The main thesis of Philip Arestis’s paper 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’ (p. 2). These comments are written in late 2011, when the economic policy debate in the European Monetary Union (EMU), but also in most other rich countries, was dominated by the ‘public debt crisis’ and discussions about the necessary degree of fiscal austerity. In this context, Philip Arestis is absolutely right in noting that ‘(i)t 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’ (p. 2).

It is equally striking that, with all the heated discussions about fiscal austerity, the deeper origins of the financial crisis are still not being properly addressed. These are, in my view, the lack of financial market regulation and, more fundamentally, the dramatic rise of income inequality especially in the United States but also in other parts of the world. It can be argued that the high confidence in financial market efficiency and the lack of attention to income inequality are rooted in the same set of theoretical premises which Philip Arestis identifies as being responsible for the lack of faith in fiscal policy both before and after the crisis. Arestis is therefore to be applauded for being very clear about the theoretical foundations on which economic policies were based during the years before the crisis and which now appear to regain their previous influence. Unless the problems with these theoretical concepts are properly understood, a ‘renaissance of Keynesianism’, as advocated by Arestis, is not very likely to happen. Clearly, from the point of view of the ‘New Consensus Macroeconomics’, the crisis came as a complete surprise. For several decades, inflation has been low and stable, output growth was seen as satisfactory, cyclical variations were low and seemed to be handled well by monetary policy, credit markets were seen as largely efficient, and income inequality was not seen as a major issue.
In the following remarks, I will restrict my comments to 1.) some additional illustrations of the extent to which the downgrading of fiscal policy and the neglect of the deeper origins of the crisis are linked together in the theoretical foundations of the type of models which Arestis qualifies as part of the ‘New Consensus of Macroeconomics’; and 2.) some reflections on one specific area in which the paper could go a step further, namely the link between fiscal policy and income distribution.

1. The failure of the
   “New Consensus of Macroeconomics”

It is true that the pre-crisis macroeconomic mainstream claimed to represent a ‘New Neoclassical Synthesis’ or a ‘New Consensus in Macroeconomics’ (see e.g. Woodford, 2003, and the critiques by Arestis and Sawyer, 2004, 2008). As in the Neoclassical Synthesis of the 1950s, the unemployment equilibrium of Keynes’s ‘general theory’ is reinterpreted as a ‘special case’ of Neoclassical economics that holds only under special conditions (in particular nominal wage and price rigidity) and only in the short run. However, unlike the Neoclassical Keynesians of the 1950s, New Keynesians pay a lot of attention to ‘microfoundations’ and accept the New Classical concept of ‘rational expectations’ (the representative agent knows and behaves according to the correct model for the economy). The most sophisticated representation of this new consensus are the so-called dynamic stochastic general equilibrium (DSGE) models. Blanchard (2008, pp. 23-24) summarises this development as follows:

‘The most visible outcomes of this new approach are the dynamic stochastic general equilibrium models (or DSGEs). They are models derived from micro foundations, that is utility maximization by consumers-workers, value maximization by firms, rational expectations, and a full specification of imperfections, from nominal rigidities to some of the imperfections discussed earlier, and typically estimated by Bayesian methods. ... DSGE models have become ubiquitous. Dozens of teams of researchers are involved in their construction. Nearly every central bank has one, or wants to have one. They are used to evaluate policy rules, to do conditional forecasting, or even sometimes to do actual forecasting.’

In these models, the macroeconomy is depicted as an intertemporal optimisation problem of the representative agent who maximises utility by choosing an optimal combination of consumption and leisure over the life cycle. Finance typically plays only a passive role in that it allows the representative agent to optimally allocate present and future consumption over his/her life time, which is often assumed to be infinite. Firms are postulated to maximise present value, thereby acting merely as
agencies of the representative household in transforming current income into future consumption (via investment).  

