

# Is Fiscal Policy Dead?\*

## I. Introduction

Writing in the well known first *Survey of Contemporary Economics* published thirty years ago for the American Economic Association, Arthur Smithies (1948) began his comprehensive article "Federal Budgeting and Fiscal Policy" with the words: "Under the impact of depression and war the theory of the relation of fiscal policy to the working of the national economy has made great strides. While important details remain to be worked out and formulations can be made more elegant, the theory is well advanced." Smithies was certainly one of the first writers to emphasise the political and administrative limitations of implementing fiscal policy as a means of achieving economic stability, which are discussed later in this paper. However, there is a ring of optimism in his opening paragraph which today would sound strange to both economists and policymakers, though it rang true at the time to his fellow macro-economists.

Not only has confidence waned in the ability of fiscal measures to secure macro-economic goals, but in addition it has been argued that where fiscal changes exert noticeable and significant impacts they may do so in a distinctly perverse and de-stabilizing manner.<sup>1</sup> In short, the question now confronting the policy administrator, is whether fiscal policy may usefully be included in the armoury of countercyclical weapons wielded in defence of short-term stabilization goals?

This changed status of fiscal policy has stemmed partly from

---

\* This article reflects the governmental and consulting experience of the authors but in no way commits any erstwhile sponsors.

<sup>1</sup> One variant of this argument has been the claim that budgetary deficits to stimulate employment must ultimately reveal themselves in an equivalent balance of payments deficit for an open economy regardless of whether the exchange rate is permitted to float or not. The issue is closely related to the case for import controls. See GODLEY (1976) and ELTIS (1976).

developments in theoretical economics generally on the one hand, and also from a changed view of the government objective function upon the other. With regard to the latter, the control of inflation — in conjunction with its balance of payments implications — has become the overriding policy objective in many countries and here, it has been alleged, restrictive fiscal policy may paradoxically exacerbate the rise in prices. Secondly, modern macro-control explicitly takes cognizance of an objective function which is multidimensional and consequently of the need to derive the appropriate policy mix in which the fiscal instrument is but one factor and may even be the relatively minor factor.<sup>2</sup> In addition, it is now generally admitted, by even the staunchest advocates of fiscal intervention, that the earlier Keynesian models to which the fiscal variables were related, were extremely *simpliste* and generated an unrealistic degree of confidence in the *precision* of fiscal control. The adoption of naive assumptions concerning the size and stability of the relevant coefficients together with a regrettable tendency to ignore the problems posed by lags in effect and dynamic disequilibria, resulted in undue reliance being placed on discretionary policy generally and on fiscal intervention in particular. Finally, the relevance of fiscal policy control has been sharply questioned by a number of studies which have sought to assess empirically the contribution of fiscal measures to stabilization goals — both absolutely, in terms of whether their net impact was stabilizing or de-stabilizing, and also relatively, in terms of their comparative performance alongside monetary control. Some of the former studies (e.g. Prest 1968) are notable for their conclusion that fiscal policy has been on balance de-stabilizing in the United Kingdom in recent years — an economy, it may be noted, where the parliamentary structure allows fairly rapid enactment and implementation of fiscal changes — whilst the latter (e.g. Keran 1969) have often concluded that the fiscal influence was virtually imperceptible in relation to its impact upon GNP. These studies are by no means conclusive; the former have generated a certain amount of controversy over how fiscal measures should be assessed (Worswick 1970, 1977), whilst the latter have frequently been criticised for

<sup>2</sup> Thus for example, it has been argued that monetary measures are superior to fiscal in the pursuit of short-term *external* stabilization goals upon the ground that they exert a more direct impact upon interest rates which may benefit the capital account of the balance of payments. For this related argument see MUNDELL (1962). For a critique of the underlying rationale see especially WILLIAMSON (1971).

dependence upon an econometric technique which is methodologically questionable and which may contain an inherent bias against the assessment of the fiscal impact.<sup>3</sup> At the same time, they have doubtless influenced present day attitudes to fiscal intervention and particularly the general feeling of agnosticism which now prevails.

