THE MEANS TO PROSPERITY
FISCAL POLICY RECONSIDERED

EEA SESSIONS

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INTRODUCTION

Herbert Stein – the head of Nixon's Council of Economic Advisers – wrote in 1969 an authoritative account of the fiscal revolution in America. The book told the story of the rise of Keynesian fiscal policies from Herbert Hoover to Lyndon B. Johnson. Policies did not change overnight. In fact, it was a long process in which the view of fiscal policy changed partly because facts changed, partly because the interpretation of facts changed. Policy priorities were guided by the experiences of the Great Depression and World War II, making full employment the prime objective, and fiscal policy served as the most important policy tool with respect to this goal.

Few anticipated the profound changes in economic environment and policy outlook that would take place in the following quarter century. The Keynesian consensus portrayed by Stein was largely abandoned in the turbulent 1970s, as economies were mired in concurrent inflation and mounting unemployment. In the course of this 'fiscal counter-revolution', monetarist ideas gained currency and combating inflation became first priority in economic policymaking. A new consensus gradually emerged, establishing the current hegemony of monetary policy over fiscal policy, and independent central banks over ministries of finance.

The war on inflation has been overwhelmingly successful, even if the victory was not just won by monetary policy alone. Inflation is virtually nonexistent in industrialized countries, and generally subdued in the developing world. The victory over inflation was however bought at a high cost in terms of sluggish growth, high unemployment and income inequality in many parts of the world, giving rise to a host of economic and social problems that take their toll. Social protection and the welfare state have become increasingly strained by mounting demands and deficient revenue flows, in what has sometimes been referred to as the 'fiscal crisis of the State'.

There is now widespread discussion of the risks of general deflation, and the specter of a 'liquidity trap' rendering monetary policies ineffectual. The world economy is in the doldrums for the third year in a row, with little stimulus to be expected from the Japanese and European economies – due not least to concerns about budgetary deficits and the

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limits imposed by the Stability and Growth Pact. The burden of pulling the world economy out of stagnation thus falls upon the shoulders of the United States.

Developing countries are strapped in a direr situation, if that is possible. In many cases external liberalization – forcefully pursued for more than a decade now – has meant that revenues have fallen at a time when globalization demands increasing social spending. The fall in revenues is in general associated with lower tariff revenue, or with higher spending on debt servicing, due to higher interest rates.

In these circumstances, the role of fiscal policy has become subject to renewed interest. With interest rates at their lowest levels in decades, and in some cases very close to zero, the scope for further monetary stimulus does seem limited. It is yet unclear whether monetary policy action taken hitherto will suffice to stage a broad recovery in asset prices and economic activity. Pessimists have warned that fiscal policy may be the only way to bring about the desired outcome.

The following conference sessions will assess in the broadest possible manner the role of fiscal policy in the light of the current economic situation, as well as the historical developments that brought us here. The aim is to analyze fiscal policy in terms of its viability, its potency, its consequences and its sustainability, and to shed some light on its relation to economic and political ideas.

Four sessions cover the most important issues regarding fiscal policy. The first session discusses contemporary views on fiscal policy. Do the traditional principles of 'functional finance' still hold in the modern institutional environment of flexible exchange rates and free capital flows? Also, the American bias for tax cuts versus increased spending is analyzed, as well as the reversal of the old idea that in a recession fiscal policy was more effective than monetary policy in reducing unemployment. The session addresses current policy issues, such as whether the United States is about to fall into a liquidity trap, whether Europe needs to revise their long-term fiscal goals, and whether developing countries can actually pursue expansionary fiscal policies in a globalized world.

The second session concentrates on the long-term limitations to expansionary fiscal policy. The NAIRU concept – crucial in the fiscal counter-revolution – is called into question. The interaction of higher productivity and fiscal policy are explored. Debt sustainability issues are brought to the fore. The third session discusses the constraints on fiscal policy in developing countries resulting from by external liberalization of trade and capital flows, as well as the social impacts of the so-called fiscal counter-revolution. That is, it explores the effect of fiscal policy on income distribution and the sustainability of the welfare state. Finally, the fourth session discusses the political economy and the intellectual history behind the fiscal revolution and counter-revolution, and the alternatives open for those that believe in more active fiscal policies.

