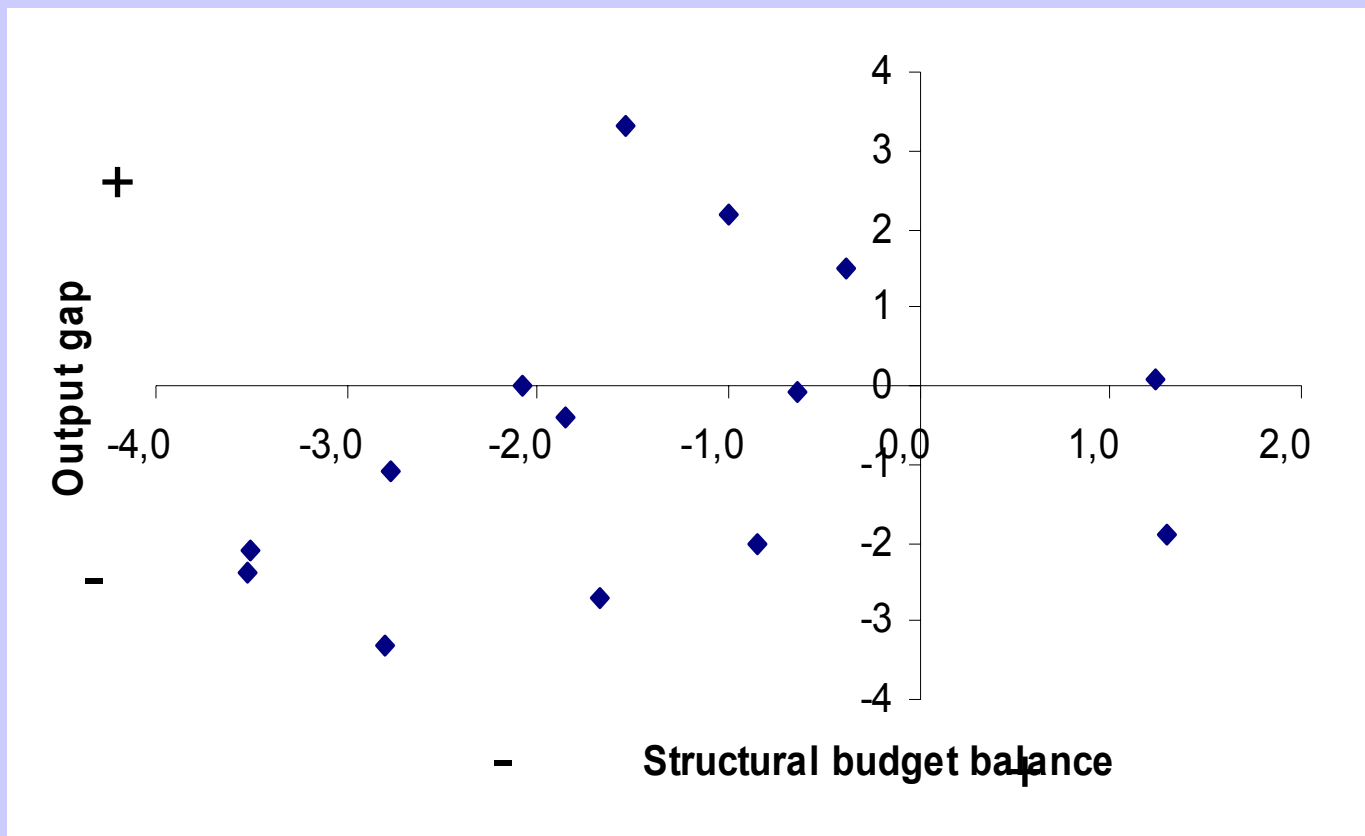


Non-Keynesian effects of fiscal policy: theory and evidence

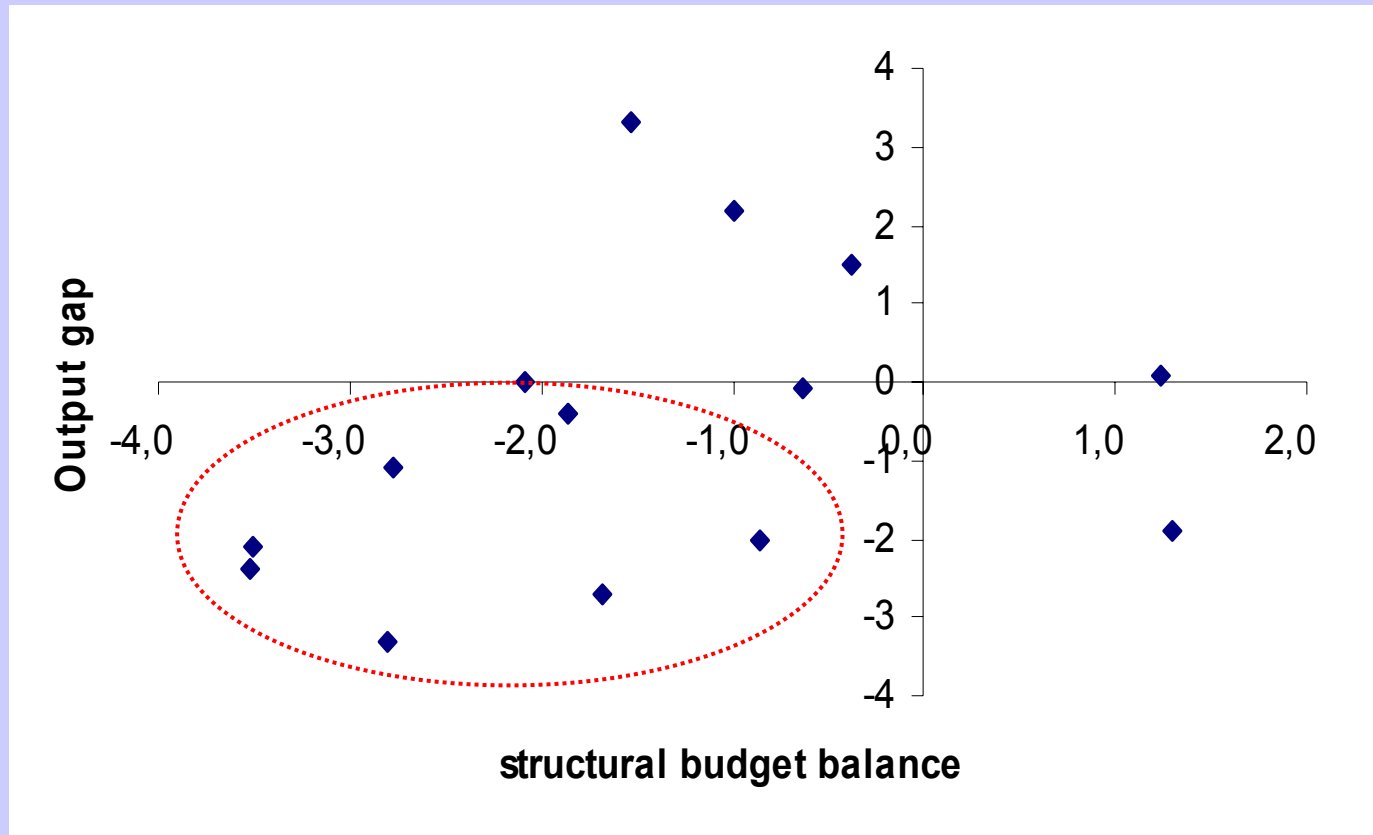
