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Introduction

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From October 12 to 13, 1984, the Federal Reserve Bank of St. Louis held its ninth annual economic policy conference. The topic of this conference was "The Monetary versus Fiscal Policy Debate: Lessons from Two Decades." This volume consists of papers and comments presented at that conference.

The debate among economists about the relative usefulness of monetary or fiscal policy actions has taken many forms over the past 20 years. The policy discussion began with a small number of studies showing that money growth was more reliably related to income growth than autonomous consumption. Today, it encompasses a vast body of empirical research, including recent investigations into the channels by which policy effects are transmitted to the economy.

The nature of the monetary versus fiscal policy debate generally has been an empirical matter. The relative ease with which one can substitute various policy measures to test their impact on economic activity has attracted many scholars. As a result, conferences such as this usually have been replete with regression output that pits one version of the so-called St. Louis equation against another.

In the papers assembled for this conference, we have explicitly avoided yet another confrontation between competing regression results. Rather, the intent of this conference was to stand back and examine the impact of the debate on the general direction of macroeconomic theory from alternative perspectives. The central theme around which the papers were built is the question "What have we learned?"

Part I of the book focuses on the development of the debate by investigating different technical aspects and the changes with regard to the basic theoretical issues. Part II examines the development of fiscal policy analysis during the past two decades. Part III contains papers that view the debate differently from the norm—namely, from public choice and rational expectations perspectives.

Part I

In "Monetary versus Fiscal Policy Effects: A Review of the Debate," Bennett T. McCallum, professor of economics at Carnegie-Mellon University, explores several key technical issues that have developed since the late 1960s. Focusing on the arguments raised against the reduced-form approach to measuring the relative impact of monetary and fiscal actions on nominal GNP, McCallum notes that an issue of continuing interest concerns the possible endogeneity of policy actions. Because such endogeneity may produce distorted empirical estimates of policy effectiveness, McCallum provides some preliminary empirical estimates based on procedures that attempt to reduce this effect. In doing so he finds that the summed effect of the money growth coefficients is about one, and that the cumulative value of the fiscal coefficients is approximately zero. The author argues that further work in this area should attempt to investigate the endogenous policy effects that may influence empirical estimates.

McCallum also reviews the conflicting evidence about the relative size of the monetary and fiscal policy multipliers, the evidence obtained by comparing the small reduced-form model results to those derived from large, multiequation macro models, and recent evidence from vector autoregression (VAR) models. In general, he argues that the evidence does not refute the contention that monetary actions are more important than fiscal actions in explaining the behavior of nominal and real GNP. Moreover, McCallum demonstrates that, in a Ricardian economy in which individuals incorporate the government's budget constraint in their future saving–consumption plans, a money-financed increase (decrease) in expenditures (taxes) stimulates aggregate demand more than a bond-financed increase.

Part II

Karl Brunner, director of the Center for Research in Government Policy and Business and professor of economics at the University of Rochester, provides an extensive analysis of the evolution of fiscal policy analysis during the past two decades in his paper "Fiscal Policy in Macro Theory: A Survey and Evaluation." Using the multiplier effects on aggregate demand and economic activity, he traces this evolution from the early discussions that focused on the impact of fiscal actions. This view, which dominated the professional macroeconomic literature during the 1940s and 1950s, was challenged by the perception of market failure inherent in the Keynesian view and by early monetarist work that presented empirical analyses of the relative impacts of fiscal and monetary impulses on the economy.

Brunner notes that this early empirical testing demonstrated the confusion over the appropriate implementation of theoretical Keynesian stabilization policies. The "reduced-form" equations approach, Brunner asserts, was a useful step in empirically testing competing hypotheses. As he notes, the evidence did not directly test the income–expenditure framework per se, but it provided a useful way of testing hypotheses that emerge directly from that framework. This empirical assault on Keynesian policy prescriptions of the pre-1960s clearly altered the notions that fiscal policy is the active component of stabilization policy, and that monetary policy plays only an accommodative role in the context of an interest rate strategy.

Although the monetary versus fiscal actions debate continues, the extent of the empirical charges and countercharges has diminished considerably from its late 1960s level. This, Brunner notes, results from a more general acceptance of the role of money as the dominant impulse in policy actions. More significant, however, in terms of the change in fiscal policy analysis, is the recent emergence of the "neoclassical" contribution to policy analysis.

Brunner extensively evaluates the emergence and impact of the rational expectations approach on the profession's perception of the significance of government actions. Citing the influential work of Robert Barro, he also examines the nature and relevance of the so-called Ricardian theme. Although Brunner acknowledges the clear limitations of this approach, he recognizes that it has opened a new dimension into fiscal analysis. In this context, the recent increased interest, both public and professional, in fiscal processes stems from this research agenda.

In concluding his paper, Brunner raises the concern about the efficacy of an activist policy. Although our knowledge has progressed from that of two decades ago, he argues that we still do not possess adequate information about the dynamic interrelationships that exist in the economy. Moreover, echoing an idea expressed by James Buchanan (see Chapter 5), he asserts that it is not clear that such knowledge would be sufficient to yield socially successful policy actions. Fiscal activism, Brunner concludes, may well produce inefficiencies greater than those that the policies were designed to control.

In commenting on Brunner's paper, Alan S. Blinder, professor of economics at Princeton University, argues that the depiction of Keynesian theory as disdainful of the effect of monetary impulses is inaccurate. Recalling his undergraduate days at Princeton in the early 1960s and citing from Samuelson's text for support, Blinder contends that monetary policy and money were in fact viewed as important by Keynesian macro theories of that time.

