The Conundrum of the Fiscal Multiplier

For years, monetary policy has been greatly favored over fiscal policy as the best means of stabilizing an economy. The argument is clear: monetary policy is managed by a small group of stewards with minimal political interference, it is seemingly effective and it can change course in a matter of days, if not hours. Fiscal policy, on the other hand, is slow, closely tied to a cumbersome and typically ineffective political process and is much less effective. This near consensus, formed by decades of successful monetary policy, is breaking apart in the current crisis. Partly, because near zero interest rates means that monetary policy has lost much of its potency and partly because fiscal policy is now widely believed to be more effective when the economy is in a deep recession.

Monetary policy stimulates the economy by lowering its interest rates, thereby lowering the general cost of capital and encouraging investment and consumption and boosting economic activity. Fiscal policy works by directly stimulating demand when a depressed economy has insufficient private demand. If unemployment is high in, say, construction, the government can initiate new infrastructure projects and employ otherwise idle resources. The newly hired construction workers then spend their extra income on goods in other sectors, thereby boosting overall demand and expanding economic activity etc. Although, few people doubt the efficacy of monetary policy there has been and continues to be a long list of counter-arguments to the efficacy of fiscal policy.

First, the *size of the fiscal multiplier* – the effect on total economic activity from a one Euro increase in government spending - is a big unknown. This is so both for theoretical and empirical reasons. 100 million Euros spend on an infrastructure project is income for the people hired for the project and whatever they spend of those earnings is income for yet others in the economy and so on potentially multiplying the original spending pushing the fiscal multiplier higher than 1. Opponents argue that this neglects the opportunity costs – the alternative use – of these resources. If the government increases its investments, it drives up the price for construction thereby crowding out productive private investment. The puzzle eventually has to be solved empirically, but no study has yet produced a convincing answer. The fundamental problem is the age-old causality-is-not-causation problem. If fiscal policy is successful at preempting a recession such that GDP changes little, but government deficit increases, a naïve observer would conclude from the lack of correlation between spending and GDP that fiscal policy is impotent, whereas the opposite is in fact the case.

Though this is far from a settled issue academically, most policy analysis has conventionally taken the fiscal multiplier to be around 0.5.[1] This implies that a 1 Euro increase in spending will increase GDP by 50 cents, which might – through higher taxes an lower spending on unemployment benefits and the like - have a positive impact on government balances of something like 20 cents, partially financing the original expenditure.

Second, the *effectiveness of government officials* is often questioned. The ideal fiscal policy targets unused labor or capital for the use for productive projects. But few ‘shovel-ready’ worthwhile projects are ready for the taking, and a sudden rush of demand for new projects often means that careful examination suffers in the rush and government money is poorly spend. The fiscal stimulus program of President Obama is widely recognized as having struggled with such problems.

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1 IMF Staff Position Note SPN/09/11

Third, the argument for fiscal policy must take into account the *reaction of the central bank*. Though sometimes central banks have multiple goals, all modern central banks are chartered with keeping inflation in check. As any effective fiscal policy is bound to create inflationary pressure, a central bank might raise the interest rate thereby potentially neutralizing fiscal policy. It was to a large extend this realization that led academics to question the efficacy of fiscal policy in the 70s.

Fourth, the effect on *fiscal solvency* has reemerged as a substantial argument against fiscal stimulus. If rising deficits adds a risk premium to government interest rates, this in itself slows down the economy. Though such concerns are widely debated these years it is clear that they should not carry much weight for economies such as the US and the UK, where interest rates on government debt are historically low.

These arguments, along with the seeming effectiveness of monetary policy, have carried the day for decades, though the depressed state of the European and American economies has weakened or invalidated at least the first three on the list: A recession means more unused resources in the economy, so crowding out is less of a concern, in particular in severely depressed industries such as construction. Second, although, government efficiency is certainly not higher in a time of crisis, the low interest rates paid on government debt in many parts of Europe and the US, means that more potential projects are becoming economically viable. Third, central banks are much less likely to counter fiscal policy by raising interest rates in a depressed economy.

The relevance of the fiscal multiplier is not just of academic interest, but also of crucial importance for current economic policy. Its size is of crucial importance for how we fix the Euro-mess. If the fiscal multiplier in the current economic climate is high, say, 1.5, then an increase in the government spending of a 1 Euro might bring in extra tax revenue from increased economic activity of about half that. Including potential dynamic effects for the following years, as Bradford DeLong and Lawrence Summers argue should be done in a recent paper[2], might make the expansion self-financing. And even if not quite self-financing the argument is a strong endorsement of fiscal stimulus at present and it imposes daunting challenges on any country seeking to close its government deficit during a recession: a country that wants to close a deficit of a billion might have to make cuts of, say, 2 to 3 billion, making the challenges that Spain, Greece, and other Southern European countries face even larger. And it makes imposing austerity on these countries the more meaningless.

The consensus is shifting towards imposing fewer conditions of austerity on countries currently or soon to be under help programs. As this happens, it remains crucial to remember where such conditions should have focused in the first place. Structural reforms, now more than ever, remain the only way to ensure the long-term fiscal sustainability of European governments. They might not move the deficit much in the short-term, but they will ensure a more flexible and healthy economy and lower the risk of severe downturns in the future.

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2 Delong, Brad and Summers, Lawrence “Fiscal Policy in a Depressed Economy”