## II. The "Success" of Fiscal Policy

In part, the downgrading of fiscal policy stems from a false view of its pretensions. Traditionally, fiscal policy has adopted a uni-dimensional view of the objective function perceiving its role to be the maintenance of that level of demand consistent with full employment.<sup>4</sup> The experience of the Second World War demonstrated that governments could command maximum usage (though not necessarily efficient usage) of available resources by sanctioning deficit financing whilst physical and other controls could be used to contain adverse side effects. The post-war years witnessed the gradual dismantling of controls and a tentative liberalisation of international trade; yet neither influence affected the status of fiscal policy, though its strict Keynesian version was considered too static by Dutch and Scandinavian economists, and was rejected out of hand by German economists of the influential Freiburg School.

Despite the fairly general expectation of a marked post-war slump, fiscal policy seemed adaptable enough to promote full employment with only modest inflation rates, and balance of payments difficulties reflected primarily the failure of international liquidity to expand in line with world demand rather than any fundamental defect of policy. Thus the conventional wisdom became one in which the authorities could so "fine tune" the economy to meet macro-economic

<sup>3</sup> We refer here to the so-called 'reduced form approach' which relates the change in the endogenous variable to be controlled to the exogenous policy variable which we are trying to assess. The validity of this approach depends crucially upon the policy variable being exogenous — and not itself a function of changes in the endogenous variable — and also on being subject to fairly frequent change so that statistically meaningful regression results can be obtained with respect to the changes in the endogenous variable. It should perhaps be noted that on occasions the reduced form approach has indicated the comparative superiority of fiscal over monetary influences; on the latter point see ARTIS and NOBAY (1969) and FRIEDMAN (1977).

<sup>4</sup> Accordingly the emphasis was focussed on *real* variables rather than on nominal magnitudes, price changes, expectations of price changes and problems of money illusion, and on the short run. The 'side effects' of fiscal intervention, e.g. budget deficits were accordingly minimized.

goals by a conscious policy of demand management. In the United Kingdom particularly where the political and institutional framework conferred considerable discretion on the government of the day with respect to tax and expenditure changes, demand management became identified with fiscal policy.<sup>5</sup> Inevitably, the experience of the last few years, when substantial and rising unemployment has coincided with accelerating inflation and when the world monetary mechanism teetered on the verge of collapse, has culminated in a re-examination of the claims of fiscal policy.

First of all, it has been claimed that the maintenance of full employment in the post-war period was less the consequence of sophisticated fiscal policy rather than the simultaneous occurrence of rapid technical change promoting a marked growth in world demand and consequently a strong secular tendency for labour to become scarce relative to capital inputs.<sup>6</sup> Secondly, increasing attention has been accorded to the views originally propounded by Tinbergen (1952) that any one policy measure is normally insufficient to optimise an objective function containing more than one argument. Macroeconomic policy then becomes primarily a question of identifying these arguments, and of devising the appropriate instruments to attain them. Efficient policy-making requires that the instruments be allocated to the argument upon which they exert their maximum impact. If policy objectives conflict, then priorities have to be specified; equally it follows that decisions are being taken with respect to the policy instrument. Thus one reason for contemporary scepticism of fiscal policy is the fact that, at the margin, inflation has temporarily superseded employment in the specification of the government objective function and that, under the influence of the monetarist revival, monetary policy is considered to be more effective in the control of inflation.<sup>7</sup>

Finally, the ability of fiscal policy to deal with the employment

<sup>5</sup> In the United Kingdom, the peculiar position of sterling frequently necessitated recourse to 'stop-go' policies which invariably included a raising of interest rates to protect the external account. Nonetheless, such monetary influences were looked upon as reinforcing the fiscal measures.

<sup>6</sup> In the United Kingdom, for example, MATTHEWS (1968) has argued that, on balance, post-war fiscal policy has been contractionary. But see the criticisms of this thesis by STAFFORD (1970).

<sup>7</sup> Indeed in the extreme monetarist view fiscal policy is important only to the extent that it brings about significant changes in the money stock. Tax and expenditure changes are merely the means whereby the monetary authorities can render the money supply exogenous for policy purposes.

objective has in all probability declined in recent years as the nature of unemployment itself has undergone change. Whereas the unemployment of the depression years, for example, was clearly related to deficiency of demand, the current unemployment, at least in the U.K. and EEC countries, is much more of a structural nature and is related to the secular decline of labour-intensive activities. In short, it is probable that in the past too much has been claimed for fiscal policy intervention engendering unrealistic expectations as to what it may achieve in the long run. Rather like the old fashioned Quantity Theory of Money, traditional fiscal policy promised too much, too precisely and too universally. Its temporary eclipse seems not only inevitable but also essential to its revival and resurrection.