Fiscal policy is downgraded in this approach by reference to the Ricardian equivalence theorem, which states that the rational household will react to government deficits by increasing current saving in anticipation of future tax rises made necessary by the current deficit. Although, with ‘sticky’ prices, there is a role for macroeconomic stabilisation policies (at least in the short run), this role is attributed to monetary policy. However, it is usually argued that financial asset price inflation or, more generally, private balance sheet positions should not be a primary concern for economic policy. In general, financial markets are assumed to be efficient, and certainly, even if they were not, neither the central bank nor the government are in a position to know ‘fundamentals’ better than the market and to detect financial asset bubbles or excessive leverage positions. Michael Woodford, one of the most prominent proponents of this view, argued:

‘Not only expectations about policy matter, but, at least under current conditions, very little else matters. Few central banks of major industrial nations still make much use of credit controls or other attempts to directly regulate the flow of funds through financial markets and institutions. Increases in the sophistication of the financial system have made it more difficult for such controls to be effective, and in any event the goal of improvement of the efficiency of the sectoral allocation of resources stressed previously would hardly be served by such controls, which (if successful) would inevitably create inefficient distortions in the relative cost of funds to different parts of the economy. Instead, banks restrict themselves to interventions that seek to control the overnight interest rate in an interbank market for central-bank balances...’

(Woodford, 2003, p. 15)

In fact, the consensus view seemed to be that the Central Bank should generally tolerate financial asset price inflation but cut interest rates sharply when a bubble bursts (e.g. Bernanke and Gertler, 2001; Woodford, 2003). Financial deregulation was praised along with the ‘greater sophistication on the part of financial markets and greater transparency on the part of central banks, the two developing in a sort of symbiosis with one another’ (Woodford, 2003, p. 16) facilitating the management of expectations by the Central Bank.

In a highly influential paper, Bernanke and Gertler (2001, p. 257) argued that ‘the macroeconomic stability associated with inflation targeting is likely to reduce the incidence of panic-driven financial distress that could destabilize the economy’, although they noted at the time that ‘this
question is clearly deserving of further research.’ In a similar vein, Clarida et al. (1999, p. 1664) concluded: ‘Under Volcker and Greenspan, ..., U.S. monetary policy adopted the kind of implicit inflation targeting that we argue is consistent with good policy management.’

This standard view was criticised long before the crisis. As noted by Stiglitz (2001):

‘If stability and efficiency required that there existed markets that extended infinitely far into the future – and these markets clearly did not exist – what assurance do we have of the stability and efficiency of the capitalist system? ... Simplistic representative agent models living infinitely long had been constructed, and, not surprisingly, in these models, the problems of instability and inefficiency did not arise.’

Indeed, problems of liquidity constraints and default were typically assumed away by means of the ‘transversality condition’. Charles Goodhart, who is seen as one of the few economists to have actually predicted the crisis, on several occasions provided a very harsh critique of this view, which has so clearly been discredited since the U.S. mortgage crisis:

‘Amongst the several problems/disadvantages of this current consensus is that, in order to make a rational expectations, micro-founded model mathematically and analytically tractable it has been necessary in general to impose some (absurdly) simplifying assumptions, notably the existence of representative agents, who never default. This latter (nonsensical) assumption goes under the jargon term as the transversality condition. This makes all agents perfectly creditworthy. ... There are no credit constraints (everyone is angelic; there is no fraud; and this is supposed to be properly micro-founded!).’ (Goodhart, 2009, p. 361)

In his paper, Arestis provides a succinct and convincing critique of the theoretical foundations of NCM, which lead to the downgrading of fiscal policy. Arestis discusses several deviations from the standard model discussed in the literature, such as the possibility that a significant proportion of households either are non-Ricardian and follow rules of thumb or face liquidity constraints in their consumption decisions. Another deviation from the standard model consists of introducing overlapping generations, an assumption that implies short planning horizons for consumers (in comparison to the infinitely lived single representative agent) and thus a potential relaxation of the Ricardian equivalence. In a sense, the deeper conceptual reason for ignoring all these potential ‘inefficiencies’ is the fiction of the representative agent which implies, amongst other things, complete ignorance of all distributional issues.
Yet, addressing the problem of excessive income inequality seems crucial to any true renaissance of both fiscal policy in particular and Keynesianism in general. Because Arestis touches upon this important issue only in passing in his contribution, and because he has extensively written about the role of income distribution for economic growth and stability elsewhere, I would like to make a few additional comments on this particular point.

