

Fiscal Policy

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[220] [V1b-Edit] [29Dec06] [Leonardo V. Vera] [6100w]

1. Introduction

Fiscal Policy generally refers to the use of taxation and government expenditure to regulate the aggregate level of economic activity and to moderate the economic fluctuations in a given economy. Indeed, the very term ‘fiscal policy’ came to mean the use of fiscal instruments as tools of macro-policy. But before the 1930s fiscal policy was not part of the lexicon of economists and the public finance inherited knowledge only dealt with selective market failures in the provision of public goods. The role of the State in ensuring the stability of the macroeconomy, in terms of employment, output and prices, begun to find recognition in the wake of the Great Depression experienced by the industrial economies in the 1930s. Since then economists’ view of fiscal policy usefulness has fluctuated widely.

Before the 1920s fiscal policy and specifically government spending policy was discussed under the name ‘sound finance’. The principle of sound finance maintained that the government budget should be balanced except in wartime. The classical liberal tradition in which this principle was held viewed government with suspicion, so any policy that would make it easier to increase government spending during peacetime was seen as undesirable.

But in the 1920s in Europe, and the 1930s in the United States, very well known economists, such as Arthur Pigou and John Maynard Keynes (in Cambridge, England) and Frank Knight, Paul Douglas, Henry Simons (at the University of

Chicago), started questioning sound-finance principles as the economies of the world fell into a major ongoing depression. Moreover, during the 1930s liberal business leaders share the feeling that running government budget deficits could help stimulate demand and they saw this type of action as a way to save capitalism with the least amount of government intervention (Colander and Matthews, 2004).

Though an early generation of Chicago economists argued in favor of the use of the fiscal policy to absorb changes in the business cycle, the reasoning behind this view rested in the fragile financial structure that prevailed in the industrial economies at that time, in the impotency of monetary policy and in the presence of price and wage rigidities. The Chicago economists recommended injecting purchasing power through fiscal means that could restore the level of profitability (Perez, 2003). Over time, as the belief that the economy operated close to full employment levels of output gained prominence among them and their followers, they abandoned the idea of reflationary or countercyclical fiscal policies. Keynes’ initial support of fiscal policy predated the *General Theory of Employment, Interest, and Money (GT)* and consequently his views in that respect were not based on it. Since the time of “*Does Unemployment Need a Drastic Reform?*” in 1924 and “*Can Lloyd George Do it?*” in 1929, Keynes had advocated public works, government expenditure undertaken in special circumstances as distinguished from regular expenditures, as a way to provide a palliative measure for the practical consequences of laissez faire. But it was later in *The Means to Prosperity* (in 1931) that he argued for public works programs using the logic of the Kahn’s multiplier. Keynes found no conflict between policies for increasing employment and schemes for balancing the budget. On the contrary, according to Keynes striving to balance the government's budget during a slump would make things worse, not better. By increasing employment and national income the budget get balance. Indeed Pérez (2003) identifies this pamphlet as the first place where Keynes suggested the use of deficit spending as a stabilization tool.

Chick (1984) and Colander and Matthews (2004) correctly point out that Keynes’ *GT* was not about

fiscal policy at all. In the *GT* there is really no trace of deficit spending as a policy recommendation or as a policy tool. Certainly, Keynes argues, in one of his most controversial propositions, for a “comprehensive socialization of investment” but the discussion was far from complete. Keynes (1936) conceived private investment as driven by subjective evaluations of future profits and as inherently volatile, therefore; he concluded “that the duty of ordering the current volume of investment cannot safely be left in private hands” (p. 320). Thus, public, or publicly-guided investment, was required to offset the fluctuations of full employment and maintain full employment.

In the discussion of post-war employment policies and consistent with his emphasis on counter cyclical public investment, Keynes drew a sharp distinction between stabilizing investment and stimulating consumption by public action. He argued for a separation of the current or ordinary budget and the capital budget (Camara and Vernengo, 2004). The first, according to Keynes, was related to government consumption and should be balance on average or even in surplus to finance the capital one. The capital budget was related to public investment and should be used for counter cyclical purposes. Though anti-cyclical budgetary actions would be accomplished by changes in the capital budget, Keynes thought that it had to be balanced in the long-run (Guger and Walterskirchen, 1988).

