

Are We All Keynesians Again?

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The unfolding global economic debacle has led many governments, including our own, to reach into their policy toolkits for fiscal stimulus measures. In doing so, they have revived fiscal policy as a counter-cyclical tool, which was so much in vogue until the early 1970s that Richard Nixon famously declared ‘We are all Keynesians now.’

Are we all Keynesians again? At first sight, fiscal pump priming might appear to have a lot going for it in current conditions: inflation is receding; spare capacity is increasing, at least in the major developed economies; and the crisis in the banking system is weakening conventional monetary policy.

Even so, the revival of activist fiscal policy ought to be highly controversial because the 1970s and 1980s saw a new consensus emerge that it was ineffective or even damaging. The lessons from that era remain valid today but are being ignored by governments desperate to prop up sagging economies. There is a debate on these issues in the United States, but they have received much less scrutiny in Australia.

The criticisms of counter-cyclical fiscal policy can be summarised as follows:

- The timing of the policy action is often wrong. The lags are such that by the time a stimulus package has its effect, the need may have passed. Even if that does not turn out to be the case this time, history suggests that policy makers will keep stimulating for too long.
- Although meant to be temporary, stimulatory measures typically become entrenched and enlarge the role of government. When the stimulus is eventually withdrawn, higher government spending remains and taxes are increased. To some this is benign, but to others bigger government is harmful to economic efficiency and growth. Historically, wars, depressions and other cataclysmic events have set the scene for a permanent enlargement of government.
- Stimulatory measures are often of a kind that distort resource allocation and impose lasting economic efficiency costs. Governments that are in a mood to increase spending in a hurry attract sectional interests and fail to subject proposals to proper scrutiny in the public interest.
- Stimulus measures do not have the ‘multiplier’ benefits often attributed to them. Temporary and one-off handouts fail to stimulate consumer spending because households are guided more by notions of their permanent income and wealth. In the current climate, temporary windfalls are especially likely to be saved, not spent.
- More broadly, increased government spending ‘crowds out’ the private sector in various ways, resulting in multipliers of less than unity and perhaps close to zero, even when there is spare productive capacity. The mechanisms of crowding out include Ricardian equivalence, interest rate and exchange rate effects of increased government borrowing, supply side responses, and damage to private sector confidence.

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The collapse in private sector confidence in recent months is a critical factor in the downturn. Fiscal stimulus will not on its own restore confidence. It may even deepen and prolong the damage if it creates such large fiscal deficits and levels of public debt that strong corrective measures will be needed in the future. At best, a stimulus will reduce the scale of production and job losses pending restoration of conditions for a sustained recovery.

In practice, the strength of Commonwealth finances carried forward from the boom provided opportunities for a credible and effective loosening of fiscal policy in Australia. But the stimulus measures adopted in late 2008 and early 2009 are excessive and largely of the wrong kind. It would have been better to accelerate desirable structural changes, such as permanent tax reform, that improve incentives for individuals and businesses.

In the United States, which holds the key to the global downturn and recovery, public finances are already a shambles with record post-war deficits, federal debt at 40 per cent of GDP, and a huge unfunded future liability for social security and Medicare entitlements. Coming on top of this, the new administration's fiscal stimulus package seems destined to be of little short-term benefit and will compound the structural fiscal weakness, which portends serious longer term problems.

The administration should concentrate on restoring the banking system to health. The restoration of confidence hinges on a return to some semblance of normality in the banking system. Unorthodox uses of public funds such as those we have already seen may be part of the solution, but such measures differ from orthodox fiscal stimulus.

There are many reasons for us not all to be Keynesians again, even if we all were—as Nixon asserted—forty years ago. The challenges to short-term fiscal activism in the intervening period were profound and have not been overturned by the current global economic debacle. Discretionary fiscal stimulus can be beneficial in limited circumstances, but the obstacles to its successful use are formidable, and the benefits at best modest.

Introduction

Such is the clamour for economic stimulus packages around the world and across the ideological divide that the fiscal policy wheel appears to have turned full circle in forty years, from demand management—to focusing on the supply side and fiscal sustainability—back to demand management. The revival of demand management, however, glosses over the practical and theoretical objections to short-term fiscal activism that were mounted in the 1970s and 1980s. Those objections remain as relevant as ever, and call into question the fiscal policy responses of the Australian and other governments to the current economic debacle.

