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Linda I'm Linda Yueh. I'm a fellow in economics at St Edmund Hall and my latest book is titled 'The Law and Economics of Globalisation,' out in the autumn of 2009.

Jonathan I'm Professor Jonathan Michie, the President of Kellogg College and I edited the book 'Globalisation' by Edward Elgar.

Martin I'm Martin Slater. I'm also a fellow in economics at St Edmund Hall.

Linda The topic we're going to tackle in the podcast today is whether or not governments should use fiscal policy to counter a recession; much like we've seen governments around the world do in this recession.

And we're going to debate the pros and cons, the arguments for and against the use of fiscal stimulus in a recession.

So the question that my colleagues and I will try and tackle today is should governments have used fiscal policy to counter the recession and continue to use it during what many believe will be a fragile recovery?

I think I'll kick off and say that one of the reasons why governments in this crisis felt they needed to use fiscal policy is because the credit crunch, which resulted from the financial crisis, made it difficult to use monetary policy in the normal way, such as cutting interest rates and waiting for the monetary transmission mechanism, where the cut in interest rates generates money flowing through the banking system and out into the wider economy. Because the credit system was clogged, it made monetary policy more difficult to use and fiscal policy became a rallying cry.

However, I think one of the things that we'll have to discuss and analyse today is what are the consequences of using fiscal policy then and looking ahead.

Jonathan, can I turn to you for your thoughts?

Jonathan Yes. On the pros and cons of using fiscal policy, whether it's effective or not, I think it's also worth pointing out that there have been disagreements on this going back for decades in the economic profession and there have been whole eras when the view was that you shouldn't use it, that it wouldn't be effective and other times when the profession almost unanimously said the opposite thing.

So broadly, up until the 1929 Wall Street crash and the 1930s global depression, up until that point all governments thought you had to balance your books; you couldn't use act of fiscal policy.

Then John Maynard Keynes came along in the Great Depression, published his 'General Theory of Employment, Interest and Money' and pointed out that you could get out of a recession by government boosting demand by spending more than it was taking in through taxes.

And that was accepted throughout the world for another whole generation or more throughout the 1950s, 1960s and 1970s. And then from 1979 onwards, when after the 1970s had led to inflation when governments had been using fiscal policy, there was another complete reversal and the 1980s and 1990s and, to an extent, right up to the global credit crunch, was an era where fiscal policy activism, if you like, Keynesian policies, had been thought to have been discredited and the world was broadly monetarist or orthodox in anti-Keynesian fiscal policy activism terms.

So I think the fact that fiscal policy has been used so actively is worth pointing that that's quite a break historically, but it's not the first time that we've seen that switch.

So I'd say that yes, it was right that the governments did use fiscal policy after the global credit crunch and it's no coincidence that they did so given that, after all, it was the biggest global recession since the global depression of the 1930s.

Linda Martin, can I turn to you for your views on the pros and cons of using fiscal policy?

Martin Well, as Jonathan said, fiscal policy has had its ups and downs and there are both theoretical and practical reasons for that.

One reason why fiscal policy fell out of favour theoretically in recent years is the resurgence of what was called the theories of Ricardian equivalence that with perfectly functioning capital markets and very far-sighted consumers and producers that the private sector might take actions which would effectively nullify the government's intentions in fiscal policy.

Now, of course, the world we have just been living through is quite clearly one where the financial markets are by no means perfect. And so the particular circumstances that we have been living are clearly ones that are very far from the world that Ricardian equivalence is thought of having some kind of sway.

So I think that whereas one might feel that in fairly stable times the effects of fiscal policy might not be very great, but the particular times we've been living through as, indeed, were the particular times of the 1930s when Keynes propounded the active use of fiscal policy are, of course, exactly those times when monetary policy and the beneficial effects of the financial system are no longer to be relied on.

Now, the other reason I think fiscal policy fell out of favour is a more practical one. And that was the question of how easy it is to fine tune changes in fiscal policy to actually control the economy.

I think there's no doubt that the early aims of Keynesian economic policy, policy makers thought that by moving public expenditure and taxation up and down you could actually fine tune the economy fairly precisely.

And they found that in practice that was a little difficult. You cannot easily bring forward large infrastructure projects or delay large infrastructure projects that are desirable in other respects just because of the financial situation. And there are some ways in which changes in fiscal policy can destabilise private sector expectations.

