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REVIEW ARTICLE

THE EBB AND FLOW OF FISCAL ACTIVISM†

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During the last quarter of the 20th Century, the conventional wisdom prevailing in academic, political and financial circles was definitely against government deficits. At the turn of the century, however, a substantial recourse to deficit spending practices in the United States reopened the debate on the usefulness of countercyclical fiscal policies. This essay discusses the main contents of this debate, reviewing the contributions to various symposiums held at a number of U.S. Federal Reserve Banks. A comparison with the views on this issue prevailing in Europe is also provided.

INTRODUCTION

For the convinced supporter of the idea that economic policy is evolving as a well-established doctrine upheld by a steady and widespread consensus, there could be nothing more frustrating than the current U.S. debate on fiscal policy.

From the early 1980s until the end of the 1990s, the superiority of monetary over fiscal policy as a tool for macroeconomic stabilization was widely recognized among academics and policy-making institutions. When necessary, the overall economy should be managed through variations in short-term interest rates, given that monetary policy was considered a more powerful and immediately effective instrument than public deficit variations. Monetary policy did not incur the long-term costs of fiscal policy, and furthermore was controlled by institutions not directly exposed to the pressure of the Congress. To accomplish this *central banker-led macropolicy*, a certain degree of fiscal discipline was needed, as it was thought that fiscal deficits would have raised long-term interest rates or prices, thus interfering with the monetary policy stance. Although it was generally admitted that automatic stabilizers were useful, and that public expenditure and taxes mattered in many important micro-economic aspects, during the 1990s the active use of counter-cyclical fiscal policy fell into such disrepute that the notion according to which fiscal retrenchments could exercise expansionary effects on economic activity spread in the economic profession.

† Reviewing: *Rethinking Stabilization Policy*, a Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, WY, 29–31 August 2002; *The Macroeconomics of Fiscal Policy*, a Federal Reserve Bank of Boston Conference, Chatham, MA, 14–16 June 2004; *Reflections on Monetary Policy 25 Years After October 1979*, a Special Conference of the Federal Reserve Bank of St Louis, 7–8 October 2004; *Fiscal and Monetary Policy*, a Conference at the Federal Reserve Bank of San Francisco, 4–5 March 2005.

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At the turn of the century, however, consensus started to swing again in favour of fiscal activism, astonishing those who had already predicted the death of Keynesian macropolicies. As Vito Tanzi laments:

> [i]n the last couple of years countercyclical fiscal policy has come back in fashion in a way that would have seemed inconceivable a few years ago. The "stagflation" of the 1970s has been quickly forgotten and, now, it is often stated that the existence of a production gap or higher unemployment is an insurance that very expansionary fiscal and monetary policies cannot bring inflation but only generate real growth. It seems that the impact of the economic literature of the past three decades has been close to zero and Keynesian economics has returned to dominate the world of policymaking. Recoveries from downturn are now attributed exclusively to countercyclical policies forgetting that all cycles eventually end and some end without recourse to countercyclical policies (Tanzi, 2003, p. 12).

To portray Keynesian policies as dominant today would be an exaggeration. Yet, renewed consensus for active fiscal policies is a fact, and it is also a fact that the most influential industrialized country is actively encouraging this change of perspective. Trying to interpret the complex mixture of events and economic thinking that started this discontinuity is not an easy task. The contributions to the symposiums under review will provide some suggestions that could help towards this aim.

CAN FISCAL EXPANSION BE EXPANSIONARY? THE TALE OF A NOT SO SMALL COUNTRY

For most of the 1990s, the United States experienced sustained aggregate demand and production expansion. With the economy growing steadily, the federal budget recorded significant surpluses. This combination of growth and tight fiscal policy was interpreted as offering the strongest corroborative evidence to the idea that Keynesian demand management policies were definitely out of date.[1]

At the beginning of the recession that followed the expansionary cycle of the 1990s, however, the United States moved towards an extremely active use of fiscal policy. Starting from 2001, tax reductions sharply brought down federal budget receipts; government spending on defence and homeland security accelerated; outlays for health-care also trended up. The government balance suddenly turned into a deficit, moving from a surplus of 2.4% of GDP in 2000 to a deficit of −3.6% in 2004. The widening of the deficit was only to a small part attributable to its cyclical component; most of it was discretionary. Forgetting that all recessive cycles eventually end and that active discretionary fiscal policy is damaging, the United States resolutely went back to deficit spending to counteract the slowdown in economic activity.

Is this just a case of political practices deviating from sound and accepted economic theory, as Tanzi complains? Recent economic developments seem to suggest a cautious answer.

[1] Although the debate revolved around the *tales* of expansionary fiscal retrenchments in small countries like Ireland and Denmark, it was the mix of growth and fiscal virtue of the 1990s in a large economy like the United States that gave great resonance to the so-called anti-Keynesian view of fiscal policy.

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Accepted as very well-timed by many commentators, the fiscal stimulus boosted aggregate demand, contrasted the recessive climate and favoured the recovery: less than two years after the drop in the first and third quarter of 2001, real GDP rose by 3% in 2003 and by 4.4% in 2004. This fiscal policy episode was undoubtedly expansionary.

Why did the authorities not just let monetary policy counteract the slowdown in line with the principles of mainstream economics, as they had successfully done during the previous decade? The main reason for this may be that in the upturn of the cycle nominal interest rates bottomed close to zero. With short-term interest rates at a historic low, monetary policy lost much of its efficacy as a counter-cyclical tool. For the same reason, the force of the fiscal stimulus peaked.

With the economic outlook displaying such manifest Keynesian features, U.S. policy-makers did not hesitate to revive and apply Keynesian solutions, in spite of all the conventional wisdom developed during the previous decades. The content of Chapter 2 of the last Economic Report of the President provides unambiguous evidence for this turnaround. The Council of Economic Advisers (CEA) clearly accepts the idea that aggregate demand shocks are an important source of business cycles: "[s]hocks that depress aggregate demand tend to lower output, lower employment (that is, raise unemployment), and put downward pressure on prices" (Council of Economic Advisers, 2005, p. 62). Recessive and expansionary phases are considered by the CEA as self-sustaining owing to a relationship which "is known as the 'accelerator model' of investment: higher GDP growth leads to more investment, which in turn leads to even faster GDP growth" (p. 59). Fiscal policy is a powerful tool to contrast the cycle: indirectly, since "lower taxes or higher transfer payments can lead to higher disposable income and thereby boost consumption spending" (p. 62); directly, because "[g]overnment purchases directly affect spending and support aggregate demand" (p. 62). While according to the *life-cycle/permanent-income* theory of consumption, only permanent tax cuts raise consumer spending, in the CEA's view "even temporary cuts could boost spending, however, if people cannot spend as much as they would like or need to due to constraints on their ability to borrow" (p. 63). Although monetary policy can be changed more quickly than fiscal policy, the latter, "especially tax policy changes, can work fairly rapidly. For example, a temporary investment incentive can cause firms to move investment forward and undertake projects now instead of in the future ... [while] it takes time for interest-rate changes to affect spending because investment plans take time to adjust to changing financial conditions" (p. 64). The superiority of fiscal policy over monetary policy as a stabilization weapon is clearly stated by the CEA:

> [f]iscal policy played an especially important role in moderating the last recession and in supporting the subsequent economic expansion. During the most recent set of interest-rate cuts, the nominal Federal Funds rate was reduced to 1 percent, possibly leaving the Federal Reserve with reduced ability to provide additional stimulus (p. 69).