2. Fiscal policy and income distribution

Keynes famously dismissed ‘the belief that the growth of capital depends upon the strength of the motive towards individual saving and that for a large proportion of this growth we are dependent on the savings of the rich out of their superfluity’ (Keynes, 1936, p. 373) and argued that, at least under the circumstances of the time, ‘measures for the redistribution of incomes in a way likely to raise the propensity to consume may prove positively favourable to the growth of capital’ (Keynes, 1936, p. 373). Keynes therefore concluded that ‘(i)f fiscal policy is used as a deliberate instrument for the more equal distribution of incomes, its effect in increasing the propensity to consume is, of course, all the greater’ (Keynes, 1936, p. 95).

In the current context, we can distinguish two areas in which fiscal policy could play an important stabilising role for the macroeconomy. The first is the design of automatic stabilisers, and the second, more relevant to the longer term, concerns the secular trend towards higher inequality in many countries.

The relationship between the distribution of income and the size of fiscal multipliers currently seems to gain renewed attention. Blanchard et al. (2010), for instance, argue in favour of strengthening automatic stabilisers by implementing measures for the redistribution of incomes towards lower income groups. As for automatic stabilisers in the traditional sense, which come from the combination of rigid government expenditures with an elasticity of revenues with respect to output of close to one, Blanchard et al. (2010, p. 15) argue that ‘(t)he main ways to increase their macroeconomic effect would be to increase the size of government or (to a lesser extent) to make taxes more progressive or to make social insurance programs more generous.’ A second, innovative way of developing stronger automatic stabilisers would consist in new ‘rules that allow some transfers or taxes to vary based on prespecified triggers tied to the state of the economic cycle... On the tax side, one can think of temporary tax policies targeted at low-income households... On the expenditure side, one can think of temporary transfers targeted at low-income or liquidity-constrained households. These taxes or transfers
would be triggered by the crossing of a threshold by a macro variable.' (Blanchard et al., 2010, pp. 15-16)

While the benefits of progressive taxation and temporary transfers targeting low and middle income groups are relatively widely recognised, there currently is an active debate about the question of whether the secular rise in income inequality was an important cause of the global crisis starting in 2007. In fact, Philip Arestis is amongst those who argue that

'the "great recession" in the U.S. is due to significant income redistribution effects from wages to profits of the financial sector, which forced poorer households to become overindebted. This was made possible through financial liberalisation and financial innovations. These are the main causes of the crisis...'. (Arestis and Karakitsos, 2011, p. 64).

The United States is clearly the country within the rich world where the rise in income inequality has been the most dramatic over the past three decades or so (see Gordon and Dew-Becker, 2008, for a survey). The most outstanding feature of inequality in the United States certainly is the explosion of incomes at the very top, especially within the top 1 per cent of the income distribution (see Figure 1). At the same time, large fractions of the U.S. population have seen only very small increases of their real incomes during the decades before the crisis, relative to the higher income groups during the same period and to their own income growth in previous decades (Figure 2). An increasing number of economists argue that it was this increase in inequality that has led lower and middle income groups to increasingly rely on credit in the financing of consumption, in an attempt to keep up with the richer households whose incomes and expenditures were so rapidly rising. Guided by the representative agent assumption and the assumptions of intertemporal utility maximisation, many influential policy makers and economists interpreted the impressive credit expansion in the personal sector as an efficient market response to a higher degree of temporary income instability which increased households’ demand for consumption smoothing (e.g. Greenspan, 1996; Krueger and Perri, 2006). But the rise in income dispersion was not compensated for by higher income mobility (e.g. Kopczuk et al., 2010), so that many households were left with debt levels that were clearly excessive, given the persistently low growth of their incomes.
Figure 1: Top fractiles' income shares, excluding realised capital gains, 1913-2008

Source: Piketty and Saez (2003), updated series available at: http://elsa.berkeley.edu/~saez/TabFig2008.xls

Figure 2: Real pre-tax family income, excluding capital gains, growth in per cent by income groups, 1947-1977 and 1977-2007