Some economic history

It was in December 1965 that *Time* magazine declared on its front cover, 'We Are All Keynesians Now,' a declaration that President Richard Nixon repeated six years later. The early 1970s were indeed the heyday of fiscal policy as a counter-cyclical tool. Whether this view of fiscal policy was authentically 'Keynesian' or a debased form of what Keynes had advocated in his 1930s writings is another matter. Labelling aside, the conventional wisdom was that governments could smooth out the business cycle by tweaking the dials of taxation and expenditure policy. It seemed that managing aggregate demand to keep it close to potential output was more important than concentrating on supply side policies to strengthen potential output itself.

Later in the 1970s this conventional wisdom began to be challenged by monetarists, supply siders, and the rational expectations school. As Keynes himself would have foreseen, official thinking was eventually influenced by the academic scribblers. By the 1990s, the main role for fiscal policy—as seen by national governments in Australia and many other countries, and by international organisations such as the OECD and the IMF—was to be steady and stable in its focus on longer-term goals such as fiscal sustainability, national saving rates, productivity, and growth. Although practice did not always match the rhetoric, short-term stabilisation was seen as a subsidiary function of fiscal policy, and its limitations in fulfilling that role were well recognised.

As an example of the official view at the time, Ken Henry, secretary to the Australian Treasury, stated:

All of the lags and questions of effectiveness pose real challenges for the counter-cyclical use of fiscal policy, but they do not rule out such use ... [however] fiscal policy has a lot of other things on its plate.¹

Henry repeated these words as recently as May 2008—leaving the door open to counter-cyclical fiscal policy, but in a much more qualified way than any statements we are hearing out of Canberra now.

The current fiscal policy debate

One result of the dramatic financial and economic developments of the past year has been a quantum shift back towards discretionary fiscal policy as a counter-cyclical tool. One would normally expect a home to economic rationalism such as *The Economist* to stand against such a tide, but even it has recently said:

As America's recession continues to deepen, one mercy is that there is no longer any serious debate that a fiscal stimulus is required to fill the hole left by the collapse of private demand ... the case for the government stepping in has become unanswerable.²

In the same vein, the IMF's chief economist, Olivier Blanchard, wrote recently:

Fiscal policy must now play the central role ... We have come to the conclusion that, at this point, the goal should be a fiscal boost of about 2 per cent of global GDP ... If the decrease in output turned out to be even worse than we currently

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forecast, the fiscal expansion would have to be even larger than we currently recommend.³

Statements such as these lead one to think that the policy wheel has turned full circle back to Nixon's declaration of 1971.

But are we really all Keynesians again? There are doubters, but their voices are not being heard above the clamour. IMF researchers⁴ recently dared to pose the question, 'Are discretionary fiscal actions helpful, or do they sometimes do more harm than good?' The best endorsement of discretionary fiscal stimulus they could come up with, based on an exhaustive multi-country study, was that '... the effects of fiscal stimulus can be positive, albeit modest.' Such faint praise contrasts with their bosses' unequivocal calls to member countries to man the fiscal barricades.

This paper argues that while discretionary fiscal stimulus packages can be effective in limited circumstances, the case against counter-cyclical fiscal policy that was built and eventually widely accepted in the latter 1970s and 1980s remains valid, and is being swept aside without justification in the current headlong rush to prop up sagging economies. Policymakers need to be much more cautious and modest in their expectations of what fiscal stimulus can achieve.

This is not an argument against the role of *automatic* fiscal stabilisers. As tax revenues and certain government transfer payments to households respond automatically to fluctuations in employment, unemployment, labour income, company profits, investment income, and so on, the budget surplus or deficit will fluctuate, and it would be wrong for discretionary fiscal policy to attempt to cancel out these effects. They are called automatic stabilisers because they work to support disposable income in a downturn and, therefore, private sector demand. They are larger than is often realised. Commonwealth tax revenue, for example, is very responsive to the business cycle.