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The CEA even denies the concern that deficits engender long-run fiscal imbalance:

> [w]hile it is undesirable to have government deficits, they are sometimes a prudent price to pay for stimulating economic growth. Without aggressive fiscal policy during the most recent recession and recovery, the large number of severe shocks facing the economy might well have caused the recession to have been much longer and deeper than it actually was, possibly further exacerbating the deficit. In contrast, reducing the deficit by reversing the tax cuts would have caused growth to slow even further. Fiscal policy provided significant stimulus during the most recent recession and recovery through both lower taxes and increased spending (p. 67).

Aggregate demand is considered the main driving force of cyclical variations; the accelerator theory of investment is restated; monetary policy is deemed to be unable to let the economy regain momentum; the "Ricardian Equivalence" is denied; lags in implementing fiscal policy actions are negligible; public deficit itself enhances long-run fiscal sustainability. Admittedly, the whole thing will sound more familiar to a reader trained on Ackley's old macroeconomic textbook than to a student taking an advanced macroeconomics class.

THE "DIRTY LITTLE SECRET"

How is the consensus against Keynesian fiscal policies reacting to such a deep separation between government policy practices and policy recommendations that come from mainstream analysis? Two different answers seem to emerge from the debate.

The first is conservative and strictly reasserts the superiority of the balanced budget. The theoretical rationale behind this position is centred on the positive relationship between government deficits (current and expected) and long-term interest rates. The belief that the fiscal surpluses of the 1990s are a crucial determinant of the "roaring" Clinton years constitutes its backdrop. It can be said that the balanced budget, which has been a Republican pillar for more than half a century, has currently become the cornerstone of Democratic economic doctrine.

The second answer revolves around a broader position that finds discretional fiscal policy useful as countercyclical tool, but only in particular circumstances. Because a multiplicity of interest rate responses to changes in the federal budget are allowed, this perspective rejects the suggestion that fiscal policy can be determined regardless of the economic outlook. Republicans are currently embracing this accommodating position.

Since the early days of the Keynesian revolution, the upward pressure fiscal deficits could exert on interest rates has always been the main argument against deficit spending policies. All the main macroeconometric forecasting models, in fact, presume a positive correlation between public deficits and interest rates. Nevertheless,

> [o]ne of the dirty little secrets of empirical macroeconomics ... is that there is almost no empirical evidence supporting this commonsense proposition (Blinder, 2002, p. 393).

With the Democrats loudly screaming against Bush's deficit programs, Republicans have rediscovered the *little secret*. Alan Reynolds, a fellow of the CATO institute

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(a Republican think-tank that has crossed swords on this subject with the Democratic Brookings Institution), provides a short *resume* of some forgotten evidence:

[i]n the 1980s, economists began to examine the facts. What they found, as Robert Barro reported in his 1987 *Macroeconomics* textbook, is that "this belief does not have evidence to support it." A 1985 analysis by Paul Evans found that historical periods of high budget deficits in the United States did not coincide with high interest rates. A 1993 survey of academic studies by John Seater concluded that, "[t]hey are inconsistent with the traditional view that government debt is positively related to interest rates" ... Another variation on the deficits cause high interest rates theory—embraced by Office of Management and Budget director David Stockman under President Reagan and by Treasury secretary Robert Rubin under President Clinton—says that budget deficits expected in the future are what affects interest rates. However, there is no evidence that expected deficits have any different effects than actual deficits. Using a variety of statistical tests, a 1987 study by Paul Evans "found no evidence that interest rates are related to current, past, and expected future budget deficits" (Reynolds, 2002, pp. 1–2).[2]

Indeed, during the 1980s increasing budget deficits were accompanied by a steady decline of the interest rate in the United States. A similar phenomenon happened in Japan during the 1990s, and when we look at the U.S. experience from 1997 onwards, we see that the data display a strong *negative* correlation between interest rates and budget deficits.[3] The firm belief that "each percent-of-GDP in projected future primary deficits raises interest rates by 40 to 70 basis points" (Gale and Orszag, 2004, p. 33) is rather hard to reconcile with these figures. Stating that "[t]he fact that long-term nominal interest rates are low does not mean they would not have been lower in the absence of the deterioration in the long-term fiscal outlook" (Gale and Orszag, 2003, p. 12) does not seem to provide a strong counter-argument. With such a mixed evidence, the idea that "the burden of proof should be on those who claim there are no such effects" (p. 27) appears to rest on rather shaky grounds.

A "ONE FITS ALL" CONSENSUS MODEL?

When economists think about the relationship between deficits and interest rates as other than a merely empirical issue, they usually move from two different explanations of how the economic system operates: the full-employment neoclassical model and the

[2] See also Evans (1985), Evans (1987), Barro (1987) and Seater (1993).

[3] According to a study by the Federal Bank of St Louis, "[e]mpirically, the linkage between budget deficits/surpluses and interest rates is weak, as a series of papers published in the 1980s showed ... [Plotting CBO's cumulative surplus projections against the yield on 10 year Treasury Inflation-Indexed Securities (TIIS), the] figure provides some countervailing evidence against the view that real interest rates move inversely to large changes in the federal government's projected budget balance ... [P]rojections of ever larger budget surpluses from 1997:Q3 to 2001:Q1 were essentially associated with rising real interest rates, not falling rates. From 1997:Q1 to 2000:Q1, the yield on the 10-year TIIS rose from 3.36 percent to 4.23 percent. Since then, 10-year TIIS yields have fallen to just under 2.5 percent, as has the size of the projected cumulative budget surpluses ... Large budget deficits or surpluses may affect interest rates, but other factors appear to be more important" (Kliesen, 2002, p. 1).

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Keynesian model. While in the first case coupling fiscal expansion with an accommodative monetary policy is considered harmful because it jeopardizes price stability, in the Keynesian model the same policy appears to be sound.

