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THE NCE VISION AND THE NKE VISION ON THE POTENTIAL EXISTENCE OF A BUDGET POLICY STABILISER IN EUROPE[*]

The work investigates the existence of a stabilising budget policy, passing through the analyses of supportes of New Classical Economics (NCE) and the supporters of New Keynesian Economics (NKE). The analysis starts from the experience of 3 countries in the 1980s, these are Denmark, Ireland and Sweden. In all 3 cases the adoption of restrictive budget policies provoked a strong, rapid and enduring resizing of public debt, and the growth did not weaken, moreover it accelerated. In all 3 cases the logic behind the policy mix actions allowed the individualisation of the respective roles of fiscal and monetary policies. Fiscal policies were joined with fiscal instruments and the reduction in public spending and furthermore monetary policy was accommodated in respect of budget contraction. It is not possible to have a single method guaranteeing the success of a fiscal manouvre. Therefore, the general theory of keynesian, non-keynesian or anti-keynesian effects of fiscal policy still needs its formulation.

Keywords: *budget policy; stabilization; Europe; new classical economics; new keynesian economics.*
JEL: E61; E62; E63.

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НЕОКЛАСИКИ ТА НЕОКЕЙНСІАНЦІ ЩОДО ПОТЕНЦІАЛЬНОГО ІСНУВАННЯ СТАБІЛІЗАТОРА БЮДЖЕТНОЇ ПОЛІТИКИ В ЄВРОПІ

У статті досліджено питання стабілізаційної бюджетної політики в контексті розвитку двох економічних шкіл — неокласичної та неокейнсіанської. Аналіз проведено на прикладі 3 країн — Данії, Ірландії та Швеції. У всіх трьох випадках прийняття обмежувальної бюджетної політики призвело до стрімкого та суттєвого переформатування державного боргу, при цьому економічне зростання не тільки не уповільнилось, а й навпаки — прискорилось. У всіх трьох випадках відбулось принципове розмежування фіскальної та монетарної політик. Фіскальна політика у всіх трьох країнах спиралась виключно на фіскальні інструменти, спрямовані на зниження державних витрат. У той же час монетарну політику було зосереджено на скороченні бюджету взагалі. Концентрація лише на одному напрямку в даному контексті не може гарантувати успіху фіскальних маневрів держави. Це доводить необхідність консолідації в єдину теорію кейнсіанських, некейнсіанських та антикейнсіанських фіскальних постулатів.

Ключові слова: *бюджетна політика; стабілізація; Європа; неокласична економіка; неокейнсіанська економіка.*
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НЕОКЛАССИКИ И НЕОКЕЙНСИАНЦЫ О ПОТЕНЦИАЛЬНОМ СУЩЕСТВОВАНИИ СТАБИЛИЗАТОРА БЮДЖЕТНОЙ ПОЛИТИКИ В ЕВРОПЕ

В статье исследован вопрос стабилизационной бюджетной политики в контексте развития двух экономических школ — неоклассической неокейнсианской. Анализ проведён на примере 3 стран — Дании, Ирландии и Швеции. Во всех трёх случаях принятие ограничивающей бюджетной политики привело к моментальному и существенному

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переформатированию государственного долга, при этом рост экономики не замедлился, а наоборот ускорился. Во всех трёх случаях последовавшие процессы помогли разграничить фискальную и монетарную политики. Фискальная политика во всех трёх странах опиралась исключительно на фискальные инструменты, направленные на снижение государственных расходов. В то же время монетарная политика была основана на сокращении бюджета как такового. Концентрация лишь на одном направлении в таком контексте не сможет гарантировать успеха фискальных маневров государства. Это доказывает необходимость консолидации в единую теорию кейнсианских, некейнсианских и антикейнсианских фискальных постулатов.

Ключевые слова: *бюджетная политика; стабилизация; Европа; неоклассическая экономика; неокейнсианская экономика.*

1. Introduction

Nowadays the topics which are of interest in Europe are centered on the potential conflict between internal objectives of individual nations and the Union objectives.

The question of public deficits and of the specific role assigned to budget policies has been the focus of analytic debates in economic and political circles since the 1990s.

