

# FISCAL FALLACIES

The failure of activist fiscal policy

Edited by Stephen Kirchner

**Contributors:**

John B Taylor

Tony Makin

Robert Carling



**Fiscal Fallacies:  
The Failure of Activist Fiscal Policy**



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## Crisis Commentary 1

The Crisis Commentary papers are based on the series of CIS events held, beginning in November 2008, to address the global economic crisis and provide CIS members and the public with in-depth analysis and varied perspective on the crisis.

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# Crisis Commentary Series—Introduction

Stephen Kirchner

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**T**he global financial crisis that emerged in 2007 and intensified in 2008 has turned into a major, worldwide economic downturn more serious than any since the Great Depression of the 1930s. The financial and economic crisis has seen considerable debate about its origins and consequences, as well as the responses of policymakers. The crisis raises important issues about the role of markets and governments in the allocation of capital and the regulation of financial institutions.

Australia went into the economic crisis better placed than most countries. However, as a small and open economy integrated into the world's capital markets, Australia cannot expect to escape the financial and economic consequences. Australia faces many of the same issues confronting other countries.

The Centre for Independent Studies initiated a series of Crisis Commentary events, beginning in November 2008, with a roundtable discussion of the global ban on short-selling stocks. Subsequent events addressed the federal government's renewed use of activist fiscal policy and other policy responses to the crisis. These events aim to provide CIS members and the general public with access to alternative perspectives on the crisis that are otherwise less well represented in the public debate.

The Crisis Commentary events have provided the basis for considerable media coverage for CIS. The aim of the publications in the Crisis Commentary series is to give these perspectives even wider currency and to serve as a reference for those interested in some of the many important issues raised by these events.

**Stephen Kirchner**

Research Fellow

The Centre for Independent Studies



# Introduction

## Fiscal Fallacies: The Failure of Activist Fiscal Policy

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The Keynesian philosophy is unquestionably the basis of a world policy today; and if the spectre of 'under-employment' appears again in the world tomorrow, as is probable, it will be the universal recourse of peoples and governments. If it is true, it will be the salvation of the world; if it is false, it may lead to catastrophe by turning the world to ineffective remedies which may make the evil much worse.

—Jacques Rueff, 'The Fallacies of Lord Keynes' General Theory' *The Quarterly Journal of Economics*, May 1947

Policymakers around the world have instinctively reached for the Keynesian playbook in the context of the current global economic downturn, rolling out discretionary fiscal stimulus measures of unprecedented size. The repeated failure of fiscal stimulus packages to deliver sustainable economic growth is always seen as arguing for yet more stimulus measures. Governments never draw the more obvious conclusion that activist fiscal policy is ineffective.

If governments could reliably spend their way out of recession, why would we ever need to experience a significant economic downturn? Why don't governments just spend their way back into prosperity? The problem is not just that activist fiscal policy is often mis-timed or mis-calibrated, although these are some of the risks associated with activist fiscal policy. There are more basic reasons why discretionary fiscal policy doesn't work.

Governments cannot create new economic activity. They can only redistribute the income and wealth created by the private sector. This redistribution can occur either between different sectors of the economy or across time. Fiscal stimulus measures attempt to bring forward demand through unfunded spending measures or tax cuts that reduce the budget balance. The change in the budget balance as a share of GDP measures the 'fiscal impulse' that government spending and tax changes are supposed to impart to the economy.

The ability of activist fiscal policy to stimulate aggregate demand and economic growth rests on the idea that governments can bring unemployed resources and labour back into employment when private sector activity is depressed. However, fiscal stimulus packages are rarely targeted directly at these unemployed resources. They often simply divert already employed resources from one sector of the economy to another, with no net gain to employment or economic activity.

Even where stimulus packages are targeted at depressed sectors of the economy, fiscal stimulus measures can interfere with the reallocation of resources that is often required before an economic recovery can get underway. Economic downturns are rarely purely cyclical affairs. They often signal the need for structural change and a reallocation of capital and labour to more highly valued uses. Government support for favoured sectors of the economy can stand in the way of these adjustments, making an economic downturn deeper and more protracted than necessary.

When an economy is at its 'full employment' level of output, it is readily accepted that increased government spending crowds-out private investment. An increase in the stock of government debt reduces the amount of capital available for private investment, although crowding-out may be offset to some degree by increased private saving and foreign capital inflow. In the short-run context of an economic downturn, crowding-out may not seem like an important issue, but it is enormously important in the long-run. Increased public sector debt displaces the role of the market in allocating capital, to the detriment of private sector capital accumulation, productivity, and economic growth. Governments do not become any better at allocating resources in an economic downturn. Indeed, once fiscal discipline is abandoned, it is likely that governments will make even worse decisions, reducing

the quality of government spending. This can weaken long-run economic performance, with costs that accumulate over many years, if not decades.

Government spending and taxing contains a counter-cyclical component, the so-called ‘automatic stabilisers,’ that kicks-in during an economic downturn, reducing the budget balance and cushioning the effects of an economic downturn, without governments having to make explicit policy decisions. These automatic stabilisers should be allowed to operate and have the advantage that they are self-correcting—with the budget balance improving as the economy recovers, without the government having to take new policy decisions.

Discretionary fiscal stimulus measures, by contrast, are not self-correcting. Unfunded tax and spending measures ultimately need to be paid for. An unfunded increase in government spending today implies a higher tax burden in the future. To the extent that households and businesses anticipate this increased tax burden, they will increase their saving to offset public sector dissaving (so-called ‘Ricardian equivalence’). The effectiveness of discretionary fiscal policy in stimulating economic activity thus relies on fiscal illusion. However, the ability of governments to exploit this illusion is limited. Empirical studies suggest that changes in private sector saving blunt the effectiveness of activist fiscal policy.

The case for fiscal stimulus in a small and open economy like Australia or New Zealand is weaker than for a large and relatively closed economy like the United States. To the extent that fiscal stimulus results in a short-run increase in demand, much of this demand will leak into imports. This might stimulate production in foreign economies, but not domestic production. If the increase in demand puts upward pressure on the exchange rate, net exports will be reduced.