### III. Taxation and Inflation

In an inflationary setting, one of the fiscal policy recommendations to be derived from simple Keynesian model analysis is an increase in the level of taxation — either direct or indirect. In either case, a decrease in the level of aggregate *real* demand is indicated and the inflationary gap is progressively eliminated as the rate of taxation is increased. Indeed, the notion that tax increases may unintentionally give rise to added inflation has been one of those popular textbook economic "heresies" frequently presented in order to test the logical skill of economics students. The conclusion that tax increases are necessarily deflationary in real terms is irrefutable within a comparative static framework, with the usual *ceteris paribus* assumptions, but it is by no means clear that the same conclusion applies in a dynamic setting. It is necessary to enquire into the probable response pattern of those who are subject to the tax change and the implications for the wage-price spiral, with respect to both direct and indirect taxes.<sup>8</sup>

Taking indirect taxes first, where the presumed connection between higher tax rates and inflation seems more apparent, it is hardly in dispute that such taxes are likely to have an immediate

<sup>8</sup> We are not concerned here with the issue of the *comparative* effectiveness of *equal yield* direct versus indirect taxes. The traditional conclusion, namely that indirect taxes exert a greater real deflationary impact when compared to equal yield direct taxes, BROWN (1950), has recently been criticised on a number of points. See especially, PEACOCK and WILLIAMSON (1967), PESTON (1971) and FORSTER and SHAW (1976).

impact upon cost of living indices. Indeed, if this were not the case, they would presumably have little relevance to the need to cut real consumption expenditures during inflationary periods. This immediately raises the question: what is the relevance of cost of living indices to the wage price spiral? In the private sector the evidence is unmistakable enough; trade unions gear their wage demands not solely to productivity changes — which would provide the basis for justifying an increase in real wages — but also to changes in the retail price index which clearly affects the real value of pay.<sup>9</sup> Likewise, in the public sector many countries have experimented with wage agreements which link the remuneration of employees to discrete changes in the cost of living. Moreover, “fixed income” recipients may also benefit from government protection against inflation. In the United Kingdom, for example, the government has recently undertaken an annual review of old age pensions, with the express intention of preventing a decline in the real value of the pension received. Similar safeguards also apply to retired public sector employees. This means, *inter alia* that indirect tax changes which raise cost of living indices, not only induce more militant trade union activity within the private sector but also imply future outlays for the central government which reduce and may even negate the intended operation of the tax multiplier.

Similar conclusions emerge with regard to direct taxes. Modern personal income tax systems almost invariably include a progressive element if only because of exemption limits so that marginal tax rates exceed the average rate. This fact takes on added significance when it is realised that trade unions will rationally bargain not for a given real gross wage but rather for a given *disposable* income in real terms. If this is the case, it follows that any attempt to maintain the customary growth in real living standards intact during inflationary conditions will lead to demands for gross wage increases which exceed, in percentage terms, the rate of inflation. Moreover, it also follows that if the government raises the marginal rate of income tax to combat inflation, it also leads to a raising of the wage demand necessary to maintain the growth in real living standards intact. Hence inflation rates of, say, ten percent annually become accompanied by wage demands closer to twenty percent.

<sup>9</sup> The existence of an upward bias in the consumer price index would imply an added impetus to the inflationary spiral (NOE and FURSTENBERG 1972).

