

A CRITICAL LITERATURE SURVEY OF THE MACROECONOMIC EFFECTS OF FISCAL POLICY IN LIGHT OF RECENT EMPIRICAL EVIDENCE

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ABSTRACT

The present paper offers a fundamental critique of the macroeconomic effects of fiscal policy after it surveys the theoretical and empirical literature on the macroeconomic effects of fiscal policy. It emphasizes the importance of the fiscal policy after reviewing the revolution of almost all economic schools . This paper links the developmental role of the fiscal policy with the objectives and measures of the economic transformation. Thus, the importance of this study can be seen from several perspectives: First, it reviews the theoretical harvest of fiscal policy and provides a comparison between the main revolutionary Economic thoughts; the classical school, Keynesian school, and monetarist school. Then it turns to conclude the fiscal policy from the new consensus mainstream economic schools. Third , the study present the macroeconomic effects of fiscal policy in developed vs developing countries according to empirical pieces of evidence provided by empirical studies applying VAR approach, finally the paper concludes the macroeconomic effects of fiscal policy according to theoretical consensus and Empirical evidence in a nutshell. Thus, the study is important for the policymakers as well as scholars as it gives its recommendations upon the last analysis in the form of “policy implications”.

Keywords: *Economic Transformation; Fiscal Policy; Macroeconomic Effects; and public spending*

1. INTRODUCTION

Fiscal Policy is an important determinant of economic developments, and often government decisions on spending and taxes play a crucial role in speeding up or slowing down economic growth. Thus fiscal policy can be defined as the use of government spending and taxes to manage the behavior of the economy by the power it has on the aggregate demand. It functions as a balancing act between the negative impacts of taxes on economic activity, and the flourishing of it by government’s spending. The two main instruments of fiscal policy are changes in the level and composition of taxation and government spending. Although these changes can affect many macroeconomic variables, the effectiveness of fiscal measures is still a debate among economists. There are three branches of fiscal policymaking following the work of Musgrave in 1959; typically: allocation, distribution and stabilization; that remain a useful conceptual framework for discussing, analyzing, and evaluating fiscal policies.

Macroeconomic effects of fiscal policy shocks still a subject of lively debate, as neither theoretical nor empirical studies have reached a consensus on either the qualitative or quantitative properties of such effects. The reason behind this lack of consensus is that fiscal

policy has received less attention compared to monetary policy specially regarding the measurement of its effects on economic activities.

The literatures on the macroeconomic effects of fiscal policy are established on two different schools of thoughts, the classical view versus the keynesian view. The classical believe in the crowding effects of government expenditure and it will not have any effect on the economy, while the keynesian position is that fiscal policy actions are the appropriate tools to stabilize the economy in the short-term. However, seminal works based on these strong positions have mixed results, with strong arguments in support of fiscal policy having a major impact on output and consumption, while others argue that fiscal policy changes do not have any effects on aggregate demand; given that individuals smooth out their consumption pattern over time (blanchard & perotti, 1999; blinder & solow, 2005; ramsey, 2008).

A modern synthesis view about the efficacy of fiscal policy emerged from the economic debates of the 1970s and 1980s. The key elements of that view are: proper timing is both difficult to achieve and of crucial importance, automatic stabilizers reduce the fluctuation of aggregate demand and help to direct the economy toward full employment, fiscal policy is much less potent than the early keynesian view implied. Between 1985 and 2000 there are about 7000 nber working papers released, of which 5 said anything in thier title or abstract about fiscal policy. The whole discussion of fiscal policy essentially disappeared from macroeconomics. (paul krugman, 10th of june 2009, lionel robbins memorial lectures)

Even though, the 2008 financial crisis has contributed to revive the interest of governments, central bankers and academia in the role of fiscal policy. The fiscal developments around the global financial crisis of 2007–09 are undoubtedly a major factor behind that comeback. The large fiscal stimulus packages adopted by many countries in the face of large adverse shocks have triggered an unusually heated debate among academics, policymakers, and commentators alike.

The question of interest here is: what is the new consensus regarding the macroeconomic effects of fiscal policy? , and how it can be used to attain Economic Transformation?