Unfortunately, there is little or no acknowledgement of these arguments against activist fiscal policy among politicians, journalists and even among financial market economists. Simplistic Keynesian doctrines still have a stranglehold on public debate, despite having been formally discredited.

As official interest rates around the world are lowered to new-zero in response to the global financial crisis, it has been suggested that fiscal policy is the only macro policy instrument policymakers have left.

But central banks are not limited to changes in official interest rates. Quantitative approaches to monetary policy can also be used. However, even if monetary policy were thought to be ineffective, this does not in itself re-establish the effectiveness of fiscal policy.

During the boom years, many commentators in Australia argued that the Howard government's discretionary tax cuts added to aggregate demand, inflation, and interest rates. Yet many of the same commentators now reject any role for tax cuts in supporting economic growth in the context of a downturn, on the grounds that unfunded tax cuts will be saved rather than spent. However, the case for a lower tax burden is independent of the business cycle. A lower tax burden should be supported as a way of boosting labour force participation and productivity, not as a tool for demand management.

Instead of demand management, discretionary fiscal policy should focus on boosting the long-run growth potential of the economy through tax and expenditure reform. Any future discretionary fiscal consolidation should have a long-term, supply-side focus. The criteria for good public policy are also independent of the business cycle. Unfortunately, governments all too often lose their appetite for reform in the context of an economic downturn in favour of short-term stimulus efforts.

The papers collected in this volume elaborate on these basic insights to demonstrate the ineffectiveness of activist fiscal policy.

John Taylor's paper, 'The Lack of an Empirical Rationale for a Revival of Discretionary Fiscal Policy,' updates his earlier research on activist fiscal policy in the United States. Taylor analyses the 2001 and 2008 temporary tax rebates, as well as the role of government spending in an economic model. He finds no empirical support for the effectiveness of counter-cyclical fiscal policy. Taylor questions the revival of interest in activist fiscal policy in the light of this evidence.

Tony Makin's chapter 'Flawed Fiscal Fundamentalism' notes that fiscal policy operates very differently in an open economy compared to the closed economy framework originally employed by Keynes. A floating exchange rate and open capital account have important implications for the effectiveness of activist fiscal policy that are all too often ignored. Makin notes that demand management is best left to monetary rather than fiscal policy.



Robert Carling's chapter 'Are We All Keynesians Again?' notes that politicians are much more enthusiastic about fiscal stimulus in an economic downturn than they are about fiscal consolidation in the context of an economic boom. This asymmetrical approach to discretionary fiscal policy promotes secular growth in the size of government at the expense of the private sector.

The chapter by Taylor has been reproduced here with his permission. The chapters by Makin and Carling were presented at a Centre for Independent Studies Crisis Commentary event on 3 February. The material in Carling's chapter was also covered in CIS Issue Analysis No. 106.

**Stephen Kirchner**

Research Fellow

The Centre for Independent Studies

Sydney, May 2009



# The Lack of an Empirical Rationale for a Revival of Discretionary Fiscal Policy

John B Taylor\*

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## Introduction

A decade ago in a paper, ‘Reassessing Discretionary Fiscal Policy,’ published in the *Journal of Economic Perspectives*, I concluded that ‘in the current context of the US economy, it seems best to let fiscal policy have its main countercyclical impact through the automatic stabilizers ... It would be appropriate in the current circumstances for discretionary fiscal policy to be saved explicitly for longer term issues, requiring less frequent changes.’ This was not an unusual conclusion at the time. As Martin Eichenbaum<sup>1</sup> put it, ‘there is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible,’ or, according to Martin Feldstein,<sup>2</sup> ‘There is now widespread agreement in the economics profession that deliberate “countercyclical” discretionary policy has not contributed to economic stability and may have actually been destabilizing in the past.’

Despite this widespread agreement of a decade ago, there has recently been a dramatic revival of interest in discretionary fiscal policy. The purpose of this short paper is to review the empirical evidence during the past decade and determine whether it calls for such a revival. I find that it does not.

## I. Experiences with two temporary tax rebates

The most visible explicitly countercyclical discretionary policy experiences during the past decade have been the large temporary tax rebates of 2001 and 2008. In both cases, rebate payments were made

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to individuals and families for several months during the year, either in the form of checks, direct deposits, or temporary changes in tax withholding rates. The specific months in each year and the aggregate amounts paid in each month are shown in Table 1, where the data are stated in billions of dollars at annual rates as reported by the Bureau of Economic Analysis (2001, 2008). In the case of 2001,<sup>3</sup> the recession started in March 2001 and ended in November; in the case of 2008,<sup>4</sup> the recession started in December 2007 and was ongoing well beyond August 2008. Hence, in both cases the payments were made while the recession was still ongoing and, thereby, exhibit virtually no response or implementation lag, which was a criticism of such discretionary fiscal policy actions in the past. Lack of good timing was not a fault in either of these more recent experiences.

**Table 1:** Rebate Payments in 2001 and 2008 (\$ billions, annual rates)

	<b>2001</b>	<b>2008</b>
<b>April</b>	0	23.3
<b>May</b>	0	577.1
<b>June</b>	0	334.4
<b>July</b>	95.1	164.1
<b>August</b>	223.1	12.4
<b>September</b>	144.9	0
<b>October</b>	2.5	0

The macroeconomic theory that rationalizes such temporary rebate payments is that they increase the demand for consumption, stimulate aggregate demand, and thereby help get the economy on a path to recovery. But what do the data show? Figure 1 illustrates the rebate of 2008. The upper line shows disposable personal income for the months from January 2007 through October 2008. The data are seasonally adjusted and are stated at annual rates.