This notion, that trade unions bargain for a given disposable income, or at least try to protect the real value of “take-home pay” in periods of inflation, also seems relevant to the revival of interest shown in the Phillips curve when the latter is modified to take account of inflationary expectations. Sophisticated versions of the Phillips Curve postulate that the relationship is dynamically unstable so that the Curve is continually shifted outwards over time as trade unions adapt their strategy to the pace of inflation (Laidler 1971). Once more, the rationale for this view is based upon the assertion that labour bargains for a real wage as opposed to a nominal wage, but this time displays a certain agility in being able to learn from experience. Suppose, however, that labour is more concerned with the more limited objective of maintaining a given disposable income in real terms. In this case, not only is it necessary to correctly anticipate the future inflationary trend, but it is also necessary to pay due regard to the implied marginal rate of tax before striking the wage bargain. Two distinct issues are involved. First, the more progressive the tax structure the more labour will have to raise its nominal wage demands to keep real disposable income constant in periods of inflation. In this connection, it should be noted that even when the nominal rate structure reveals little progressivity, the implicit tax structure may be steeply progressive if nominal wage increases imply the loss of means-tested benefits. Secondly, it implies that a raising of the marginal rate of tax, undertaken as an anti-inflationary device, also automatically raises the Phillips relationship. Just as there exists a distinct Phillips Curve for each and every level of expected inflation, so too there will be a distinct Phillips relation for each and every level of marginal tax rates if our assessment of union motivation is correct. The implied association between the progressivity of the tax structure and the wage-price spiral is of interest when it is recalled that more progressive fiscal structures have often been advocated as a means of increasing the degree of automatic stability incorporated into the budgetary structure.

#### IV. Government Expenditures and Inflation

So long as major industrial countries are preoccupied with inflation coupled with high unemployment, it is apparent that traditional remedies in the form of tax rate increases are not likely to work.

What, then, of alterations in the amount and composition of government expenditure? At first sight the technical case seems watertight and the traditional Keynesian fiscal policy model might still be viable, for a reduction of government expenditure, on goods and services at least, has both greater leverage than equivalent tax changes and has no repercussions on the wage-price spiral. Unfortunately, growing attention to behavioural reactions to fiscal measures throws doubt on this case also. In the first place, reduction in government expenditure on goods and services must reduce the demand for labour, and is therefore likely to be incompatible with the employment objective. Secondly, certain forms of government expenditure, such as education and health services, may be considered by wage earners as part of their real wages, and if we extend the argument to transfer expenditure, wage earners may feel their life-cycle earnings are threatened if social security benefits are reduced in real terms. It is uncertain if the associated cuts in real wage form an important element in wage bargaining in specific sectors of the economy, but wage earners as voters are likely to resist cuts in the "social wage" produced by reduced government expenditure. Thirdly, even if such resistance is not encountered, it is conceivable that cuts in government expenditure in services which are also provided by the private sector may have a substitution effect which increases demand for these alternative private sources of supply. Thus it has been argued by Bailey (1971) that standard Keynesian macro-economic theory ignores the possibility of substitution between private and public consumption.<sup>10</sup>

The problems associated with expenditure changes do not end with questions concerning the dimensions of Keynesian theory. Once the objective function becomes multi-dimensional, including such arguments as social justice (as reflected for example in some optimal income distribution) and efficiency in resource use, then constraints on large-scale alterations in the size and composition of government expenditure begin to multiply. Indeed, one of the earliest objectives voiced against Keynesian fiscal policy was based on the "economic waste" associated with stopping and starting investment projects in such a way as to conform with attempts to reduce the amplitude of the business cycle.

<sup>10</sup> But see criticisms of Bailey's thesis by PEACOCK (1972) and AULD (1973).

## V. Post-Keynesian Theoretical Developments

As previously indicated in the introduction to this paper, the status of fiscal policy has been profoundly altered by developments in economic theory which called into question the more elementary Keynesian models to which fiscal policy recommendations were related. Of particular significance has been theoretical work on the determinants of consumer behaviour, supported in part by empirical findings, which has questioned the extent to which consumption is related to measured disposable income. Arguing that the marginal propensity to save out of recorded income is decidedly high, the permanent income hypothesis of consumer behaviour concludes that tax induced changes in recorded disposable income, undertaken as a compensatory measure, would have a minor impact upon the level of consumption. Although this argument need not apply to expenditure changes<sup>11</sup> it limits fiscal policy as policymakers will probably favour tax changes which are more flexible and more sensitive: in particular, it implies that tax changes denoted or regarded as exceptional and temporary will be ineffective as a means of curbing inflationary tendencies.