This fundamental divergence is not so clear-cut in the current debate since the *expectation-augmented* Phillips curve makes the system behave as it were in full employment even if resources are under-employed. As is well-known, according to this relationship the adjustment through prices starts not at full employment but as output approaches its *potential* level, a supply-side equilibrium at which inflation stays constant. If the deficit drives output above the equilibrium level, inflation will restore the equilibrium. Yet, a responsible central bank will prevent this, changing the interest rate according to its inflation target (or some form of Taylor's rule). Acting this way, the bank averts the start of an inflationary process sustained by the expectation channel, and avoids enacting a more restrictive monetary policy that restores lower inflation by bringing real output below its potential level. In essence, this is a restatement of the old neoclassical argument: targeting a steady inflation rate stabilizes output variations too; when the central bank manages the interest rate so as to ensure that the supply level that stabilizes inflation finds adequate demand, there is no need to use the more *troublesome* fiscal policy tool.

Among the reasons which make fiscal policy more problematical, great relevance is nowadays attributed to the *institutional* argument. Hotly debated during the 1960s when monetarism started questioning deficit spending practices, this line of reasoning revolves around the idea that the decision-making procedure that leads to changes in the budget is too long, as is the time span from the implementation of the policy to the moment it impacts the economy. Moreover, the political process is thought to be biased toward fiscal deficits: Congress is unable to turn the budget into surplus during the expansionary phases of the cycle, and thereby fails to balance the budget on average. Fiscal policy could stimulate economic activity, but institutions manage to hamper its action, and risk impacting the economy pro-cyclically and engendering long-term fiscal imbalances.

Fiscal policy therefore should not play an active role unless nominal rates hit zero: "[w]ith the current interest rate approach to targeting inflation at a rate near zero, there is a risk that the federal funds rate would approach its lower bound of zero in a recession. This could reduce the power of monetary policy to stimulate demand further" (Taylor, 2000, pp. 28–29). How concrete is this risk to be considered? Recent research shows that "there is a small risk that such a bound could be reached when inflation is targeted at 2 percent, but the likelihood rises as the inflation target gets lower" (pp. 29–30).

Although this is itself proof of a change of climate (deficits impact the economy albeit with a delay), references to fiscal policy lags and to the inflation target as a cause of the liquidity trap are indicative of the very limited role that fiscal policy can play in this theoretical setting. The fundamental reason for this has to be the minimal importance given to a state of under-employment of resources. As a

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general rule, the system attains the *natural* employment equilibrium. However, demand and supply shocks generate short-term business cycle downturns. A positive interest rate that balances planned saving and planned investment exists; the demand for money is stable; the supply-side equilibrium can be determined independently of aggregate demand conditions. As a result, the only floor that can be admitted to the interest rate is zero. Moreover, given that spare capacity is a transitory and self-correcting occurrence, the fiscal policy tool can fit into the short-run only incidentally: "[w]ith the average recession lasting just eleven months from peak to trough, it takes remarkably good luck to add fiscal stimulus at just the right time" (Feldstein, 2002, p. 153).

Another way to blur a clear-cut alternative between the neoclassical and the Keynesian case is to confine full-employment to the long-run, while allowing underemployment in the short-run. Expansionary fiscal policy will lead to higher output today but will lower national saving and thus the future natural rate of output:

> [i]f the economy is operating well below full employment of labor and capital, the increase in aggregate demand associated with an actively stimulative deficit may be beneficial, since it can bolster consumer spending and increase use of existing stocks of labor and capital to give the economy a boost in the short term. In the long run, however, as full employment is approached, persistent under-use of existing labor and capital does not occur. Under those circumstances, the only way to raise economic growth is to expand the economy's capacity to produce and to generate more income at home and abroad. By reducing national saving and thereby impeding the accumulation of capital over time, deficits hinder that prospect (Rubin *et al.*, 2004, p. 8n).

This conclusion follows if the forces guaranteeing full-employment equilibrium work instantaneously, with the result that the system is in a permanent state of full-employment. In this circumstance, there is no difference between the short-run and the long-run, providing that deficit variations cannot spur output and private saving. Yet how does the long-run full-employment constraint bind if the presence of underemployment is admitted in the short-run? With under-employed resources, higher output today will also bring higher private saving. This possibility leaves open only two ways to reconcile the expansionary short-run effect of fiscal policy with a depressive effect on accumulation. The first is the classical crowding-out argument: expansionary fiscal policy raises interest rates through money demand, reducing the amount of output invested; yet, this is not a necessary outcome, as an accommodative monetary policy is able to avoid the contraction of investment. The second is to restate the instantaneous full-employment argument in the less clear-cut form of a natural rate of output around which the activity level cycles: if output is close to its equilibrium level, public deficit variations can engender only small output variations, and private saving increases may well not outpace public dissaving.

The long-run vs short-run argument thus raises the same two basic issues we have encountered when analyzing the *non-accelerating inflation model*: is the supply-side equilibrium stable without the help of active fiscal policies? Moreover, does this

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supply-side equilibrium display the basic feature of being determined independently of demand conditions? The belief that recessions, if not properly contrasted, become longer and deeper, and the reference to the accelerator theory of investment clearly imply that the CEA answers in the negative both questions. Looking at the issue from this perspective, it seems rather difficult to envisage a framework which will be able to encompass both the CEA position and the academic consensus.

U.S. ANTIKEYNESIANISM: A MATTER OF FORM OR SUBSTANCE?

In the United States, the decade which opened with the end of the Vietnam War is usually considered the critical turning point that led to the overcoming of the erroneous Keynesian belief that had dominated economic thinking since World War II. Considered as one of the causes of the high and persistent inflation which characterized that tumultuous period, public deficits fell into disrepute. In 1977, when President Carter's attempt to provide a fiscal stimulus was rejected by Congress, the case against fiscal policy was formally settled. The Federal Reserve started a massive deflationary plan and aggregate demand management through deficit spending left the stage.

The ban on discretionary fiscal policies was not, however, destined to be long-lasting: less than five years after the rebuttal of Carter's fiscal package, a new phase of fiscal activism started with the massive tax cuts and expenditure increases of the Reagan administration.

Admittedly, many questions raised by that period remain unsettled. Reagan is universally known as the champion of the U.S. return to liberal, free-market policies. Undeniably, the ideology and practices of that administration were strongly in favour of the private market process, as witnessed by its massive privatization program. However, the fact that during Reagan's administration active fiscal policy regained the role that it had lost before the deflationary plan has been somewhat overlooked. While *the social content* of the Keynesian option was definitively rejected, active countercyclical fiscal policy was admitted. The practical result of that choice was the restriction of the political feasibility of Keynesianism to reductions in taxation and increases in defence spending.