2 . THE THEORETICAL HARVEST

Economic thought may be roughly divided into three phases; namely: pre-modern (Greco-Roman, Indian, Persian, Islamic, and Imperial Chinese), early modern (mercantilist, physiocrats) and modern (beginning with Adam Smith and classical economics in the late 18th century). This section will review the theoretical literature of fiscal policy on two parts; part one compare between the classical school, Keynesian school, and monetarist school as the main revolutionary Economic thoughts. Then part two will conclude fiscal policy from the new consensus mainstream economic schools.

2.1 Fiscal policy in Classical, Keynesian, and monetarist schools

The Classical school was the primary school of thought in economics until the 1930’s and the time of the Great Depression. Classical economics focused on the supply side of the economy (thesis). As they believed in Say’s Law “Supply creates its own demand”. Classical economists’ view of fiscal policy was much more limited than it is viewed today. The idea of discretionary policy was not widely accepted, since Governments were simply expected to balance their budgets annually. Thus, expansionary fiscal policy, for example increasing government spending without increasing taxes to stimulate the economy, was not generally considered by policy makers. Since the economy was assumed to be at full employment with potential output, an expansionary policy could only lead to higher prices. Prior to the 1930s, the fluctuations in the level of economic activity is thought to be were largely self-correcting, depending on monetary policy to prevent excessive movement in prices. Thus, according to classical economists, fiscal policy is ineffective in boosting demand, due to the nature of markets to settle at equilibrium at all times.

Keynesian economists, on the other hand, argue that the recuperation of equilibrium in markets is a prolonged process, and fiscal policy (in coordination with monetary policy, according to neo-Keynesians) is required to elevate private consumption and private investments (Anti-thesis). The standard “Keynesian” response to a recession is a fiscal stimulus. According to the Keynesian models, either tax cuts or increased government spending can increase total demand, and therefore total output and employment. An initial increase in spending (by either the government or the recipients of the tax cuts) results in new series of additions to income results in a total increase in GDP greater than the original increase in government spending or reduction in taxes. Thus with “multiplier greater than one.

The Monetarism revived the interest in monetary policy, as the stagflation period of the 1970s was among the theoretical and practical developments that led to the rejection of fiscal policy as a macroeconomic stabilization tool or even a full employment determination. The monetarists argue that while it is not possible to have full employment of the labor force all the time (as classical economists argued), it is better to leave the macro-economy to market forces. Friedman modified some aspects of the classical theory to provide the rationale for his noninterventionist policy recommendation. In essence, monetarism emphasized that the use of fiscal policy is largely ineffective in altering output and employment levels. Moreover, it only leads to the crowding out. While, Monetary policy- on the other hand- is effective, but with a condition that monetary authorities do have adequate knowledge to successfully manipulate the money supply. Hence, monetarism advocates that neither monetary nor fiscal policy should be used in an attempt to stabilize the economy because this may lead to greater instability in the economy, and the money supply should be allowed to grow at a constant rate. Thus, The monetarist policy recommendations are similar to those of the classical economists, but with some different justifications.

The main differences between those three main Economic schools regarding Fiscal policy can be summarized in a nutshell as follows; First, with the classical believe in the little role of fiscal policy to manage aggregate demand, so it is seen as the basis for Monetarism who believe that Fiscal Policy is often bad policy and a small role for government is good. In contrast to the Keynesians who believe Governments need to use fiscal policy, especially in a recession, Friedman's model argues that current fiscal spending creates as much of a drag on the economy by increased interest rates as it creates present consumption, shifting demand from the investment sector (I) to the consumer sector (C). and so it has no real effect on total demand. Second, Concerning Government borrowing, the Keynesians Suggest that government borrowing may be necessary to increase overall aggregate demand, unlike the monetarists who believe that fiscal policy based on borrowing is harmful, as they point out that it will lead to an increase in interest rates which in turn reduces private expenditures on consumption and investment, thus government spending crowds out private sector spending. Third, respecting supply side policies, both monetarist and classical economists emphasize the role of supply side policies in promoting long-term economic growth. Monetarists recommend it to be used to reduce market imperfections, they consider it the only non-inflationary way to get increases in output; increasing the capacity of the economy to produce (the long-run AS) and so be able to reduce the natural rate of unemployment. Although; Keynesians doesn't reject supply side policies, they say they that it may not always be enough. E.g. in a deep recession, supply side policies can't deal with the fundamental problem of a lack of demand.