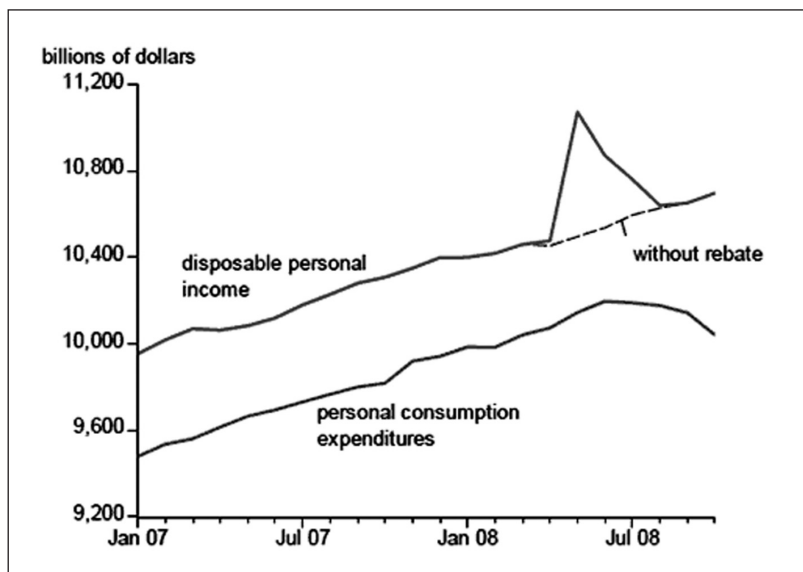
Disposable personal income is the total amount of income after taxes and government transfers; it therefore includes the rebate payments. Subtracting the rebate payments from the top line results in

the dashed line in Figure 1, which shows what the disposable personal income would have been without the rebates. Notice the sharp increase in disposable personal income in May when rebates were mailed or deposited in people's bank accounts. Disposable personal income then started to come down in June and July as total payments declined, and by August had returned to the trend that was prevailing in April.

The lower line in Figure 1 shows personal consumption expenditure over the same period.

Observe that consumption shows no noticeable increase at the time of the rebate. As the picture illustrates, the temporary rebate did little or nothing to stimulate consumption demand, and thereby aggregate demand, or the economy. In fact, recently revised data show that consumption began declining in July 2008 and continued to decline through October.

**Figure 1:** Income, Consumption, and the 2008 Rebate Payments



While Figure 1 is very revealing, policy evaluation requires going beyond graphs and testing for the impact of the rebates on aggregate consumption using more formal regression techniques such as shown

in Table 2. The regressions in Table 2 pertain to the period from the start of 2000 through the third quarter of 2008 and thus include both the 2001 and the 2008 rebate periods. To test whether the rebates had a positive and significant effect on consumption, I include both personal disposable income without the rebates and the rebate payments as two separate variables in the regressions. To allow for lagged effects of changes in income, I include a lagged dependent variable in the equations.

The first column of Table 2 shows that the impact of the rebate is statistically insignificant and much smaller than the significant impact of disposable personal income excluding the rebate. This confirms the results illustrated in Figure 1 and extends them to the 2001 as well as the 2008 rebates. But an advantage of using regressions is that one can include other factors that affect consumption. For example, the second regression in Table 2 includes the price of oil, which would be expected to have a depressing effect on consumption. It is important to try to account for oil prices because the rebates could have a positive impact once the negative effect of oil prices are taken into account, especially in 2008 when oil prices rose rapidly in the spring and summer. Because the impact of oil price changes occurs with a lag, I tried several alternative lag lengths for the oil price variable. Table 2 reports the case where the impact was the highest so as to give the rebate variable the greatest opportunity to have a statistically significant effect. Note that while the coefficient on the rebate variable is higher with the oil price variable than without, it is still not statistically different from zero. These results are robust to changes in the sample period and specification. For example, sample periods that include only one rebate episode also show no significant effects of the rebate. The results are similar if nominal income rather than real income is included in the regression or if the interest rate is added to the regression. Correcting for first-order serial correlation of the error rather than adding a lagged dependent variable also yields similar results.

**Table 2:** PCE Regressions with Rebate Payments

Lagged PCE	.794 (.057)	.832 (.056)
Rebate payments	.048 (.055)	.081 (.054)
Disp. Pers. Income (w/o rebate)	.206 (.056)	.188 (.055)
Oil Price (\$/bbl lagged 3 months)	—	-1.007 (.325)
R <sup>2</sup>	.999	.999

**Note:** The dependent variable is personal consumption expenditures. Standard errors are reported in parentheses. The oil price is for West Texas Intermediate. The sample period is January 2000 to October 2008.

These results are consistent with the permanent income theory or life cycle theory of consumption in which temporary increases in income are predicted to lead to proportionately smaller increases in consumption than permanent increases in income. In these regressions, a temporary increase in income—represented by the rebate variable—has a small and statistically insignificant effect. In contrast, when the increase in income is more permanent—as represented in these regressions by the personal disposable income variable without rebate—the change in consumption is larger and statistically significant.

The results are also consistent with earlier macroeconomic time series studies<sup>5</sup> of temporary government payments or surcharges in the 1960s and 1970s, which later became incorporated in macroeconomic textbooks. Indeed, it was such permanent income theories and the empirical studies supporting them that led many economists to conclude that such discretionary fiscal policy actions are not a good policy tool. That consensus apparently broke down during the debates about the fiscal stimulus of 2008 when a number of economists wrote and testified that such a temporary rebate program would be an effective stimulus.<sup>6,7,8</sup> One reason for that change in the view of some economists at the time might have been the apparent success of rebate payments

made in 2001. However, those rebate payments were part of more permanent multi-year tax cuts passed that same year, which would be expected by the permanent income theory to boost consumption and the economy.

Of course, the permanent income and life cycle theories are approximations and do not take account of liquidity constraints that make it difficult for some consumers to borrow; thus, they may spend more of the temporary income than predicted by the theory. In fact, using micro survey data David Johnson, Jonathan Parker, and Nicholas Souleles<sup>9</sup> found significant effects for the 2001 rebate payments, and this too may have led to a change in views around the time of the 2008 rebates. More recently, Christian Broda and Jonathan Parker<sup>10</sup> found that individuals in their micro survey spent a statistically significant amount of the 2008 rebates, but apparently this was not enough to move aggregate consumption as shown in Figure 1.

In sum, recent evidence on the impact of rebate payments on aggregate consumption does not provide a rationale for a revival of discretionary countercyclical fiscal policy.