Though after WWII Keynesianism came to be considered as identical with fiscalism and fiscal policy became a form of demand management in a number of countries, we should say that in Keynes’ thinking, fiscal policy did not occupy as central position as it did in the conventional Keynesian models and in policy-making in the 1950s and 1960s. Indeed Keynes’ policy advice turned out to be much less straightforward than Lerner’s concept of ‘functional finance’ which came to dominate fiscal policy in the early post-war period.

In proposing the rules of functional finance, Lerner’s stated purpose was to show that the primary question facing governments is how to ensure that the impact of fiscal policy could be most beneficial upon the level of output and employment in the economy regardless of whether it increases or decreases government debt. Though the accumulation of

government debt by current deficit-spending imply that future generations would be burdened with its payment, functional finance meant that the national debt is not a burden on posterity because posterity pays the debt when fiscal policy decisions affect levels of economic activity. This emphasis in output and employment regardless the level of government debt is consistent with the Chartalist view about how government fiscal policy operates. Accordingly, taxes do not, and cannot, finance government spending since the government cannot collect more taxes than it has spent in one given year. If however the government were to limit its spending below the level that would provide citizens with the means of tax payment desired, there could remain an excess supply of goods and services to government and/or markets. From this viewpoint, resources are effectively unemployed because of insufficient government spending which is the source of means of tax payment.

Most industrialized economies soon absorbed Lerner's functional finance ideas and, for most of the post-war period, government fiscal and monetary policies were indeed assessed largely in terms of their effects on output and employment, regardless of whether these increased or decreased the public debt. This is precisely what is done in standard IS-LM exercises: the purpose of taxation or government spending is to shift the IS curve around and of increasing/decrease the supply of money and bonds is to move the LM curve so that output and employment will be at full employment - and not because it is necessary to ‘raise revenue’, ‘raise funds’, ‘close the deficit’, etc.

At the beginning of the 1960s, in the U.S. Kennedy’s tax reductions to weaken ‘fiscal drag’ and later on the Vietnam war acted as expansive global forces. Furthermore, for some twenty years after the Second World War, Keynesian economic policies in countries of the capitalist West were successful in generating rapid growth with high employment. Cornwall and Cornwall (2005), for instance, take a close examination of the data for the post-World War II period (1960-1973) for the main 18 OECD countries and show that using a 3 per cent rate as the full employment rate of unemployment all but four of the eighteen countries experienced full employment. They also note that during this period the low

unemployment economies did not experience appreciably higher rates of inflation, indicating that the inflation rate was not merely a politically acceptable trade-off; and that these economies did not pay a higher inflation cost for their full employment.

This so-called 'golden age of capitalism' did not survive the economic traumas of the 1970s. When inflation in industrial countries went on rising after unemployment had stop falling, the composite model (the Keynesian/Phillips model) that appeared to be working satisfactorily in empirical terms until the second half of the 1960s proved to be inadequate. By the late 1960s and early 1970s the Keynesian remedies to ensure the stability of the macro-economy met with challenges from several quarters, primarily the monetarists. The resurgence of the quantity theory of money – under the new name of 'monetarism' – brought with both a renewed belief in the power of monetary policy and a resurgence of interest in the so-called 'crowding out' effect. Thus, monetarists clung to the view that fiscal policy was powerless.

There are several channels through which this crowding-out effect can occur. The most conventional form of crowding-out occurs when the deficit is finance by selling bonds. The price of the bonds is bid down (due to oversupply) which is equivalent to an increase in interest rates. The higher interest rate causes private investment to decline or to be crowded out as a result of higher deficit. An interesting development of the crowding-out hypothesis that emerged in the 1970s and has since been associated with New Classical Economics was the proposition of the 'Ricardian Equivalence'. Its origin dates back to the classical economist David Ricardo (1772-1823). In 1917 Ricardo wrote about how to finance a war with annual expenditures of \$20 millions and asked whether it makes a difference to finance the \$20 millions via current taxes or to issue government bonds with infinite maturity (so-called consols) and finance the annual interest payments of \$1 million in all future years by future taxes (at an assumed interest rate of 5%). His conclusion was that in the point of the economy, there is no real difference in either of the modes. He argued that in both situations taxpayers would have more money now; but they would realize that they would have to pay higher tax in future and therefore save the extra

