegating decisions on fiscal policy to ‘an independent fiscal policy committee’ to improve its effectiveness and the financial discipline of the government (see HM Treasury, 2003, p. 74, for a brief summary of these propositions). In the same spirit of analysis, Linnemann and Schabert (2003), utilizing a model of wage and price stickiness, demonstrate that fiscal policy can affect output if the monetary authority does not react aggressively to output changes. Furthermore, in models where capital accumulation is also accounted for, as in Arestis et al. (2007) for example, aggregate demand, which would now include investment expenditure more prominently, would be more susceptible than otherwise to changes in the rate of interest. This consideration gives more credence to the proposition that co-ordination of fiscal and monetary policy becomes paramount.

These policy prescriptions are rather different from Taylor’s (2000) suggestion of fiscal policy and monetary policy co-ordination, with the two policies being interdependent but with different objectives. A monetary policy concerned with output stabilization around the cycle in the short-run and with controlling inflation in the long run. And a fiscal policy that focuses on a passive act in the short run through automatic stabilizers, but on a series of medium- to long run objectives to be achieved by discretionary action. The UK appears to be a good example of this policy prescription. An activist monetary policy as just described, along with a passive short-run fiscal policy (which supports monetary policy via the operation of the automatic stabilisers), but with an active long-run fiscal policy to deal with objectives that include low debt, the provision of public services and investment, social equality, and economic efficiency. However, the success of this co-ordination is predicated on a leadership role for fiscal policy (it takes precedence in cases of conflict), but without either policy losing its ability to act independently (HM Treasury, 2003; Hughes Hallett, 2004). A further possibility, discussed in Kirsanova (2009), is for an active monetary policy to pursue the normal ‘inflation targeting’ objective supported by fiscal policy that focuses on debt stabilization. Monetary policy alone cannot pursue both objectives for there is always the possibility that such policy is bound to detract from inflation stabilization.

A contribution that examines the role of fiscal policy under conditions of ‘zero-bound’ nominal rate of interest is Woodford (2011). Utilising a standard DSGE model, this study concludes that the size of fiscal multipliers depends on the response of monetary policy. A fiscal policy multiplier in excess of unity is possible but only when monetary policy is constrained by the zero lower bound. Under such circumstances, and

83
in view of the inflationary pressures of the expansionary policy, the real rate of interest falls, so that the role of fiscal policy is to fill the output gap, a task that normally is given to monetary policy within the confines of the DSGE model. Clearly, though, if the size of the multiplier depends crucially on the monetary policy response, the conclusion that should follow is for a full co-ordination of fiscal and monetary policy along the lines suggested above in this contribution. Such coordination is surely the way forward in terms of the proper conduct of stabilization policies than what is proposed in the Woodford (op. cit.) study.

The ‘great recession’ has highlighted the importance of financial stability, which had not been seriously considered prior to it. The belief in the efficiency of financial markets prevented a realistic and necessary approach to financial stability (IMF, 2010b). As a result, both the supporters of the NCM framework and policymakers have ignored “the implications for systemic stability of financial market imperfections, including those stemming from international frictions, moral hazard and other distortions to incentives, such as externalities and herding” (IMF, op. cit., p. 7). As a result potential systemic risk was ignored and financial regulation and supervision “were increasingly light-touch and reliant on self-correcting market forces” (IMF, 2010b, p. 7); and, indeed, in the case of the ‘shadow banking’ it was completely absent.

The main operations of any Central Bank should be directed towards financial stability. The events leading to the ‘great recession’ testify to this important requirement. Financial stability has attracted renewed interest and focus as an instrument of monetary policy. The focus of financial stability should be on proper control of the financial sector so that it becomes socially and economically useful to the economy as a whole and to the productive economy in particular. Banks should serve the needs of their customers rather than provide short-term gains for shareholders and huge profits for themselves. IMF (2010b) suggests that financial stability in the form of macro prudential policies is the way forward. Indeed, the same publication suggests that if the current low interest rates were to produce excessive risk-taking or bubbles, these should be addressed through macro-prudential policies mainly and not only through interest rate policy measures.

We would, thus, go a step further and argue that it is vital for full co-ordination of both monetary and financial stability policies with fiscal policy, along with discretion in applying them. Consequently, the conclusion from this discussion is two-fold. The first is that fiscal policy does have a significant role to play as an instrument of economic policy. Second, co-ordination of fiscal and monetary/financial stability policies is the best way forward in terms of macroeconomic stabilization.
4. Summary and Conclusions

We have argued in this contribution that fiscal policy does have a significant role to play as an instrument of economic policy. As such it does not deserve to be so downgraded as in the NCM model. Fiscal policy is an effective instrument of regulating the level of aggregate demand, and one of the crucial factors that determine the economic performance of a country through its impact on allocation, distribution and stabilization. Fiscal policy is thereby a key component of any macroeconomic framework alongside monetary/financial policy. This leads us to a further major conclusion of this contribution. Co-ordination of fiscal and monetary/financial stability policies is the way forward in terms of macroeconomic stabilization. In this endeavour, the authorities should employ a great deal of discretion in its application. Such co-ordination becomes even more effective when the fiscal and monetary/financial stability authorities have a common objective, for example maximization of social welfare.

The inevitable overall conclusion of this contribution is then that it is high time for the renaissance of Keynesianism.

References


Anmerkungen

1 Blinder (2006) argues on similar grounds against the ‘Ricardian Equivalence’ principle. It is based on the unrealistic theoretical assumptions of long-time horizons, perfect foresight, perfect capital markets and the absence of liquidity constraints.

2 The study by Smets and Wouters (2003) is used as a benchmark specification in the Coenen and Straub (2005) study. The latter is an augmented specification with non-Ricardian households in relation to Smets and Wouters (2003).

3 Bayesian inference methods rely on the use of prior information obtained from earlier studies in the estimation of a stochastic dynamic general equilibrium model. Such methods are particularly useful when the sample period of the data is short, and also when it is necessary to solve highly non-linear estimated relationships.

4 The Markov-switching process assumes that the relevant policy reaction function is state dependent. Consequently, “The model embeds the possibility that policy rules may evolve over time according to a known probability distribution and that private agents form expectations of policy according to that distribution ….. The estimated joint monetary-fiscal policy process is inserted into the calibrated DSGE model. Government spending, which is a central focus of the analysis, evolves exogenously” (Davig and Leeper, 2009, p. 2).