## **II. Model simulations and the impact of government purchases**

The ineffectiveness of the 2008 rebate payments as a stimulus to consumption has recently led to proposals to increase government purchases as an alternative stimulus. While increasing government purchases will certainly raise GDP in the short run more than temporary rebates, it is not clear whether this will be any more effective in stimulating a sustained economic recovery. Indeed, even if the impact of the tax rebates were to raise consumption significantly more than shown than in Figure 1, the increase would have been temporary, probably following the pattern of the rebate in Figure 1. It is difficult to see how such a temporary blip in consumption would lead to a sustained expansion of a large dynamic economy.

There is little evidence that short government impulses can jump start an economy adversely affected by other forces. In the current recession, the economy has been pulled down by the housing slump, the financial crisis, and the lagged effects of high energy prices.



Expectations of future income and employment growth are low because the effects of the financial crisis are expected to last for many years. Unless these effects are addressed, a short-term fiscal stimulus has little chance of causing a sustained recovery.

The theory that a short-run stimulus will jump start the economy is based on older 'Keynesian' theories that do not adequately include, in my view, the complex dynamic or general equilibrium effects of a modern international economy. Nor do they usually include endogenous (or rational) expectations of the future. The problems with such models can be illustrated by again using the evidence from the rebates, and I believe similar problems arise when analyzing other stimulus proposals as well. For example, according to model simulations of Mark Zandi,<sup>11</sup> GDP would have risen by about a dollar and a quarter for every dollar of a refundable one-time rebate. But Figure 1 and Table 2 show that in reality, the impact was only a few pennies for each dollar and insignificantly different from zero in 2008. One needs to understand why the models were in error before using the same models to analyze the impacts of new types of proposals for 2009. In contrast, simulations of my empirically estimated multi-country dynamic model<sup>12</sup> with rational expectations indicates that multi-year changes in government spending phased in at realistic rates have a maximum government spending multiplier of less than one because of offsetting reductions in the other components of GDP.

To be sure, it may be appropriate to increase government purchases in some areas, including for infrastructure as in the 1950s when the interstate highway system was built. But such multi-year programs did not help end, mitigate or prevent the recessions of the 1950s. In sum, there is little reliable empirical evidence that government spending is a way to end a recession or accelerate a recovery that rationalizes a revival of discretionary countercyclical fiscal policy.

### **III. Recent experience with the automatic stabilizers**

The earlier widespread view of fiscal policy was that instead of focusing on discretionary countercyclical actions, it should focus on the automatic stabilizers as well as on more lasting, long-run reforms that benefit the economy—from tax reform, to entitlement reform, to infrastructure spending, and to keeping the debt to GDP ratio in line. Is there any

change in the behavior of the automatic stabilizers that would change this view?

Table 3 provides evidence of how the automatic stabilizers have changed over time. It is an update of a similar table and analysis in my 2000 paper.<sup>13</sup> It divides the total federal budget deficit on a quarterly basis into two components: a structural part and a cyclical part. The structural part is a quarterly interpolation of the annual number reported by the Congressional Budget Office (CBO). According to CBO methodology, the structural deficit is affected by changes in tax rates or spending programs such as the 1982 tax rate cuts, the 1993 tax rate increases, and the 2001 tax rate cuts. The structural deficit is also affected by changes in the economy, such as changes in the income distribution or the share of income in different tax categories. The cyclical part is computed in Table 3 as the difference between total deficit and the structural part.

To measure how the automatic stabilizers have changed over time, I regressed each of these measures (structural, cyclical and total) as a percentage of GDP separately on the percentage GDP gap. I used the CBO measure of potential GDP to compute the GDP gap, which results in a reasonable description of the ups and downs of the economy at a business cycle frequency. I report the slope coefficients from each of these regressions in Table 3 for several different sample periods. All the coefficients are highly significant statistically. As computed, the sum of the coefficients in the first two columns should equal the coefficient in last column except for rounding errors.

**Table 3:** Simple Regression Coefficients of Deficit Components on GDP Gap

Sample	Structural	Cyclical	Total
1983:1 1994:4	.00	.35	.36
1983:1 1997:4	.14	.35	.49
1983:1 2007:4	.48	.34	.82
1995:1 2007:4	.71	.29	1.00

Table 3 shows that there indeed have been large changes in the relation between these measures of the deficit and the GDP gap.

While the coefficient on the cyclical component has remained fairly constant around one-third, the coefficient on the structural component has increased dramatically over time. In fact, the cyclical movements in the structural deficit have overtaken the cyclical movements in the cyclical deficit. More research is needed to determine exactly why this change has occurred. It is important to determine whether this high responsiveness will continue into the current recession. If so, the automatic stabilizers will be very powerful and the deficit will increase significantly on this account. In any case, Table 3 provides no evidence to change the ‘widespread agreement’ of a decade ago to focus fiscal policy on the automatic stabilizers rather than on discretionary countercyclical actions. It may even suggest the opposite.

#### **IV. Changes in monetary policy effectiveness**

Another reason for the widespread view a decade ago about fiscal policy was that monetary policy had improved after the late 1960s and 1970s and played an essential countercyclical role as it achieved both greater price and output stability during the great moderation. However, there were also concerns expressed about the limits of monetary policy if the zero bound on interest rates were to be reached as it had in Japan in the 1990s. The recent change in monetary policy in the United States and the resulting constraint of the zero bound is another reason why some are calling for discretionary fiscal policy actions.

In my view, however, the experience during the past decade does not show that monetary policy is ineffective or that fiscal policy is more appropriate when the short-term interest rate reaches the lower bound of zero. Indeed, the lesson from Japan is that it was the shift toward increasing money growth—quantitative easing—in 2001 that finally led to the end of the lost decade of the 1990s. It was certainly not discretionary fiscal policy actions. Increasing money growth—or simply preventing it from falling as in the Great Depression—remains a powerful countercyclical policy.

While a full treatment of monetary policy in the current environment is well beyond the scope of this paper, there is no evidence in the past decade that suggests that monetary policy has run out of ammunition and needs to be supplemented by discretionary fiscal actions.

## **Conclusion**

A decade ago there was widespread agreement that fiscal policy should avoid countercyclical discretionary actions and instead should focus on the automatic stabilizers and on longer term fiscal reforms that positively affect economic growth and provide appropriate government services, including infrastructure and national defense. In this paper I have briefly summarized the empirical evidence during the past decade on (1) the temporary rebate programs of 2001 and 2008; (2) macro-econometric model simulations; (3) the changing cyclical response of the automatic stabilizers; and (4) the role of monetary policy in a zero interest situation.