In Europe, the growth of deficit and public debt at the end of the last century has never been perceived as a consequence of poor economic performance. The aggregate weight of social policies in most of Europe and the consolidated relations between political agreement and public spending, justified by employment policies, allowed for choices which are not always in line with the objective of rebalancing public-private in the process of supporting growth. The situation has changed with the introduction of the Euro and hence also the conditions of practicability of the budget policy in Europe.

On the one hand, it is evident that the European Union is a single market and a potential area for common economic policy. On the other hand, at the same time the Union is within the processes of globalization and technological revolution, which bring their own more articulate approaches to budget policy (for more see Morselli, 2013).

The notions of "balancing" and "deficits" are often reconsidered. Today the economic debate takes place substantially between those in favour of New Classical Economics (NCE) and New Keynesian Economics (NKE).

Those who support NCE are the followers of a type of new Say's Law applied to public deficits. They do not believe in stabilising virtues of budget policy supporting demand, due to the fact that their analysis is concentrated on the supply side.

The NKE supporters are sceptical about the virtues of demand and are in agreement on the fact that fiscal policy could improve global supply from the perspective of endogenous growth.

These new theories of endogenous growth reaffirm the role of fiscal policy and move towards a new flowing economy, which is to say a new school of synthesis that prompts the aversion of Keynesian-integralists.

2. Effects of budget policies in Europe

Most modern economists find agreement on the allocated and distributive effects which budget policies can have; whereas when it comes to stabilising effects there is more debate from those who support New Classical Economics (NCE) and those who support New Keynesian Economics (NKE).

The followers of NCE ponder the potential consequences of a budget shock on economic activity. For example, Barro (1990, 1991, 1992) considers 3 hypotheses in his models:

The first is that budget balance, $G_t = T_t$, and incomes are made up of only forfeit taxes.

The second refers to the distinction between two categories of public spending: The relative spending to the services of final consumption and those relative to the services of intermediary consumption. The first category of spending presents the characteristic of substitution in all, or in part, to the spending for private consumption and the second of producing services which increase the efficiency of private sector.

The third hypothesis is related to the distinction between definitive variations and temporary variations in public spending. Such a distinction cannot be fully complete without reference to the concept of "permanent level of public spending", that corresponds to a level of public spending which is constant, having the same actualised value of the spending profile defined as G^*, so that:

$$G* = r \cdot \sum_{t=1}^{t=\infty} \left[G_t / (1+r)^t \right] \tag{1}$$

With r as the rate of actualisation, supposed constant and equal to the real interest rate.

It is in reference to this key concept that Barro defines as temporary and definitive variations of public spending.

A temporary variation in public spending is the variation of a unit of public spending in the first period, when G^* is constant.

A definitive variation in public spending is a simultaneous variation and amounts to an equal value of G (which is the period) and of G^*.

The effects of budget shocks, as introduced by Barro, are different depending on whether one examines a temporary variation or a definitive variation in public spending. The case of temporary variation of public spending G_1 is indicative of a unitary shock which corresponds to a movement in time of public spending and of the corresponding tax, due to the fact the budget stays in equilibrium (with G^* constant).

The consequences in the economic activity of this shock are: there is a simultaneous reduction in private global demand for goods to an amount equal to α unit (with $\alpha < 1$), because of the partial substitution of public demand by private demand; the net demand for goods (Y^d) grows by $(1 - \alpha)$ unit; there is a growth in the global supply of goods (Y^s) by β unit, growth of the productive character (total or partial) of public spending.

As a general rule, ($0 < \alpha + \beta < b$) one can verify that the shock (linked to the temporary variation in public spending) has no effect when (limited case) $\alpha = \beta = 0$. Barro is thus brought to the conclusion that temporary variation in public spending G_1 has the following effects:

1) an effect of global demand: $Y_1^d = (1 - \alpha)G_1$;

2) an effect on the global supply of goods $Y_1^s = \beta \cdot G_1$;

3) an effect on the excess of the global demand for goods: $Y_1^d - Y_1^s = (1 - \alpha - \beta) \cdot G_1$.

Hence, it has an expansive effect on production because the relationship between the variation of production and the temporary variation of public spending is positive, as $(1 - \alpha - \beta)$ has a positive value (see, for example, Morselli, 2012).

