Monetary and Fiscal Policy
Fiscal Policy: Alternative Approaches

New Keynesian and New Classical Approaches to Fiscal Policy

Now we're ready to enter one of the big debates of macroeconomics. Does fiscal policy work? For a lot of this century the government policy of the United States has been driven by the ideas of John Maynard Keynes, who argued that government spending can pull the economy out of a recession and reductions in government spending or increases in taxes can slow the economy down when it's overheated.

During the 1950's and 1960's in this country, government policy, fiscal policy, government spending and taxes were pretty much driven by the ideas of John Maynard Keynes. Now, developments in the 1970's calls Keynes' wisdom into question. Things that were going on in the supply side, supply shocks, oil price increases gave us stagflation and made Keynesian policy appear relatively ineffective, or in some cases Keynesian policy seemed to actually worsen the problems of the economy. Nowadays the big debate in macroeconomics is whether fiscal policy can be effective at all, that is, does Keynes' idea still hold sway in the new millennium? Or have new ideas about economics, ideas that are based more on the disciples of Adam Smith, the spontaneous adjustment of prices and wages to clear markets; ideas about macroeconomics that are more closely based on macroeconomics. Those ideas seem to have captured the imagination of a lot of macroeconomists.

So what we're going to do in this discussion is look at why Keynesian ideas about fiscal policy may, in fact, not work, and then at the end of the discussion come back and talk about how the new Keynesians are defending their ideas against the new classical economists.

So let's start with the new classical view. Why might it be that an outward shift in the aggregate demand curve that comes about when the government spends more money or cuts taxes, why might it be that this outward shift in the aggregate demand curve does not, in fact, have the effect of stimulating the economy and leading us to a new higher output level Y1? Why might that not happen? Well, there are two reasons to believe that aggregate demand outward shift would not, in fact, have the desired result.

The first is that the short-run aggregate supply curve may, in fact, adjust so quickly that the economy is pulled right back to full employment. If the short-run aggregate supply curve begins to shift upwards because we are above full employment, then prices are going to tend to rise. If that adjustment process occurs very rapidly because of rational expectations, then the short-run aggregate supply curve moves immediately to its long run position, the price level rises to compensate for the extra demand that the government has pumped into the economy and there's no real change in output. Now there may be some change in the composition of output because we're going to have crowding out, but there's no stimulation of the economy. When the government spends more, prices rise flexibly and we never leave the green line. This is the view of macroeconomics that's based on micro, which is that prices rise immediately to eliminate excess demand or fall to eliminate excess supply.

The second reason why the new classical economists argue that fiscal policy is ineffective is that prices and wages adjust very, very quickly to eliminate excess demand, therefore we can't hang out at a point like Y1 where outputs beyond full employment because prices will simply rise until we get back to the green line, kind of like a shortage of onions doesn't persist because the price of onions goes up until the quantity supplied is equal to the quantity demanded.

So the first reason why the new classical economists argue that fiscal policy is ineffective is that prices and wages adjust very, very quickly to eliminate excess demand, therefore we can't hang out at a point like Y1 where outputs beyond full employment because prices will simply rise until we get back to the green line, kind of like a shortage of onions doesn't persist because the price of onions goes up until the quantity supplied is equal to the quantity demanded.

The second reason that the new classical economists believe that fiscal policy is ineffective is that if people are rational and forward looking, then what's going to happen is people think about the government budget. They say, "Huh! You know, the government's spending more money which means that eventually they're going to have to raise more taxes to pay off their debt, that means coming soon is more tax burden for me and I better start saving money right now to have the money in the bank to pay the taxes when the government finally gets around to increasing them." What happens then is that every dollar that the government spends in additional money is a dollar that consumers are going to reduce their spending to put the money in the bank so that they'll be prepared to pay the taxes when they come due. This is a very, very hyper-rational view of the way people think about the future, however in the new classical world, that's exactly what people do. People are forward looking and then they see that an increase in government spending is going to lead eventually to an increase in taxes so they prepare for it now by reducing their spending accordingly. Well, what happens in that case is the aggregate demand curve doesn't shift out
at all. The government tries to shift it out, but people know that taxes are coming, so they shift it right back by reducing consumer spending so the aggregate demand curve never leaves its initial position and nothing happens, nothing at all. No crowding out, no adjustment in prices. People simply increase their savings to match the increase in government spending. So there you have it, the new classical view, a world in which people are rational and forward looking and a world in which wages and prices can adjust freely to clear markets. One of two things happens. Either the government spending increases aggregate demand and prices undo the effect or the government tries to shift aggregate demand outward and people undo the effect by saving in anticipation of higher future taxes. No effect for fiscal policy, no effect in the short run because there really is no short run. Prices adjust too quickly and, again, no effect in the long run because you're going to be at full employment always in the new classical view of the world.