money in order to pay the future tax. Barro (1974) revived interest in the Ricardian equivalence proposition under the heading of *are government bonds net wealth?* He developed more sophisticated variations on the same idea, particularly using the theory of rational expectation and a number of restrictive assumptions (people live forever, perfect capital markets, intergenerational altruism, lump-sum taxes and full employment). In essence, Barro (1974, 1989) argues that the effect of expansionary fiscal policy on future taxes leads consumers to change their saving. Recognizing that a tax cut today means higher taxes in the future, people will simply save the value of the tax cut they receive now in order to pay those future taxes. Therefore expansionary fiscal policy and an increase in debt cannot stimulate aggregate demand, and as a result, the increase in debt has no real effects.

The case for using discretionary fiscal policy to stabilize business cycles found new challenges when analyzed in the context of developing countries. After the Second World War, governments in developing countries (in the initial years of independence as for instance in African countries or involved in some kind of planned development as in Latin America) had to spend a large amount of its resources in establishing the infrastructure in its broadest sense, viz., educational, financial, physical, technological and social. These countries had negative public savings and limited private investment. Despite large inflows of foreign aid, the increasingly large financing gap became the main concern of most government. The situation was further aggravated by the high exposition to shocks. Moreover, political incentives and external and fiscal constraints created a bias towards both high debt and high inflation. This gradually led to a weak fiscal structure and poor fiscal management raising vulnerabilities against the frequent internal and external shocks.

The policy approach that would eventually become the mainstream solution to these multifaceted problems in developing countries in the early 1980s was explicitly hostile to State intervention in the economy. The particular policies that were suggested—and then imposed in the context of international agreements—that eventually became known as the Washington Consensus (Williamson, 1990) included as a first item fiscal discipline. In

some sense it was a return to the principles of sound finance. The emphasis on fiscal discipline was associated with the concern that high fiscal deficits were behind macroeconomic instability, on one hand, generating inflation, and, on the other, generating balance-of-payments problems. Unfortunately, under the influence and pressure of the IMF/World Bank adjustment programs, monetary and fiscal policy management became even more procyclical, deepening the cycle particularly during recessions. A procyclical bias in fiscal policy occurs when, during recession, government spending decreases and taxes goes up. There are a limited number of empirical studies that show that fiscal policy has been historically strongly procyclical in developing countries (see, for instance Kaminsky, Reinhart, and Vegh 2004, Braun 2001, Gavin and Perotti 1997 and Akitoby, Clements, Gupta, and Inchauste 2004).

As emphasized by Perry (2003), this procyclical character of fiscal policy may end up generating unsustainable fiscal results over the cycle –as proved to be the case in several Latin American countries, most recently in Argentina and Ecuador. This may explain also why most of the discussion on fiscal policy in developing countries turned later to long term sustainability issues, largely ignoring the short-run effects on economic fluctuations and employment.

Arguments against State intervention in the economy of course had strong contemporary overtones, especially in the context of the American and British economy of the early 1980s. The inflation rate of the late 1970s was enough to convince President Reagan that the most acceptable measure against inflation seemed to be a curb of government expenditures. The subsequent 1981 tax cut (a landmark in the history of fiscal policy) was also justified not by the Keynesian aggregate demand considerations — which were denigrated — but a new doctrine called supply-side economics or the economics of incentives. From a fiscal view, tax cuts were supposed to produce higher tax collections. Although the whole approach turned out to be about reducing the presence of the State in the economy as well as the fiscal deficit, the expectations were in blatant contradiction with later events. A buildup of defense expenditure, continued growth in spending on entitlement programs, such as Social Security and

Medicare, and an effective lower tax collection combined to produce a huge deficit. Moreover, the period 1981-88 was one of recovery from the recession, bringing unemployment back down to 6%. This is the reason why American Nobel prize James Tobin understood Reaganomics as “the biggest and most successful demand-side fiscal gambit in peacetime U.S. history” (Tobin, 2001, p. 3). The deficit spiked early to reach 6.2 point of GDP in 1983 and 5 points in 1984, then it declined gradually in the second term of Reagan's presidency. In Britain, the advent of the Thatcher years heralded a major departure from State intervention which was accompanied by the downgrading of fiscal policy and the return to balanced budgets.