2.2 MACROECONOMIC EFFECTS OF FISCAL POLICY IN THE NEW CONSENSUS (SYNTHESIS) MAINSTREAM ECONOMIC SCHOOLS

The fiscal policy synthesis is a compromise between the Keynesian macroeconomics and the classical microeconomics, which can be seen in The Neo-classical and the neo-Keynesian

theory. With the stagflation period of 1970s and the monetarist’s counterrevolution, a new consensus stated the repudiation of fiscal policy as a useful tool for macroeconomic stabilization. (e.g. Allsopp and Vines 2005; Bernanke 2002 and 2003; Blinder 2004; Krugman 2005; Solow 2005; Wren- Lewis 2000). Thus there is a camp sees that mainstream economics has entered an era of the New Economic Consensus (NEC) (Snowdon and Vane 2005; Goodfriend 2004).

The New Consensus’s defining characteristic is the claim that the macroeconomic outcomes are determined by the choice-theoretic micro-foundations; accordingly, all macroeconomic models must adequately incorporate “rational” individual intertemporal decision-making. Thus it gives much importance to the monetary to lead and correct the economy. However, it sees that Central Banks can not any more neither exogenously alter the stock of money nor set the short-term interest rate, and so it has to leave the credit needs of the economy determine the money supply endogenously. Thus, it is recognized that both monetary and fiscal policy must be coordinated together; they have to play the same tone; and this is because of the fiscal policy’s potential effects on output and inflation. Thus, an inflation targeting monetary policy can also influence those fiscal effects (Woodford 1998). And so, according to NEC monetary and fiscal policies must be closely coordinated (Bernanke 2002; Woodford 1998; Wren-Lewis 2000).

The main goal has been always filling the difference between actual and potential output “demand gap”, however the nature of this gap is what distinguishes between post Keynesians and the new Consensus view. Potential output; according to the new Consensus; is achieved only if prices and wages are perfectly flexible, this is in contrast to the New Keynesian I which it is considered as a measure of full employment . With the pro-investment pro-growth approach of the New Keynesian that depends on 1) increasing aggregate demand, 2) stimulating investment, 3) increasing productive capacity, and thereby reducing this demand gap. This policy could range from defense spending up to building roads. For Arestis and Sawyer, the main virtue of functional finance is that it always raises demand (unlike in the NEC, where fiscal policy has demand side effects only in non-Ricardian regimes). (Arestis and Sawyer 2004, p. 132).

In the NEC it does not matter whether government finances spending by bonds or by printing money, excessive amounts of each will be inflationary. The new consensus has advocated the need for fiscal policy as a stabilization tool in times of crises. Many economists now believe that fiscal policy should be allowed to dominate; especially that fiscal policy had an important role to play in a Japanese-style deflationary drag when monetary policy reached its zero interest rate bound.

With respect to the choice-theoretic foundations in Bernanke, Woodford, and other NEC economists, fiscal policy would operate as a supply-side or demand-side tool depending on how it impacts incentives and expectations. They conclude that Fiscal policy can manage inflation by anchoring expectations appropriately. However, according to them; based on the fiscal theory of the price level, fiscal policy comes in the second place after monetary policy. This is in contrast to the Post-Keynesians who believed in fiscal policy as the most potent tool for macroeconomic coordination and stabilization. Suggesting that there is nothing inflationary about fiscal policy in a world where the norm is to have uncertainty, involuntary unemployment, and capacity underutilization with administered prices and money contracts.

2.3 THE ROLE OF THE MACROECONOMIC EFFECTS OF FISCAL POLICY IN TARGETING THE ECONOMIC TRANSFORMATION

Recent decades witnessed many paradigm Shifts regarding the concept of economic development to either inclusive growth; that implies both macroeconomic and microeconomic