By far the most severe theoretical assault upon the potency of fiscal policy has sprung from those economists who stress the monetary and/or wealth effects of fiscal intervention. Stated briefly, they characterise the simple Keynesian model analysis as naive in focussing only upon initial impacts and ignoring other consequences which may negate or "crowd out" the fiscal stimuli. This debate, analysed mainly within the context of a budget constraint,<sup>12</sup> highlights the nature of the division between monetarists and neo-Keynesians. Consider for example, an increase in government expenditure upon goods and services in order to alleviate unemployment. How is this increase in demand to be financed? If the necessary funds are obtained by taxation then private sector spending will be curtailed accordingly and all that has occurred is a displacement of private by public expenditure.<sup>13</sup> In contrast, if the increased outlay is financed by

<sup>11</sup> See SUMNER (1974).

<sup>12</sup> Amongst the more important contributions are BLINDER and SOLOW (1973), CHRIST (1968), HANSEN (1973), SILBER (1970) and STEINDL (1974).

<sup>13</sup> Although following the balanced-budget theorem discussions, some expansionary impact may occur to the extent that part of the additional taxes are paid from savings. In addition, the changed composition of demand may be directed towards labour intensive output.

expanding the money supply there is no offset to the increased demand for goods. Indeed, the monetary expansion reinforces the fiscal action as the income recipients of enlarged Government outlays find their money holdings increased. With a stable demand for money function they enlarge their expenditures and add to demand.<sup>14</sup> Monetary-financed fiscal action is accordingly more potent than tax-financed expenditures. On this point both monetarists and Keynesians would undoubtedly agree; where they would differ is that the former would insist that little net effect would occur in the absence of the monetary change. Keynesians, however, point to a third means of finance — the issue of government debt in the form of bonds. By making the yield attractive, the government can induce the private sector to give up idle cash holdings in exchange for bonds, the proceeds of which finance the government outlays. In addition, interest payments upon the debt raise private sector disposable incomes and generate a further increase in private sector outlays. Hence the rationale for the Keynesian proposition that fiscal policy can effectively influence the level of real output and employment without necessarily generating excessive monetary expansion.<sup>15</sup> The Keynesian statement expressly ignores wealth effects. If the public look upon the acquisition of new bonds as an increase in net wealth and increase their demand for money accordingly the impact of government expenditure is again crowded out as the adjustment to optimal money holdings occurs at the expense of consumer outlays.<sup>16</sup> The existence of and strength of alleged wealth effects is still far from being empirically determined and there are considerable difficulties in isolating such effects from other influences, notably the degree of liquidity changes. There can be no doubt however of the significance of this issue not

<sup>14</sup> The attempt to adjust to equilibrium money holdings may spill over into rising prices and/or imports. Hence the charge that monetary-financed fiscal policy generates inflation and balance of payments difficulties regardless of whether it meets the employment goal.

<sup>15</sup> It will be appreciated that what is involved here is an increase in velocity as idle monetary balances are translated into active. Keynesians then typically consider the scope for velocity changes to be greater than generally held by monetarists.

<sup>16</sup> The controversy can be summarised graphically in terms of the IS/LM analysis. The increased government expenditure generates an outward shift of the IS curve raising real income. In the case of tax financing the IS curve returns inwards as private sector outlays fall; in the case of monetary finance the outward shift of the IS curve is reinforced by an outward shift of the LM curve. In the case of bond finance the outward shift of the IS curve is countered by the induced inward movement of the LM curve if wealth effects are significant. Essential to this thesis is the view that the demand for money is sensitive to wealth changes whereas consumer outlays are generally insensitive.

only for the potency of fiscal action but also for the status of monetarism generally.<sup>17</sup> The analysis of the budget constraint has emphasized the interdependence of monetary and fiscal action in sharp contrast to the conventional Keynesian models which specifically analysed real and monetary sectors of the economy in terms of *independent* simultaneous equations. In a similar vein, it has been argued that if the demand for money were to be a function of *disposable* income as opposed to gross income (which in many ways appears to be a sensible assumption to make), then direct tax increases to counter inflationary pressures will be accompanied by a decline in the demand for money. The resultant easing of interest rates serves to offset the tax multiplier to the extent it stimulates additional investment or increased consumption spending by generating wealth effects via the increased capitalization of bonds.<sup>18</sup> Moreover, it may be recalled that the Keynesian insistence upon the need for compensatory fiscal action sprang in large measure from the belief that monetary measures were ineffective owing to the interest-elasticity of the demand for money. However, recent theoretical and empirical contributions have suggested the distinct possibility of an upward sloping IS function and in this case, monetary measures are shown to be *more* effective the *greater* the interest elasticity of the demand for money.<sup>19</sup>