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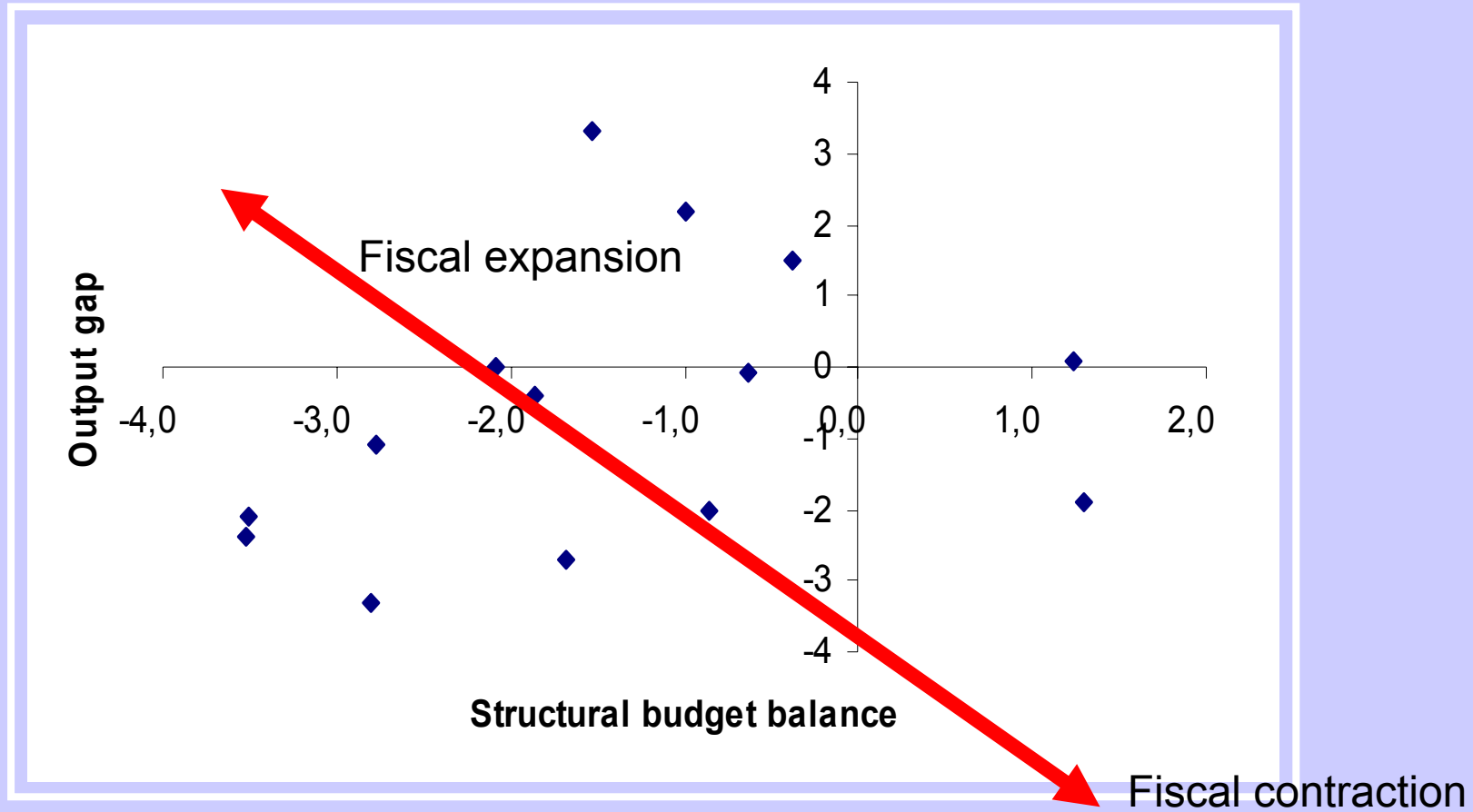
EU-countries: activity (output gap) and structural budget balance