Revised estimates released with the government's fiscal stimulus announcement on 3 February 2009 show that the automatic budgetary responses alone would have driven the Commonwealth budget into deficit in 2009–10 (though not in 2008–09). This is not, therefore, a debate about whether the Commonwealth budget should go into deficit. If the downturn is deep enough, it will and it should. Rather, what should be controversial is the part, if any, to be played by discretionary fiscal policy.

The best that can be said of the present case for active fiscal stimulus is that the conditions prevailing in some countries are more receptive to stimulatory policies than when they have been tried in the past. Fiscal stimulus is more likely to be effective and justified when inflation is not a problem and when monetary policy has broken down. In the current situation inflation, although recently uncomfortably high, is receding rapidly and there is no prospect of it re-accelerating in the foreseeable future; and orthodox monetary policy has been at least weakened, if not rendered impotent, by a break-down in the system of financial intermediation.

Even in relation to the second condition, however, there are doubts that it lends weight to the case for fiscal stimulus. The American academic and former US Treasury official John Taylor, who is best known for the Taylor rule of monetary policy and as a voice against discretionary fiscal policy, has recently commented that experience '... does not show that monetary policy is ineffective or that fiscal policy is more appropriate when the short term interest rate reaches the lower bound of zero ... Increasing money growth (through quantitative easing)—or simply preventing it from falling as in the Great Depression—remains a powerful countercyclical tool.'⁵

Another influential academic voice of caution against pump priming has been that of American economist Robert Barro. Writing recently, Barro commented that 'the financial crisis and possible depression do not invalidate everything we have learned about macroeconomics since 1936,' and that talk of multiplier effects of increased government spending is 'voodoo economics.'⁶

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Governments often get the timing wrong

The first reason for scepticism towards discretionary fiscal policy is that governments often get the timing wrong. There is a lag, first, from a turning point in the business cycle to recognising the event in terms of economic statistics. Then there are further lags from recognition to a decision to act, from decision to implementation, and from implementation to the actual impact on the economy, which is likely to be drawn out over time and unpredictable in its exact timing. The lags tend to be longer in a US type decision-making and legislative framework, which involves more political negotiation than the Westminster system, but lags are also a feature of the latter.

As well as the lags, there is always the uncertainty about the size of a downturn in the business cycle. HSBC Australia's chief economist, John Edwards, once quoted an unnamed British policy economist who remarked that the lags in data and the frequency of revisions meant that '... we not only do not know where we are going or where we are—we often do not know where we have come from.'⁷ One consequence of the lags and uncertainties is that by the time the economic impact of a stimulus is felt, the need for it may have passed or at least diminished. In the current US downturn, for example, it is likely that the second and larger instalment of fiscal stimulus will not even be enacted—let alone impart its full economic impact—until fifteen months after the downturn began. This happens to be a longer lag than the average duration of a US downturn.

The consensus seems to be that this cycle is different in that the downturn is shaping up to be so severe and prolonged that the stimulus will be appropriate even if its exact timing is not optimal. In other words, if the target is a bull's eye rather than a barn door, a bit of inaccuracy doesn't matter. Policymakers are risking a lot of their already seriously depleted reserves of fiscal credibility on that being the case. Whether or not it is the case, policy lags at the other end of the cycle will still be a problem. Governments will keep stimulating long after the economy has started to recover, if only because their economic policies will be driven more than anything else by the unemployment statistics, which are always the last indicator to turn around, long after aggregate demand for goods and services has started to recover. This prolongation of stimulus sets the scene for a new set of problems in the recovery in the form of inflation and excessive public borrowing.

Discretionary fiscal policy tends to be asymmetric and promotes growth of government

Governments are more eager to stimulate demand in a downturn than they are to withdraw the stimulus and dampen demand in an upswing. Expansionary policies are politically more rewarding, at least in the short term, before the longer term harm done by inappropriate stimulus becomes apparent.

This asymmetry gives fiscal activism a bias towards increasing deficits and public debt over the business cycle. In addition, increases in government spending in the downturn phase, even though they may be intended to be temporary, become entrenched and are validated by increases in taxation in the upswing phase, thereby lifting the size of government over the business cycle. It is no coincidence that both public debt and the size of government ratcheted up substantially during the 1970s and early 1980s, when fiscal activism was at its peak, or that the US public sector got a substantial boost from the New Deal in the 1930s.