The Reagan legacy of huge deficits fostered a dramatic repositioning of fiscal policy in the U.S.. Blinder (2004) finds a new devotion to fiscal prudence, in 1985, when Congress passed the Gramm-Rudman-Hollings Act which required adherence to annual targets for the federal budget deficit. A similar trend in Europe established a number of aims for macroeconomic policy specified in the Treaties around the European Monetary Union (EMU). The EMU was based on an original arrangement of public finance relations between member countries where fiscal policy remained decentralized, but was subject to rules which were meant to combine discipline and flexibility. The Stability and Growth Pact (SGP), which complemented and tightened the fiscal provisions, laid down in the Maastricht Treaty (the backbone of fiscal discipline in EMU). The SGP is widely viewed today as the most stringent “commitment technology” ever adopted by sovereign governments on a voluntary basis in the attempt to establish and maintain sound public finances. The fiscal rules of EMU were based on a simple predicament: government should reduce budget deficits to close to balance and then let automatic stabilizers play freely. Discretionary counter-cyclical budgetary policy was not really considered integral to this system. This seems to be surprising to some extent since monetary policy within a monetary union can no longer play this role. As argued by Buti and van den Noord (2004) EMU is commonly seen as a regime of monetary leadership where the role for fiscal policy is

to support the central bank in its task to keep inflation in check.

The view among academic circles and policymakers regarding the usefulness of fiscal policy may have swung just a bit too far in the 1980s and 1990s. As Blinder (2004) points out “virtually every contemporary discussion of stabilization policy by economists—whether it is abstract or concrete, theoretical or practical—is about monetary policy, not fiscal policy” (p. 1). Moreover, the high world economic instability that prevailed in the last two and a half decades led most national governments in emerging and developing economies to implement fiscal policies targeting higher deficits. Thus, the budget deficit has held a role of great, even mythic, importance in public discussions. However, although the ‘heritage’ of the debate in the 1980s and 1990s casts a strong skepticism over the use of discretionary fiscal action to fine tune the economy, the potential usefulness of fiscal stabilization is being re-considered. The debate on fiscal policy has revived, for instance, in Europe where it now centers on how to facilitate the workings of automatic stabilizers as a counter cyclical instrument, or in Japan where the prolonged slump have seen a revival of the debate about its effects in stimulating economic activity.

2. Relevance of Counter Cyclical Fiscal Policy

In the short run, the possible role that fiscal policy could play in stabilizing output may occur through the operation of automatic stabilizers and/or discretionary fiscal policy. Automatic stabilizers are budget components that respond automatically to the business cycle without any explicit government action, while discretionary policy consists of active policy measures meant to stimulate the economy during bad times. The appropriateness and feasibility of either, as we will see, may vary according to the individual country circumstances.

The popular view on automatic stabilizers relies on the assumption that fluctuations in GDP or income are partially smoothed by changes in taxes and transfers over the business cycle so that disposable income is less volatile than income. As the economy slides into a recession incomes are falling but collected income taxes falls, unemployment is rising

but transfers and payments of unemployment benefits also rises. In this setting automatic stabilizers have obvious appeal as a counter cyclical policy instruments since they are supposed to be not subject to time inconsistency problems. These arrive when government policymakers are best off to promise that there will be no inflation tomorrow, but once agents and firms in the economy have fixed nominal contracts, the government decides to expand public expenditure. In opposition to discretionary actions, automatic stabilizers are not affected by implementation lags. Precisely because they are not discretionary, they are also less likely to affect market expectations adversely. It is also argued that automatic stabilizers are more effective in stabilizing output fluctuations because they are more predictable and, unlike discretionary measures, they do not require political forecasting.

But there are a number of factors that may account for the weak automatic stabilizers. For example, automatic stabilizers may be constrained by the combination of low tax elasticity and relatively low share of taxes in GDP that tends to reduce the responsiveness of revenues to demand shocks. Their impacts depend on how strongly consumption demand responds to changes in disposable income and this in turn may depend on whether the shock is seen to be temporary or permanent. They are relatively ineffective when the source of the shock to the economy is from the supply rather than the demand side and since they are backward-looking by nature, they are less useful in preventing a demand shock. Furthermore, it is likely that automatic stabilizers are less important in developing countries. In these economies the revenue/GDP and expenditure/GDP ratios are far smaller than in advanced countries. Since the tax base in these economies is small, the share of income-elastic taxes is smaller than in industrial countries. On the expenditure side, few developing countries have significant social security, and unemployment benefits are not an important expenditure category that moves with the cycle. At the same time, improving automatic stabilizers poses an important challenge: it implies introducing additional welfare and unemployment programs, which countries may be unable to afford without raising their fiscal deficits.