Based on this review, I see no empirical rationale for a revival of countercyclical discretionary fiscal policy.

## Endnotes

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# Flawed Fiscal Fundamentalism

Tony Makin

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## Introduction

Australia is experiencing one of the largest fiscal turnarounds in its economic history based on the premise that governments can expand aggregate demand to counter a financial crisis induced recession. Nothing better exemplifies the resurrection of Keynesianism than the level of support it has received amongst policymakers, business leaders, unions, and commentators. It also demonstrates that a little knowledge, especially of macroeconomics, can be a dangerous thing.

Tens of billions of dollars worth of direct public spending, tax bonuses, and temporary welfare payments have been announced by the federal government since the 2007–08 budget. Along with the effects of the cyclical downturn itself on government revenue and outlays, this has transformed an estimated federal budget surplus of around 2 percent of GDP into a deficit of the same magnitude. With further fiscal deficits expected in the years ahead, it also ensures the federal government will re-emerge as a significant net borrower in financial markets for some time, requiring some \$200 billion in coming years.

What we are now witnessing on the federal fiscal front is nothing short of an embrace of flawed fiscal fundamentalism. Like other forms of fundamentalism, unreconstructed Keynesianism relies on a literal interpretation of an obscure text written long ago when circumstances and institutions were quite different. The text in question is Keynes' *General Theory of Employment Interest and Money*,<sup>1</sup> published in the economically unenlightened 1930s—a time when monetary policy and independent central banks as we now know them did not exist.

The simple idea that by pumping up total spending, government can supplement depressed private spending and temporarily boost economic activity has appealed to economists and governments since the Great Depression of the 1930s. However, the following discussion suggests that the policy language used to describe changes in the stance of fiscal policy is tendentious at best and grossly misleading at worst.<sup>2</sup> Indeed, there is as much a case for calling some forms of fiscal expansion, especially unproductive public spending, fiscal ‘repression’ rather than fiscal ‘stimulus.’

### **Counterarguments to fiscal activism**

In its most basic form, Keynesian fundamentalism is founded on the now-redundant assumption that economies are closed to international trade and investment. But globalisation has greatly altered how fiscal policy works. These days, we cannot properly understand macroeconomic behaviour without taking account of foreign capital flows, exports, imports, exchange rates, and international competitiveness—variables that Keynes ignored in his original work.

First-year economics students are asked to believe in the Keynesian fantasy that extra domestic expenditure is the wellspring of even more additional output, though for those who continue their economics studies it is usually countered in intermediate level macroeconomics by exposure to theories, such as the Mundell-Fleming model,<sup>3</sup> that show fiscal activism can be completely ineffective as a stabilisation tool.

The original Keynesian theory only works if you pretend the economy is completely isolated from the world economy. Only under the assumption of a closed economy would extra public spending fall entirely on domestically produced goods and services. And this occurs only if there is no offsetting behaviour by households and firms due to the additional demand for financial resources implied by the associated rise in borrowing and public indebtedness.

Yet in reality, extra aggregate spending for given national production widens the trade deficit, mainly via spending on imports, but also via spending on goods and services that would otherwise have been exported. This additional spending has to be funded by additional capital inflow from abroad, with little effect on domestic production and jobs.



Private investment also fails to offset extra debt-funded public spending because interest rates increase when governments start borrowing more. Future downgrades to the creditworthiness of state and federal governments by international credit rating agencies will further add to borrowing costs, which are likely to increase with increases in public sector borrowing requirements. To the extent that the extra borrowing is sourced from abroad at higher cost in the present financial environment, this means the future stock of capital is lower than otherwise.

There is a glaring paradox about the use of discretionary fiscal measures and deficit financing to offset the effects of the global economic downturn. While the credit crunch and overall shortage of funds have primarily caused a downturn in real sector activity, for some reason governments around the world foresee no problems borrowing funds to cover their worsening fiscal deficits. Yet, extra government borrowing can only exacerbate the global funds shortage, pushing up long-term global interest rates.

This paradox is even starker for the United States, which started the crisis with a huge budget deficit, arguably a prime cause of the crisis in the first place because the US budget deficit contributed to unsustainable expenditure in excess of US domestic production. Yet the United States will now need to borrow even more to facilitate President Barack Obama's proposed stimulus package.

As modelled more formally in Makin,<sup>4</sup> higher government consumption lowers national saving, weakens the external position, and contracts national income. An easier fiscal stance resulting from higher public consumption spending, therefore, proves counterproductive as a means of boosting national income. On the other hand, public spending on highly productive infrastructure can raise national income, provided its rate of return exceeds the servicing cost of the borrowing required to fund it.

But if the extra government spending fails to generate an economic return sufficient to cover the servicing costs of the foreign borrowing, the seeds are sown for a future currency crisis. Such crises become self-fulfilling whenever foreign lenders suddenly cease lending on the expectation of future currency depreciations.

Lastly, the Ricardian Equivalence proposition implies that household consumption immediately contracts to offset fiscal expansion because households realise that higher taxes will be necessary in the future to repay public debt. There is ample international evidence that this occurs, at least partially, in advanced economies.<sup>5</sup> Taken together, the above linkages seriously caution against using large-scale fiscal activism as a supplement to monetary policy.

### **The international evidence**

In surveying the empirical literature on the effectiveness of fiscal activism, the IMF itself in last year's *World Economic Outlook* stated:

Perhaps surprisingly, the empirical literature on the effects of fiscal policy does not provide a clear answer to the simple question of whether discretionary fiscal policy can successfully stimulate the economy during downturns.<sup>6</sup>

There is no conclusive evidence that activist fiscal policy aimed at changing the course of the short-term business cycle has ever worked to the longer term benefit of any economy. Many studies supportive of fiscal stimulus simply reflect their starting assumptions, including the questionable Keynesian premise that increased spending automatically increases output and employment.