The long-term implications of growth in the size of government comprise another topic well beyond the scope of this paper. It is relevant, however, that there exists a broad school of thought that sees growth in the size of government, beyond a point that all developed countries have far exceeded, as being harmful to the dynamics of economic growth.⁸ If one accepts this proposition, then fiscal activism, by being biased towards expansion of the size of government, tends to damage long-term economic growth prospects, whatever temporary benefits it might deliver in the short-term.

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Fiscal stimulus often involves bad public policy

The rigour of the public policy framework, never in the best state of repair, is weakened further when governments are in a rush to deliver fiscal stimulus. Bad public policy, such as subsidies to industry, 'make work' schemes, or rushed adoption of public investment options regardless of their economic and social returns, impose economic efficiency costs that need to be set against any short-term benefits of expansionary policies to the level of economic activity. Short-term boosts to aggregate demand, GDP and employment can have vastly different longer term consequences depending on the nature of the policies that bring them about. Distortional policies bring with them an 'opportunity cost' resulting from the wasteful use of resources.

There is nothing like a whiff of recession and a government spending spree to attract sectional interests, who know that their pleas for assistance are more likely to be heard and acted upon when governments are in a rush to spend. Bad policy proposals are more likely to survive scrutiny in these circumstances.

The worsening macroeconomic outlook, while not the main reason for the Australian government's recent \$6 billion motor vehicle industry assistance package, would certainly have been an influence and may have resulted in a larger package than otherwise. Similarly, the Bush administration's decision to assist the US auto industry was influenced by the short-term macroeconomic situation even though the industry's problems are essentially structural.

Back to Australia, can anyone seriously suggest that the huge lump-sum social security payments to households in December constituted good social policy, or that massively increased subsidies to first home buyers represent good housing policy? And was it wise of the Commonwealth government to grant more than \$300 million to local government, subject only to the condition that it all be spent by 30 June 2009?

Multipliers are variable and unpredictable

The ultimate effects of stimulatory policies on aggregate demand and GDP—or 'bang for the buck'—are variable and unpredictable. The stimulatory effects of cash benefits to households through tax cuts and increases in social security payments are blunted by leakages into increased saving and imports. This is especially so if the fiscal changes are known to be temporary; according to Milton Friedman's widely accepted permanent income hypothesis, household consumption depends more on expected permanent income and wealth than on temporary boosts. The multiplier effects of temporary changes are small. Taylor provides evidence that last year's temporary tax rebates in the United States had little effect on consumer spending.⁹ Permanent changes in tax and benefits are more effective provided they are fiscally sustainable.

It is often believed that increases in government direct expenditure on goods and services have higher multiplier effects than tax cuts, but even this has been called in to question. For example, Mankiw¹⁰ cites US evidence that tax reductions have larger multiplier effects than any increase in government expenditure because tax reductions are more beneficial to private investment. Increases in current expenditure are likely to be wasteful and entrenched. Increases in capital expenditure (or 'infrastructure' as it is labelled nowadays) can avoid these problems but must be subjected to rigorous investment appraisal. It is also easier to turn off the capital expenditure tap when the need for stimulus has passed. The problem with capital expenditure, however, is that the implementation lags are longer.

Barro has estimated a multiplier of 0.8 for US wartime government purchases, and one 'insignificantly different from zero' in peacetime.¹¹

'Rational expectations' work against effective fiscal stimulus

According to the theorem of Ricardian equivalence, a decline in public sector saving (an expansionary shift in fiscal policy) brings about an equivalent increase in private sector

saving (which neutralises the expansionary effect of the fiscal change). The theorem gets its name from David Ricardo's writings in 1820, but was made prominent in modern times in 1974 by Barro as a challenge to discretionary fiscal stabilisation policy.¹²

A deficit-financed tax cut or increase in government expenditure may fail to stimulate aggregate demand because the private sector, guided by rational expectations, discounts the future tax burden required to service and repay the increased public sector debt. The private sector will act on its expectations of lower future disposable income and wealth by reducing its own demand for goods and services, and its decisions on labour supply and capital formation may be influenced by the adverse incentive effects of expected future tax increases.