Barro further adds that this effect is positive, it shows the positive effect of a temporary budget shock, but in the moment in which the effect is less than 1, it indicates a result of attenuation of the shock and not of amplification. In this case, it is explained by the difference between the results obtained by Barro and the results of traditional Keynesian multiplier.

For Barro it is an analysis of the supply of the public spending on demand and on the global supply, while the Keynesian multiplier takes only demand into account. According to Barro, there is a grade of partial substitution (α) between public and private spending which has the effect of supply (β), that Keynes did not take into account.

At this point in the reasoning it is not possible to avoid outlining some significant points of the analysis of different multiplying effects for new classicalists (with budget in equilibrium or in deficit) the multiplier effect is equal to zero, for the Keynesians of the synthesis (budget in deficit) the multiplier effect is more than 1; for Barro – it is less than 1.

The case of definitive variation in public spending corresponds to a simultaneous increase and is equal to the amount of G and of G^*, that can be analysed as an extension to the preceding case, examining an increase of G which shifts with the same movement of G^*, that brings about (at its limits) a continuous increase of G and of G^*.

The impact on the growth G^* of is the following. It has an effect on the global supply of goods. In effect G^* increases but T^* also increases also T^*, this brings about a growth in the supply of work (because the forfeit tax has a yield effect but also a substitution effect).

Therefore, $Y_1^s = \alpha G^*$. It also has an effect on global demand for goods. Real income of agents reduces just as their consumption. In effect, if G^* increases by a unit, agents receive α unity of collective services for every period, which directly substitute their consumption; but the same increase of G^* brings β supplementary unit of production for agents due to public spending.

Real income of agents therefore decreases by $-(1 - \alpha - \beta)$ but as they contribute to growth within production of α, the impact on the global demand is:

$$Y_1^d = [-(1 - \alpha - \beta) + \alpha]G^*; \tag{2}$$

at the end, therefore, there is an excess of net global demand for goods that is:

$$Y_1^d - Y_1^s = [-(1 - \alpha - \beta) + \alpha]G^* - \alpha G^*; \tag{3}$$

and therefore:

$$Y_1^d - Y_1^s = -(1 - \alpha - \beta)G^*. \tag{4}$$

The impact on the G_1 growth is, in turn, the following, and this concerns the previous case of shock to the budget for a temporary variation (G_1) of public spending:

$$Y_1^d - Y_1^s = (1 - \alpha - \beta)G_1. \tag{5}$$

The impact on the simultaneous growth of G^* and G_1 could be obtained through the sum of previous results, in order to have:

$$Y_1^d - Y_1^s = -(1 - \alpha - \beta)G^* = (-1 + \alpha + \beta)G^*. \tag{6}$$

To which is added:

$$Y_1^d - Y_1^s = (1 - \alpha - \beta)G_1 \tag{7}$$

therefore, the excess of global demand for goods in this case is:

$$2(Y_1^d - Y_1^s) = (-1 + \alpha + \beta)G^* + (1 - \alpha - \beta)G_1. \tag{8}$$

From the moment that G^* and G_1 show equal values of growth, we get:

$$2(Y_1^d - Y_1^s) = (-1 + \alpha + \beta) \cdot 1 + (1 - \alpha - \beta) \cdot 1, \tag{9}$$

and therefore:

$$2(Y_1^d - Y_1^s) = -1 + \alpha + \beta + 1 - \alpha - \beta = 0, \tag{10}$$

for which:

$$Y_1^d - Y_1^s = 0. \tag{11}$$

In conclusion, surplus demand does not vary, global supply and demand vary to the same proportion, the real interest rate therefore does not vary:

Equiproportional variation in global supply and demand is presented as:

for G_1: $Y_1^d = (1 - \alpha)G_1$, $Y_1^s = \beta G_1$ (12)

for G^*: $Y_1^d = [-(1 - \alpha - \beta) + \alpha]G^*$, $Y_1^s = \alpha G^*$ (13)

for the sums: $Y_1^d = (\beta + \alpha)$, $Y_1^s = (\beta + \alpha)$ (14)

and, from the moment that $G^* = G_1 = 0$, one can observe as the equiproportional variation that of $(\beta + \alpha)$. A shock to budget can provoke a permanent increase in public spending at the goods market, brings an equiproportional increase in supply and in global demand to the amount equal to $(\beta + \alpha)$, without a variation in real interest rate.