determinants of the economy; or Sustainable economic growth. The microeconomic dimension captures the importance of structural transformation for economic diversification and competition, while the macro dimension refers to changes in economic aggregates such as the country's gross national product (GNP) or gross domestic product (GDP), total factor productivity, and aggregate factor inputs. Since Transformation in economics refers to a long-term change in the state and the structure of existing economic sectors, thus a new broad concept has emerged and it is used now widely especially in respect to strategic development planning; for ex. Malaysia's National Transformation Program (ETP), Obama's promise of achieving economic transformation, many Statements by IMF Managing Director Christine Lagarde recommending policies to achieve the needed Economic Transformation for Egypt, Pakistan...etc. There are many specialized centers around the world studying analyzing the Economic Transformation like The Center for Economic Transformation (CET) at New York City's, ECDP ...etc. Also there is a well-known two reports with two different methodologies measuring the progress in economic transformation around the world. The first report is the “BTI” report that measures Economic Transformation. in terms of seven criteria, which are based on a total of 14 indicators. The BTI's concept of a market economy includes not only aspects such as economic performance, regulatory or competition policy and property rights; it also includes elements of social justice, such as social safety nets, equality of opportunity and sustainability as it considers comprehensive development not only aims at economic growth, but also requires successful poverty alleviation and the freedom of action and choice for as many citizens as possible.” The second report is “ ACET” ,in which Economic Transformation means Growth with “DEPTH” that stands for (Diversification, Export competitiveness, Productivity, Technological upgrading and Human well-being by providing more productive jobs and higher income, and that everyone benefits from shared prosperity).

Thus while pursuing further improvements in the macroeconomic and business environments, countries have to diversify their production and exports. The 2016 African Transformation Forum remarkable consensus, both within and outside Africa, that economic transformation holds the key to sustained growth and prosperity. This new approach follows Amartya Sen's multidimensional development focusing on human well-being (Sen, 1999). According to UN 2013report, a profound Economic Transformation can end extreme poverty and promote sustainable development, improving livelihoods, by harnessing innovation, technology, and the potential of business.. .

Thus, Economic Transformation is not a new term , it is a more generalized concept for development with inclusive growth that can be defined as a dynamic process through which a country's economy, society and institutions modernize and move to more developed levels;(Breisinger, C. and Diao, X. 2008.p.15) ; targeting the Linking of the poor to transformation through investments that enable them to participate in the process (Timmer 2008).

Generally Speaking, Fiscal policy influences saving, investment, and growth in the long run. In the short run, fiscal policy primarily affects the aggregate demand. Although the role of fiscal policy in developed economies differs from the role of it in developing ones, it is important for achieving the transformation in both the developed and the developing countries. In developed economies, a fiscal policy aims at maintaining full employment and stabilizing growth. While in developing countries fiscal policy is used to create an environment for rapid economic growth as the government has not only to mobilize more resources for investment but also to direct the resources to those channels where the yield is higher and the goods produced are socially acceptable. (Popa Ionela, Codreanu Diana. 2010, pp.2, 3).

For both developed and developing economies, Fiscal tools can be used to redistribute income in favor of the poor by both tax and expenditure policies without avoiding the efficiency concerns. In advanced economies, fiscal policy can get this goal by raising retirement ages in

pension systems, with adequate provisions for the poor whose life expectancy could be shorter; improving the access of lower-income groups to higher education and maintaining access to health services; implementing progressive personal income tax (PIT) rate structures; and reducing regressive tax exemptions. While in developing economies, it can do so by consolidating social assistance programs and improving targeting; introducing and expanding conditional cash transfer programs as administrative capacity improves; expanding noncontributory means-tested social pensions; improving access of low-income families to education and health services; and expanding coverage of the PIT”. (IMF policy paper, 2014). Fiscal tools can also be employed to contain inflationary and deflationary tendencies in the economy. And for sure it can be used to promote the growth for those industries that have high employment generation potential by increasing employment opportunities in the form of Fiscal incentives by tax-rebates and concessions.