Finally the post-Keynesian concern with the problems of economic development and growth has further weakened the relevance of fiscal policy to be regarded as the main countercyclical tool. In the case of less advanced economies, Keynesian-oriented fiscal policies have been shown to have little relevance to those countries typified by an acute factor imbalance, especially in those economies where extensive unemployment is combined with rapid rates of population growth (Peacock and Shaw 1971). At the same time, neo-classical models of economic growth, which conclude that equilibrium growth

<sup>17</sup> Wealth effects associated with bond issue are, of course, essentially illusory. The fact that governments issue paper notes does not make society one jot richer in terms of its ability to command resources. However, if bondholders "experience" increased wealth and behave accordingly, the reality or otherwise of increased wealth becomes irrelevant. The extent that bondholders perceive future tax burdens to serve and retire the debt will also condition estimates of the net impact. On this latter point, see especially BARRO (1974) and CAVACO-SILVA (1977).

<sup>18</sup> In terms of the familiar Hicks-Hansen framework this implies interdependence between IS and LM curves; the inward shift of the IS curve being compensated partially at least, by an outward shift of the LM curve. For specific reference to this possibility see especially HOLMES and SMYTH (1972).

<sup>19</sup> Cf. SILBER (1971); and BURROWS (1974).

paths ultimately tend towards their "natural" rates, determined solely by population expansion and the pace of technological progress, assign at most a modest role to fiscal policy; and such models are much in vogue.

## VI. Problems of Administration and Implementation

Once having identified the objective function and the role of fiscal policy (albeit more limited than originally suggested) in maximising it, economists have not been backward in coming forward with suggestions for reform of legislative and even constitutional arrangements which would facilitate "efficient" policy formation. It is tempting for economists to describe opposition to such proposals as being "irrational", but a more sensible approach in line with the micro-foundations of macro-economics would be to examine the motivation of politicians and administrators in order to ascertain the causes of resistance. What may seem to be untutored opposition to policy proposals which follow logically from stated objectives may reflect a careful weighing of the costs and benefits of these proposals on the *individual* welfare function of politicians and administrators.

If one accepts the Downs' proposition that politicians maximise their length of life in office, the maximisation of this function will require that fiscal policy, along with other policies, must be adapted to increase the chances of re-election. This does not necessarily mean that the arguments found in the objective function of government as identified by economists are irrelevant, but rather that politicians are sensitive to the *time path* of the economic variables which reflect those objectives. It should therefore come as no surprise to economists and anyone else that the use of fiscal policy may become dominated by the "political cycle". For example, on the assumption that voters' memories are short, as elections approach, fiscal measures may be concentrated on achieving popular short-term movements in the employment percentage and in growth in real incomes, even if this means "trouble" later when any resultant rise in the inflation rate has to be contended with.<sup>20</sup> Fiscal measures are particularly important in seeking success in the political popularity stakes for

<sup>20</sup> For a review of the analysis and the evidence see LINDBECK (1976). For an attempt to test a "political" model of the inflationary process and the role of the budget, see PEACOCK and RICKETTS (1978).

taxes and expenditure changes can be designed to affect a large span of the electorate, whereas monetary policy measures, though arguably just as effective in achieving short term goals, are less obtrusive.

Nor can it be assumed that high-minded administrators will see the protection of the "public weal" against the short-term goals of politicians as requiring an unrestricted use of fiscal policy in maximising stabilisation objectives. Administrators (in our experience) become heavily committed to the expenditure programmes for which they are responsible and will fight valiantly against cuts when anti-inflation policy so demands. While officials in the Ministry of Finance may have a strong interest in smoothing the legislative and administrative path for quick action, along the lines suggested by economists, those in spending departments may prefer the retention of complicated legislative procedures which make such quick action difficult if not impossible, and give administrators time to prepare a strong case, usually couched in terms of the "wasteful" nature of uncompleted programmes, to "sell" to their Ministers.