Source: http://www.stateofworkingamerica.org/files//family_income_growth.xlsx
While these developments constitute an important deviation from the standard consumption model of the 'New Consensus Macroeconomics', it also contradicts the simple Keynesian consumption function, which predicts that saving rises more than proportionally so long as income rises. As a matter of fact, both the United States and most other rich countries, albeit to a lesser degree than in the U.S., have experienced a secular fall in the private saving rate over the past decades. Yet, many Keynesian economists have long embraced the relative income hypothesis first formulated by James Duesenberry (1949) or the related habit persistence theory of saving, which posits that household saving rates depend positively on the current rate of income growth relative to that rate of income growth to which consumers have become accustomed in the past (see Marglin, 1984, for a survey). These theories predict that the aggregate saving rate tends to fall, when income inequality rises and many households experience a slowdown in income growth but credit is easily available. In any case, with the mortgage crisis starting in 2007 the substitution of credit for wage income as a source of consumer demand finally turned out to be unsustainable, and the overindebtedness of many U.S. households became apparent.

Interestingly, this view of the crisis, which can also be extended to consider the destabilising effects of rising inequality in countries other than the United States, is now shared by economists with rather different theoretical backgrounds. Prominent proponents of this hypothesis include Raghuram Rajan, former chief economist of the International Monetary Fund (IMF) (Rajan, 2010), Robert Reich, former secretary of Labour under Bill Clinton (Reich, 2010), Nobel-laureate Joseph Stiglitz (Fitoussi and Stiglitz, 2009; UN Commission of Experts, 2009), Dominique Strauss-Kahn, former managing director of the IMF (Strauss-Kahn, 2011), supported by research of the IMF staff (Milanovic, 2011; Berg and Ostry, 2011; Kumhof and Rancière, 2010, 2011). A joint IMF-ILO working paper also supported this view (IMF-ILO, 2010). See van Treeck and Sturm (forthcoming) for an extensive review of these debates.

While there is less agreement on the precise causes of this rise in inequality, there can be no doubt that tax policy contributed to it in an important way. As can be seen in Figure 3, the U.S. tax system once used to be fairly progressive, especially at the very top of the income distribution. But overall tax rates were substantially reduced for these top incomes exactly at the time when the inequality of pre-tax incomes was heavily on the rise. As it is very unlikely that market incomes at the very top are mainly driven by supply-side factors such as skill-biased technological change or globalisation (e.g. Dew-Becker and Gordon, 2005), there should be large room for manoeuvre for changing the distribution of income through appropriate policy measures. An important challenge for fiscal policy is
therefore to contribute, alongside other domains of public policy, to the reversal of the rising inequality over the past three decades.

**Figure 3:** Tax rate for each of the 4 federal taxes for various groups of the income distribution

a) 1960

![Graph showing tax rates for 1960 income distribution](image)

b) 2004 (based on 2000 incomes adjusted for economic growth)

![Graph showing tax rates for 2004 income distribution](image)

In sum, while I fully agree with Philip Arestis that ‘fiscal policy does have a role to play as an instrument of economic policy’, I would add that every particular policy measure in this domain should be expressly designed in a way favourable to the redistribution of incomes. Indeed, Keynes’s opening statement in the concluding chapter of the General Theory (‘Concluding notes on the social philosophy towards which the General Theory might lead’) is as topical as 75 years ago: ‘The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes.’

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Milanovic B. (2011), More or less, Income inequality has risen over the past quarter-century instead of falling as expected, IMF, Finance and Development, September 2011.


Anmerkungen

1 The importance attributed to nominal rigidities is clearly in contraposition to Keynes’s view (e.g. 1936, ch. 2).

2 Wickens (2008, pp. 12-3) provides a succinct description of the ‘basic dynamic general equilibrium closed economy’ model: ‘The model may be described as follows. Today’s output can either be consumed or invested, and the existing capital stock can either be consumed or used to produce output tomorrow. Today’s investment will add to the capital stock and increase tomorrow’s output. The problem to be addressed is how best to allocate output between consumption today and investment ... so that there is more output and consumption tomorrow.’ This view is clearly non-Keynesian in the sense that one of Keynes’s main points in the General Theory was that saving and investment decisions were taken by different agents and that the rate of interest would fall to coordinate the ex-ante plans of savers and spenders in a way so as to bring the aggregate level of investment in line with the level of saving at full employment.