This amalgam of restless activism on countercyclical actions and a conservative attitude towards government intrusion into the private enterprise system has been the hall-mark of U.S. economic policy until today. The supply-side narrative of *Reaganomics* performed the task of recomposing these two tendencies into one single ideology, as James Tobin rightly remarks:

> [t]he architects of Reaganomics styled themselves Supply-Siders. They scorned the Demand-Side theories and policies they attributed to John Maynard Keynes and to his "liberal" followers, whom they held responsible for the stagflation of the 1970s. In their view the Federal Reserve could and should control inflation by stabilizing the supply of money, as preached in the Monetarism of Milton Friedman. Keynesians were, they argued, dangerously wrong to think that Demand-side stimuli to spending could lift employment, GDP, and economic welfare.

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Instead what the country needs are policies to enhance Supply, in particular by lower taxes, providing incentives to work, save, innovate, take risks. That was the spirit and the purpose of Reagan fiscal policy. In practice Reaganomics turned out to be the biggest and most successful Demand-side fiscal gambit in peacetime US history. What it was not was what it was intended to be, a Supply-side transformation of the economy (Tobin, 2001, p. 3).

Someone has defined President Reagan as an accidental Keynesian,[4] suggesting that his Keynesianism was unintentional, and his policy choices were implemented for other reasons. According to this argument, Reaganomics was in line with the mainstream of its times. Picturing Reagan as an accidental supporter of demand-side stimuli is, however, a rather naive explanation that somewhat ignores the fact that during the 1980s the administration made recourse to a fiscal activism which was completely at odds with the growing academic consensus of those years.

Toward the end of the Presidency of George H.W. Bush, a Democratic majority in Congress put a stop to deficit spending, even though a severe recession was hitting the economy. This turnaround was confirmed with Clinton's accession to the White House, when Congress rejected a small expansionary fiscal package the Administration was attempting to push through, and enacted a deficit reduction instead. Roughly at the same time, the business cycle entered into a sustained growth phase characterized by low unemployment, falling inflation and substantial increases of output per hour worked. Fiscal orthodoxy, in the modern form of the expansionary fiscal retrenchment effects, was embraced by the Democrats, and budget discipline was listed among the *determinants* of a period of relative economic prosperity.[5]

Theoretically, the explanation for this revolved around the impact of fiscal policy on private agents' expectations and confidence. However, the debate on *why* Keynesian prescription may work in reverse never really took place. Since the anti-Keynesian case was strengthened by evidence that fiscal retrenchment was accompanied by steady growth, it is not surprising that, when in 2001 the new political reality shifted once again toward deficit spending macropolicies, the practical relevance of the anti-Keynesian view was heavily questioned. Recalling the Clinton years, Blinder remarks that:

[a]mong politicians and media types, the notion that raising taxes and/or cutting spending would expand (rather than contract) the economy took hold rapidly and uncritically—with seemingly little thought about exactly *how* this was supposed to happen. Quicker than you can say "Robert Rubin," the idea that *reducing* the budget deficit (or increasing the surplus) is the way to "grow" the US economy—even in the short run—came to dominate thinking in Washington (Blinder, 2006, p. 14).

[4] Meyer (2002, p. 179).

[5] In the 1992 *Economic Report of the President* the CEA argued that "an attempted stimulus that abandoned, or was perceived to abandon, serious discipline on the growth of future spending or on the reduction in the multiyear structural deficit probably would produce a substantial rise in interest rates. That would offset a large portion of the direct stimulus in the short run and would leave the economy thereafter with a higher cost of capital, which would be detrimental to investment necessary for long-run growth" (Council of Economic Advisers, 1992, p. 25).

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A more decisive consideration is expressed by Makin, who states that:

the notion that somehow raising taxes and reducing expected future deficits was the key to the expansion of the 1990s is certainly debatable ... and perhaps a dangerous notion right now" (Makin, 2002, p. 175).

The position of Alan Auerbach, an influential defender of fiscal orthodoxy, deserves particular attention. He reports that evidence on the cyclical responsiveness of discretionary fiscal policy "suggests that these fiscal changes have been countercyclical, making them potentially helpful to the cause of macroeconomic stabilization. Indeed, the cyclical responsiveness appears to have increased during the past decade" (Auerbach, 2002, p. 128).[6] Although the exercise of disentangling discretionary changes from overall budget variations is subject to many limitations, the finding that, as a general rule in the United States, discretionary manoeuvres have widened the deficit during recessions and have moved the federal budget in the direction of surplus during the recoups is noteworthy for several reasons. Firstly, it confirms the steady counter-cyclical use of discretionary fiscal fine-tuning that has characterized U.S. fiscal policy during the last decades, in stark contrast with the academic belief that fiscal policy is not a tool for macroeconomic stabilization and its use should be focused on long-run issues regardless of cycles.[7] Secondly, the fact that discretionary fiscal policy has not been poorly timed runs against the time-lag argument again fashionable at present. Thirdly, the data contradict the belief that the long-run sustainability of public finances is impaired by the fact that a policy of increasing the deficit in recession is easily implemented, while the reversal in time of sustained growth is never enacted: like automatic stabilizers, discretionary changes can operate symmetrically over the cycle.

While it is admitted that fiscal policy in the United States has been used systematically to contrast the cycle, Auerbach still does not support the case for Keynesian policies of aggregate demand management. He ambiguously defines fiscal policy as "potentially helpful" for macroeconomic stabilization, and in concluding analysis he states that "contractionary fiscal policy may not restrict activity and might even have a salutary effect on output. This possibility may be relevant for understanding the impact of fiscal policy in the 1990s, although the mechanism is

[6] Referring to a wider time-span he reports that "if one breaks the entire sample period down by Presidential party (i.e., Reagan, Bush, and Bush vs. Clinton), the estimated behavioral responses are relatively similar across parties. The estimates suggest stronger responsiveness by Republicans to both the GDP gap and the projected surplus, for both revenues and expenditures. These differences, though, are not significant" (Auerbach, 2006, p. 15).

[7] Commenting on Auerbach's results, Meyer states that contrast in clear terms: "ideas matter for policy. But, in my view, you seem to contradict this result. It seems to me that during the latter period, ideas changed and became increasingly skeptical about the effectiveness of discretionary activist fiscal policy. At the beginning of the Reagan Administration there was a clear disavowal of short-term stabilization policy, and that has continued. More focus was on long-run supply-side, tax policy, worrying about deficits, etc. So, the question is, why do your data show differently?" (Meyer, 2002, pp. 178–179). Mayer tries to deal with this issue, maintaining the tenet that ideas matter, political actions follow ideas, and thus, if a deficiency cannot be located in the data, Keynesian policies have been enacted by mistake. Yet, the data might simply show that ideas exert little influence on fiscal policy practices.

