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Discretionary Fiscal Policy and Budget Deficits: An 'Orthodox' Critique of Current Policy Debate

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Abstract

A return to discretionary fiscal policy is required in the current economic crisis. Advocacy of deficit spending is consistent with mainstream economic models, whether those relying on traditional textbook analysis or those aligned with the New Neoclassical Synthesis. The notion that deficit budgets are necessarily profligate rests on an outdated theory of public finance that ignores endogenous money. It is the productive capacity of the economy and not the government's extent of taxing its citizens, or borrowing from them, that provides the limit to the use of fiscal policy levers.

Introduction

> A solid majority of economists is now of the opinion that, even in a capitalist system, full employment may be secured by a government spending programme, provided there is in existence adequate plant to employ all existing labour power and provided adequate supplies of necessary foreign raw materials may be obtained in exchange for exports (Kalecki 1943: 420).

Over the past few decades, discretionary fiscal policy of the form perceived by Kalecki has not been a central component of macroeconomic policy formulation. Instead, 'neutral' and 'responsible' fiscal policy has been widely advocated, taken to correspond to the achievement and maintenance of balanced or surplus budgets (across the cycle) and reductions in the stock of Government debt. This policy stance is, for example, asserted directly in the most recent Australian Government's Budget papers:

> The Government's fiscal strategy aims to ensure fiscal sustainability over the medium term. The Government's medium-term fiscal strategy involves:
>
> - achieving budget surpluses, on average, over the medium term;

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- keeping taxation as a share of GDP on average below the level for 2007–08; and
- improving the Government's net financial worth over the medium term (Australian Commonwealth Government 2008: 1.4).

Similar principles are found in fiscal policy strategy statements in many other countries, perhaps most significantly in the EU fiscal policy framework enshrined in the Stability and Growth Pact and Article 104 of the EC (Maastricht) Treaty. Here, a rules-based fiscal policy was instituted in an attempt to ensure that member states avoid excessive government deficits. These policy rules were defined in terms of the achievement of deficit and debt-to-GDP ratios, with subsequent modifications allowing for 'temporary' departures from these guidelines under specific and verifiable circumstances. Within the EU framework, 'neutrality' of fiscal policy is emphasised, with European Central Bank (ECB)-implemented monetary policy, primarily targeting price stability, being the chosen instrument for discretionary macroeconomic policy actions.[1]

The 'neutral' and 'responsible' principles of 'sound' fiscal policy continue to be put forward in opposition to the calls for significant fiscal stimulus during the current global economic downturn. While expansionary monetary policy and central bank 'rescue packages' for financial institutions have met with fairly widespread approval, incumbent governments have struggled to convince their electorates that expansionary fiscal policy in the shape of budget deficits represents a 'responsible', and indeed *essential*, fiscal policy stance. In terms of the current debate within Australia, one can only suspect that when the fiscal budget goes into deficit, the (self-proclaimed 'fiscal conservative') Government will feel obliged to issue an 'apology' to its apprehensive electorate and face censure and derision from the opposition coalition parties who seek to equate budget deficits with 'fiscal negligence'.

The purpose of this article is not primarily to develop a critique of orthodox macroeconomic theory, although there are certainly compelling grounds upon which such a critique could be constructed. Instead, its major purpose is to counter some of the naïve interpretations of orthodox theory that appear to have informed much of the current discussion of the role and effectiveness of fiscal policy. Firstly, it is argued that an active role for discretionary fiscal policy is not inconsistent with a considered interpretation of what may be construed to be mainstream economic analysis, both in terms of the traditional textbook models and the more recently formulated New Neoclassical Synthesis (NNS) approaches. Secondly, the idea that there is something inherently 'irresponsible' or 'profligate' with budget deficits is shown to rest on a rather antiquated view of public finance which fails to encompass the realities of endogenous money and interest rate targeting monetary policy. In the context of the current 'economic crisis', these conclusions confirm that 'responsible' fiscal policy under current circumstances *requires* fiscal budget deficits. It would be 'irresponsible' to do otherwise. In more general terms, it is concluded that governments' capacity to implement discretionary fiscal policy, and to provide economic and social services and infrastructure, is not constrained by their ability to collect

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tax revenue and/or borrow from the private sector, but rather their actions are constrained by the productive capacity of the economy to facilitate the associated demand pressures.

The remainder of the article is organised as follows. Section 2 revisits the well-known textbook portrayal of the nature and effectiveness of fiscal policy. These models are re-interpreted in a manner that is consistent with the realities of endogenous money and interest rate targeting monetary policy. In Section 3, these issues are reconsidered in the context of what has been termed the 'New Neoclassical Synthesis' (NNS) model, said to more accurately reflect the 'modern consensus' within mainstream macroeconomics. Here, arguments for the suppression of discretionary fiscal policy, and preference instead for monetary policy actions, are difficult to substantiate. While it is not our purpose to develop a systematic critique of mainstream approaches to macroeconomics, some critical observations as to the NNS are presented in Section 4. In Section 5, the 'financial constraint' said to confront government spending is scrutinised, where the rather antiquated textbook depictions of public finance are shown to provide some misleading conclusions regarding the mechanism through which governments and the private sector 'finance' their transactions. Some concluding comments relating to current policy debate and the role for discretionary fiscal policy and government spending are presented in Section 6.

