

The Dubious Benefits of Fiscal Stimulus

John Maynard Keynes once wrote: “There is no harm in being sometimes wrong – especially if one is promptly found out.” Unfortunately for the world, the problems with Keynes’ ideas were not discovered promptly, and the lessons were too soon forgotten as Keynesian thinking enjoyed a revival with the recent global financial crisis and subsequent recession.

At the time of the Great Depression in the 1930s, Keynes advocated fiscal stimulus – higher government spending or tax reductions – to boost total spending in the economy and put the unemployed back into jobs.

Milton Friedman on the other hand pointed to the role of monetary policy, arguing that the action of the US central bank, the Federal Reserve, in tightening monetary policy turned a recession into a depression.

Keynesian ideas were highly influential in the 1950s and ‘60s. They lent encouragement to spending increases, public works programmes, and government intervention more generally to stabilise economies and ward off recessions.

But there were always doubts about the Keynesian prescription. If one round of fiscal stimulus boosted the economy, why stop there? Wouldn’t more rounds be even better? The analogy of a drug addict requiring more and stronger ‘fixes’ was often used to question the Keynesian orthodoxy.

The experience of many countries in the 1970s confirmed these doubts. Stimulus attempts by governments following the OPEC oil shocks produced increasing inflation and less and less impact on growth. The 1970s are remembered as a decade of stagflation and growing public debt.

Keynesian ideas waned in subsequent decades as most governments focused on non-inflationary monetary policies, stronger public finances and measures to free up over-regulated economies. Monetary policy became the main instrument for keeping inflation under control and economic activity on a reasonably stable path.

OECD economies performed better during the 'great moderation' that began in the 1980s and lasted until the crash of 2008.

Faced with the crisis and the prospect of serious recession, governments took two main forms of action.

First, their central banks cut interest rates sharply, as Friedman would have advised. There seems to be broad agreement that this strategy helped most to limit the recessionary fallout.

In addition, many governments boosted government spending and/or cut taxes. Some went well beyond the orthodox approach of allowing the so-called 'automatic stabilisers' to work – accepting lower tax revenues and higher welfare payments without cuts to other spending.

The merits of large fiscal stimulus packages in the United States, Australia and other countries are questionable. Economic researchers will continue to explore this issue, but to date several findings stand out.

First, the impact of additional fiscal stimulus appears to have been quite limited relative to monetary easing.

Second, much of the spending appears to have been wasteful – notable examples in Australia are the home insulation and school building programmes – as well as badly timed, arriving after the worst of the GFC had passed.

Third, tax cuts seem more effective than spending increases. Christina Romer, President Obama's chief economic adviser, concludes in a recent article that "tax increases are highly contractionary ... tax cuts have very large and persistent positive output effects." Cuts to high marginal tax rates are the most effective.

Fourth, while fiscal stimulus may cushion the economy somewhat in the short term, this is likely to be at the expense of slower medium-term growth. There is no free lunch. The huge public debt burdens of Greece and other countries seem likely to be a severe drag on their economies through

reduced confidence, higher interest rates, crowding out of private investment and resource misallocation.

New Zealand reacted to the financial crisis in broadly orthodox ways. Monetary policy was substantially eased but the government did not go in for additional stimulus packages on top of what was already a sizeable lift in spending and planned tax cuts. Even so, it faces significant budget deficits and a higher debt level.

Internationally, there is still debate about whether stimulus measures should be maintained to support weak economies or withdrawn to unwind debt spirals. New Zealand's experience in the early 1990s and Britain's a decade earlier suggest that, through effects on interest rates and confidence, fiscal discipline may strengthen rather than undermine economic activity when budget positions are unsustainable.

Naïve Keynesian ideas have not survived the GFC well, and indeed should never have been entertained. Keynes once wrote:

"If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coal mines which are then filled up to the surface with town rubbish, and leave it to private enterprise [to dig them up again] ... there need be no more unemployment and ... the real income of the community, and its capital wealth also, would probably become a great deal greater than it actually is."

Few economists would take that proposition seriously today.

Roger Kerr (rkerr@nbrt.org.nz) is the executive director of the New Zealand Business Roundtable.