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unclear" (Auerbach, 2002, p. 144). This position expresses well the ambiguities of what we have called the accommodative reaction: the balanced budget orthodoxy allows for a more elastic approach; however, the mainstream is still against discretionary fiscal policy. G.W. Bush's successful deficit expansion has weakened the old academic consensus. Yet, that the economy grew during the Clinton administration while the public budget moved into surplus remains the main case in point.

FITTING SURPLUSES INTO CLINTONOMICS

Evidently, to argue in favour of the Keynesian case, a rethinking of the 1990s correlation between surplus and growth in the United States cannot be avoided. To this end, let us recollect some characters of the Clinton era which seem of particular relevance to the argument under discussion.

The main features of the economic outlook of that period are well-known. From 1993 to 2000, real economic growth averaged around 3.7% and employment grew by more than 2.3 million civilians per year. This performance was similar to the one realized during the expansionary phase of the Reagan and G. H.W. Bush mandates (4% of real growth and 2.4 million of new employment per year from 1983 to 1990),[8] although the Clinton era was much more stable in terms of volatility of GDP changes.[9] Compared with the performance of the previous decade, the 1990s was a period of substantially low inflation; average inflation fell from 5.7% in the 1980s, to 3% in the 1990s; inflation volatility was also much lower. Policy choices are the other diverging feature of these two episodes. Public deficit in percentage of GDP averaged −4.2% during the Republican expansionary cycle, and −0.7% during the two Clinton mandates. On the monetary front, the responsiveness of the Federal fund rate to output variations was much higher during the 1990s than in the previous period: in striking contrast to the idea that rules must guide monetary policy choices, during the Greespan years the federal fund rate has been timely fine-tuned on a discretionary basis.

When we attempt to fit the role of restrictive fiscal policy into such a long-lasting recovery, two points should not be overlooked. The first concerns the timing of fiscal austerity. The U.S. economy did not escape the downturn at the beginning of the 1990s, while contractionary measures were being taken. Almost the whole mandate of Bush senior was characterized by a prolonged slump. From 1989 to 1991, real GDP growth fell from 3.5 to −0.2%; in the meantime, the deficit in percentage of GDP grew from −2.8 to −4.5%. In 1993, when President Clinton took office, the downturn was definitively over: real GDP had already grown by

[8] Private consumption expenditures contributed to percentage change in real gross domestic product by roughly the same amount in these two phases (2.6%). Gross investment contributed much more during the Clinton years (1.4 against 0.9%), while net exports were detrimental to GDP growth in both periods, although more markedly so during the 1990s.

[9] Cf. Mankiw (2001), and Council of Economic Advisers (2005), chapter II.

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3.3% in 1992, while the deficit still recorded a significant −4.7%.[10] Both before and after the turning-point of the cycle, fiscal policy was expansionary. Moreover, in 1992 the start of the investment boom became apparent (Figure 1).[11]

The second concerns the composition of the package. Budget surplus was the result of a steady and substantial reduction in defence expenditure (the so-called *peace dividend*), and personal tax increases on capital gains, which presumably fell primarily on top earners (Figures 2 and 3).

What the Clinton period shows, therefore, is that during a prolonged expansionary phase of the cycle a substantial cut in defence expenditure in conjunction with increased revenues from direct taxation assured substantial budget surpluses. The Keynesian position is by no means embarrassed by this finding, since sustained aggregate demand can been assured through channels other than public saving variations. This alternative source of demand is identified by many as an interest rate policy oriented not only to guarantee stable inflation, but also to sustain output growth.[12] From the second half of the 1990s, while productivity surged, falling interest rates strengthened business investment, the house-building boom and private consumption. Public surpluses were not the cause of the investment boom.[13] Indeed, capacity utilization grew over the whole period, and Federal fund rates proved that they were related not to budget surplus, but to the previous change of real GDP.[14]

The causal relationship between surpluses and investment may have well worked in reverse: fostering a sustained output growth, the investment boom generated cyclical

[10] It is worth noting that, excluding the Reagan's iper-activist policy stance from 1983 to1986, the deficit in 1991 and 1992 reached the highest magnitude ever recorded in the U.S. after World War II.

[11] While in 1991 total nonresidential fixed investment and residential investment fell (−5.4 and −9.6%, respectively), in 1992 the former rose by 3.2% and the latter 13.8%. Total nonresidential fixed investment will grow at an average rate of more than 9% until 2000.

[12] See Pivetti (2004) for a detailed analysis of the main channels through which the loose monetary policy of the 1990s in the United States sustained aggregate demand.

[13] "Consolidation only started in 1993–4, after the economy had bounced back quite strongly. The ground for recovery was prepared by the US Federal Reserve's sustained easy money policy and a weak dollar. Consolidation of US public finances took place in an environment of remarkably stable nominal GDP growth of around 6 percent as the US Fed refrained from aborting the long boom of the 1990s even as unemployment fell markedly below any previous conventional NAIRU measure … The US managed to consolidate precisely because it enjoyed a long boom, at declining levels of unemployment and with nominal bond yields that were closely aligned with nominal GDP growth. Not any expansionary fiscal contraction, the US experience illustrates the effective use of decisively countercyclical macroeconomic policies that allowed growth-based consolidation. Not thrift caused growth. It was expansionary monetary policy, in particular, that ignited and sustained growth, while fiscal consolidation was one consequence of that. In fact, it was only because private spending was stimulated *sufficiently and beforehand* that public finances could be successfully consolidated even without the Keynesian 'short run' damages of fiscal retrenchment" (Bibow, 2004, pp. 20–21).

[14] More than from public dissaving, interest rate variations seem to be driven by policy actions set according to preceding changes in output levels. The Federal funds rate, for example, grew between 1994 and 1995, when the deficit in percentage of GDP was falling (from −3.9% in 1993 to −1.4% in 1996), and in 1999 and 2000, when *surpluses* grew (from 1.4 to 2.4%). Before the rise in the interest rates, real output growth was 4% in 1994, and 4.5 and 4.2% in 1997 and 1998, respectively. These are the highest increases of the whole Clinton era.