So if things are going well otherwise, then, of course, it is probably reasonably sensible not to rock the boat too much in fiscal policy. But again, the situations we've been living through things have not been well otherwise. So this would appear to be quite rightly a situation in which you would actually take much larger decks on fiscal policy.

Linda I think both of you raise good arguments about why it is we've seen this revival. Can I just probe a bit and say, "But what about the consequences?" Surely one of the reasons, as Jonathan pointed out, that Keynesian fiscal policies fell out of favour was because of the inflationary consequences associated with it.

Jonathan Yes. Well, generally there were two reasons why governments became cautious about using fiscal policy when after apparently very successfully during the 1950s and 1960s keeping full employment, in the 1970s it seemed to hit difficulties. One was with the rise in inflation, although now we can see maybe there were all sorts of other factors going on there, including increased oil prices.

But the other was that if one government tried to use fiscal policy, increased spending or cut taxes, the danger was that that increase in spending went to buy goods from overseas and it would just lead to a big increase in imports, balance of payments deficit. You wouldn't boost your domestic economy at all and you could into a balance of payments crisis, particularly if your exchange rate was fixed.

So I think it's vital to remember the global dimension to all this and whether you're talking about fiscal policy in a single economy or in one country with other countries pursuing different policies.

And when Keynes expounded the theory, explained his 'General Theory of Employment, Interest and Money', he explicitly considered a closed economy; just ignored that problem about imports and exports. But once you relax that assumption and get into the real world, there is the immediate question, "Okay, if your economy's in recession and you need to expand demand somehow, how are you going to do it? If the government boosts demand by £10 billion or $10 billion, will that all go to create jobs in your economy?" And the answer depends partly whether that money is spent domestically or whether it's spent on buying imports from other countries.

And that then comes on to an incredibly controversial policy area of protectionism and whether you should try and restrict imports coming into the economy.

And protectionism is generally thought to be a bad thing, that we should always have free trade and so on. But it's actually much more complex if you're in a situation where the world economy is in recession, there's unemployment in the various countries, and a government, a country is thinking how can they get out of this situation, because ideally all countries would follow the same policies and boost the economies.

But if they don't, then the question is "Is there anything one country can do?" And the answer is it may be that without protectionism, without some sort of control on increase on imports that will follow if that country alone boosts demand through fiscal policy, unless they have that coordination then actually it may be the only way the government can tackle unemployment and boost the economy domestically is precisely to have some control on the degree to which imports will rise as a result of that fiscal activism.

And what is very interesting, that was illustrated in the post-credit crunch recession of 2009 where Barack Obama introduced his huge fiscal stimulus. Because if you remember there was precisely great controversy when he tried to devise policies to ensure that as much of that increase in demand would go into demand for American goods, create American jobs, as possible.

Linda That was one of the arguments why the G20, when they met to discuss the recession, wanted to coordinate their fiscal policies because the idea was some of the expenditure would surely spill out into other countries exports, your imports, and the IMF believed if countries coordinated their spending then they would have the maximum benefit and they estimated a range of things that could happen. But, of course, there was no explicit coordination.

However, because of the synchronisation of this global recession for virtually every country, it turned out that every country pretty much spent at around the same time anyway.

But it does raise questions about the basis for the Obama American policy, which you mentioned, and also the buy local Chinese policy, which came on the back of that. So the two major economies in the world which were spending on this stimulus. Around $2.5 trillion have been pledged to be spent in fiscal policy around the world, and China and the United States account for $1.5 trillion of it. And these two countries both had some measures of protectionism within their own policies.

I think something else which struck me about, and this is a very European debate, is the extent to which fiscal policy needs to be spent in a discretionary sense. Because the IMF, you'll recall at the time, suggested that all countries spend 2% of GDP and the continental Europeans, the Germans and the French, were very much against the idea of increasing the discretionary part of fiscal spending because one of the benefits of fiscal policy, as Martin said, there is an implementation lag because not every project can be spent today; not everything is shovel ready. Some things can be done quickly, like a cut in VAT, but others cannot be done quickly.

However, one of the fastest things about fiscal policy are the automatic stabilisers; the counter-cyclical movement of fiscal policy where in a recession benefit payments go up, taxes come down, which increases disposable income in the private sector, which automatically boosts the economy.

So this difference between the size of the automatic stabilisers and America versus Europe was certainly another bone of contention when countries are trying to work out if each other are properly coordinating rather than being protectionist about their fiscal spending.

Martin, do you have any arguments on the consequences, perhaps, of fiscal policy?