Blinder also argues that the notion that simple correlation analysis provides an effective hypothesis testing procedure can only hold under very restrictive conditions. This criticism applies to the use of reduced-form type of models in which nominal income is explained by fiscal and monetary actions. If the policy measures are orthogonal, then one may decompose the variance of income growth into the variances of fiscal actions, monetary actions, and an error term. Once fiscal and monetary policies are set by policymakers to offset movements in income, however, this orthogonality condition does not hold. Because of the covariance between fiscal and monetary actions, estimates of each policy tool's effect on income may be grossly inaccurate.

On the issues of the government budget constraint and the Ricardian equivalence theorem, Blinder generally agrees with much of Brunner's analysis. He does argue, however, that there is evidence that, properly estimated, the monetary authority does "monetize the deficit." His analysis of the data suggests that larger deficits do cause faster growth in back reserves, although the effect is relatively small in magnitude.

Robert J. Gordon, professor of economics at Northwestern University, also provides comments on Brunner's paper. Like Blinder, Gordon argues that Brunner's description of the early monetary versus fiscal policy debate is misleading. Gordon notes that the evolution of the policy prescriptions should not be studied without explicit reference to the events of the time. For example, he cites the weak economic recovery occurring during a period of rapid money growth during the late 1930s that discredited the role of monetary policy among many economists. Also citing from one of Samuelson's early editions, Gordon produces numerous quotes to support his contention that monetary policy was not ignored by early Keynesians. The declining importance of activists' fiscal policy arguments and the rise of monetary policy's importance during the late 1960s and early 1970s also reflect the events of time and supporting empirical evidence: the growing importance of the Friedman–Phelps natural rate hypothesis and the empirical results reported by Andersen and Jordan are two mentioned in the discussion.

Gordon also finds the importance placed by Brunner on reduced-form spending equations to be curious. He references the work of Blinder and Goldfeld and his own research wherein the estimated coefficients derived from standard "St. Louis equations" are shown to be biased. In this vein he reports that some of his recent research suggests that there is empirical support for the notion that innovations in the money supply and autonomous innovations in structures investment have an impact on the business cycle.

In his comments on Brunner's Ricardian equivalence theory discussion, Gordon takes the position that much of the empirical work, using reduced-form consumption equations, on this question is unlikely to provide reliable evidence. Some of his objections to such estimations include the following: the inclusion of government spending and tax revenues as explanatory variables resurrects the Goldfeld and Blinder criticism; such equations generally do not properly account for lags between changes in taxes and spending; there is no distinction between permanent and temporary tax changes; and more. With these criticisms, Gordon argues that Brunner's emphasis on these tests seems misplaced.

Part III

The papers that make up the third part of this book provide an alternative view to assess the successes and failures of the monetary versus fiscal policy debate. In his paper "Can Policy Activism Succeed? A Public Choice Perspective," James M. Buchanan, director of the Center for Study of Public Choice and professor of economics at George Mason University, poses the question "Can any activist policy, monetary or fiscal, succeed within the existing institutional–constitutional framework?" He points out that concepts of "success" and "failure" in macroeconomic policy require some preconceived notion of society's preference for certain policy outcomes. Even under the most simple of models, however, Buchanan concludes that policies most often will be deemed failures by society.

This viewpoint is based on the notion that, in the absence of a well-defined set of rules establishing policy parameters, policymakers are likely to be more responsive to pressure for short-term rather than long-term solutions. In this vein, Buchanan notes that the removal of viable constraints on the actions of monetary authorities under a pure fiat money regime produces predictable outcomes of expansionary policy actions.

Buchanan's analysis of the setting of monetary and fiscal policy leads him to conclude that unless institutional–constitutional constraints can be enacted, the success of macroeconomic policy is doubtful. In the area of fiscal policy he contends that the reduction or removal of budgetary manipulation precedes a genuine hope for achieving success in macroeconomic policy. In this context he makes an argument for the constitutional rule enforcing a balanced budget. Similarly, Buchanan argues that monetary policymakers' discretionary power also should be limited by binding policy rules, such as Milton Friedman's money growth rule, a price rule, or a rule based on a self-regulating commodity base.

In the last chapter, John Taylor, professor of economics at Stanford University, presents a rational expectations outlook of the debate in his paper "An Appeal for Rationality in the Policy Activism Debate." Taylor notes that, during the past decade, the monetary versus fiscal policy debate was largely supplanted by the so-called policy ineffectiveness debate. Essentially based on discussions of the models of Lucas, Sargent and Wallace, and Barro, the policy debate evolved from the monetary versus fiscal policy issue to the issue of whether any policy could be effective in manipulating macroeconomic variables when economic agents are rational. As this debate progressed, it was discovered that the policy ineffectiveness results were based on certain assumptions in these models.

The effect of these findings, Taylor notes, was to turn the discussion away from the issue of policy ineffectiveness and back to the numerous remaining areas of the debate. For example, how does one deal with the problem of lags and uncertainty? How does one implement an activist policy rule? Although these (and other) issues remain unresolved, Taylor argues that the current state of the policy activism debate is one in which there is no operational structure specific enough to be used in resolving disagreements. In this context he suggests that the rational expectations approach, which the author outlines in five general principles, could provide such a suitable framework to evaluate alternative policies.