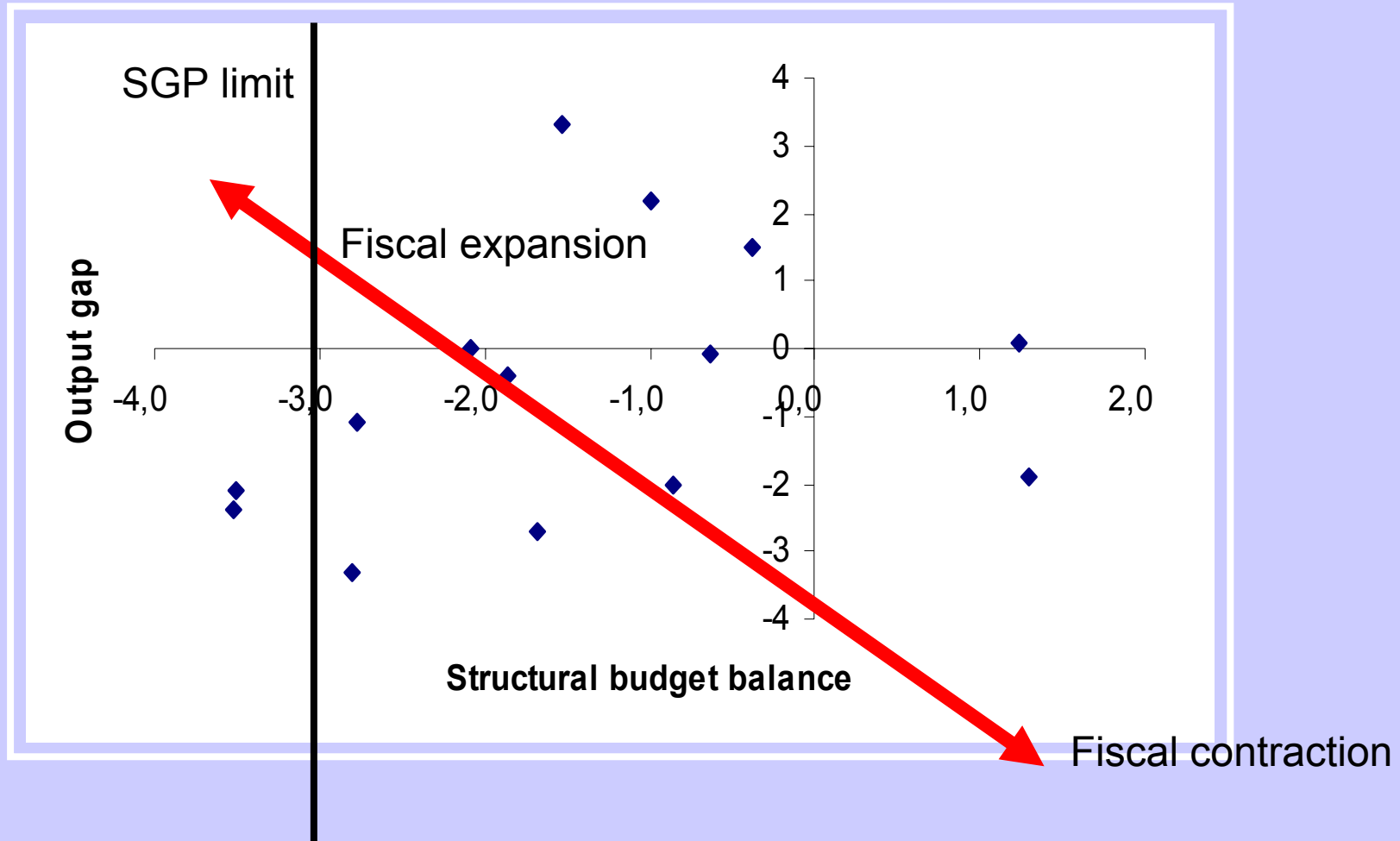
Many EU-countries – low activity, high unemployment and structural budget deficits