Fiscal Policy and 'Textbook Macroeconomics'

There can be little doubt that interpretations based on traditional textbook macroeconomics continue to inform much of the current debate over fiscal policy and government spending in general. This is despite the fact that policy makers and academic economists frequently (often implicitly) use modes of thinking and analysis that depart significantly from what is delivered to students of economics as representing the received wisdom. In this section, the standard textbook scenarios are revisited and then re-interpreted to reflect the contemporary actuality of endogenous money and interest rate targeting monetary policy.

The short-run analysis of macroeconomic policy has been traditionally investigated within the confines of the so-called Mundell-Fleming (IS/LM/Balance of Payments) fixed-price open economy equilibrium models, combined with the related aggregate-demand-supply framework.[2] Generations of undergraduate economics students have dutifully informed their examiners that, in the case of open economies with flexible exchange rates, and where a high degree of (international) capital mobility exists, monetary policy is far more effective than fiscal policy in terms of its effects on nominal output (i.e. the general price level and/or real output). Expansionary fiscal policy is associated with higher *market-determined* interest rates and related exchange rate appreciation driven deteriorations in trade balances, both of which combine to significantly 'crowd-out' the initial stimulus to nominal output levels that the expansionary fiscal policy had provided. Expansionary monetary policy on the other hand, depicted as being transmitted through an increase in *monetary aggregates*, is associated with lower interest rates and exchange rate depreciation and increased net exports, all of

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which augment the initial monetary policy stimulus. Clearly, under the assumed conditions, monetary policy is much more potent than fiscal policy in terms of its potential effect on influencing nominal output.[3]

The fiscal policy ineffectiveness conclusions emerging from the standard textbook macroeconomic equilibrium models are fundamentally contingent on the assumption of an exogenously determined monetary aggregate. By increasing the demand for a *given* stock of money (*determined by the central bank*), expansionary fiscal policy inevitably leads to higher (market-determined) equilibrium interest rates. However, the legitimacy of the assumption of an exogenously determined monetary aggregate, controllable by the central bank, can not be defended. Instead, it is imperative that macroeconomic models of any persuasion recognise endogenous money supply determination along with interest rate (as opposed to monetary aggregate) targeting monetary policy. This is the reality in which central banks operate, as stated explicitly, for example, in the Reserve Bank of Australia's explanations of the nature of monetary policy:

> The Reserve Bank has no prescribed target for the level of settlement balances [Cash], supplying whatever amount is needed to keep the cash rate near the target (RBA 2003: 4).

Contrary to the standard textbook models of money supply determination, there is no deterministic relationship between the money base and monetary aggregates. Changes in monetary aggregates are not primarily driven by central bank-induced changes in the money base, but instead by portfolio decisions made by lenders and the expenditure plans of borrowers. For this reason, central banks implement monetary policy by targeting interest rates, primarily through the market operations that establish and maintain central bank discount rates — which in turn represent the benchmark rate in financial systems where a spectrum of retail rates are observed — reflecting differences in term structure and perceived risk.[4] The eventual effects on monetary aggregates of this process are indeterminate and of no direct consequence to the monetary authorities in the context of the implementation of monetary policy. The cost of finance is fundamentally determined by central banks, while the availability of finance depends on the portfolio decisions made by financial institutions.

Importantly, when the traditional macroeconomic textbook models are reformulated to incorporate the endogenous money-interest rate targeting monetary policy scenario, the fiscal policy ineffectiveness conclusions dissipate.[5] Expansionary fiscal policy does not imply higher market-determined interest rates, simply because the increased money demand generated though higher output is not confronted with a fixed money supply, and the market rate of interest is instead largely determined by the discretionary actions of the central bank. Consequently, fiscal policy can no longer be presumed to be relatively ineffective, despite the existence of flexible exchange rates and a high degree of international capital mobility. There is no reason why the exchange rate should appreciate, leading to the predicted deterioration in net exports.

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In short, it can not be argued that the principles that characterise traditional textbook macroeconomic equilibrium models inevitably support the contention that monetary policy is relatively more effective than fiscal policy as a potential instrument for macroeconomic stabilisation policies.

Fiscal Policy and the New Neoclassical Synthesis Model

While the textbook models described above have had a significant effect on the way macroeconomic policy has traditionally been perceived to operate, it appears that these models fail adequately to capture the 'consensus' said to exist amongst contemporary macroeconomists engaged in policy debate and formulation. Recently there have been attempts made to develop alternative (textbook?) models that incorporate the consensus elements said to exist within 'modern macroeconomics', and it is in this context that the 'New Neoclassical Synthesis' (NNS) approach has emerged as a vehicle for the representation of mainstream thinking within macroeconomics.[6]

As portrayed by Taylor (2000: 90), the 'consensus' elements that form the foundations of NNS model are as follows. It is maintained that the 'long run real growth trend' or 'potential GDP' can be understood using the Solow type growth model 'extended to make "technology" explicitly endogenous'. Expectations regarding inflation and future policy decisions are endogenous, and 'quantitatively significant'. There is no 'long-run trade off' between inflation and unemployment, implying that monetary policy is neutral in the 'long-run'. However, in the short-run, due largely to price and wage 'stickiness', an inflation-unemployment trade-off is likely to be present and money is non-neutral. In this sense, it is sometimes suggested that the proposed synthesis combines a 'New Keynesian'-style demand determined short-run with a 'Neoclassical' supply determined 'long-run'. The final area of consensus related to monetary policy decisions:

> [M]onetary-policy decisions are best seen as rules, or reaction functions, in which the short-term nominal interest rate (the instrument of policy) is adjusted in reaction to economic events (Taylor 2000: 90).