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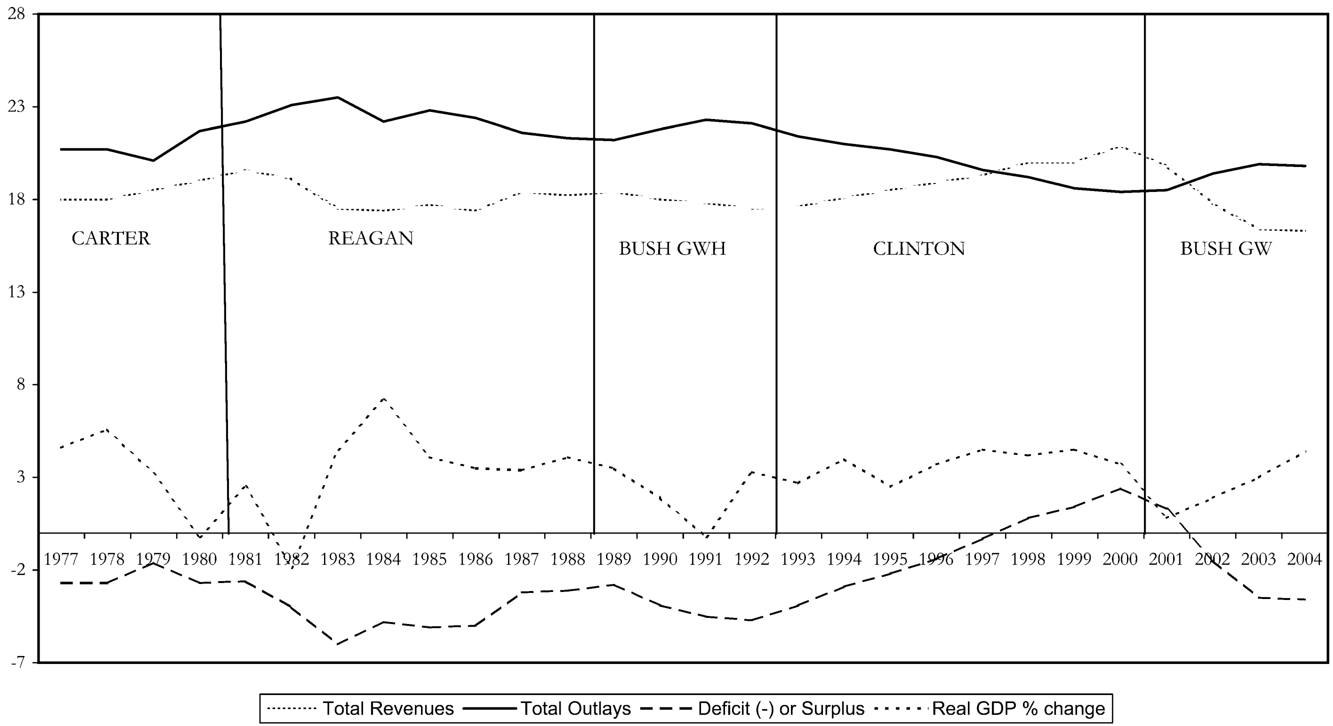

FIGURE 1. Revenues, outlays, surplus or deficit (% of GDP), and percent changes in real GDP.
Sources: Bureau of Economic Analysis and Office of Management and Budget.

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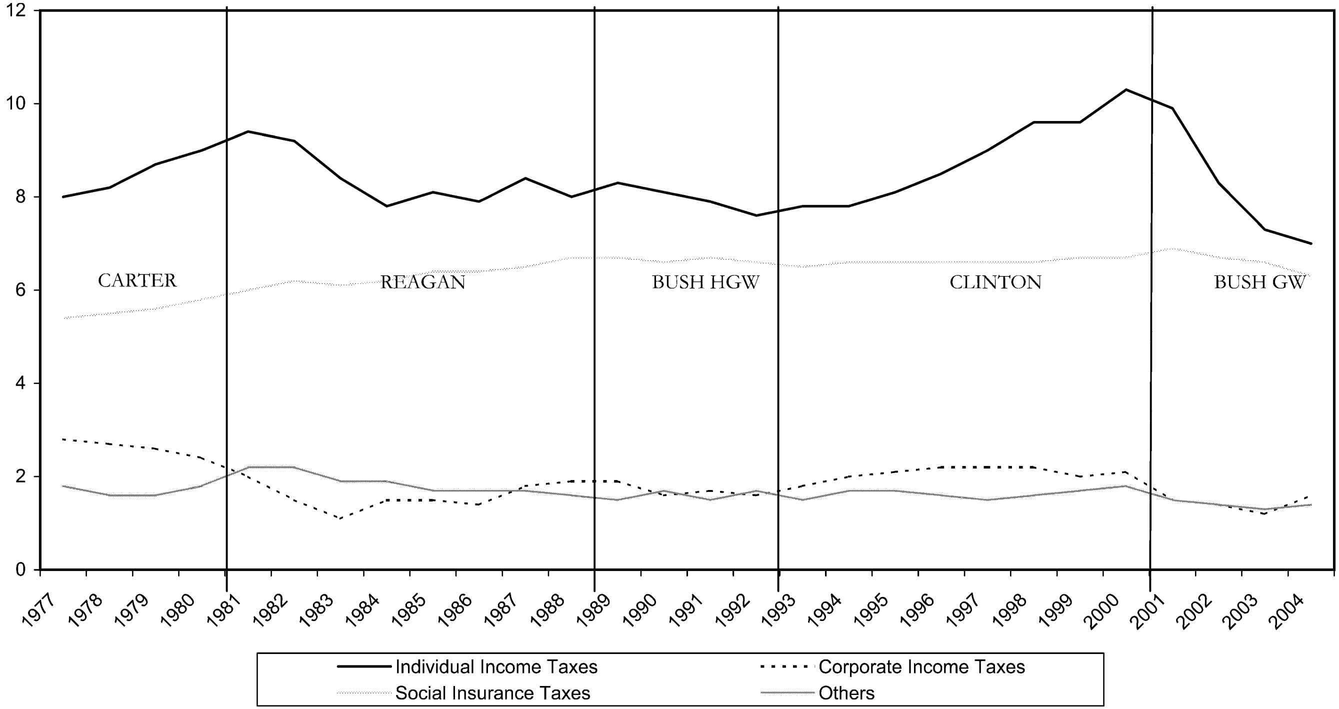

FIGURE 2. Federal receipts by mayor category (% of GDP).
Sources: Bureau of Economic Analysis and Office of Management and Budget.