Separating out the automatic changes in the fiscal position from the discretionary ones is difficult, and it is impossible to assess the counterfactual of how the economy would have performed had there been no fiscal response. Empirically, it is also difficult to disentangle the effects of fiscal stimulus from the effects of monetary policy easing that often occurs simultaneously. Estimating the economy-wide effects of fiscal stimulus is further complicated by the fact that earlier monetary easing has lagged effects of up to 18 months on economic activity.

There is nonetheless a sizeable international literature on fiscal multipliers. If extra fiscally induced domestic spending raises national output, multipliers are positive, and fiscal stimulus is effective. If multipliers are negative due to crowding out effects, 'fiscal stimulus' is a misnomer as it subtracts from output expansion.

While some studies yield positive fiscal multipliers in support of the Keynesian paradigm, including earlier academic work by the IMF's Chief Economist, Olivier Blanchard,<sup>7</sup> there are many other academic studies that suggest the opposite.<sup>8</sup> The IMF has been careful to qualify a call for fiscal stimulus with the proviso that it would not suit all countries and that debt sustainability may be a problem for some.<sup>9</sup> For instance, IMF Managing Director Dominique Strauss-Kahn<sup>10</sup> stated:

Of course, not every country can undertake fiscal stimulus. Some countries—both emerging and advanced—cannot finance higher deficits without risk to their creditworthiness. Some will need to contract their budgets rather than expand them.

We could read into this proviso that large international borrowers in the current climate should take special care. Selectively quoting the views of individual IMF staff as justification for fiscal largesse, as many presently do, is not the full story.

What has been ignored in current debate is that fiscal contraction that targets wasteful government programs improves macroeconomic performance. Numerous empirical studies,<sup>11</sup> some undertaken at the IMF, support this. In essence these studies imply that cutting wasteful public spending programs 'crowds-in' private investment and this increases national income.

Such improvement occurs through lower interest rates, accelerated real investment and national income, as well as stronger exchange rates and external positions. This directly contradicts the Keynesian notion that fiscal policy is an effective counter-cyclical instrument. However, results critically depend on whether reduced government spending is in the nature of consumption or investment.

### **Australia's fiscal experience: Some inconvenient truths**

The acceptance of Keynesian ideas last reached its peak in the 1970s when fiscal policy was deemed superior to monetary policy as a means of manipulating total spending in the economy. Budgets were explicitly framed to address the short-term business cycle, and fiscal deficits and significant public indebtedness were the norm.

Back then monetary policy played a more accommodating role, and inflation targeting and the notion of central bank independence were unheard of in most economies. Not coincidentally, the 1970s was the most abysmal decade for OECD economies, including Australia, in the post-war era according to a series of macroeconomic indicators that include economic growth, inflation, unemployment, and stock market prices.

Since then, the standard Keynesian view that fiscal expansion stabilises macroeconomic activity has continued to provide federal governments with a rationale for expansionary fiscal policy, for instance, in the early 1980s and early 1990s to counter recessions at those times. However, there is no evidence that fiscal activism effectively alleviated earlier economic downturns.

The key question is whether Australia really needs fiscal ‘stimulus’ in the form of budgetary outlays when monetary policy is best placed to influence short-run macroeconomic activity. Since the onset of the global financial crisis official interest rate has been cut substantially, allowing the exchange rate to depreciate to boost Australia’s competitiveness.

Rationales for fiscal stimulus ignore the fact that Australia is an economy that is, and always has been, heavily reliant on foreign borrowing. Foreign borrowing, channelled mainly through the banking sector, bridges the gap between the nation’s investment needs, including for housing, and its own saving level.

It is Australia’s status as an international borrower, much laboured in past economic policy debate but now seemingly forgotten, that suggests there are serious risks associated with fiscal ‘stimulus,’ particularly if the stimulus comes in the form of increased government spending that ultimately proves unproductive.

For instance, subsequent to the fiscal expansion of the early 1980s there was a currency crisis in 1985 followed by the downgrade of Australia’s creditworthiness by international credit rating agencies—evidence that the value of the dollar and the nation’s creditworthiness depreciates precipitously when the rest of the world disapproves of Australia’s public spending habits. The irony is that confidence in the economy was then best restored by subsequent re-tightening of fiscal policy. In this way, past budget surpluses provided a measure of macroeconomic security.

The size of the public sector in Australia and other advanced economies has grown extensively with government spending in the OECD region as a whole rising from around 25 percent of GDP in 1960 to more than 40 percent today. A reason for this is that governments have increased public spending during economic downturns, but not fully reversed it during upswings.<sup>12</sup>

This is not to deny that fiscal policy can improve the quality of public investment, including in human capital, and play a growth enhancing role. For instance, there is some evidence to suggest that improving returns from public investment through education and infrastructure can raise overall productivity.

## **Macroeconomic policy management**

Since the early 1990s, short-run macroeconomic management had been assigned to the Reserve Bank of Australia (RBA) to conduct monetary policy at arm's length from government, its main objective being inflation control. With the radical re-casting of fiscal policy as a short-run macroeconomic stabilisation tool, there are now two separate federal authorities responsible for national macroeconomic management: the RBA and the federal Treasury acting on behalf of the government.

The assignment of fiscal policy to longer term goals was not long ago widely accepted because monetary policy was on both theoretical and operational grounds thought to be more capable of influencing the economy in the short run. In particular, monetary policy was less handicapped by so-called implementation lags and the difficulties of reversing new public spending initiatives after the business cycle swings up.

Under previous arrangements, the fact that only one macroeconomic policy authority, the RBA, sought to stabilise the economy in the short term and obviate conflict in official circles regarding where the economy was headed. Under current circumstances, if both the RBA and Treasury try to steer short-run activity, yet cannot agree on basic macroeconomic forecasts, as is often the case, it follows they will have contradictory views about policy settings.

Cooler national policy responses to the global financial crisis have prevailed in comparable countries such as New Zealand, which is doing relatively less on the public spending front, but is no less exposed to

the external financial crisis than Australia. The lesson to be learned from New Zealand in particular is that the aggregate supply side of the economy should also be receiving urgent attention to directly assist the business sector—the ultimate source of production in any economy.