In this section, attention is focused primarily on inferring conclusions from the NNS model relating to the effectiveness of fiscal policy in the 'short-run', with comments on the 'long-run' properties of the NNS model deferred to the following section. Of particular significance are the implications for fiscal policy arising from the monetary policy reaction functions described above by Taylor, along with the nature of the 'short-run trade-off' between prices and output.

Much of the analysis carried out within the NNS framework concentrates exclusively on the nature and role of interest rate targeting monetary policy, and analogous conclusions regarding fiscal policy have to be extracted indirectly from the theoretical models being constructed. The following functional relationships, central to much of the NNS analysis, can be used for such a purpose[7]:

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$$y_t = a_0 + a_1 y_{t-1} + a_2 y^e - a_3(i_t - p^e_{t+1}) + u_1 \quad (1)$$

$$p_t = b_1 y_t + b_2 p_{t-1} + b_3 p^e_{t+1} + u_2 \quad (2)$$

$$i_t = R^* + p^e_{t+1} + c_1 y_{t-1} + c_2(p_{t-1} - p^T) + c_0 \quad (3)$$

where y is the output gap (actual less full capacity output); p = inflation; i = nominal rate of interest; R^* = 'equilibrium' real rate of interest (consistent with y = 0?); p^T = target rate of inflation, e superscripts indicate expected values. Equation (1) is the aggregate demand relationship, showing the output gap as a function of past and expected future output gaps, the real rate of interest and 'demand shocks' (a_0). Equation (2) is a generic Phillips Curve relationship (with $b_2+b_3 =1$), while equation (3) is the monetary policy reaction function of the type referred to in the above quote from Taylor.[8] This policy reaction function explicitly incorporates interest rates as the policy instrument, with the control of inflationary pressures perceived to be the major policy target. In these functional relationships, money supply is in effect a residual outcome, having no causal feedback effects on the economy.

In terms of the functional relationships outlined above, the impact of fiscal policy on the economy has to be interpreted as being transmitted initially through the a_0 variable in equation (1). Expansionary fiscal policy, for example, can be seen to add to current demand, thereby reducing the gap between full capacity and current output levels. In this setting, two important conclusions can be readily observed. Firstly, expansionary fiscal policy would only fuel inflationary pressures in the economy and place upward pressure on interest rates if the accompanying increases in demand pushed the economy beyond full capacity output. Secondly, at least in the context of the relationships specified in the model, fiscal policy is potentially much more effective in terms of its effect on real output than is monetary policy. The effectiveness of monetary policy in influencing real variables depends on the sensitivity of expenditures to variations in (real) interest rates. Fiscal policy, on the other hand, impacts directly on demand without being 'crowded out' by higher interest rates unless full capacity utilisation is encountered or central banks depart from their policy reaction functions. These conclusions are consistent with those derived from the traditional IS/LM textbook models when adjusted to incorporate endogenous money and interest rate targeting monetary policy.

Therefore the traditionally argued case against the usage of discretionary fiscal policy is not to be found in the NNS model, said to encompass a consensus within 'modern macroeconomic thought'.[9] In general, fiscal policy emerges as a potentially more powerful instrument than does the monetary policy alternative. Discretionary fiscal policy becomes ineffective only if aggregate demand is stimulated to the point where the output gap becomes positive (y>0), leading to higher inflation and hence to the imposition of higher interest rates by the central bank to bring the economy back towards full capacity output (y=0). Indirectly, the challenge to fiscal policy effectiveness emerges from the view that fiscal policy multipliers are negligible, implying that government spending and taxation decisions do not warrant inclusion in an aggregate demand function. The most obvious source of such arguments is to be found in the so-called Ricardo-Barro Equivalence Theorem (RBET), which

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can be interpreted to imply that budget deficits do not matter; they have no effect on aggregate demand, national saving, real interest rates, exchange rates or current and future output levels. Budget deficits are fully offset by increases in private saving because rational forward thinking economic agents, being 'aware' of inter-temporal fiscal budget constraints, realise that government borrowing today has to be financed later through higher taxes. The relevance of the RBET remains a highly contentious issue within mainstream economic analysis, which is hardly surprising given the long list of assumptions that need to be admitted if the theorem is to be accepted, together with lack of convincing empirical evidence in support of its central propositions.[10] It cannot therefore be conceded that the RBET is a component of what could be termed the 'consensus position' within mainstream macroeconomic thinking. It does, however, in a broader context emphasise the importance of expectations in influencing the outcomes of any policy actions.