It is important to note that there has been a void in the discussion of fiscal policy. While recent developments in monetary theory have been fast to spread to policy analysis and practice, and one may add the media, the same is not true about fiscal policy. Issues like the timing of fiscal policy, cyclical adjustments, long-term sustainability and the social implications of fiscal policy are quite arcane and far detached from most informed discussions in the public eye. The sessions try to link contemporary theory and its often contrasting positions to significant empirical findings, their applications, and policy relevance – to establish a closer relation between theory and empirics, on the one hand, and policy and practice, on the other. The endeavor is to fill what seems to be an important niche in economics: a role for work that effectively brings the relevance of fiscal policy to the forefront of the discussion of how to reactivate the global economy.

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This mini-conference includes four sessions featuring twelve papers plus commentaries:

Session I: The Efficacy of Fiscal Policy

For a whole decade Japan has been stagnated. For some this reflects a liquidity trap, which resulted from the burst of a speculative bubble. Since the burst of the bubble in the United States, the question on almost everybody's mind is whether the U.S. is also falling into a liquidity trap. If that is the case, what can monetary policy do? Are the current tax cuts the way to get around the stagnation problem? A similar question can be asked about the long-term high unemployment of the European economy. Does the Stability and Growth Pact need revision?

The session addresses theoretical and applied issues related to short-run fiscal policy. Topics to be discussed include cyclical adjustment issues, the effects of the asymmetry between taxes and outlays on the one hand, and spending on goods and services and transfer payments on the other, decision lags, implementation lags, and effect lags. Two questions behind the technical material are whether fiscal consolidations are expansionary, and whether fiscal policy is ineffective vis-à-vis monetary policy.

Session II: Long-Term Sustainability of Fiscal Policy

Critics of active expansionary fiscal policy often claim that higher deficits and debt accumulation cause high interest rates. That, in turn, leads to lower private spending, choking off the positive effects of fiscal policy. The empirical relation between deficits, debt, and interest rates is then a crucial one, and will be thoroughly discussed. Also, what do low interest rates imply for the sustainability of fiscal policies? The other major speed limit and constraint on expansionary fiscal policy has been the so-called Non-Accelerating Inflation Rate of Unemployment (NAIRU). However, the 1990s have shown that the NAIRU is hardly the equivalent to the gravitational constant in physics. It is de rigueur to ask then whatever happened to the NAIRU. A closely related question is how faster labor productivity growth impacts the conditions for fiscal policymaking?

Session III: External and Internal Constraints on Fiscal Policy

After a decade of external liberalization policies, developing countries often find themselves under pressure to pursue fiscal austerity in order to maintain external balance. In today's era of globalization and open financial markets, is it at all possible for countries below the Equator to use active, expansionary fiscal policies. Or are emerging markets condemned to a permanent fiscal squeeze? The session addresses these and related issues.

“The era of big government is over”. This familiar political slogan of the late 1990s holds that the growth of government – also known as Wagner’s Law – has reached its limit. Cuts in many social programs were then seen as the natural outcome of the new times. This session will discuss some of the most pressing issues in this area. Do we need to reform Social Security? What would be the impact of Social Security reform on the sustainability of fiscal policy? What are the effects on State and local governments budgets of the ‘end of welfare’?

Session IV: Fiscal Policy – Political Economy and Intellectual History

Monetary policy is widely believed to display regularities akin to the familiar ‘Taylor rule’. Under this kind of policy regime, what are the ramifications and impacts of fiscal policy? One of the presentations in this session will address this issue.

Active, counter-cyclical fiscal policy has itself experienced cycles. Keynesian fiscal policies first came into intellectual vogue during the Roosevelt administration, and a key figure in the promotion of these policies was the German émigré scholar Gerhard Colm. One paper in this session will assess the life and legacy of Colm, and his impact on American thought and practice of fiscal policy.