Keynesian effects: trade-off – closing the output gap or improving the budget?



Keynesian effects: trade-off – closing the output gap or improving the budget



Hypothesis: Non-Keynesian effects

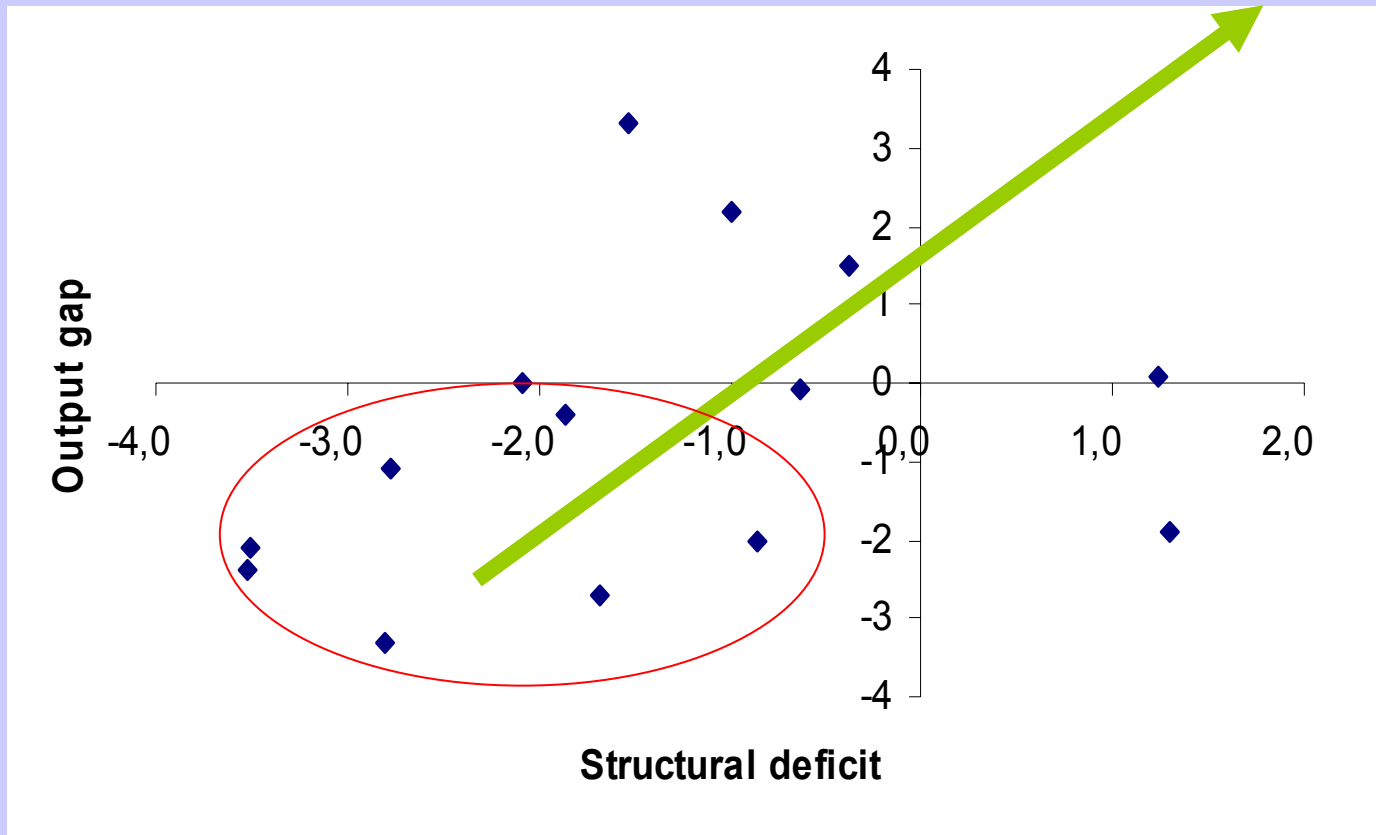
Fiscal consolidation:

Improvement of public finances (lower structural deficit)

and

Improvement in aggregate activity (lower unemployment)

Non-Keynesian effects: No policy dilemma



Support for Non-Keynesian effects?

- Is there any evidence of such non-Keynesian effects?
- Can this be used in the present situation to argue for fiscal contractions both to improve activity and public finances?

Keynesian/Conventional view on the effects of fiscal policy

- Short vs long run
- Long run: the effects of a fiscal expansion on aggregate activity is in general ambiguous – various crowding out mechanisms
- Short run: an increase in public consumption or a decrease in taxation will increase activity (especially for temporary changes)

Non-Keynesian effects

Can a fiscal contraction be expansionary in the short run?

- Possible via expectation effects
- If contraction signals a permanent lower level of public activity and thus taxation = increase in private consumption and investment
- Most plausible if consolidation is via a spending cut

An expansionary fiscal contraction relies on

- * Initial conditions (high debt and level of public consumption)
- * Political situation – credibility of policy change
- * Shift in expectations

Empirical evidence

- Case stories: Denmark 1983-86
 Ireland 1987-89
- Econometric evidence

Roughly half of the episodes of fiscal contractions turned out to be expansionary

Empirical evidence: Non-Keynesian effects are uncertain

Case story – Denmark 1983-86

Fiscal tightening and expansion

but also

- * tight incomes policy (abolishing indexation) – real depreciation
- * liberalisation of financial markets
- * fixed exchange rate policy

Econometric studies

- * The reason for expansions is contested – in many cases a previous improvement in competitiveness (real depreciation)
- * Some contractions were expansionary and other contractionary - do we know which conditions were critical for the outcome?

Empirical evidence – business cycles

- Short run movements in output – changes in aggregate demand play an important role
- Fiscal policy multipliers are in general Keynesian – though they may be small, and the short- and long run effects may differ

Policy implications

- The evidence on expansionary fiscal contractions is too uncertain to provide a basis for general unconditional policy recommendations
- Ample evidence on the role of aggregate demand in the short run makes experiments based on beliefs in non-Keynesian effects highly risky

Lessons from the literature on expansionary fiscal contractions

- Expectations matter and can influence how policy works in important ways
- Most EU countries: fiscal policy is not sustainable given projected demographic changes
- Credibility problem for fiscal policy: either expenditures or taxes would have to be changed

- To avoid "negative" expectations effects it is important to make fiscal policy credible, i.e. focus on the medium to long run consequences
- Credible and consistent reforms dealing with problems of fiscal sustainability are very important
- Reforms: welfare policies, pensions and retirement – need to announce well in advance

Policy

- * Not the time to experiment with non-Keynesian effects
- * Need for reforms to make fiscal policy sustainable
- * Credibility and consistency – need for broad political support
- * If a consistent and credible plan can be made for sustainable fiscal policy
 - no need for current cut backs (demographics changes come later)
 - positive expectations effect - risk of future tax increases falls