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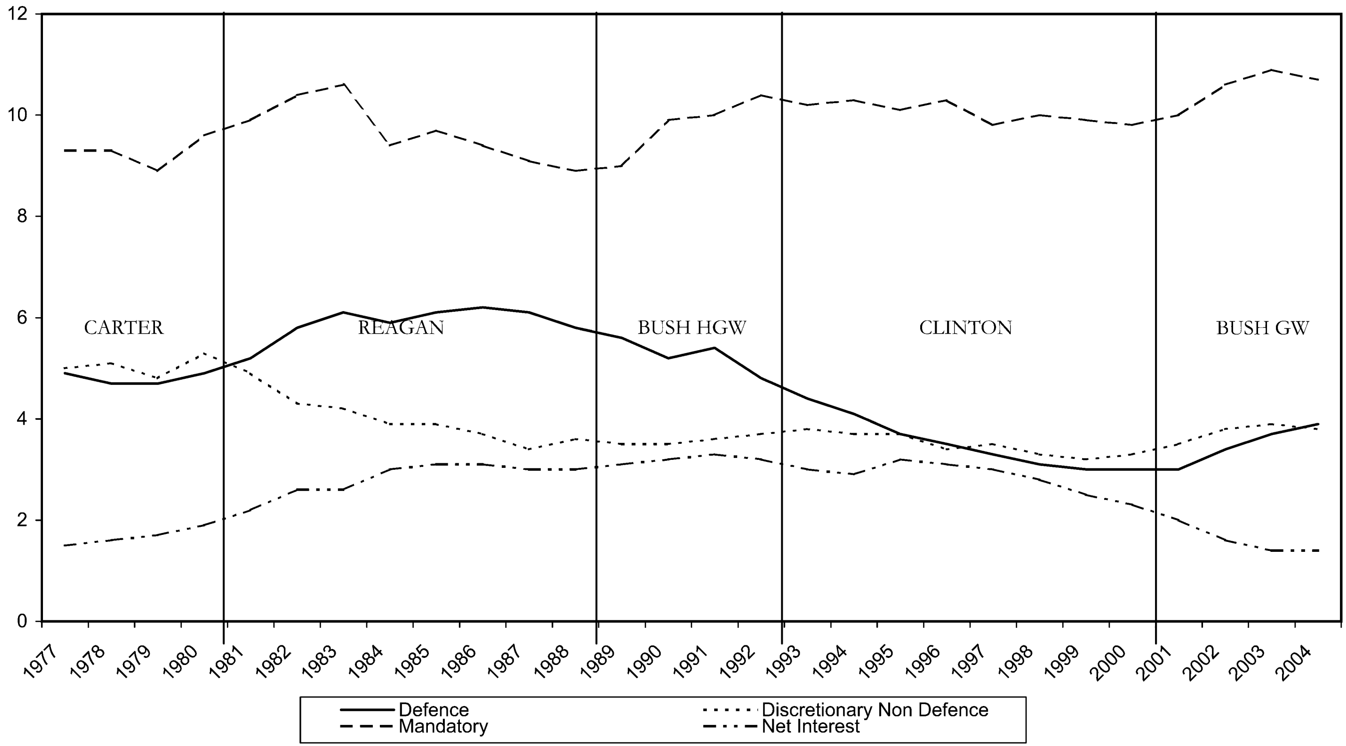

FIGURE 3. Federal outlays by mayor category (% of GDP).
Sources: Bureau of Economic Analysis and Office of Management and Budget.

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increases in taxation, and counteracted the depressive effects of discretional restriction in the fiscal stance.

EUROPE IN DISAGREEMENT

A constant countercyclical use of discretionary variations in the public balance does not characterize the economic policy choices of the whole industrialised world. In contrast to the United States and Japan, European countries have given practical content to the fiscal orthodoxy that has dominated the academic arena for the last 25 years. According to the European Central Bank,

> [i]n the course of the last few decades there has been a shift in the prevailing views in Europe about how fiscal policy should contribute to macroeconomic and price stability. Thirty years ago the prevailing opinion was that fiscal policy could be fine-tuned to steer the course of the economy in the short term and, consequently, maintain macroeconomic stability in the long term. At present, the consensus is that such fiscal policies can fail on both accounts. They can destabilise the economy in the short term and erode the sustainability of public finances and undermine macroeconomic stability in the long term. In contrast, the prevailing view now leaves the smoothing of income fluctuations in the short term to the operation of the automatic stabilisers ... [Discretionary] measures nowadays are not considered useful for the purpose of managing aggregate demand but rather are justified by the need to preserve the sustainability of public finances in the long term and by the necessity of raising potential economic growth. Both automatic stabilisation and sustainability-oriented discretionary fiscal policies provide a predictable and stable environment for economic agents to implement welfare-improving actions. Moreover, an appropriate set of fiscal policy rules and institutions is seen as essential to generate a favourable fiscal policy environment, notably in a monetary union with decentralised fiscal policy-making (European Central Bank, 2004, pp. 45–46).

No concession towards deficit spending is made by the European Central Bank: fine-tuning through discretionary fiscal policy has pro-cyclical effects and leads to higher deficits over time. The sole outcome of an effort to manage aggregate demand in that way is a corruption of the policy environment conducive to price stability:

> [a]ttempts by governments to use the demand effects of fiscal measures to reduce output volatility have ... had disappointing results. Lags between identifying the need for measures and their effective operation are long, causing measures aimed at boosting economic activity to be effective often in economic upturns, and vice versa. Thus, discretionary demand management may be a source of destabilisation rather than moderating economic fluctuations. More pronounced business cycles due to procyclical fiscal policies may, in turn, be reflected in larger price fluctuations. Moreover, the conduct of fiscal policy over the cycle often turns out to be asymmetrical. A policy of increasing deficits in a recession by introducing stimulative measures is usually easily adopted, but policy reversals in periods of above-average economic growth are more difficult to implement. As a result, government deficit and debt ratios are generally at a higher level after a full business cycle, reducing the sustainability of public finances. Thus, while benefits to short-term macroeconomic stabilisation may be limited, fine-tuning may turn out to have adverse longer-term consequences (European Central Bank, 2004, p. 47).

While the case for the well-timed and successful fiscal stimulus in the United States is overlooked, the European Central Bank still enriches its reports with references to

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the Denmark and Ireland consolidations of the mid-1980s.[15] The contrast between the European and the U.S. views on fiscal policy could not be more striking.

The United States and the European countries follow diverging paths not only on economic policies, but also on economic performance. During the last quarter century the two areas have recorded substantial differences in real growth, with output growth in European countries substantially outpaced by the United States. Since 2000 the difference has increased. The customary explanation for such a widening gap between Europe and the United States locates the sources of the problem in an excessively *rigid* European labour market and insufficient structural reforms. "The argument was sometimes made that European wage determination (unlike the US) exhibited 'real-wage resistance' or effective indexing of the nominal wage. This stickiness of the real wage could certainly be a source of unemployment in principle and in fact" (Solow, 2000, p. 5). Nevertheless, as Solow notices, "real-wage resistance must eventually have worn off. The profit share has risen to very high levels in Europe, meaning that real wages have not kept pace with productivity. But unemployment did not wither away, so this story is inadequate. And the further rise in unemployment after 1990 came during a period when labor markets were being deregulated in the major nations of Europe. (The most recent increase in Germany, in 1996–97, actually happened at a time of wage moderation.) Some other forces must have been at work" (p. 5).

If the root of the problem cannot be located in the labour market, what kind of resistance is at work in Europe?

