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The Monetary-Fiscal Mix

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Abstract

We detail the monetary context within which fiscal policy must operate. The monetary and the fiscal organs of the State must coordinate so as to “stabilize an unstable economy” (Minsky). The specific instruments that will emerge to fulfil the task are the rate of interest on government bills and the income tax rate.

Keywords: stabilization policies; fiscal position.

JEL Classification Nos.: B50; E12; E63

The vocabulary of structure

A standard response to the fiscal portion of the title would include the usual suspects Barro and Ricardo and notions like the fiscal theory of the price level (indeed, a twisted version of this result will be found below). The theorems are derived from utility maximization exercises. Our approach is not inconsistent with methodological individualist practice but cannot be associated with the reductionism of a Menger [1]. Individual actions and responses are part of a structure. The real world is an intersubjective construction. It is common to all because it is based on collective and routine modes of interpretation. Since we share a common cognitive apparatus with our fellowmen, we also share a common environment with them. A ‘social role’ implies regularities of action and specific expectations. Shared ideas have concrete effects including social conditioning. For instance, the ubiquitous social discount rate that figures in all dynamic optimization exercises might not be helpful in making sense of reality. Since consumption growth rates change over time, modelling in terms of a constant social discount rate would be hard to justify [2]. As another example, and close to our theme, social effects in the field of tax compliance explain the data better than the standard model or non-expected utility models [3]. Among the cultural elements that matter are trust in governments and a shift from an enforcement-oriented tax ideology to a service-oriented approach. In some cases in which markets yield inefficient outcomes, agents may have interests that coincide with the social optimum but may fail to execute their programs [4]. The government, in such situations, may create a “choice architecture”, design the environment in which people make their choices. Thus, social norms have been used to ‘nudge’ people towards tax compliance. For instance, a UK Behavioural Insights team found that providing information to delinquent taxpayers on the fraction of people who pay their taxes on time increased tax compliance by about 15 %.

The bulwark of any mainstream macro model is a starred value of aggregate output, a notional full-employment level of activity. Exercises are conducted in deviations of actual output from this “natural” level. However, there is no unique level of income to which an economy is drawn [5]. A range of unemployment and income combinations can be associated with a stable inflation rate. We escape the practice of thinking in terms of a definitive macroeconomic architecture. Instead, we view the economy as an evolving fabric of public policy and private practices that do not find in notions of equilibrium and efficiency a resolution of problems [6]. The connection with the heterodox tradition is that, following Goodwin and Kalecki, we suggest that the cycle cannot be separated from the trend for the purpose of determining changes in aggregate output [7].

In other words, we invert the standard weightage attached to the existence and stability of equilibrium and study the requirements of the order of systems. The effects of the whole on the parts illustrate the principle of downward causation [8]. Higher-level structures push or hinder the behaviour of smaller units. The structure of the whole is absent in the parts. The former is characterised by emergent properties that are not only absent in the parts but might stand in opposition to them.

2.1. The monetary-fiscal mix: Intuition

In a milieu in which government spending and progressive taxation do not find favour with the profession, instead of negative feedbacks, deviations in the economy become self-amplifying [9]. Since the demand for Basics, notably food, is insensitive to price changes, a universal norm might be implanted in the form of policy here. Another example are the Basel macroprudential norms, which will be reproduced below, whose primary intent is the implanting of shock-absorbers in financial systems all over the world. However, they have been described as automatic destabilizers in that they are countercyclical. They link credit availability with banks’ equity [10]. The need of the hour is automatic stabilizers unconstrained by fiscal rules. As another example, consider 100 % reserve requirements. While guaranteeing ultra stability, by definition, the implication might be a drastic scaling down of investment activity.

Otherwise put, there might be a tradeoff between existence and stability if the former takes place at the origin of price-output space. Thus, the extension of the competitive model to monetary institutions might lead to the study of the institution of free banking. Many scholars extol this epoch in contrast to the instability that was to come later because of the entry of Central Banks on the stage. However, historians have shown that free banking did not directly impact on growth [11]. Charter banks had a positive effect on manufacturing. It was the Federalist financial revolution of the 1790s and the attendant system of state-chartered banks that set the US on a path of virtuous growth. Finally, as an illustration of the long-standing connection between the two macro organs of the state, we report the history of Colonial Paper Money, a bill of credit, which Farley Grubb, [12], has been studying closely. He has broken up the market value of the instrument into real asset present value and a liquidity premium value. The real asset private value of the bills accounted for around 80 % whereas the value of the bills as ‘money’ accounted for 10 % to 20 % of their market value. The paper did not depreciate. It traded below face value because of discounting, not depreciation. Given a positive liquidity premium, the implication is the paper money traded at an appreciated value over its real value. That premium was positively associated with the quantity of paper in circulation per capita and the mode of monetary emission. Paper money penetrated deep into the economy and increased the general acceptability of money wage payments in business. The New Jersey bills were structured as zero-interest bills of credit. They had predefined redemption dates in specie equivalents. The government redeemed these bills under a fiscally-credible tax structure. Good reputation was earned by keeping taxes for redeeming the paper money under tight bounds. Paper money was regarded as a debt from the people to themselves. While it had to be redeemed, the payment of interest was not called for. Besides, that would mean an unnecessary tax imposition. Thus, the instrument was a zero-interest bearer bond. The bills were emitted directly by respective colonial legislatures and not by banks. Colonial legislatures printed money and placed it in the colony’s treasury. Thereafter, they directly spent the money as in the payment of government salaries. In some instances, they lent money to their subjects who secured the loans by pledging their lands. The statistical relationship between the quantity of money and prices was weak.

