Fiscal policy: Does it work? Do we need it?

Once upon a time fiscal policy played a strong role in the operation of the economy. Demand management was a central idea, where policy was tightened or loosened accordingly to offset the impact of shocks on output and unemployment. Activist fiscal policy though now appears to be a relic of these past times. The new consensus is that fiscal policy is slow and cumbersome, and may actually amplify rather than dampen the cycle. Monetary policy is a better counter-cyclical tool, and much more in tune with today's priorities of creating and sustaining low inflation economies.

As a counter cyclical policy, fiscal policy is likely to get in the way of monetary policy- and many countries now operate fiscal rules (e.g. the Stability and Growth Pact (SGP) in the euro area) to constrain fiscal policy. Fiscal policy is now directed to longer term specific objectives such as building the public infrastructure or encouraging incentives through the tax system.

Over the last decade, most countries have been successful in their goals of achieving permanently low and stable inflation (see figure 1). Monetary policy through inflation targeting and often central bank independence has been regarded as the cornerstone of policy-making. It is therefore a tadge ironic that in a time when the operation of monetary policy has been so highly acclaimed that the potential influence of fiscal policy is growing.

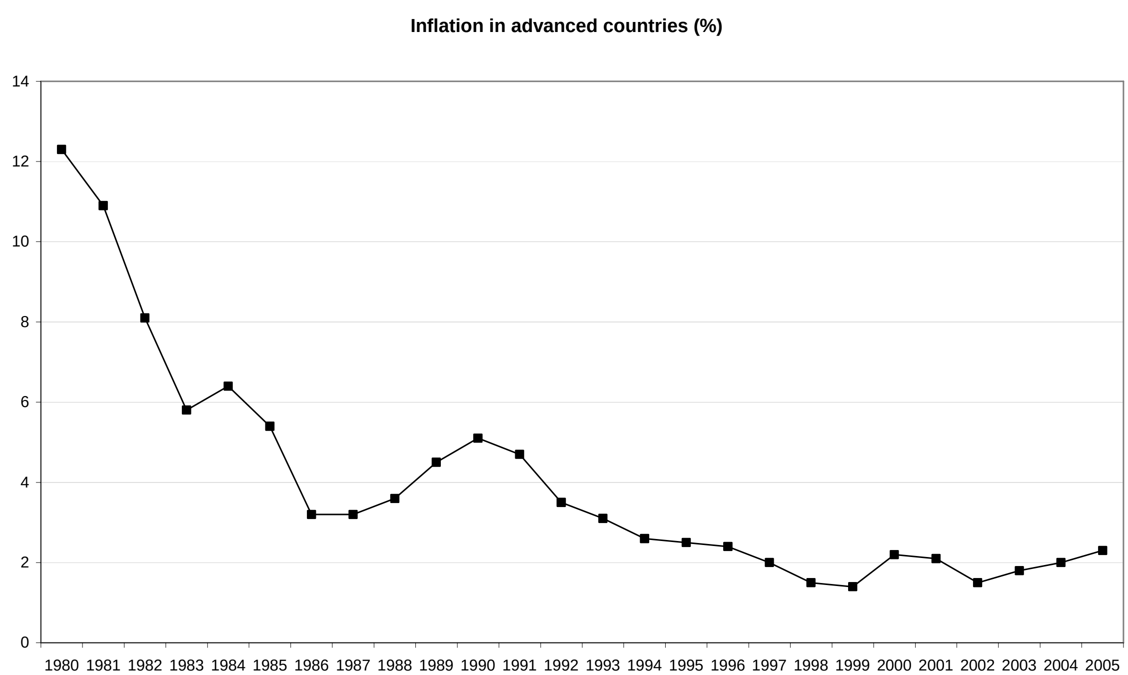

Figure 1: Source IMF World Economic Outlook
(Advanced Economies- Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Korea,

Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, UK, USA)

In the G7, low inflation and low interest rates have become the norm. However, if the global economy slows, or falls into recession, the scope for monetary policy to intervene is diminished. If interest rates are already at low levels, then reducing them further is unlikely to encourage greater consumption and investment. The Keynesian concept of the liquidity trap seems now more than ever to be a consideration. When interest rates were closer to double figures the scope for monetary policy to influence the economy was that much greater.

Although nominal interest rates cannot fall below 0%, it is possible for the real interest rate to fall by generating inflation. One of the problems with deflation in Japan is that even though nominal interest rates are low, negative inflation rates produce higher real interest rates which lead to further deflationary pressures. One way out of the deflationary mire in which Japan finds itself could be to generate expectations of higher future inflation and therefore lower real interest rates. However, this would require a reversal of the commitment to low inflation targets, and it might be difficult to restore the credibility of low inflation announcements once the public have raised their expectations. Therefore, as a possible counter-cyclical policy does fiscal policy require another look?

Even if we accept that fiscal policy is needed, there are still doubts about just how effective it actually is. Ricardian equivalence suggests that any tax break is effectively neutral, as rational households will predict that future taxes will rise in present value terms to pay for them. As a result the value of the tax break is saved in its entirety to fund the future tax increases. At the heart of the Ricardian Equivalence notion is the lifetime utility maximising household which achieves its optimal position by smoothing consumption over time. It is this desire to smooth consumption that renders tax policy as ineffectual.

An article by Kenneth Lewis and Laurence Seidman (‘A tax rebate in a recession: is it safe and effective?’, 2005 University of Delaware Department of Economics working paper series) finds that this smoothing behaviour is much weaker in practise than theory. Most households are too uncertain about the future to plan that far ahead, and many lack the borrowing facilities required to make smoothing work. Therefore consumption is much more closely tied to current income than the permanent income hypothesis would suggest. Tax breaks are therefore unlikely to be largely offset by saving behaviour.

The impact of government spending is much stronger than tax breaks, but as a counter-cyclical policy lever it is more limited. This is because the lags involved in establishing programs of public spending are fairly substantial. Lewis and Seidman indicate that increases in temporary benefits for the unemployed make more sense than programs of public works. Therefore, counter-cyclical fiscal policy can operate effectively if automatic stabilisers are strengthened, by perhaps responding automatically to economic data.