3. THE DEVELOPED COUNTRIES VERSUS THE DEVELOPING COUNTRIES IN THE LATEST EMPIRICAL PIECES OF EVIDENCE

There are many obvious differences between developed and developing countries, Generally: government budgets as shares of GDP are smaller than in developed industrialized countries; In developing countries consumption of goods and services- especially government wages - are the biggest share of government spending, while transfers are commonly small; the biggest component on the revenue side are often the indirect taxes. The existing empirical studies can be divided mainly into two groups: the Structural Vector Auto regression (SVAR) approach and the narrative approach. Studies using the SVAR approach generally find results consistent with the New Keynesian model unlike those produced with the narrative approach which tend to be consistent with the neoclassical model. Since Modern macroeconomics views the economy as a dynamic, stochastic system, The VAR model has proven to be especially useful for describing the dynamic behavior of economic and financial time series and for forecasting. With respect to the evaluation of macroeconomic effects of fiscal policy, VAR approach is widely used, in contrast to SGE where there are few empirical evidences in developed countries and almost non studying macroeconomic effects of fiscal policy in developing countries. thus the coming review will be with VAR approach studies.

With respect to pro-cyclicality of the fiscal policy, There are strong pieces of evidence that fiscal policy (including total expenditure, the share of total expenditure in GDP, public consumption and public investment) has been procyclical in developing countries as Fiscal expansions tend to take place in good times, and not in bad times. (See: Gavin and Perotti (1997), Kaminsky, Reinhart and Végh (2004), Ilzetzki and Végh (2008), and Calderón and Schmidt-Hebbel (2008)). These Fiscal procyclicality can be due to the findings of positive correlations between fiscal variables and output over the business cycle which can be explained by the procyclical bias of discretionary policies and the weakness of the automatic stabilizers (ex. income taxes and transfer programs). This is in contrast to the countercyclical discretionary fiscal policy that exist in developed countries aiming at dampening aggregate fluctuations, and using the automatic stabilizers to increase the government spending and reduce tax revenues during downturns. One can conclude that empirical pieces of evidence from almost last three decades suggest that developing countries have not been so successful in using discretionary fiscal policy to stabilize output fluctuations; however some successes do exist. However, IMF (2005) Provides evidence that in developed countries automatic stabilizers improve overall budget performance by 1/2 percentage point (van den Noord, 2000; Bouthevillain and others, 2001; IMF, 2004), so its findings suggest that developed countries used discretionary procyclically as well.

Regarding fiscal multipliers, they vary with: country characteristics; stance of monetary policy; and the state of the business cycle. Neither theory nor empirical evidence suggests that

they are not constant Both Ilzetki, Mendoza and Vegh (2012) and Kraay (2012b) provide evidence suggesting that multipliers in developing countries are larger during recessions. Other existing empirical evidences suggest that the stimulative effect of government spending in these countries is likely to be quite small; For instance, (Ilzetki, Mendoza and Vegh, 2012) used quarterly fiscal and national accounts data for a sample of 27 emerging markets using VAR-based identification schemes and found a one-year government spending multiplier equal to about 0.3.; while Kraay (2012a, 2012b) used a large sample of developing countries to develop an identification strategy assuming substantial lags between the approval and implementation of aid-financed development projects and the findings suggest that the government spending multiplier is on average somewhere between 0.4 and 0.5. These in contrast to (Biau and Girard, 2005) evidence of a cumulative multiplier of government spending larger than one, and positive reactions of private consumption and private investment in France. Afonso and Furceri in their 2008 research conclude that for OECD and EU countries in the period from 1970 to 2004 overall size and volatility of government expenditure have strong negative influences on economic activity, as they find that an increase in total expenditure share in GDP decreases economic activity growth by 0.13 percentage points in OECD countries and by 0.09 percentage points in OECD countries. Perotti and Monacelli (2006) focused on the joint response of trade balance, consumption and real exchange rate, they find that a rise in government spending induces real exchange rate depreciation and a trade balance deficit.

Fata's and Mihov (2001) assuming that government spending categories are contemporaneously unaffected by GDP and its components to apply a VAR approach with identification of fiscal shocks by Choleski ordering of the variables, their findings show persistent increases in private consumption and insignificant reactions of private investment in response to a spending shock; thus their outcomes correspond to (New) Keynesian predictions. After this, Blanchard and Perotti (2002), developed a structural VAR (SVAR) approach with US data concluding a rising private consumption after a spending shock with spending multipliers for consumption and output between one third and unity their results support both neoclassical and New Keynesian models.; however, spending and tax shocks trigger a fall in private investment. Also Perotti (2004) empirical evidence provide a relatively large positive effect on private consumption and no response of private investment, investigating the effects of fiscal policy in Australia, Canada, Germany and the U.K. While in West Germany using data over the period (1975:1 – 1989:4), Perotti (2005) provides evidence of a significant positive cumulative response of GDP to a government spending shock at 4 quarters which reverses into negative at 12 quarters; For the same sample period, private consumption and private investment show insignificant responses at 4 quarters and a significant decline at 12 quarters; however, results are sensitive to the chosen sample period. For 1960:1 – 1974:4 the cumulative private consumption response at 4 quarters proves to be significantly negative. (Heppke- Falk et al. 2006) found increases in output and private consumption as a result of a positive shock in government spending in Germany, although the effect is relatively small.