One can also wonder what would have happened to the Australian economy had fiscal packages of recent magnitude been drafted in response to the 1997–98 Asian crisis. At that time there was no big fiscal policy shift. Monetary policy and the exchange rate entirely bore the pressure of the economy’s adjustment to the external shock, and, as it turned out, bore this pressure most successfully.

If other major economies do pump prime their economies despite previous tearful endings, it may well be that the optimal response here is to be quite fiscally inert. This is because fiscal expansion in major trading partners will spill heavily over into their demand for imports. This would increase our exports and boost aggregate demand without Treasury moving a single dollar closer to raising public debt.

Past episodes of fiscal consolidation, as rare as they have been over the past half century in Australia, appear to have stimulated economic activity. Two examples that spring to mind are Treasurer Keating’s budgets of the late 1980s and Treasurer Costello’s 1996–97 budget.

In both instances, stronger than expected growth followed fiscal consolidation achieved by posting budget surpluses on the back of spending cuts. In contrast, there is no evidence that fiscal largesse and the big federal deficits that run during recessionary periods actually smoothed the path to recovery.

The fact remains, however, that consumption of all levels of government now stands at more than 18 percent of GDP, compared to around 12 percent in the early 1970s. Public investment has always been relatively smaller, and now stands at around 3 percent of GDP. Ample scope therefore exists for cutting government consumption as a means of bolstering the economy.

## **Concluding Comments**

Fiscal activism has been largely discredited over recent decades because extra government spending proved to be less effective in influencing the economy than once thought. Keynes’ original 1930s advocacy of public spending as a stabilisation tool was set against the background of the

Great Depression, double-digit unemployment, and a persistently falling price level. Yet numerous economists have, for various reasons, denied that fiscal expansion assisted the US recovery from the Depression or helped Japan during its 'lost decade' of the 1990s.<sup>13</sup>

In the end, extra government outlays can only generate sustained national output increases if they involve or encourage productive, not unproductive, new expenditure. This is a major lesson of the global financial crisis, a major cause of which was the rest of the world's unwillingness to fund the US budget deficit and its runaway housing industry. Excessive public sector borrowing risks downgrades to Australia's international creditworthiness and an exchange rate crisis, which would be a repeat of the economy's experience in the mid-1980s.

This is not to say that more public infrastructure is not needed. However, infrastructure assists supply side capacity and has lasting benefits provided it is sufficiently productive. For this reason, it should be afforded priority over public consumption aimed at short-run demand stabilisation, the efficacy of which is highly dubious.

A tragic consequence of Keynes' contribution to economics was that for decades before it came to be discredited, most notably from the 1960s to the 1990s, it shifted attention away from the supply side of the economy, where output is first determined, to the demand side.

Keynes famously wrote more than 70 years ago: 'Practical men who believe themselves to be quite exempt from any intellectual influences are usually the slaves of some defunct economist.' These days, the 'practical men' are policymakers, commentators and bank economists, it seems.

As I have suggested previously, Keynes himself, whose relevance, properly interpreted, was for a different time and quite different circumstances, is now that defunct economist, though obviously still far from being recognised as such in policy circles. Present debate on fiscal activism is driven more by pure politics than rational economic analysis.

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# Are We All Keynesians Again?

Robert Carling

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When Richard Nixon said, ‘We are all Keynesians now’ in 1971, activist counter-cyclical fiscal policy was in its heyday. Now, almost 40 years later, that policy fashion seems to have made a comeback—so widespread is the clamour for fiscal stimulus packages as a response to the current economic debacle. For example, *The Economist* recently editorialised in relation to the US situation:

As America’s recession continues to deepen, one mercy is that there is no longer any serious debate that a fiscal stimulus is required to fill the hole left by the collapse of private demand ... the case for the government stepping in has become unanswerable.<sup>1</sup>

And in Australia, the *Sydney Morning Herald* commented in its editorial:

It is a measure of how much and how quickly the global economic implosion has changed Australian and international thinking that relatively few would argue that the government should not take urgent and substantial action now.<sup>2</sup>

Almost all, if not all, the developed countries have now announced fiscal stimulus packages. But the revival of counter-cyclical fiscal policy glosses over the case against it that was built up and eventually widely accepted in the 1970s and 1980s, leading to a new consensus that fiscal policy should be more stable and focused on long-term goals. That case remains valid today, but it is being swept aside in the headlong rush to prop up sagging economies.

All the talk of stimulus and multipliers is straight out of a 1960s macro-economics textbook, as if everything that was subsequently learnt about the limitations of activist fiscal policy had been invalidated. There is at least some debate on these issues in the United States, thanks to academics like John Taylor and Robert Barro, but there has been very little such debate in Australia, where the use of fiscal stimulus has gone largely unchallenged.

This situation should change—though so much stimulus has already been injected I fear it is too late. At the very least, too much is being expected of fiscal stimulus. At worst, it will be ineffective in the short-term and damaging in the longer term.

But before explaining why, I should define what aspect of fiscal policy I am talking about. I am *not* talking about the so-called automatic fiscal stabilisers, which operate when tax revenue falls and certain government outlays rise automatically, without government policy changes, in response to a downturn in economic activity, employment and profits.

It is generally accepted that governments should allow these automatic responses to occur rather than make policy changes to offset them. We now know that the Commonwealth budget would have gone into deficit next year (but not this year) even without any of the government's fiscal stimulus packages. The deficit would have been around \$15 billion next year—assuming of course that the Treasury economic forecasts underlying those estimates are correct.

But the key issue is not whether the budget will or should be in deficit; it is whether the government should push the budget further into deficit through discretionary fiscal policy changes—which, of course, the Rudd government has now done, on a large scale.

This aspect of fiscal policy is variously known as 'activist,' 'discretionary,' 'counter-cyclical,' or 'stabilisation' policy. In the post-war years, faith in such policies grew to the point that it was believed the business cycle could be smoothed out or fine tuned. Aggregate demand, according to this view, could be managed through tax and expenditure policy adjustments so that the economy would never stray far from its potential or full employment level of production. Although often labelled 'Keynesian,' fine tuning was in fact a debased form of what Keynes had advocated in the 1930s.