Barro's intervention sparked a lively debate that, like so much else in economics, has never been settled. But many economists, while stopping short of accepting full Ricardian equivalence, nonetheless see an important grain of truth in the theorem. As David Smith, a British academic economist, has put it, 'there is now considerable evidence from international studies ... that a high proportion of any increase in public borrowing is indeed neutralized by an offsetting shift in private sector savings.'¹³ And as the European Central Bank generalised in a 2005 study, 'fiscal expansions which generate uncertainty about the future course of budget policies and even jeopardise the sustainability of public finances may have an adverse impact on confidence and economic activity.'¹⁴

These warnings are surely relevant now to countries that are adding previously unthinkable annual borrowing requirements—now measured in the trillions in the United States—to public debt levels that were already high. It is not merely conceivable, but highly plausible, that US taxpayers are so fearful of the consequences of current fiscal policy for future tax burdens that they are squirreling away more than they otherwise would, and that their investment and labour supply plans are being coloured by the prospect of stronger tax disincentives.

Fiscal stimulus is offset by 'crowding out'

Ricardian equivalence is a particular case of a more general economic phenomenon known as 'crowding out.' This occurs when a fiscal expansion triggers economic reactions that work in the opposite direction to the direct stimulatory effects of the fiscal change. As Smith (2006) comments, the evidence that a high proportion of an increase in public borrowing is offset by increased private saving '... applies even if one might be agnostic as to whether this reflects, first, a rational expectations phenomenon on Barro lines or, alternatively, the upward pressure on long-term interest rates caused by official debt sales. Whatever the precise mechanism involved ... there exists a destabilizing negative feedback between the budget deficit and private sector activity and the tax base.'

Interest rate and exchange rate responses are the most commonly cited crowding out mechanisms. In contemporary conditions—with the private sector's demand for credit weakened by depressed investment and consumption activity, inflation declining, and monetary policy highly accommodative—the public sector may get away with greatly increased borrowing without putting upward pressure on long-term interest rates. This situation could change rapidly, however, once the private sector regains its appetite for borrowing. It is doubtful that governments will be agile enough to withdraw fiscal stimulus packages when that happens.

Supply side responses represent another crowding out mechanism. Expansionary fiscal measures that distort resource allocation, or harm private sector confidence in the *future* climate for capital formation and labour supply, will come at a cost to productivity and potential output in the longer term, regardless of any short-term benefits in lifting aggregate demand closer to potential output. In this way, fiscal stimulus may buy a short-term reduction in unemployment at the expense of a long-term increase in the natural rate of unemployment.

Not all discretionary fiscal policies necessarily cause crowding out. That depends very much on the starting point. If fiscal policy has been unduly tight, there are opportunities

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for a *sustainable* shift towards a more balanced fiscal stance, and if the measures adopted are non-distortional, then the fiscal expansion can be beneficial. This could be the situation in Australia. In the US, by contrast, fiscal policy was already too loose even before any expansionary measures were taken.

Private sector confidence is the key

Whatever may be the initial causes of a recession, a loss of business and consumer confidence becomes instrumental in driving the downward spiral of demand, output and employment. Equally, restoring confidence is a necessary condition for a sustained recovery.

Some advocates of fiscal stimulus appear to believe that fiscal measures can restore confidence by turning around the momentum of economic activity from negative to positive. Fiscal policy jumpstarts the economy, and private sector confidence takes over, as it were. But this view glosses over all the limitations to successful fiscal stimulus discussed above.

Throughout economic history, fiscal expansion has probably never prevented a recession, nor has it been solely responsible for a sustained recovery. Certainly Japan's experience in the 1990s leaves little basis for confidence in the power of fiscal stimulus. Confidence takes on a life of its own, and the best that fiscal stimulus can do is to reduce the scale of the loss of output and employment in a recession pending the restoration of conditions for a sustained recovery. This limited role can still make fiscal stimulus worthwhile, but expectations of its effects should be modest. At worst, fiscal laxity can deepen and prolong the loss of private sector confidence if it creates such a large fiscal imbalance that there is no way out of it without drastic action.