> It is possible that one source of continued high unemployment in Europe is that the domestic demand for goods and services, and therefore for labor, has been forced to unnecessarily and unhealthily low levels? To be more blunt, I mean to suggest that American fiscal and monetary policy has been more successful than Europe has been in supporting aggregate demand, and above all more aggressive in taking advantage of opportunities to expand whenever inflationary pressure has been weak, whatever the cause of that weakness ... In even more unfashionable words, I think that some part of European and German unemployment is "Keynesian" in character and would respond to expansionary demand-side policy at a time when there is little inflationary pressure (Solow, 2000, p. 9).

Solow suggests that the differences in growth between the EU and the United States can be explained in terms of a particular form of *hysteresis* coming from economic policy. Fiscal policy is not used because of fear of jeopardizing price stability. This, in turn, causes output stagnation. A permanent stagnation contracts the measured potential output, and the narrowing of the gap between effective and potential output levels justifies the restrictive fiscal policy stance. Lowering the estimates of the potential output quarter after quarter, the ECB denies the effects that a deliberate expansion of demand could exert on the level of production and employment, constrains output growth and presents this policy choice as inescapable.

[15] European Central Bank (2004, p. 48).

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CONCLUSION

Historical events never let the consensus on economic policy issues crystallize. The prevailing views about how fiscal and monetary policy should be conducted are therefore subject to major changes. One of these turnarounds occurred in 2001 when, after a decade in which deficit spending programs were supplanted by fiscal austerity, the U.S. government enacted massive increases in defence expenditure and reductions in personal taxation, reaffirming the effectiveness of fiscal policy as a countercyclical tool.

It seems arguable that economic developments have pushed for this change of perspective. With inflation well under control, a shrinking aggregate demand both domestic and international, nominal interest rates close to zero and a productive capacity enlarged to a great extent by the easy money and the investment boom of the 1990s, deficit spending appeared a reasonable policy option that the U.S. administration did not fail to exercise in spite of a solid academic consensus against the use of countercyclical fiscal policy.

If events do not follow ideas, ideas must follow events, thus the opening of such a wide gap between the theory and practice of policymaking imposes a reassessment of prevailing views. Strangely enough, from an European viewpoint, this work of reconsideration has been set in motion by a number of Federal Reserve Banks, as witnessed by the symposiums under review. Four key interrelated points seem to emerge from their contributions.

The first is the appearance in balanced budged orthodoxy of a more accommodative position allowing a certain degree of flexibility on fiscal matters. This flexibility is greatly restricted by the tenet that output cycles around a stable natural level which cannot be changed by monetary and fiscal policies. The presence of steadily unemployed resources is denied; nevertheless, the forces which assure full employment do not work instantaneously, and policy actions may help to contrast supply and demand *shocks*, avoiding substantial output and price variations. To this end, as a general rule, monetary policy has to be preferred to fiscal policy, because monetary manoeuvres are activated in a timely way, are quickly reversible, and do not have the long-lasting costs of public budget variations. However, when nominal interest rates bottom close to zero, the monetary option is impracticable, allowing the countercyclical use of deficit spending. Although the re-establishment of the legitimacy of discretionary fiscal policy is confined to this exceptional situation, the focus of the debate has clearly shifted away from supply constraints to aggregate demand deficiencies, and monetary policy is no longer considered the sole instrument able to manage aggregate demand. The most striking evidence of this change of climate is the reappearance of an old anti-Keynesian argument (the presence of implementation lags involving the time it takes for appropriate fiscal actions to get underway), a loss of relevance of the Ricardian argument, and a downsizing of the fears of the potentially destabilizing effects of deficit spending in the long run. In many respects, the debate is timidly moving back towards the theoretical conciliation offered by the

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neoclassical-Keynesian synthesis, rewritten in the more modern language of the real business cycle theory and of the neo-Keynesian modelling, and much more centred on its neoclassical contents than the compromise of the 1960s.

A second point emerges from a reconsideration of the fiscal policy stance in the United States during the last 25 years. A remarkable amount of empirical work indicates that during the whole period discretionary manoeuvres have been unequivocally addressed to counter the cycle. This steady recourse to fiscal fine-tuning was obscured during the Reagan administration by its supply-side rhetoric, and during Clinton's mandates by a dynamic use of monetary fine-tuning that sustained output growth and let the public budget assume a passive role. No trace of an anti-Keynesian use of fiscal policy can be found in the economic choices of both Republican and Democratic administrations. On the contrary, with the exclusion of the period of the Volcker disinflation, deficit spending has been considered the prime move to counter economic slowdown. In this respect, it could be stated that the real turnaround of the Bush administration is not in the use of public deficits to manage aggregate demand, but in the explicit reference to the Keynesian theory of demand and output determination as a rationale for this policy choice.

A related point then surfaces as one attempts to make sense of the association between the U.S. trust in managing the cycle through discretionary fiscal policy actions, and their solid consensus towards a restriction of the government's role in the market process. In this respect, it should not be overlooked that in the United States any political ambiguity implicit in the Keynesian doctrine was definitively removed after the Volcker disinflation. Deprived of any reform potential, U.S. Keynesianism was progressively considered a merely technical device to increase output and employment when needed. Its use was admitted, as testified by the experience of the last 25 years, but only by ensuring that any permanent and potentially enlarging intrusion into the private market system was excluded. The spectrum of the budget options this *countercyclical Keynesianism* allows is strictly restricted to variations in taxation and defence expenditure. Indeed, these choices characterize the Republican mandates of Reagan, the Bush presidencies, and also the Clinton era. The *dividend of peace* accumulated during the latter was blocked into budget surpluses and did not fund increases in social and public investment programs. The Clinton administration was thus unable to formulate and implement an alternative fiscal policy strategy. From this perspective, the shift of the balanced budget orthodoxy from right- to left-wing parties appears as the necessary outcome of the exclusion of increases in public investment and social outlays from the range of fiscal policy options. Democratic forces, being unable to trade *more butter* against *less guns*, are left with no choice, except the one between cuts in taxation and embracing the balanced budget credo.

The lack of defence expenditure as a source of an easily achievable and potentially reversible public outlay characterizes European fiscal policy. Because social programs (public pensions and health systems in particular) are the primary way through which aggregate demand has been sustained, deficit spending policies have never been

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completely deprived of their social implication, and thus they have not assumed the more limited and dynamic form of the *countercyclical Keynesianism*. As a result, in Europe the demise of social and public investment programs which started in the 1980s has coincided with the rebuttal of demand management through fiscal policy. Deficient in a source of public expenditure compatible with a downsizing of the public sector, Europe has no countercyclical deficit spending formula except cuts in taxation. Of course, increases in taxation and retrenchments in public expenditure are also viable options for those still ready to believe in the anti-Keynesian effects of fiscal policy.

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