The NNS Model: Some Critical Observations

As noted earlier, it is not the purpose of this article to develop a critique of the NNS approach. However, a few brief comments are warranted; in particular, in relation to the proposed 'long-run' properties of this model. Firstly, the model describes a closed economy, which has tended to characterise much of the NNS analysis. Clearly the role and effectiveness of all macroeconomic policy instruments is affected by implications arising from trade and capital flows, exchange rate adjustments and the international transmission of demand and supply shocks. Secondly, while it may be argued that money supply is demand-determined, this should not be taken to infer that 'money does not matter'. In particular, an endogenous money supply does not imply that linkage between financial and real variables is limited to the cost of finance. Also significant is the availability of finance, which while not determined by central banks, is in part a function of credit rationing processes at a given rate of interest. Functional relationships between interest rates, inflation and real output cannot be assumed to be independent from the nature and magnitude of debt financing instruments and the portfolio decisions made by financial institutions themselves. The neglect of such issues within the NNS approach leaves it ill-equipped to consider the episodes of financial instability that are known to characterise contemporary financial systems, and to consider the significant feedback between such episodes and the real sector of the economy.[11]

Thirdly, the existence of a unique 'equilibrium' real rate of interest, at which the real output gap would equal zero, becomes somewhat illusory in light of the points just raised. As Arestis and Sawyer (2003: 6–8) demonstrate, once the aggregate demand is expanded to incorporate explicitly the various determinants of spending (consumption, investment and government), then the 'equilibrium real interest rate' depends on the parameters of the consumption and investment functions and the level of government spending. These parameters are unlikely to be constant and indeed may well react to policy decisions and general economic conditions. The notion of an equilibrium real rate of interest

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is therefore a rather indistinct concept, unless the New Classical world of automatic market-clearing is inappropriately imposed on the analysis.[12]

According to the NNS approach, in the 'long-run', both fiscal and monetary policy are neutral in the sense that they cannot influence equilibrium values of any real variables in the economy:

> There is no long run trade-off between inflation and unemployment, so that monetary policy affects inflation but is otherwise neutral with respect to real variables in the long run (Taylor 2000: 90).[13]

Again, the absence of any reference to fiscal policy is noteworthy; however, its long-run ineffectiveness arises for the same reasons as monetary policy. The long-period equilibrium is presumably the position an economy would gravitate towards, after the economy had fully adjusted to a change in one of the demand or supply variables included in the model. In terms of the algebraic representation of the model presented above, it is clear from the aggregate demand and Phillips Curve relationships that real GDP will continue to change, driven by movements in the inflation rate, until it reaches its supply determined full capacity level at the 'equilibrium' real rate of interest.

In a comparative static sense, the adjustment to long period equilibrium cannot be determined from the generic model presented above, as the nature of the 'lagged' adjustment is not specified. Clearly, in the context of the NNS model outlined above, the 'speed of adjustment' depends in part upon the way in which expectations are formed. However, it is not only the possibility of incomplete adjustment of inflationary expectations that allows for the existence of a short-run trade-off between the level of unused resources and the rate of inflation:

> There is a short run trade-off between inflation and unemployment with significant implications for economic fluctuations around the trend of potential GDP; the trade-off is due largely to *temporarily sticky prices and wages* (Taylor 2000: 90, emphasis added).

The existence of 'sticky prices and wages' presumably explains the inability of price adjustments to clear markets in the short-run, and it is the absence of these impediments that enables the economy to proceed to its predetermined long-run equilibrium position. The critical issue therefore is the reason for the failure of price adjustments to occur in the short-run, an issue that drives a wedge between competing schools of thought in economic theory. The neoclassical component of the NNS synthesis would suggest that these impediments are due to purely transitory imperfections in the availability and interpretation of information. However, the Keynesian partners to the synthesis may provide different explanations. Adopting the so-called 'New Keynesian' perspective, it could be argued, for example, that the existence of price and wage (and nominal interest rate) stickiness is consistent with rational maximising behaviour under conditions of risk and asymmetric information.[14] Under those circumstances, questions arise as to why price stickiness dissipates through the passage of time, and why inflationary expectations would not be based on the presumption that these impediments would remain as characteristics of the 'modern economy'?

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Other Keynesians, such as the Post-Keynesian school, would argue that the smooth journey through logical time from the short to long run becomes even more problematic if decision-making under uncertainty is contemplated, where expectations become subjective in nature (as Keynes had emphasised)[15] and the realisation of equilibrium configurations of economic variables through time is relegated to the realm of the mythical 'golden age'. So clearly, the reasons for the failure of (various) price adjustments to operate in the short-run need to be established before a meaningful discussion of the distinction between 'short' and 'long' run properties of an economic system can proceed.[16]

Finally, it should be noted that the authors of the NNS claim to abide by the Solow-type growth theory framework (to describe the derived supply determine long-run equilibrium conditions), subject to a very significant 'extension'. This extension allows 'technology' to be 'explicitly endogenous' (Taylor 2000: 90), and presumably is meant to reflect a common thread found in the rather voluminous 'New Growth Theory' literature. However, there is nothing in the formal expositions of the NNS model that explicitly accounts for 'endogenous technology'. One of the major implications of New Growth Theory is that path dependency undermines the notion of unique long run equilibrium configurations such as a 'natural rate of unemployment' and equilibrium growth paths that are independent from short-run relationships. This would challenge the existence of the notion of a 'supply determined long-run' that is somehow divorced from 'demand determined — supplied constrained short-run' fluctuations in the level and composition of real output.[17] The NNS approach falls well short of incorporating the ideas of New Growth Theory, but instead is aligned directly with the older Solow-Swan family of models.