The above discussion highlights the fact that there are circumstances and contexts where discretionary counter cyclical fiscal policy could be a far better candidate for the stabilization job. This is clearly the case in Southeast Asian economies, where the recession that followed the Asia crisis was attacked with expansionary fiscal policy (Jansen, 2002). But many analysts have argued that discretionary fiscal policy is especially difficult to use for stabilization because of the ‘inside lag’—the gap between the time when the need for fiscal policy arises and when it is implemented by the executive and Congress. Arestis and Sawyer (2004) clearly remark that fiscal policy is much more subject to democratic decision-making than monetary policy. Thus, what seems to be its strength in terms of social and political consensus, can also be its weakness in terms of its economic goals. But lags are not immutable. The sources of many, if not most, of them lie in policymaking institutions that can be changed (Blinder, 2004). One such idea is to reduce the inside fiscal lags by the adoption of a ‘fiscal policy rule’ (Taylor 2000; and Budnevich 2002) so long as it emphasizes full employment (Arestis and Sawyer, 2004) and where authorities should respond to output fluctuations through a fiscal policy reaction function.

Another question that arises with respect to discretionary fiscal policy is that it is sometimes very difficult to implement in financially open economies where a fixed exchange rate system prevails. This is precisely the case of many developing economies. Under borrowing constraints, an adverse external shock sometimes requires a reduction of absorption, making fiscal policy contractionary. Moreover, orthodox economists and multilateral agencies such as the IMF argue that, against an adverse external shock, fiscal contraction gives international investors confidence avoiding capital outflows. To this there are others that argue that investors will lose confidence when they see that fiscal and monetary contraction leading the economy into a deeper recession.

Another additional issue arises from the alleged possibility of crowding-out. This already described view on the effectiveness of fiscal policy is quite controversial. In particular what seems to be restrictive is to neglect a possibly complementary relationship between public and private investment.

Keynes sharp distinction between stabilizing investment and stimulating consumption by counter cyclical public action is quite relevant here. Public and private investment may be linked by a complementarity relationship if public capital provides positive externalities on the private sector. It was Aschauer (1989), who in a seminal empirical contribution, showed that for the United States, there was a strong positive relationship between productivity and the ratio of the public investment to the private capital stock. After that, several authors have elaborated on the work of Aschauer and have look at the issue for other developed and developing countries.

In this so-called crowding-in hypothesis many channels may be involved. Belloc and Vertova (2006) summarize three of them. With the first, the availability of economic and social infrastructures may create favorable conditions for private decisions to invest, by offering essential services to the production system both in the short and long run (transportation, communication, education, and so on). Secondly, higher public capital may lead, on the one side, to increments in total factor productivity and, on the other, to reductions in production costs (through availability of streets, highways, electrical and gas facilities, mass transit, and so on). And finally, public investment, by increasing total demand, may give rise to profit and sales expectations, so to spur private decisions to invest more.

Thus even if private investment is found directly more productive than public investment, any conclusion on adjustment strategies should be qualified with the consideration of the relationship between public and private investment. Indeed, if the crowding-in hypothesis holds, a fiscal adjustment which reduces public investment implies a contraction in the fixed capital formation and a slowdown in economic performance.

3. Fiscal Policy and Inflation

There is a further issue around the idea that counter cyclical fiscal policy may entail a ‘deficit bias’. For a long time, economists and policymakers have worried about the relationship between government budget deficits and inflation. The

orthodox view has been that the main culprit behind the inflationary process is the creation of high-powered money (and thus seignorage) to help finance fiscal imbalances. Through the so-called 'seignorage', the government appropriates an amount of real resources by means of base money creation. Under certain circumstances if a larger budget deficit translates into a larger money stock of money, then the money issuing authority will be in practice attempting to force agents to hold more real balances than they otherwise would. Inflationary expectations, and inflation, should then be adjusted upwards and real balances would fall further. This inflationary finance story, that occupies a distinguished place in descriptions and explanations of inflations and hyperinflations, was heavily influenced by the works of Philip Cagan (1956).

