CHAPTER 2:

LITERATURE REVIEW

This section will review and discuss the findings from literature concerning the implementation of a stimulus during an economic downturn. It begins the theory behind the stimulus package, followed by the various studies related to the said stimulus policy. This should be an interesting read as many economists and policymakers have questioned the true effectiveness of the stimulus in stimulating the economy.

Stimulus Theory

The 1930s' Chicago school of economics believed that a fiscal policy played an important role to offset the effects of depression in times of recession compared to a monetary policy.

According to Chicago economist, Henry Simons:

"*Once a deflation has gotten under way, in a large modern economy, there is no significant limit which the decline in prices and employment cannot exceed, if the central government fails to use its fiscal powers generously and deliberately to stop the decline". (1938, 222)*

The Wagner's Law One had explored the principal causes of growth in the public sector – the "Law of increasing expansion of public and particularly state activities" which indicated a positive structural correlation between public spending and per capita GDP (Wagner, 1893). The empirical evidence of this hypothesis, either in the form of standard regression analysis (Ganti and Kolluri, 1979 and Georgakopoulos and Loizides, 1994) or in the form of error-correction regression (Kolluri, Panik and Wanab, 2000) showed that the result differed considerably from country to country.

The Keynesian school of thoughts predicted that an expansionary fiscal policy (increasing government expenditure or decreasing tax) would increase disposable income, and raise private consumption. Blanchard and Perotti (2002); Mountford and Uhlig (2008); Fatas and Mihov (2001) had proven the positive effect of government expenditure and revenue policy on consumption and output. In fact, most of the compelling arguments supporting an activist fiscal policy can be traced back to the Keynesian models, such as Elmendorf and Reifschneider (2002).

On the other hand, the Non-Keynesian effects of fiscal policy changes by Feldstein (1982) proposed that a permanent reduction in government expenditure may lead to increased aggregate demand because this policy espouses a cut in future tax. People will be more inclined to spend, as they expect their future income will "increase" due to reduced taxation. For the economy, this is an increase in current consumption and aggregate demand. Giavazzi and Pagano (1990) provided empirical evidence to support this theory.

Stimulus Factor

Many developed countries have recently launched aggressive fiscal stimulus packages to tackle the global financial crisis. The composition of the budget package is important and may vary by country depending on the priorities set by its respective government. For example, if the government intends to promote growth, it should focus on more productive elements in the budget. Lucas (1988) argued that public investment in education increases the level of human capital and leads to long-term economic growth. Romer (1990) studies included the relevance of research and development expenditure, while Barro (1990) stressed the importance of government expenditure in public infrastructure for economic growth. Therefore, it is important for the government to identify their key sectors that require the upmost support in sustaining their economic recovery.

The size of public debt and composition of fiscal stimulus could be two important factors affecting the result of the fiscal policy according to the IMF, *World Economic Outlook* (October 2008). The reports also explained that expansionary fiscal policy seems particularly effective in shortening recessions associated with financial crises and boosting recoveries (IMF 2008 a). Most stimulus efforts in the past have been ineffective partly because they were too small according to Romer and Romer (1994).

Using OECD country data, Drazen (1990), Giavazzi and Pagano (1995), and Giavazzi et al. (2000), showed that the effectiveness of fiscal reconstruction depends on the size and duration of the policy. The Keynesian effect will occur if

the size is small and time is short, while the non-Keynesian effect will occur when the size is large and time is long. If the duration of the policy is long and continues in the future, consumers will expect a return to an expansionary policy that works to stimulate consumption.

Governments across developing Asia continue to implement sizable fiscal stimulus packages especially during severe crisis to keep their fiscal deficits under control and public debt at manageable levels (Seok-Kyun Hur and others, 2010). However, some studies suggested that tax cuts will stimulate economic activity more than public spending across emerging Asian countries (Shikha Jha and others, 2010).

Studies using *vector autoregressive (VAR) methods* conclude that fiscal multipliers have declined over time and, in some cases, may even have been negative (Perotti, 2005). Cross-country studies often find small fiscal multipliers and in some cases multipliers with a negative sign (Christiansen, 2008). The most notable studies with "negative multipliers" are found in the literature on expansionary fiscal contraction initiated by Giavazzi and Pagano (1990) and surveyed in Hemming, Kell, and Mahfouz (2002).

Blanchard (1990) found that the initial debt level has an important influence on fiscal policy effect because high government debt level means that the probability of government carrying out contractionary fiscal policy becomes higher and future tax reduction is more likely to happen.

Stimulus measures usually appeared at unsuitable time and appeared ineffective in the past. *"There is now widespread agreement that countercyclical*

discretionary fiscal policy is neither desirable nor politically feasible" as supported by (Taylor 2000), Feldstein (2002), and Eichenbaum (1997). Elmendorf and Furman (2008) had also provided a summary about short-run fiscal stimulus.

Emanuele et al. (2009) examined the effect of fiscal policy response in banking crises. They found that timely countercyclical fiscal measures contributed to shortening the length of crisis episodes by stimulating aggregate demand.

Joseph Stiglitz, the Senior Vice President and Chief Economist of the World Bank, argued that the confidence from the public comes from a good macroeconomic environment and not tight policy in the midst of financial crisis.

"Maintaining tight monetary policies has led to interest rates that would make job creation impossible even in the best of circumstances'' (Stiglitz, 2002, p.17).

Blinder (2004) began a reconsideration of the case against fiscal policy, stating that "*virtually every contemporary discussion of stabilization policy by economists—whether it is abstract or concrete, theoretical or practical-- is about monetary policy, not fiscal policy".*

There is still a large pool of literature to draw on with regards to the basic fundamental of the fiscal stimulus and the effectiveness of government spending to stimulate recovery through a stimulus budget. In the next section, we shall look into the historical impact of the stimulus when applied in various countries across the centuries.