Importantly, there is a failure to recognise that fiscal policy has the potential to affect the composition of both output and the capital stock, thereby influencing productive capacity in the future and the pattern of economic growth. This important theme was emphasised in Domar's (1944, 1946) pioneering contributions, where it is shown that an economy's growth path is influenced by both the level and composition of government spending. This in turn has implications for the 'sustainability' of debt-financed fiscal deficits when sustainability is viewed from the perspective of the ratio of public debt to real GDP. In particular, in cases where the debt ratio is growing, debt-financed government spending can be 'sustainable' where more public resources are devoted to capital expenditures and a smaller share to current expenditures.[18]

Government Spending and the 'Budget Constraint'

In justifying the application of non-discretionary fiscal policy rules, the European Parliament (2006: 1) claimed that in the absence of such measures, a Member State may choose 'to run high budget deficits and accumulate debt' and attempt to 'escape the full cost of its profligacy'. The association of budget deficits with 'fiscal irresponsibility' is widely held, however yet again the economic rationale for the association appears to be rather flimsy, at least in the context in which the 'irresponsibility' edict is normally issued.

Firstly, from the discussion above, it can be seen that in terms of the NNS model, budget deficits would be 'irresponsible' in terms of fuelling inflationary pressures only if they corresponded to situations of full, or close to full, capacity utilisation. Secondly, higher interest rates would occur only following discretionary actions by central banks, and if their polices are linked to policy rules as represented in the NNS model, interest rates would not be increased unless inflationary consequences were anticipated. Alternatively, the fiscal irresponsibility and profligacy judgements are often based on the alleged evils associated with the accumulation of government debt. This conclusion in turn often rests on a rather antiquated and simplistic representation of a government's 'budget constraint'. The so-called 'budget constraint' confronting the implementation of fiscal policy can be summarised as follows:

$$(G - T) + iDg = \Delta Dg + \Delta B$$

where Dg represents the stock of (interest bearing) government debt held by the private sector. Government spending is therefore depicted as being constrained by the government's revenue base (T) and the willingness of the private sector to purchase government securities (Dg). The option of the government 'monetising' deficit spending by 'selling' securities to the central bank is also noted; a financing option usually categorised as 'printing money' in the exogenous money context (assumed to arise because of the misguided presumption of a deterministic link between the monetary base and monetary aggregates).[19]

However, again, the traditional textbook account of the so-called 'budget constraint' sheds little light on government finance in a world in which governments spend by crediting the private sector banks' settlement accounts (reserves) held at the central bank.[20] Consider, for example, an increase in government spending not financed through tax revenue or by the 'open market' sale of government securities to the private sector. The financial implications of this fiscal policy action in a world of endogenous money with interest rate targeting are relatively straightforward. The immediate effect of the government spending is to add to the cash reserves of the private sector banks in which the government cheques are deposited. This in turn increases (net) liquidity in the cash market where the central bank discount rate is established and defended, assuming that the central bank did not implement offsetting market operations (buying and selling its own or government short-term securities, or associated derivatives such as re-purchase agreements). Under these circumstances, the actual central bank discount rate would tend to *decrease*. This in turn would lead to *downward* pressures on retail interest rates, a conclusion that would appear rather inconceivable to the readers of the standard textbook analysis outlined in the early paragraphs of Section 2 above. However, it is not a conclusion that the Reserve Bank of Australia (RBA), for example, finds difficult to accept:

> In a world where the Reserve Bank was undertaking no open market operations, the amount of cash that underpins the [Cash] market (exchange settlement funds, or what the academics call 'high powered money') would depend on the Governments fiscal balance, and it is

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> not hard to see that this would be likely to result in monetary instability. Any government deficits not financed by an exactly coincident issue of debt to the public … would mean a rise in cash and a fall in interest rates. Similarly, a surplus not exactly matched by debt retirement would lead to shrinkage of the amount of cash and an escalation of interest rates (RBA 2001: 15–16).

More realistically, the central bank could choose to defend the target cash or discount rate in line with its pre-determined monetary policy stance. This could be done, for example, by the central bank *reducing* liquidity in the inter-bank cash market by 'issuing' securities to the private sector banks (i.e. debiting their settlement accounts and adding short term securities to their portfolios). It needs to be emphasised that these market operations would offset the tendency for the actual discount rate to *fall below the target rate,* an outcome that would have put *downward pressure* on market interest rates. The eventual outcome on broad monetary aggregates of this process is dependent entirely on how potential lenders and borrowers react to the policy changes. It is these portfolio decisions that determine changes in the money supply, and not the liquidity management operations pursued by central banks in the short term cash markets.

It should also be noted that the central bank operations being outlined relate to transactions with participants in the inter-bank cash market, and differ substantially in both their nature and outcomes to the open market purchase and sale of government securities involving the non-bank public. Budget spending, not financed through taxes levied on the private sector, does not imply an increase in government securities held by the non-bank private sector. The alternative should not be simplistically referred to as the monetary authority 'printing money': the effect of an increase in the money base on monetary aggregates depends on portfolio decisions that influence the willingness of financial institutions to lend, and the propensity of spending units to borrow. If expansionary fiscal policy has achieved its intended purpose, the money supply will increase consequently, whether or not the government spending is financed by borrowing. The notion that government deficits will need to be financed through higher taxes in future periods is also shown to be a spurious component of the RBET challenge to fiscal policy outlined earlier.