There are several reasons why the relationship between deficit financing and inflation is not straightforward or fails. One is that countries make different choices on printing money to finance the deficit, partly because they differ in the extent to which other means of finance are available, partly because the tax base (the stock of outside money) is often rather low. Some high-deficit countries finance the deficit with cheap domestic finance, some have access to extensive concessional external finance and some effectively eliminates printing money as a means of financing. To illustrate this we can use the following identity depicting the intersection of the government budget constraint and the balance sheet of the Central Bank, namely

$$(G - T) = (M_t - M_{t-1}) + (B_t - B_{t-1}) - e(R_t^* - R_{t-1}^*) \quad (1)$$

The fiscal deficit on the left-hand side depends on fiscal revenue, T , and global government expenditure, G . Thus a positive deficit will imply a change in the money stock, M , and change in the stock of public debt held by the public, B , or a change in the international reserves position, R^* . Each financing mechanism would entail different macroeconomic repercussions; money printing would be linked to inflation, use of reserves with exchange rate movements and possible balance of payments crises, foreign borrowing with external debt crises, and internal borrowing with higher interest burden and potentially explosive debt dynamics.

A second reason that may invalidate the inflationary finance story has to do with the fact that a surprising number of episodes of high seignorage are due to increases in real money balances instead of accelerating inflation. Therefore, seignorage may increase even when inflation is nil, due to increases in the demand for money, for instance.

In an open economy, inflationary finance would exist insofar as a flexible exchange rate system is assumed. But the inflationary finance story also requires zero output growth, a constant velocity of money and fully flexible prices in the economy. Thus a deficit financed by money creation creates a situation in which agents find themselves holding excess money balances that they spend on foreign goods and/or external assets. As domestic residents sell their local currencies in exchange for foreign currencies, a nominal depreciation occurs. If the purchasing power parity holds then domestic prices will increase.

One important difficulty with the canonical inflationary finance approach in open economies arises from the fact that references to adverse shocks in the balance of payment are absolutely absent. In the orthodox approach the fiscal deficit would be the ultimate cause of the money creation and inflation. The prior question about what produces the fiscal deficit is left unanswered. But the fact of the matter is that reliance on fiscal austerity alone does not address the core of the problem. Heterodox economists of different persuasions have emphasized over the years adverse external shocks such as war reparation payments (in the early 20s) or foreign debt services (in the 80s) as basic causes of the exchange rate devaluations and of inflation. Indeed, in the presence of distributive conflict, the fall of real wages following a real devaluation would be resisted through increases in nominal wages, and accommodated with greater inflation. In this context, money is passive in the sense that money supply is adjusted to the evolution of the exchange rate and prices in sustaining higher nominal income levels. Solimano (1989) and Camara and Vernengo (2001), for instance, provide analysis of these alternative or challenging views to inflation that surged within the context of the European hyperinflation of the 1920s and 1940s, and in Latin America after the several high inflation episodes of the 1980s.

4. Fiscal Policy and the External Sector

Since 2002, the U.S. has seen the simultaneous emergence of current account and fiscal deficits which apparently reflects increasing U.S. borrowing from abroad. These deficits have been called twin deficits and the linkage is an automatic result of a national account identity in which injections equals leakages in terms of the circular flow of income.

$$(X - IM) = (S - I) + (T - G) \quad (2)$$

where S , I , X and IM stand for private saving, private investment, exports and imports plus net factor services to abroad respectively. The identity became commonplace during the 1980s and 1990s in the U.S. because it was supposed to entail a relationship between budget and trade deficits. The relationship has also been widely discussed in the context of developing countries. The hypothesis states that a budget deficit caused, for instance, by an expansionary fiscal policy ($G > T$) will lead to a current account deficit ($IM > X$).