Hence, the global effect of a permanent budget shock on economic activity is positive and therefore it is well distanced from the principle of inefficiency of stabilising budget policy because a budget in equilibrium causes positive stabilising effects. This determines a move back to the Keynesian approach. The supporters of NKE and especially Mankiw (1989) and Romer (1990) are relatively sceptical about the efficiency of a stabilising policy, even recognising the positive role of endogenous growth, in terms of reallocation and distribution. A position relevant to Mankiw (1992), and for certain verses indicative of a move back between NCE and NKE, is based on the elements that should permit a Keynesian "reincarnation".

Mankiw provides arguments that answer some questions on the efficiency of the stabilising budget policy.

In the first instance, "the policy decision-maker should learn to live with inflation because it derives from a low level of unemployment". For Mankiw, just as for almost all of the NKE supporters, a choice does not exist between inflation and unemployment, because the Phillips curve is vertical. A stabilising budget policy that fights unemployment today has no effect, at least while it does not accept that unemployment is stronger than it was spontaneous.

In the second place, "the political decision-maker will be free to react discretionally in response to changes in economic conditions, avoiding the application of strict rules". Mankiw thinks that if policy moves towards being discretional, this will leave inflation to run and reduce unemployment, economic agents take the new pattern of inflation and, consequently, see results as they expect in inflation; all that would then cancel the potential effects of the discretional budget policy.

Furthermore, it confirms that budget policy is a powerful instrument of economic stability while monetary policy is almost irrelevant.

In conclusion, the possibility of existence of a stabilising budget policy is today put back into discussion as much by the current NCE school of thought, as the current NKE. This brings one to ponder on the hypotheses which stay at the analytical base in the two approaches and especially those relative to the stability of private sector, of which market economies are not characteristic examples.

3. Restrictive budget policies

In the traditions of economic analysis theories, the expected effects of restrictive budget policies were recessive (Keynesian synthesis) or neutral (Ricardian equivalency).

Giavazzi and Pagano's (1990) analysis makes the results of a restrictive budget policy evident. Surprisingly, it seems to bring to light expansive consequences, bringing the usual accepted analyses back into debate.

Clearly, this is not a study without lively accompanying analytical contradictions by different statistical works, for example the contributions of Alesina and Perotti (1997); Bertola and Drazen (1993); Sutherland (1997); Creel (1998).

The analysis departs from the experience of 3 countries in the 1990-s (Denmark, Ireland, Sweden), that have 3 points in common; the reduction of the deficit lasts at least for 3 consecutive years in a relatively contemporary period (1982–1986 for Denmark; 1987–1989 for Ireland; 1985–1987 for Sweden). In all the 3 cases the expansive effect is seen with an improvement in growth and a contemporaneous growth of consumption and investment.

In the Danish case, events are seen in conjunction with the process of recession in the presence of public deficit (6,9% of GDP) and also in concurrence with a political change of government that brings about a strong increase in public earnings, that increases in turn GDP by 7 points, from 1982 to 1986. Public spending endures the reduction of 5,5 points of GDP.

Successively, a tendency inversion comes about: the GDP growth rate of 3% and the primary surplus of 3.5%. In the components of global demand, the consumption of families grows in net terms, while the savings interest of families reduces by 2 points on GDP. The only negative data is represented by the balance of payments, negative both from the start and throughout the period in consideration.

Even the Irish case is marked by a difficult circumstances such as the public deficit being equal to 10,9% of GDP. Furthermore, in that context a new government whose first measures brought about a reduction in public earnings of 3,1%, and public spending is reduced by 12 points of GDP. The negative growth rate therefore passes 5% of GDP in 1989 and the primary balance will pass from – 4,2% of GDP in 1985 to 4,3% of GDP in 1989.

As far as the components of global demand are concerned, they increase consumption and reduce savings, while the balance of payments in the first phase is positive, becoming negative later on.

The Swedish context is linked to a measure of public finance that brings about increases in the impositions of large reductions in public spending. The first grew by 2,6% of GDP, while the spending reduced by 5,5% of GDP.