Regarding the empirical evidence of some recent study upon the effects of expenditure shock in developing countries, Lozano and Rodríguez (2011) found that an expenditure shock in Colombia has positive and significant effects on output, private consumption, employment, prices, and short-term interest rates. Unlike Ravnik and Žilić (2011) have suggested that a revenue shock in Croatia has a long-lived diminishing effect on the overnight interest rate and an expenditure shock leads to an immediate decline in the short-term interest rate. Ben Slimane and Ben Tahar (2013) also conclude that a revenue shock in Egypt has a persistent negative impact on short-term interest rate following a short-lived immediate increase.

4. CONCLUDING REMARKS

There is some kind of consensus in the previous researches and empirical evidences that fiscal policy becomes more important, thus it can play a crucial role in achieving the relatively required Economic Transformation in both the developed and the developing countries, but the role of it may differ in developed economies from developing ones. Fiscal policy can influence saving, investment, and growth in the long run, and in the short run, fiscal policy primarily affects the aggregate demand; The new consensus has advocated the need for fiscal policy as a stabilization tool especially in short run in a recession period. Those macroeconomic effects typically include effects of government spending and government revenues on economic growth, inflation, interest rate, public and private investment, and private consumption). The two macroeconomic effects from the change in government purchases is called; the multiplier effect and the crowding-out effect. According to The NEC, it does not matter whether government finances spending by bonds or by printing money, excessive amounts of each will be inflationary. In developed economies, a fiscal policy aims at maintaining full employment and stabilizing growth. While in developing countries fiscal policy is used to create an environment for rapid economic growth as the government has not only to mobilize more resources for investment but also to direct the resources to those channels where the yield is higher and the goods produced are socially acceptable.

The extensive empirical literature reviewed here studied the macroeconomic effects of fiscal policy using VAR approach and there are some policy implications that can be concluded as follows: Fiscal multipliers are not constant, but vary with country characteristics. The macroeconomic effects of public investment vary depending on how it is financed, Government projects financed through debt issuance have stronger expansionary effects than budget-neutral projects that are financed by raising taxes or cutting other spending;

Some general recommendations for the potential macroeconomic effects in any country can be provided including: First, Fiscal interventions need to be timely in order to be effective, and the interventions must be productive based on adequate data. Second, the spending should focus on projects that act as automatic stabilizers, along with sustainable finance; Spending increases should concentrate on areas where the expenditures are either reversible or likely to increase growth in the future, focusing in areas such as infrastructure where there are reasonable expectations of long term growth benefits merely, expanding tax bases as well as direct cost recovery through future user fees. Third, It is a must to build a strong fiscal position and large reserve stocks that saved in good times to finance the needed fiscal expansion in bad times. Fourth, Developing countries should consider the following priorities in the use of the limited scope they may have for expansionary fiscal policy:

1. Strengthening social safety nets is vital. A side benefit of strengthening such safety nets is that it also strengthens automatic stabilizers that are widely viewed as a more effective form of countercyclical fiscal policy;
2. One significant difference between developed and developing countries arises from the nature of the tax systems in the two sets of countries. A progressive tax system, which may be more typical of the developed country case, would generate counter-cyclical behavior, whereas a regressive one, most likely to prevail in developing countries, would generate pro-cyclical behavior;
3. Governance is probably the most important and significant factor that affects the relatively higher deficit bias in developing countries, as it relates to poor tax administration and expenditure management;

With all these theoretical insights and empirical evidence in hand, one can conclude that fiscal policy as a tool of demand management is most likely to be used far less frequently and intensely in developing countries than in developed ones because of the relatively high marginal propensity to consume identified for these countries

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