Standard economic theory would not find the situation surprising. A first theoretical explanation of the relation between fiscal policy and current account deficits can be found in the Mundell-Fleming framework (MF). The MF approach indicates that an increase in government expenditure or a decrease in taxation induces an upward pressure on interest rates that, in turn, will trigger capital inflows and an appreciation of exchange rates, ultimately leading to an increase in the current account deficit. A second theoretical explanation of the linkage between the twin deficits is the Keynesian absorption theory, which suggests that an increase in the budget deficit would induce domestic absorption, that is an increase of total expenditures of domestic residents, and hence, import expansion, causing an increase or a worsening of the current account deficit.

The experience, both in developed and developing countries, shows that the relationship between fiscal deficits and external balance takes a wide variety of forms that go beyond the simple twin deficit causality. It may happen, for instance, that the foreign account is balanced while the budget deficit has to match the borrowing of the private sector. It is

perfectly possible also that a fiscal deficit may be caused in the first instance by an autonomous fall in exports, an autonomous increase in imports, or an autonomous rise in the international interest rate, quite independent of government decisions to spend. In commodity exporters and highly indebted countries, for instance, what happens very often is that they face inherent instability from fluctuating export prices and foreign interest rates that deteriorate the current account and translates into higher budget deficits. If causality is reversed, then the policy implications are substantially different. Also, sometimes domestic investment could be the driving force, from the domestic side of the economy, leading to a deteriorating trade balance (Blecker 1999).

Moreover, budget and current account deficits sometimes follow quite divergent paths. One possible explanation for this divergence is related to the impact of output fluctuations on budget and current account deficits. For instance, if the economy enjoys a surge in productivity that prompts an expansion in economic activity, then to reap the opportunities of higher productivity, private investment increases. As investment expenditure typically reacts more strongly to the business cycle than private saving does, and the current account balance deteriorates. At the same time, the output expansion generates both an increase in tax receipts and a decline in government expenditure, due, for example, to a decline in unemployment benefits. Therefore, the budget balance improves.

Another explanation of the relation between budget and current account deficits is based on the presumption that the twin deficits are not related. Such a view is supported by the Ricardian Equivalence Hypothesis. It states that, for a given expenditure path, the substitution of debt for taxes has no effect on aggregate demand nor on interest rates. As a result, it implies that a tax increase would reduce the budget deficit but would not alter the external deficit, since altering the means that the government uses to finance its expenditures does not affect private spending nor national saving. Empirical work on the Ricardian equivalence proposition in industrial countries produces evidence that is mixed (Fischer and Easterly, 1990) while for developing countries is rather weak.

5. Sustainable Fiscal Stance

Debt sustainability has become one of the most used and abused concepts in recent discussions regarding international financial issues. Public Debt sustainability is an important issue, in particular to the countries belonging to the EMU, where the need to ensure fiscal sustainability was often invoked as a rationale for the fiscal rules set out in the Maastricht treaty and in the SGP. Debt sustainability is also important in a number of developing countries, where the fiscal budget has been caught up in an explosive spiral of increasing indebtedness—a ‘snowball effect’ in which the debt generally absorbs a growing proportion of fiscal revenue.

Sustainability of the fiscal stance is a long-term problem and concerns the way in which budgetary viability may get eroded over time due to financing of government expenditure through borrowing. The most known concept of fiscal sustainability relates to the government’s ability to indefinitely maintain the same set of policies (regarding taxes and expenditure for instance) while remaining solvent. This means that the focus of fiscal sustainability analysis is frequently not on default itself—which governments frequently avoid—rather it is on the consequences of the policy changes needed to avoid eventual default. The notion of fiscal sustainability is not new. In the beginning of the 20s, for instance, when writing about the public debt problem faced by France, Keynes (1923) alerted to the need for the French government to conduct a sustainable fiscal policy in order to satisfy its budget constraint. Keynes stated that the absence of sustainability would be evident when "the State's contractual liabilities (...) have reached an excessive proportion of the national income" (p. 54). In Keynes's words, there is a problem of sustainability when "it has become clear that the claims of the bond-holders are more than the tax payers can support" (p. 55). According to Keynes, at that stage the government "must come in due course to some compromise between increasing taxation, and diminishing expenditure" (p. 59). But Keynes was never in favor of repayment at whatever cost as he left it very clearly when denouncing the absurdity of the reparation question after the Versailles peace treaty (Keynes, 1920).