In all 3 countries' experiences of adopting a restrictive budget balance, the reduction of public deficit was large, rapid and long-lasting. The growth did not weaken, moreover it accelerated thanks to a contraction of families' savings interest and to consumption growth.

In all 3 cases, one sees a drastic reduction in public spending. Fiscal pressure was increased in Denmark and in Sweden and reduced in Ireland.

In any case, the data that held the biggest surprise was the growth of GDP and the phenomenon of strong Keynesian unemployment.

The reasoning of policy-mix action in all 3 cases allows us individualise the respective roles of fiscal and monetary policies.

Fiscal policies were combined with the fiscal instrument and the reduction of spending. Therefore, the effects of the contraction are imputable to both these instruments, this should lead us to an accurate analysis of the dynamics of these instruments.

The Danish case, in this respect, poses two questions, taking account of the importance of the increment of fiscal outgoings which accompanies a reduction in spending. Monetary policies, on the other hand, were accommodating in the framework of spending reduction. In Irish case the local currency devalued by 8% in 1986. In Swedish case, the krona devalued by 16% in 1982, with the evidential effects of the manouvre on both. It is about the processes of devaluation, prior to the adjustment, that have taken place in small economies open to trade.

The contraction of budget, therefore could not have important effects on weak budget multipliers for definition, given the marginal propensity on these countries' importation. The accommodating monetary policy has perhaps been the key to success of the programme of budget contraction in both countries.

In the Danish case, there was a small devaluation of 3% in respect of the currency of the European Monetary System (EMS), at the start of the restrictive policy. However, successively, it was addressed by monetary policy: the Danish krone was linked to the German mark within the EMS. This brought an immediate fall by 100 points on the base rate, which reached 10%. Immediately afterwards, again, a realignment within the EMS brought about a revaluation of Danish krone by 2,5%, with a fall in the base rate of 7,5%. Therefore, this was a strong monetary policy, with a fall in inflation between 10 and 3%. Furthermore, the balance of commercial budget endured a deterioration. Hence, in the Danish case the monetary policy was less accommodating in respect to the other two cases and has played a different part in the success of the recovery programme.

4. Keynesian, Non-Keynesian (or Ricardian) and Anti-Keynesian effects

Taking into account the terminology of Cour et al. (1996), one can distinguish Keynesian (recessive) effects, non-Keynesian effects (neutral) and anti-Keynesian (expansionist) effects.

These new analyses seem to be able to focus the research in 3 perspectives; announcement effect (in the hyper-classical analysis, HC); composition-effect (in the NCE); threshold-effect (in NKE). Giavazzi and Pagano, referring themselves to

Danish and Irish experiences, gave an explanation in the hyper-classical view. This makes the announcement-effect evident in the framework of "expectancy theories" (in some ways these adopt the approach already forwarded by Feldstein (1982).

The situation which unfolds from the announcement-effect is that: every contraction of budget policies determines a change of expectancy in private agents. It is notable that restrictive budget policy can come about from a variation in taxation or of public spending.

If private operators reasonably expect a relevant reduction in fiscal duties accompanied by an equal reduction in spending, the recessive Keynesian effect is usually in the reduction of spending, can be cancelled out, or more than compensated for, by an expected expansion of the aggregate demand, linked to taxes reduction.

The families that interpret a contraction of budget as a signal of future reduction in taxes therefore go and increase their consumption and reduce their savings.

Giavazzi and Pagano take up the arguments of Feldstein: the correction of public spending through the reduction in spending is preferable to a correction through the growth of taxation, as this growth poses a problem of credibility for a budget policy.

The announcement-effect linked to the process of expectancy shows that, contrary to the neutral-effect (compensation), attested in the NCE analysis, in the version of Ricardian equivalency, budget policy can exert effects on global demand. However, taking into account the possible complexity of varied effects and combinations of variation in spending and public income, the real impact on aggregate demand can swiftly become indeterminable in the ambit of a restrictive policy.

If the results of Giavazzi and Pagano confirm their theories, the results of other works appear more dubious. Creel (1998), for example, illustrated how econometric tests applied to the dynamics of Danish and Irish consumption produce satisfactory results in the long term. Families do not come to consider the reductions of public deficits as the signal of future reductions and fiscal duties.