## VII. What Remains for Fiscal Policy?

In large part, the decline of fiscal economics has been the consequence of the adoption of models of macro-economic behaviour which were naive in the extreme. Such models incorporated, if only implicitly, assumptions underlying micro-economic response patterns which were difficult to justify by reference either to utility maximization theories or casual empiricisms. It can hardly be considered surprising that the ultimate impact of policies based upon such models differed from that which was originally predicted. Elsewhere, the deliberate adoption of simplifying assumptions as an aid to model construction has minimized the importance of the fiscal variable. This is particularly relevant to the development of the more esoteric growth models which have virtually ignored the place of the public sector and its influence on both growth and stability.

Fortunately, recent advances in theoretical macro-economics have tended to reverse this process and to attach considerable importance to the micro-economic assumptions underlying the macro-economic model.<sup>21</sup> This has generated an increased awareness among

<sup>21</sup> Compare, for example, LEIJONHUFVUD (1968) and PESTON (1974).

fiscal policy makers about the expected response to a fiscal change which may be far more complex than that suggested by simple regression analysis. In addition, the increased emphasis now given to controlling monetary aggregates as instanced in DCE targets fixed by the IMF has promoted a new awareness of the importance of methods of finance. It is now much more fully realised, for example, that a given fiscal measure will exert a differing impact depending upon whether it is financed by domestic sources or overseas loan. Greater sophistication in model building has generated greater realism in the formulation of fiscal policy which is now seen as but one element in total budgetary and macro-economic control. In short, fiscal policy must be assessed in relation to other policy instruments including monetary policy, exchange rate policy and possibly prices and incomes policy. Nor should it be concluded that fiscal-dominated demand management policies have been altogether ineffective in stabilizing fluctuations in gross domestic product (Worswick 1977). Finally, in any appraisal of discretionary fiscal policy measures it must be recalled that their impacts are conditioned by the automatic fiscal stabilizers incorporated into the fiscal system. The more successful the fiscal authorities are in promoting automatic stability, increasingly important as the breaking down of trade barriers renders economies more liable to external shocks and disturbances, the greater are the difficulties for the discretionary policy maker. This does not of course render the task of the fiscal policy maker any easier. What it does, however, is to warn against the advocacy and adoption of fiscal policies which must inevitably discredit the operation of the fiscal tool.

In short, fiscal policy is not dead and does not deserve to die, but some major surgery is necessary in order for it to function properly.

Buckingham  
St. Andrews

A. T. PEACOCK - G. K. SHAW

#### REFERENCES

- ARTIS, M. J. & NOBAY, A. R., "Two Aspects of the Monetary Debate", *National Institute Economic Review*, August 1969.
- AULD, D. A., "Multiplier Analysis and the Complementarity of Government Expenditure", *Finanzarchiv*, Vol. 32, No. 3, 1974.