In the early 1940s, Domar (1944) developed the well established, although presently a bit underrated, strand of the literature that identifies sustainability with the dynamic stability of the public debt/GDP ratio around a constant steady state. This definition has a lot intuitive appeal. Accordingly, the dynamic stability of the debt-GDP ratio is ensured as soon as the rate of output growth in the economy is greater than the real interest rate on public debt. In a further contribution, Blanchard (1990) devised a simple framework for the analysis of sustainability in which a budget debt will be sustainable at any point of time when the value of current debt is lower than the net present value of future primary balances, that is, the fiscal balance once the interest payments on debt are deducted. But this definition, simple as it is, has faced the problem of not being operative, since it is quite difficult to derive the series of future fiscal balances or to impose a particular rate of discount on the future.

A basic problem with the conventional sustainability framework is the critical assumption about the behavior of key macroeconomic variables. A high and explosive debt/GDP ratio is supposed to be controlled by reducing government expenditure. However, as remarked by Jha (1994) this may not be as simple as it looks at first glance. Reducing government expenditure may lower real national income and then tax revenues and exacerbate the debt situation. Thus, using sustainability targets to correct the size of the primary balance (to avoid default) may not be such a good idea since government spending cuts may be self-defeating. Moreover, it is sometimes argued that a deficit that results from high public investment will be sustainable since spending on public infrastructure often promotes growth (though inefficient public investment has been extensively documented in developing economies). Indeed, as shown by Rakshit (2000), when the government borrows in order to meet capital expenditure, it accumulates assets. As a consequence, sustainability (in the Domar sense) now requires the growth rate to be higher than the interest rate less the return on assets being accumulated by the government—a much less onerous condition than the canonical one.

6. Conclusion

Although the heritage of the debate in the 1980s and 1990s casts a strong skepticism over the use of discretionary fiscal action to fine tune the economy and stabilize business cycles, deeper inspection reveals that the relationship between fiscal policy and the rest of the economy has remained one of great contested areas in macroeconomics. Indeed, economists' view of fiscal policy usefulness has fluctuated widely since 1920s.

There are good reasons to think that the potential usefulness of fiscal stabilization needs to be re-considered. Concerns about investment crowding out, inflation, scarce saving, and international trade problems do not pose insurmountable barriers to the effectiveness of fiscal policy. But since each economy is unique, none of the links between fiscal policy and the rest of the economy is automatic, for there are institutional and structural configurations that imply specific causality mechanisms as well as choices in policy instruments and sources of financing that may have different macroeconomic effects.

Further analysis is necessary to be able to provide guidance regarding the form to integrate both macroeconomic stability and solvency considerations. The current method of integrating them, instituting restrictions on deficits, works pro-cyclically, and often worsens the fluctuations. The pro-cyclical character of fiscal policy is an increasing burning topic and the economic solutions in vogue today are biased in favor of the use of rules. But more research is needed here since any rule may entail a dilemma between flexibility and credibility and a too rigid one, in the pursuit of credibility, may lead to high cost in forgone flexibility.

Increasing interdependent and integrated markets presents a country's economy with a number of dilemmas as well. Changes in the external environment may improve or worsen the domestic fiscal situation. However, in developed countries the changes in the fiscal variables can be attributed to policy responses (an adverse oil price shock, for instance, reduces real incomes but may face a conscious discretionary government reaction) while in developing economies, the observe change in the fiscal variables may not be attributed mainly to policy changes but to the link that exists between the budget and the foreign sector. Several questions need to be

addressed in this respect: what is the structure or institutional arrangement which a country's economy needs in order to be able to pursue an independent fiscal policy? Is this in fact possible in an increasing global economy?

Though fiscal policy remains a powerful instrument for regulating aggregate demand when the economy's resources are underutilized, research on the combination of public spending and revenues that is most helpful to achieve higher output and poverty reduction is required. Moreover, the reader is not necessarily force to accept the view that fiscal policy must face an immutable barrier by full employment. Recently, new endogenous growth literature have proposed a number o channels through which fiscal policy could induce increases in potential output (affecting factor accumulation or influencing technical progress). This is an area where the identification of the required fiscal policy instruments and prescriptions is needed.

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[Number 220] [Version 1b-Edit] [29 December 2006]
[Leonardo V. Vera] [6,100 words]