Significantly, two important conclusions emerge from the above RBA statement in relation to expansionary fiscal policy actions. Firstly, in the absence of offsetting market operations to defend its discount rate, this rate would tend to fall. Secondly, it demonstrates that a government does not have to issue its own securities to finance its deficit spending, and indeed no central bank actions would be required if a like-minded central bank is willing to co-ordinate policy stance by allowing its discount rate to fall, offsetting the need for its securities to be exchanged for cash within the official discount market. The ability of governments to finance the provision of goods and services is not 'constrained' by the capacity to obtain revenue from the private sector or the willingness of the non-bank public to hold government debt instruments. Balanced budgets or surpluses do not represent 'sound budget management' and the acclaim ac-

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corded to governments achieving budget surpluses arises from a fundamental misunderstanding of the fiscal policy environment.

It should be emphasised, however, that the fiscal policy financing issue is distinct from debate over the appropriate stance of fiscal policy. The absence of the financial constraints imposed by textbook renditions does not imply that fiscal budget deficits correspond to 'responsible' macroeconomic policy. In line with the theoretical models discussed above, expansionary fiscal (and/or monetary) policy can, under some circumstances, lead to undesirable inflationary pressures, and higher real interest rates may occur as a consequence if central banks are following the policy reaction functions envisaged in the NNS models. The point is that the option of expansionary fiscal policy is not to be discarded on the grounds of 'financial constraints'. It all hinges, as Kalecki (1943) had surmised, on the capacity of the economy to absorb the increased aggregate demand associated with the fiscal stimulus.

Concluding Comments

Two main conclusions emerge from this article. Firstly, mainstream macroeconomic theory does not contain compelling principles in support of the view that fiscal policy is less effective than monetary policy as an instrument of discretionary macroeconomic policy. Fiscal policy ineffectiveness conclusions emerge only if the realities of endogenous money and interest rate targeting monetary policy are denied, or if it is believed that the economic system to which fiscal policy is being applied resembles that depicted by the idiosyncratic New Classical vision. Secondly, the idea that there is something inherently 'irresponsible' or 'profligate' associated with budget deficits rests on rather simplistic interpretations of the 'budget constraint' confronting fiscal policy and government spending in general. Put simply, government spending is not constrained by the capacity to collect tax revenue and/or borrow from the private sector; budget deficits do not lead inevitably to the accumulation of government debt. Budget deficits become 'irresponsible' only when the implied policy stance is inappropriate to the prevailing economic circumstances.

The interpretation of mainstream economics presented in this article provides very clear policy implications in the current setting of deteriorating global economic conditions. Expansionary fiscal policy represents the most potent instrument available to governments in the attempt to reverse the deteriorating economic outlook. Expansionary fiscal policy stimulates aggregate demand directly, and while the impact multipliers associated with fiscal policy instruments may be subdued somewhat by 'dwindling animal spirits', these obstacles are likely to be far less pronounced than those arising from the insensitivity of spending to falling interest rates during economic downturns. Lower central bank discount rates in themselves are not sufficient to induce financial institutions to increase lending. Fiscal policy can be applied much more selectively than monetary policy, as alternative expenditure and revenue options are available that can target particular areas of economic activity.

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Clearly the optimal strategy is co-ordinated fiscal and monetary policy, with the latter formulated explicitly in the context of central banks' indispensable role of maintaining confidence in the operations of the financial system.

During periods of economic downturn, expansionary countercyclical fiscal policy *necessarily entails budget deficits*.[21] Even in the absence of significant discretionary fiscal policy actions, budgets tend automatically to deficit unless the important role of automatic stabilisers is suppressed. The failure to recognise the imperative for budget deficits in the current economic climate has been a regrettable aspect of recent debate on the policy responses to the prevailing economic circumstances. The context in which this has occurred is partly explained in the following commentary:

> The truth is, among practising macro-economists an enlightened Keynesian approach to fiscal policy has always been orthodox. It's just that, when Costello was preaching his Neanderthal and politically expedient nonsense about the abiding evil of all deficits and debt, few of the pros had the courage to come to the defence of the orthodoxy (Gittins 2008).

However there has been little respite from the 'Neanderthal and politically expedient nonsense about the abiding evil of all deficits and debt', as is reflected in the views attributed to the current coalition leader:

> Malcolm Turnbull has warned Kevin Rudd that voters will rightly see any budget deficit as a failure of economic management and the Prime Minister will be judged for it. As Mr Rudd toughened his warnings of hard economic times yesterday and would guarantee only that current circumstances did not require a budget deficit, he asked voters to trust him in the hard economic decisions to come in the next year. But the Opposition Leader warned that trust did not extend to a Coalition "leave pass" to drive the budget into the red for the first time since 2001 … "You're wanting me to give Kevin Rudd a leave pass to have lazy economic management and run the budget into deficit?" Mr Turnbull asked at the National Press Club. "Well, if that's the invitation, I decline it. I know Mr Rudd would love permission, a leave pass, to run the budget into deficit … We must not give that to him. He has to start making difficult decisions" (The Australian, 25 November 2008).[22]