In the current downturn, the restoration of private sector confidence will depend heavily on a return to some semblance of normality in the banking system. Orthodox fiscal stimulus will not do the trick, but unorthodox uses of public funds to help repair the financial system may well be part of the answer. Interestingly, Alan Greenspan argued in *The Economist* on 20 December 2008 that the best way to repair the credit markets is to further recapitalise the banks, and that the use of public funds to do this (pending a return to private recapitalisation) would have more 'bang for the buck' than an orthodox fiscal stimulus of equivalent size.

Conclusion

When we are constantly being told that the global economic situation is the worst since the 1930s, it is perhaps not surprising that governments are acting in accordance with that old maxim, 'don't just stand there, do something,' and that 'something' includes discretionary fiscal stimulus. Once-cherished fiscal rules aimed at long-term fiscal sustainability are being jettisoned.

But policymakers seem to have forgotten the lessons learned in the 1970s and 1980s about the limits to effective fiscal stimulus, which led to a reassessment of the role of fiscal policy away from short-term tinkering towards long-term stability and the fundamentals for sustained growth. As set out above, the obstacles to successful short-term fiscal management are formidable. The fiscal fine-tuning of decades ago—whereby tax and expenditure policies were adjusted in an attempt to smooth out the business cycle—has been discredited and deserves the same fate as economic planning, its close relative from the same era.

In Australia, it is appropriate that the government has not resisted the budgetary effects of the automatic stabilisers. However, the government has gone much further by adopting discretionary policy measures that will cost the budget \$29 billion in 2008–09, \$20 billion in 2009–10, and smaller but still significant amounts in the following two years. Owing to the strength of Commonwealth finances carried over from the boom, the Australian government was well placed among developed countries to deliver a credible stimulus—meaning one that would not compromise underlying fiscal sustainability.

However, the stimulus measures adopted in late 2008 and early 2009 are very large by historical standards and pose a threat to future fiscal sustainability. Confidence is more likely to be harmed than assisted. The claimed justification for the stimulus rests on highly uncertain economic forecasts. The stimulus extends too far in time, with much of the impact not to be felt until 2010, when a recovery is likely to be well under way in any case.

The form of the stimulus is less than ideal, with too much emphasis on lump-sum household income supplements and direct government expenditures of dubious merit. It would have been better for the government to have accelerated desirable structural changes such as permanent tax reform that improves incentives for individuals and businesses to invest and work. As Barro says, ‘... we should avoid programs that throw money at people and emphasise instead reductions in marginal income tax rates—especially where these rates are already high and fall on capital income.’¹⁵ Any short-term stimulus from such reforms would be essentially secondary to the longer term benefits.

In the United States, which holds the key to the global downturn and recovery, the fiscal policy calculus is quite different. The public finances are a shambles, with federal debt already 40 per cent of GDP, and the Congressional Budget Office estimating that the federal deficit will climb to US\$1.2 trillion this year, even without the planned further stimulus package. The new administration has proposed a stimulus package of more than US\$ 800 billion. With this cost included, the deficit would be more than 10 per cent of GDP. In these circumstances, the stimulus will fail the credibility test; it will compound a structural fiscal weakness that portends serious problems down the track.

One plausible, but not mainstream, scenario is that as housing activity and prices bottom out and the financial system is brought back to life, the US recession will end and a sustained recovery commence before the end of 2009. If so, any further fiscal stimulus would not be worth the risk. It would come too late to pass the test of doing more short-term good than long-term damage. If, on the other hand, this recession is much worse than average and there is nothing but economic gloom as far as the eye can see, then the case for another round of stimulus could be stronger. The problem is that the US government is not well placed to deliver it. Its effects on fiscal sustainability will pose a threat to confidence. It will not address the fundamental problem, which is the financial system break-down and credit crunch. At best, further fiscal stimulus will soften the blow of the downturn pending the revival of the financial system.

There are many reasons for us not all to be Keynesians again, even if we all were—as Nixon and others asserted—forty years ago. The challenges to short-term fiscal activism in the intervening period were profound and have not been overturned by the current global economic debacle. Discretionary fiscal stimulus can be beneficial in some circumstances, but the obstacles to its successful use are formidable, and the benefits at best modest. It can soften a downturn, but it will not bring about a sustained recovery.

At best, further fiscal stimulus will soften the blow of the downturn pending the revival of the financial system.

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