Alesina and Perotti, in 1995, added the budget corrections of OECD countries to the analysis and suggest a possible explanation from the viewpoint of revisited NKE, emphasising a twin aspect; the permanent level of public spending (according to Barro) is a modality of the correction's composition.

The decisive role of the permanent variable level of public spending is linked to the possible presence of fiscal distortion in the case of non-forfeit imposition (almost a generalised rule in advanced countries).

In effect, a distortive fall in taxation brings about positive effects on GDP through the mechanism of supply-effects, the existence of which is inevitable in a hypothesis of taxation with distortive effects. Therefore, every correction of the balance which brings about variation in the permanent level of public spending will have an effect on the level of activity.

Not any less decisive is the role of the variable permanent level of public spending, that is linked to a differentiation between normal situations and restrictive budget situations.

Under normal situation, adjustment has (as its objective) the adoption of imposed charge on an almost invariable (and therefore permanent) level of public spending.

In a restrictive situation, an adjustment towards the lower permanent level proves itself to be inevitable and can therefore bring about a positive supply-effect, towards the expectancy of a fall in distortive taxation.

It is evident that, in the case of this composition effect, it is in a framework of Ricardian equivalency revisited, from the moment that taxation does not exercise neutral effects. Furthermore, this hypothesis can bring about anti-Keynesian behaviours (or allow the emergence of non-Keynesian behaviours, at that time the effect of fiscal distortion could be neutralised), but it cannot facilitate Keynesian effects, linked to the eventual rises of public deficit.

If the works of Alesina and Perotti can support the thesis put forward, there could also be a fall in the savings rate at the moment of budget contraction, which could be superior to the simulated previsions from the traditional equations of consumption; this could bring about a possible uncontrollable effect. In effect the function of consumption becomes unstable at the moment of budget corrections and that brings about more significant empirical proof.

Framing their analyses in the NKE perspective back in the 1990s, Bertola, Drazen and then Sutherland, proposed two explanations in terms of threshold-effect, capable of generating a non-linearity in the functions of consumption and savings.

For Bertola and Drazen, the behaviour of reasonable private operators varies in function in terms of public debt sustainability. Until the latter does not reach the threshold of non-sustainability, agents can justifiably ignore the consequences of accumulating public debt. While, when the threshold is reached, families anticipate the authoritative intervention of a relevant adjustment.

If the monetisation or the default of the debt are to be excluded, a rise in taxation should be expected; this induces reasonable individuals make savings consequently. It is therefore a fundamental threshold effect for the consumption-savings choices.

For Sutherland, the behaviour of private reasonable individuals depends essentially on the relative uncertainty of the intergenerational distribution of future taxation. Sutherland presents a model of interlinked generations, in which agents have a limited duration. This means that the expiry of public debt has weak points because the weight of the correction can be passed on to future generations and therefore private agents will have Keynesian behaviours. In any case, with the increase in the effects of expiry on the debt and the emergence of a threshold of unsustainability, operators realise that the charge on the debt can weigh also upon their own generation and therefore adopt an anti-Keynesian behaviour. Therefore the reactions to a budget policy can be many, in function with the agents' conscience which may have agents over the generations who are called on to support the weight of the correction. If private operators understand the imminence of an adjustment of relevant size, usually Keynesian, they can become anti-Keynesian. In this way a restrictive budget policy has recessive effects when the debt is of a small scale, and expansive effects when the debt is of greater dimensions.

5. Conclusions

Notwithstanding all the forces which come into play, the method of analysis that can guarantee the success of a fiscal manouvre has not yet been fully explored.

The interpretation in terms of threshold-effect does not explain the specification of agents' expectancies with regard to the future expiry linked to budget adjustments when taxation ties do not exist in the analytical frame, apart from the generic reference to a threshold of unsustainability that is very different in different countries.

One might also question the state of agents' expectancies when the economy is in Keynesian regime for a short period, or in a system of Ricardian equivalency with a long-term horizon.

In conclusion, the general theory of Keynesian, non-Keynesian or anti-Keynesian effects on fiscal policy is likely to still need formulation; to think that the expectancies, more or less rational, can substitute together the variables which are responsible for human decisions is quite misleading.

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