Predictably, this line of assertion has been echoed in the ongoing criticisms of the various fiscal stimulus packages that have been introduced in Australia, the US, and elsewhere. These persist despite the IMF's (2009) recent endorsement of the introduction of significant fiscal stimulus polices for OECD economies. What the Gittins account overlooks is that amongst the 'pros', the 'enlightened Keynesian approach' has become somewhat clouded through the rather simplistic interpretations of mainstream economics that have gained currency over recent years. These interpretations have been adverse to a role for discretionary fiscal policy, with monetary policy predicated on pre-determined policy rules being more widely advocated. As has been argued in this article, this approach to macroeconomic policy formulation is not dictated by what has been char-

acterised as the 'theoretical consensus' said to inform mainstream macroeconomics. Rather as Kalecki (1943) had concluded over half a century ago, the major obstacle to the acceptance of the role for discretionary fiscal policy lies not so much in the deficiencies of economic theory, but more in the powerful philosophical and political convictions that shape the way economic theory is translated into policy prescriptions. If Kalecki's conjectured 'political business cycle' remains operational, government spending policy would come again into its own once the slump had become established. By the time this point has been reached, lasting damage to business confidence would have been inflicted, along with deteriorations in the living standards of those most vulnerable to the hardships accompanying economic downturns.

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Notes

1. The budgetary surveillance and 'excessive deficit' procedures (EDP) were more completely spelt out in the SGP signed at Amsterdam in 1997. EDP applied initially when the ratio of the planned or actual government deficit to GDP exceeded 3 per cent, with deficits above this limit considered excessive except when 'temporary' and due to 'exceptional circumstances'. EDP also applied if the ratio of government debt to GDP exceeded 60 per cent, unless the ratio is 'sufficiently diminishing and approaching the reference value at a satisfactory pace'. In 2005, the ECOFIN council introduced modifications with the term 'close to balance or in surplus' replaced by country-specific 'medium-term budgetary objectives', determined on the basis of the debt ratio and potential growth. Some of these themes are discussed further in Hart (2007b). A comprehensive analysis and critical perspective of national fiscal policies in the European Union can be found in contributors to the recent Ferreiro et al. (2008) edited volume.
2. The IS/LM model maps the relationship between investment and savings, and the relationship between liquidity preference and money supply. The intersection of these curves is taken to represent simultaneous equilibrium in all markets. Variants of the standard textbook model can be found in the widely used editions of Blanchard (2003), Dornbusch, Fisher and Startz (2001), Mankiw (2000) and Salvatore (2001). The role of these models in shaping macroeconomic thought is discussed by Laidler (1999) and by various contributors to Young and Zilberfarb (2000), and further in Kriesler and Nevile's (2002) critical account. The textbook models originated initially from Hicks' (1937) famous 'IS/LM' 'suggested interpretation' of Keynes' *General Theory* and the desire to interpret Keynes' insights within the more familiar equilibrium modes of thinking. Hicks' (1983: 61–62) later caution on the IS/LM model, 'When one turns to questions of policy, the use of

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equilibrium models is still more suspect' rarely accompanies analysis of the textbook equilibrium models.

3. Ultimately, the effectiveness of either set of policy instruments depends critically on the extent to which the impact on nominal income decomposes into real output and general price level effects. The resolution of this question has been traditionally pursued within the AD/AS framework. However, unambiguous conclusions cannot be derived from this framework, as different representations of the aggregate supply function have been associated with the various 'Keynesian' and 'Neoclassical' schools that battle recurrently for dominance within mainstream economic thinking. The general textbook 'resolution' is to assume the existence of a positively sloped short-run aggregate supply curve, however with a vertical 'long-run supply curve' indicating the absence of a relationship between the general price level and real output. The 'long-run' neutrality conclusion is closely aligned with the alleged existence of the vertical 'long-run' Phillips Curve and NAIRU concept.
4. The central bank discount rate is used here as a generic term to denote the discount rate at which the central bank supplies funds (largely to the banking system). Examples include the ECB's repo rate, the U.S. Federal Reserve federal funds rate and the RBA's cash rate.
5. Examples of the reformulation of the IS/LM/BP textbook models along the intuitive lines discussed in this paragraph can be found in Aspromourgos (1999) and Hart (2005, 2007a). The notion of endogenous money is very slowly making its entry within the equilibrium-based textbook models, such as for example in Jones' (2008) alternatively specified IS/MP framework. If the 'LM' curve is to be retained, the inclusion of endogenous money is likely to imply a horizontal LM curve. If there is less than perfect (international) capital mobility, and the 'BP' curve has a positive slope, fiscal policy is in fact more effective than monetary policy in terms of adjusted textbook model which retains all of the other traditional assumptions. Similar conclusions are also derived in the Godley and Lavoie (2005–6) modelling, where within a stock-flow approach monetary policy is represented by interest rate targeting as opposed to the traditional textbook notion of open market purchases and sales of securities. In this setting, it is demonstrated that governments can achieve higher levels of activity by an appropriate choice of fiscal policy, at least within the limits imposed by the inflationary consequences of high activity levels (not considered explicitly in the modelling).
6. This 'consensus' is similar to that emerging from a symposium at the 1997 Annual Meeting of the American Economic Association, where Blanchard, Blinder, Eichenbaum, Solow and Taylor were asked to consider if there is a core of practical macroeconomics that could be used to underpin macroeconomic policy. Their views were published in the *American Economic Review*, Vol. 87 (2) and are discussed in Nevile (2005).
7. Similar representations of the NNS model can be found in Meyer (2001), Arestis and Sawyer (2003), Taylor (1999) and Romer (2000), while Taylor

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(2000) presents what he terms a suitable 'textbook level' exposition. Many of the key relationships are also discussed in Clarida et al. (1999).