Now how do the Keynesians answer this? The Keynesians answer this first of all by saying, well, wages are sticky. Wages are sticky for several reasons. They're sticky because of labor contracts that are negotiated by unions where the wages have to stay constant over a period of time. They're also sticky because of efficiency wage arguments that companies don't change their wages for fear of losing their best workers or for fear of not paying their workers enough to be able to afford good nutrition and adequate leisure to be productive and also the consequence of motivation. You pay a high wage simply to keep your workers showing up on time and doing the best work. So wages stay fixed because they're not purely driven by the need to make supply and demand for labor equal. There are other things that the wage does that influence the quality of labor and therefore, wages don't change to clear the market the way other prices do.

Well, if this is the case that wages are held fixed by institutional constraints like labor contracts negotiated by unions and other productivity constraints as in the efficiency wage story, then wages are sticky so when the aggregate demand curve shifts outwards with increased government spending, we will move along the short-run aggregate supply curve and it won't start shifting upwards until something else changes. It may not shift upward at all if the efficiency wage considerations are really binding and if labor unions have held the wage constant in the short run, it may be a while before the adjustment process starts. So the new Keynesians say that if you can shift out the aggregate demand curve, aggregate output will increase at least until wages can adjust and that may take a long time and it may not ever happen if efficiency wage considerations are very, very strong.

So there you have it. We've restored Keynes' power in a kind of sophisticated way by saying labor contracts and efficiency wage considerations give us sticky wages and this was the argument that was made against Keynes back in the 1930's when he first wrote that wages are sticky because of things that are additional considerations in the labor market that may not apply in the market for onions or the usual supply and demand situation.

Finally, there's this thing about how do we get the aggregate demand curve to shift outward if people anticipate higher taxes in the future and one answer that the new Keynesians would give to this is that people are liquidity constrained, that it's easier for the government to borrow money than it is for households to borrow money. So if the government gives you a tax break today, they've effectively lent you money and you're going to go out and spend more. Sure you know that taxes are coming in the future, but it's easier for the government to borrow money and give it to you in the form of a tax cut than it would be for you to go to the bank and get the same loan. The government gets a better interest rate, the government has a better credit rating and all of that. Therefore, tax cuts, even though you know you have to pay it back in the future, does stimulate your consumption because the government can borrow at a better rate than you can.

Well, there you have it. The two sides keep arguing with each other and if I haven't come down on one side or the other, it's because I want you to appreciate that the argument is kind of complex. Every year macroeconomists dig their ditches deeper trying to decide whether, in fact, Keynes' ideas can be justified in a world where information flows rapidly and contracts can be renegotiated. Are there reasons why the stickiness of wages might persist even in a very rational economy? And if that's the case, then Keynesians' policy prescriptions still have some validity. On the other hand as we move into a world where online auctions and instant stock market quotes and everything tends to cause prices to change constantly all day. As prices become more flexible, we seem to be more in the world of the new classical economists where you wouldn't expect for dis-equilibrium or imbalances to persist. Therefore these blue curves most instantly. People are rational and forward looking and in that world it seems less likely that anything the
government does would actually be able to move the economy away from its full employment level. So there you have it, the debate between two camps of macroeconomists. One side that follows the thinking of John Maynard Keynes, sticky wages give fiscal policy power and the disciples of Adam Smith, the new classical economists who say that rapid adjustment of wages and prices means that the economy always has to be at full employment and it finds some way to get there. If people are forward looking and rational and prices are flexible, then fiscal policy is ineffective. These two sides will probably keep arguing for some time.