Martin Well, on the international consequences of course yes, protection is one thing that comes up but I suppose personally I would prefer to see that kind of issue dealt with by devaluation, which is another way of essentially stopping things leaking from abroad. And in most cases where countries have considered quite carefully protectionism one usually finds that there's some reason why they are constrained from using the exchange rate; either by actual international agreements, as was the case with the gold standard, or with some kind of macroeconomic policy objective, as there is in the case, for instance, of the Chinese economy vis-a-vis the Americans.

So on the whole if you can actually manage that by exchange rate movements I think that has less unfavourable effects on international confidence than a lapse into protectionism will do.

Therefore the international side has a problem that clearly we cannot all devalue at the same time. But equally, of course, we cannot all get out of our international problem by protecting at the same time. So this is only something that can really shift the pain around and this perhaps comes back to Linda's point about different countries being in different fiscal positions.

The other obvious problem with fiscal policy that people perceive is that it leads to an increase in indebtedness in the long term and that's obviously exercised people a lot in the last year. We see public debt going up. Is this a problem or is it not? And quite clearly there are really quite well-defined battle lines drawn on that.

Now one needs to distinguish quite carefully at the beginning between two different concepts here. One is the annual deficit that a country has and the other is the cumulative amount of debt that a country has managed to amass over a period of years.

And one of the causes, I think, of confusion for a lot of commentators about whether one particular economy is in a worse position than another is that people tend to slip from one to the other.

So one can see, for instance, in the UK's case the UK has a very large annual deficit, so if you actually take that as being the measure of the problem you would say the UK is one of the most vulnerable countries in this kind of situation.

On the other hand, the UK, rather fortunately, is starting from a position of a relatively more favourable position of accumulated debt than many other countries, so that after a few years, although we may actually have larger annual deficits than many of our European partners, we will only be catching up on their cumulative debts.

And there's no doubt that the annual debts are quite big relative to GDP at the moment and the cumulated debts relative to GDP are going to be much bigger than we have been accustomed to in the last 20 years.

But historically that is not necessarily the case that they are bigger than we have had before. We have had larger national debts at the end of the Second World War, for instance. But at the moment there are countries, for instance Japan has a much larger cumulated national debt relative to the GDP than we do.

So it is still really quite a matter of judgement as to whether you think that these things are seriously going to become derailed in the near future.

Linda I suppose the big argument - there's lot so big arguments over this question - and that really goes to whether or not governments should continue to use fiscal policy because indebtedness could either crowd out private investment, which is the very typical argument that governments doing a lot of borrowing, squeeze out more efficient private sector investment. The counter argument to that is that only happens if you're assuming a rather fixed supply of savings and it probably won't happen in this global context where we may actually have a savings glut; there's a great deal of savings out there.

And I think the other big consequence, in addition to repayment, which Martin has mentioned, is whether or not it's inflationary. So having an accumulation of deficits on an annual basis of the scale we're talking about in some countries of exceeding 10% of GDP, does that, in the medium term, turn into a problem with inflation?

I want us to turn now to, if we could, exit. There's a lot of talk now about exiting from fiscal policy. So, of course, there is a counterpart to monetary policy; when do you start raising interest rates, withdrawing quantitative easing? But there's a similar argument on the fiscal side.

The arguments here, I think, are rather difficult to assess. I'll start with one, and this does come to the temporary VAT cut policy, which is what you normally want for something like boosting spending in a recession, is to force people to spend today instead of spending, say, next year. So you give them a VAT cut this year that expires at the end of this year or a 'Cash for clunkers' programme which expires at the end of the year or in six months. Then people push ahead their purchases. So therefore you get the boost to spending that you need today.

However, there's still a debate about whether or not other types of fiscal policy should be extended to support the economy through the recession.

Martin?

Martin Well, I think the problem with withdrawing a tax incentive is that a temporary tax incentive, if it's known in advance, will have the effect of bringing forward consumption expenditure into the incentivised timeframe. And when you actually take it away you then find, of course, that you have brought forward consumption demand that you would have expected to be in next year and therefore you find an excessive overreaction. And that is the thing that worries policy makers.

Now, policy makers therefore are in a rather odd fix. Ideally you would say that the thing to do with fiscal policy is that the private sector really would like a very firm plan to see when all these fiscal stimulus measures will disappear. And it's only that will actually keep their confidence up in the long term and avoid some kind of indebtedness crisis.