8. Following McCallum (2001) and Arestis and Sawyer (2003), lagged interest rates could be added to Equation (3) to represent interest rate 'smoothing' undertaken by monetary authorities. The c_0 variable has been added to equation (3) to acknowledge possible 'departures' from strict adherence to monetary rules by central banks, perhaps arising through financial stability considerations, exchange rate issues and changes in foreign interest rates. Kriesler and Lavoie (2005) provide an interesting critique of the representation of monetary policy within the NNS models.
9. A similar conclusion is reached in Setterfield's (2007) more detailed consideration of the stabilising role for fiscal policy in the NNS framework. Specifically, Setterfield demonstrates that even if the assumption of the existence of 'natural' equilibrium values of real variables defined exclusively on the supply-side of the economy is accepted, the passive monetary policy/active fiscal policy combination is at least as effective as the conventional active monetary policy/passive fiscal policy combination in lending stability to equilibrium values (such as the rate of inflation). The case for discretionary fiscal policy as a valid macroeconomic instrument is also argued strongly by contributors to the Creel and Sawyer (2009) edited volume, with Fontana (2009) in particular emphasising the role of fiscal policy in the setting of endogenous money.
10. Barro (1989) himself listed a number of criticisms of his theorem, and many others have been raised subsequently, as noted in Arestis and Sawyer (2003: 13–14). The long lists of criticisms include: people do not live forever, and hence do not care about taxes that are levied after their death; private capital markets are 'imperfect'; future taxes and incomes are uncertain; taxes are not lump sum, since they depend typically on income, spending, wealth and so on; the result hinges on full employment; less than perfect foresight; partial liquidity constraints; a non-altruistic desire to pass some of the current fiscal burden to future generations; and significant distributional effects, assumed to be negligible by the RBET proponents.
11. A useful starting point for such an analysis is found in Minsky (1985).
12. Keynes had famously quipped that in the 'long-run we are all dead'; in the New Classical version it could be argued that in the long-run we are all alive, irrespective of sins committed in previous lives. Some further comments on the notion of an equilibrium ('natural', 'neutral'?) real rate of interest can be found in Arestis and Chortareas (2008) and Smithin (2007).
13. Despite its widespread usage within the mainstream economic literature, there is in fact very little evidence in support of the existence of a unique or constant NAIRU. In this case of Australia, the validity of the assumption of a constant NAIRU is inconsistent with Gruen et al.'s (1999) extensive modelling.
14. The 'New Keynesian' position is discussed in Mankiw (1993), and the Mankiw and Romer (1991) volumes provide a collection of the various theories that come to form the 'microeconomic foundations' of this version of Keynesian Economics.

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15. Keynes (1936: 162–3): 'We are merely reminding ourselves that human decisions affecting the future … cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist; and that it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim, or sentiment or chance'.
16. Romer (1996: 241–308) discusses further the 'microeconomic foundations' of incomplete nominal adjustment, with respect to the 'neoclassical' and 'New Keynesian' perspectives discussed in this paragraph.
17. These themes are raised directly in Fine's (2000) exposition and critical assessment of New Growth Theory. These conclusions are reinforced in the 'path dependency' literature, as discussed for example in Setterfield (1992). Similar inferences can also be drawn from analysis along the lines of those developed by Salter (1965) that highlights links between productivity growth through time and current wage and price settings and the composition of output. Also of relevance is the dynamic modelling in the tradition of Kalecki (1968) and Goodwin (1982) demonstrating the inseparability of cyclical and trend components of economic growth processes.
18. This conclusion is argued persuasively in a recent article by Sardoni (2008) that formalises Domar's intuition on the sustainability of fiscal policy question. As Sardoni also stresses, these considerations challenge the legitimacy of the simple debt ratios upon which the EU's EDP is based. The neglect of these themes in much of the current literature can be observed in the often-cited Blanchard et al. (1990) exposition of the debt financing sustainability issue.
19. The term 'printing money' is, again, a popular misnomer. The January 2009 RBA 'Financial Aggregates' shows currency (notes and coins) in circulation at $44.6 billion, while the M3 aggregate was $1135.1 billion. In other words, notes and coins in circulation amounts to less than four per cent of M3, with fluctuations in M3 reflecting in the main changes in bank deposits rather than the scenario of Governments 'printing money' and dropping it from Friedman's figurative 'helicopter'.
20. Mitchell and Mosler (2002) present a particularly clear explanation of these themes in their discussion of 'financing' issues arising in the context of their proposed Job Guarantee Scheme.
21. It should be noted that the underlying cash balance of the budget is not a true indicator of the stance of fiscal policy, which would be more accurately reflected in the calculation of structural deficits where attempts are made to abstract from the cyclical effects on government revenue and expenditure items. Similarly, revenue and expenditure measure do not have equal impacts on aggregate demand.
22. Accessed at http://www.theaustralian.news.com.au/story/0,25197,24701990-5013871,00.html. Of concern is the appended report that the latest News poll suggesting that 56 per cent of respondents would be concerned if the Government took the budget into deficit.

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