Fine tuning was thoroughly discredited in the 1970s. To be fair to the advocates of discretionary fiscal stimulus now, their argument is a bit more sophisticated and runs along the following lines:

- The economic situation and outlook is so grim that it is more like the 1930s than any of the post-war recessions. It is not a matter of fine tuning but softening the blow.
- Most economies, at least in the developed world, have rapidly widening margins of spare capacity that could be absorbed by a boost to aggregate demand.
- Inflation, although recently too high, is receding rapidly and threatens to become deflation in some countries.
- The monetary policy interest rate has reached its lower bound in the United States and Japan and is close to it in some other countries. This is a liquidity trap situation.
- Orthodox monetary policy has been rendered impotent by the breakdown in the system of financial intermediation; therefore, the burden must fall on fiscal policy.

These are the elements of the best case that can be made for fiscal stimulus in the current situation, but the best case is also vulnerable to the arguments against counter-cyclical fiscal policy that I alluded to earlier, and to which I now turn in some detail.

Most importantly, expectations of multiplier effects are greatly exaggerated. Far from exceeding unity, multipliers will struggle even to come close to unity, and may even be closer to zero. A multiplier of zero means that the fiscal stimulus fails to achieve any increase in GDP. How can this be?

For a start, policy changes that give a temporary boost to household purchasing power, such as the lump-sum pension hand-outs in December and some of the measures announced in February, run foul of Friedman's permanent income hypothesis. According to the hypothesis, household spending is guided by notions of permanent income and wealth, not by temporary fluctuations, which are likely to affect saving rather than spending. There is plenty of empirical evidence that this hypothesis holds true in practice.

Then there is a large body of literature about ‘crowding out,’ which means that increases in government spending or increases in government deficits for whatever reason tend to result in offsetting shrinkage in private sector activity through a variety of mechanisms. Prominent among these is Ricardian equivalence which, stripped of the jargon, says that a deficit-financed fiscal stimulus may fail because the private sector is smart enough to figure out that the deficit comes with a future tax burden required to service and repay the increased public sector debt. Again, there is empirical evidence that Ricardian equivalence holds, at least in part.

Other crowding out mechanisms include interest and exchange rate effects of fiscal deficits in an open economy, and adverse confidence effects. Panicky policy responses and actions that create greater uncertainty about future fiscal policy will have an adverse impact on confidence.

Other planks in the case against fiscal stimulus include the risk that lags in recognition of cyclical turning points, decision making, policy implementation and impact will result in stimulus being mistimed and turn out to be pro-cyclical instead of counter-cyclical. It is likely that stimulus will continue for too long, simply because government becomes locked into a course of action or fails to recognise when a recovery has started.

Activist fiscal policy tends to be asymmetric, with governments keener to stimulate than to dampen demand, resulting in ratcheting up public debt. It is also biased towards public sector expansion because expansionary spending measures become entrenched and are eventually validated by tax increases. Historically speaking, war, depression and other cataclysmic events have led to permanent enlargement of government. There are those who see the current crisis as an opportunity to introduce new government spending programs. Whatever short-term impact these may or may not have, permanent expansion of government will be a drag on economic efficiency, productivity, and growth in the future.

If all that is not enough, the rigour of the public policy framework—such as it is even in normal times—is further weakened when governments are in a rush to devise stimulus packages.

Governments in a hurry to spend attract sectional interests. Proposals that allocate resources inefficiently are not subject to as much critical scrutiny as they normally would be and are more likely to be adopted. The cost in inefficient resource allocation has to be set against any short-term stimulatory benefit.

For these kinds of reasons, the IMF staff recently concluded after a major study of the effectiveness of counter-cyclical fiscal policy that ‘the effects of fiscal stimulus can be positive, albeit modest.’<sup>3</sup> This is faint praise. They are saying that it all depends on the starting conditions, the timing, and the kinds of measures adopted—and even then, don’t expect much. This is coming from the researchers in the bowels of the IMF; it is not what their bosses are shouting from the rooftops.

I also would concede that fiscal stimulus can have a positive effect in certain circumstances. The various offsets, such as crowding out, are not necessarily complete. It depends on the country and the circumstances. But in many cases, any positive short-term impact is likely to be weak and to raise doubts as to whether such a use of taxpayers’ money is worthwhile or just plain wasteful.

In Australia, the strength of Commonwealth finances carried over from the boom did provide room for a credible and effective loosening of fiscal policy in the downturn. But what the government has done, with policy decisions costing \$29 billion this year and \$20 billion next year, goes way too far and must raise concerns about future fiscal sustainability. They have dug a big hole and created a problem for the future. The stimulus is too large and continues for too long, all based on economic forecasts that have a lousy track record.

Moreover, the kinds of measures adopted are in many cases wasteful of taxpayers’ money. If they wanted to do something, they should have brought forward the tax cuts already legislated for the next two years. They could also have instigated some additional capital expenditure, provided it was subjected to rigorous appraisal and could be implemented quickly enough.

In the United States, which is critical to the global outlook, the fiscal calculus is worse. Public finances were already chronically weak even before the Obama stimulus, with a deficit of around 8 percent of GDP this year and federal debt climbing rapidly towards

50 percent of GDP. In addition, there is the looming problem of the unfunded liability for future social security and Medicare entitlements. Adding another fiscal stimulus of almost US\$800 billion on top of all this fails the credibility test. It will struggle to have any positive effect and is more likely to undermine confidence further. If ever there was a case of crowding out, this is it.

The new administration would be better off concentrating on the broken financial system and accepting the fiscal cost of restoring it to health, whether through the purchase of bad assets or recapitalisation of banks, but hopefully not nationalisation. Financial intermediation is the lifeblood of an economy, and its restoration to something like normal is critical to the restoration of confidence. Use of taxpayers' money for this purpose is not what is normally meant by fiscal stimulus, but it would do more than a conventional fiscal stimulus to bring about a sustained recovery.

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## Fiscal Fallacies: The failure of activist fiscal policy

The papers collected in this volume demonstrate the ineffectiveness of activist Keynesian fiscal policy, referencing recent debates over fiscal stimulus packages in Australia and the United States. The papers review the open economy, crowding-out, and Ricardian equivalence arguments against activist fiscal policy.

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