But, of course, if consumers are well aware that the incentives are going to disappear at a particular time, then you have a very serious problem about a bit in aggregate demand immediately they are withdrawn.

One of the possible ways that the authorities could counteract that, one, of course, is that they could withdraw things almost arbitrarily without actually signalling very much in advance. That, I think, is something that they'd be rather loath to do.

The other course, of course, is that they really have to withdraw these things very slowly indeed. They do not want to have sharp cut offs in the fiscal incentives because that will actually produce really quite big dislocations over short periods of time of aggregate demand.

So in terms of the exit strategy, I would think that therefore you really should run the stimuluses down very slowly; not actually take a short, sharp shock policy implication.

Jonathan Yes, that's right. Because it's important to remember that the context is that we need to `[[?? 0:22:43]]` the deficit in order to tackle these huge debts which have been accumulated.

But the basic point is that if government spending was cut or taxes were increased too sharply, the reduction in demand, if that pushes the economy back into recession, means that government spending, ironically, would then go up again on unemployment pay; certainly tax revenues would fall. And actually the result of that might be to increase the government deficit rather than reduce it and increase the total amount of accumulated debt that actually made the problem worse that you're trying to solve.

So even for that, quite aside from any question about whether you want to be spending this money on schools, hospitals, etc, quite aside from that it's important to not choke off any recovery by tightening fiscal policy too quick.

But there's a separate point as well about if and when you are able to reduce demand coming from government because demand is recovering elsewhere, once you're in a position to be able to reduce and possibly eliminate the government's fiscal deficit, the discussion at the moment globally seems to be very much about government spending cuts to do that. But, of course, the other side of the coin is tax increases. And it's quite possible to eliminate the fiscal deficits and pay down the big debts through tax increases rather than government spending cuts.

And I think there's a strong argument for taking that approach; increasing taxes on a whole range of areas. Because of the crisis having been caused by the banks the media's picked up on taxing the bank bonuses, putting a tax on bank profits and so on.

But the general point would just be to return to having a more progressive income tax and wealth tax structure in countries across the world. Because one of the contributory factors to the whole global recession, the credit crunch, in the first place was the huge increase in inequality over the previous 10, 20 years and particularly the emergence of a large number of super-wealthy billionaires who are actually driving the demand for all these new financial products that were being invented, bundled up and then sold around the world.

So actually just even to create a more stable global economy over the next 10, 20 years one of the important tasks will be to reduce that huge inequality. And the way to do that is to introduce high rates of income and wealth taxes on those very wealthy individuals.

So there's two questions. One is, you have to take a gradual approach to reducing the government deficit as the economy recovers. But also that doesn't have to be through government spending cuts. It can be through tax increases.

Now, there's one final point there which comes back to this point about internationalism and global action where, again, the more coordination you can get on that the better and it's good that there has been talk about trying to get rid of the international tax havens and so on.

But another new tax which has been discussed quite a bit recently is the so-called Tobin tax, so actually introduce a tax on financial speculation to damp it down.

And interestingly this was a proposal which was put forward by Tobin, the Nobel prize-winning economist, decades ago, well before the financial crisis, but precisely because he thought it was just economically harmful to have so much financial speculation going on. And his words it was actually good to put some sand in the wheels of all that. And I think it's been proved dramatically right by the events of 2008 and 2009.

And that tax on financial speculation would have a dual benefit: A, it would raise huge sums and B, it would reduce the amount of that speculation which went on.

Linda We've done taxes. We've done getting rid of debt. I suppose it's probably time to wrap up and I thought I would actually try to wrap up on a slightly brighter note, if that's actually possible.

We're talking about fiscal policy which is we've talked about crowding out but there is this notion of crowding in where government spending can make private investment more efficient if it spends on things like infrastructural need, smart grids for energy, green new deal, green technology, investing in R&D, research and development, and demonstration of new projects.

And if that's why we're accumulating debt, then the pay off may actually come in the future and, I suppose, if we do see another round of fiscal spending or maintenance of fiscal spending we could perhaps cross our fingers that the spending will go into things which are socially productive.

But that's all the good news I have on trying to find a bright note in the mountain of debt we're swimming in.

But it does seem from our discussion today I think the panel seems to be of the view that fiscal policy was necessary in this recession, is necessary through the recovery but the important thing will be to be able to bring down the amount of indebtedness through ways which don't just involve cuts in spending but perhaps new ways of taxation.

But I think the issue here is going to be timing. When do you bring it down?

And we'll leave it there.