- BAILEY, M., *National Income and the Price Level*, 2nd edition, McGraw-Hill, 1971.
- BARRO, R. J., "Are Government Bonds Net Wealth?", *Journal of Political Economy*, November/December 1974.
- BLINDER, A. & SOLOW, R. M., "Does Fiscal Policy Matter?", *Journal of Public Economics*, November 1973.
- BROWN, E. C., "Analysis of Consumption Taxes in Terms of the Theory of Income Determination", *American Economic Review*, March 1950.
- BURROWS P., "The Upward Sloping IS Curve and the Control of Income and the Balance of Payments", *Journal of Finance*, March 1974.
- CAVACO-SILVA, A., *Economic Effects of Public Debt*, York Studies in Economics, Martin Robertson, London, 1977.
- CHRIST, C. F., "A Simple Macro-Economic Model with a Government Budget Constraint", *Journal of Political Economy*, January/February 1968.
- ELTIS, WALTER, "The Failure of the Keynesian Conventional Wisdom", *Lloyds Bank Review*, October 1976.
- FORSTER, B. A. & SHAW, G. K. "The Direct/Indirect Tax Ratio and Effective Demand: A Respecification", *Public Finance*, No. 2, 1976.
- FRIEDMAN, BENJAMIN M., "Even the St. Louis Model Now Believes in Fiscal Policy", *Journal of Money, Credit and Banking*, May 1977.
- GODLEY, WYNNE, "What Britain Needs is Growth - But it Must be the Right Kind", *The Times*, November 1st, 1976.
- HANSEN, B., "On the Effects of Fiscal and Monetary Policy: A Taxonomic Discussion", *American Economic Review*, September 1973.
- HOLMES, J. M. & SMYTH, D. J., "The Specification of the Demand for Money and the Tax Multiplier", *Journal of Political Economy*, January-February 1972.
- KERAN, M., "Monetary and Fiscal Influences on Economic Activity - The Historical Evidence", *Federal Reserve Bank of St. Louis Review*, November 1969.
- LAIDLER, D. E. W., "The Phillips Curve, Expectations and Incomes Policy", in Nobay, A. R. and Johnson, H. G., *The Current Inflation*, Macmillan, London 1971.
- LEIJONHUFVUD, A., *On Keynesian Economics and the Economics of Keynes*, Oxford University Press, London 1971.
- LINDBECK, ASSAR, "Stabilization Policy in Open Economics with Endogenous Politicians", *American Economic Review*, May 1976.
- MATTHEWS, R. C. O., "Why Has Britain Had Full Employment Since the War?", *Economic Journal*, September 1968.
- MUNDELL, R. A., "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability", *International Monetary Fund Staff Papers*, March 1962.
- NOE, NICHOLAS N. & FURSTENBERG, G. M., "The Upward Bias in the Consumer Price Index Due to Substitution", *Journal of Political Economy*, November/December 1972.
- PEACOCK, A. T., "The Multiplier and the Valuation of Government Expenditures", *Finanzarchiv*, Vol. 30, No. 3, 1972.
- PEACOCK, A. T. & RICKETTS, MARTIN, "Inflation and the Growth of the Public Sector", in *The Political Economy of Inflation*, F. Hirsch & J. Goldthorpe (eds), Martin Robertson, London 1978.
- PEACOCK, A. T. & SHAW, G. K., *Fiscal Policy and the Employment Problem in Less Developed Countries*, OECD, Paris 1971.
- PEACOCK, A. T. & WILLIAMSON, J., "Consumption Taxes and Compensatory Finance", *Economic Journal*, March 1967.
- PESTON, M. H., "The Tax Mix and Effective Demand", *Public Finance*, No. 3, 1971.



- PESTON, M. H., *Theory of Macroeconomic Policy*, Philip Allan, Oxford 1974.
- PREST, A. R., "Sense and Nonsense in Budgetary Policy", *Economic Journal*, March 1968.
- SILBER, W. L., "Fiscal Policy in IS-LM Analysis: A Correction", *Journal of Money, Credit and Banking*, November 1970.
- SILBER, W. L., "Monetary Policy Effectiveness: The Case of a Positively Sloped IS Curve", *Journal of Finance*, December 1971.
- SMITHIES, A., "Federal Budgeting and Fiscal Policy", in *A Survey of Contemporary Economics*, Vol. I, Howard S. Ellis (ed.). Published for The American Economic Association by The Blakiston Company, Philadelphia, 1948.
- STAFFORD, B., "Why has Britain Had Full Employment Since the War? - Comment", *Economic Journal*, March 1970.
- STEINDL, F. G., "Money and Income: The View from the Government Budget Restraint", *Journal of Finance*, September 1974.
- SUMNER, M. T., "Fiscal Policy and the Permanent Income Hypothesis", *The Manchester School*, December 1974.
- TINBERGEN, J., *On The Theory of Economic Policy*, North-Holland, Amsterdam 1952.
- WILLIAMSON, J., "On the Normative Theory of Balance of Payments Adjustment", in Clayton, G., Gilbert, J. C. & Sedwick, R. (eds), *Monetary Theory and Monetary Policy in the 1970s*, Oxford University Press, London 1971.
- WORSWICK, G. D. N., "Fiscal Policy and Stabilization", in Cairncross, Sir Alec (ed.), *Britain's Economic Prospects Reconsidered*, Allen & Unwin, London 1970.
- WORSWICK, G. D. N., "The End of Demand Management?", *Lloyds Bank Review*, January 1977.