2.2. The monetary-fiscal mix: Arithmetic

We employ the stock-flow consistent framework of Wynne Godley and Marc Lavoie [13] to illustrate our ideas. Godley-Lavoie matrices hark back to early eras of national income accounting which stemmed from the urgency of practical policy making. Indeed, going back as far as Petty in 1665, the discipline of double-entry booking was used to make the case for progressive taxation rather than equitable forms of taxation to support activity [14]. Later, Lowe in 1823 used national income data to connect the tax burden and taxable income remaining after subsistence income that could not be taxed was deducted. The context in all cases was slumps and widespread poverty. Unsurprisingly, the wealthy were unhappy with the enterprise and early national income accountants were either exiled or fell out of favor. In our times, the development of national income accounts has flowered with the growth of democracy.

The central figures in our framework are the monetary and fiscal authorities and commercial banks. The separation between the monetary and fiscal authorities is particularly untenable in the present conjuncture [15]. Governments must recapitalize their banks and insure their deposits. Fiscal spending is called upon for the purpose with the build up of debt. Lax bank supervision leads to deteriorating fiscal balance. In order to induce more investment, the fiscal account should exclude investment projects from the one-year horizons of national budgets. In general, policies which stimulate growth should be excluded from the budget.

In all introductions to macroeconomics identities, money is not to be found. So, in an elementary account without investment, national income Y is broken up into private consumption, C , and government consumption, G . There is, also, the income shares breakup into wages, WB , and profits, F . Once more, for the sake of simplicity we ignore profits. The wage bill is the product of the wage rate and the number of people employed. Disposable income YD , is the deduction of income taxes T , from GNP. Note that the fiscal authorities are already almost completely specified. We assume that taxes are levied on wages (incomes) are some rate θ . The non-standard or structural portion of our description consists of the definition of inflation. Define the ratio of the wage bill to national income as unit costs, UC . Then the rate of inflation, π , is defined by $UC = (1 + \pi)UC_{-1}$. Inflation is not a monetary phenomenon. Now, putting our relationships together,

$$Y = C + G = WB$$

and

$$YD = Y - T = WB - T \tag{1}$$

Therefore,

$$YD/Y = (1 - \theta)WB/Y = (1 - \theta)(1 + \pi)UC_{-1}$$

Suppose the tax department sets $(1 - \theta) = 1/(1 + \pi)$

The result is

$$YD/Y = UC_{-1} \tag{2}$$

We might call this result ‘fiscal policy for the inflation rate’. Comparing equations 2 and 1, we see that the working class is better off from the imposition of a tax because inflation has been reduced to nought. Indeed, it is possible to allow for increasing disposable income with a positive inflation rate. Our interest is mirrored in the comparison Peter Temin [16] makes between economic history and economic development. The former is concerned with high-wage sectors, the latter draws attention to low-wage economies.

Consider now, a budget deficit supported entirely by the issuance of bills, B , at a rate of interest r_b . We assume that banks accept the entire offering. For the sake of simplicity, we ignore the strong structural closure, that the Central Bank would hold the residual paper if the private sector is not enthusiastic. Banks are characterized in the starkest terms; their liabilities are bank money, M , and their assets are their loan portfolio, L . The modern definition of financial stability is

the buildup of leverage or the fragility of the funding of financial intermediaries [17]. Attention is to be focused on the composition of the balance sheets of firms and the risks they represent. By the same token, changes in the funding structure of banks in their net worth is tracked. Two ratios that excite the imagination of regulators all over the world are the bank liquidity ratio, $BLR = B/M$, and the capital adequacy ratio, $CAR = M/L$. Assuming one-period contracts,

$$B = (1 + r_{b-1})B_{-1}$$

Furthermore, using the two ratios introduced in turn,

$$M = (1 + r_{b-1})(BLR_{-1}/BLR)M_{-1}$$

and

$$L = (1 + r_{b-1})(CAR_{-1}.BLR_{-1})/CAR.BLR)L_{-1}$$

The following observations are not exhaustive. Once more, we take recourse to history in explaining the second equation, the critical role of the monetary and fiscal authorities in motivating lending through the medium of banks. The New Deal was a nexus of institutional breakthroughs across sectors [18]. A national bank holiday ended a wave of financial panics. During the hundred days sojourn, there was an upsurge in economic activity. Fiscal and monetary policy was less responsible than the emerging Banking Act. Roosevelt generated a shift in expectations by rejecting three Hoover administration dogmas: the gold standard, balanced budgets, and small government. For the first time, the government imposed minimum wage and maximum working hours provisions, requiring that firms recognise the rights of employees and collective bargaining. The first bracketed term on the right-hand side of both equations is unusual because the deposit rate and the loan rate, in turn, are expected. The expression underscores the underpinning of government paper in the dynamics of bank balance sheets. For instance, the zero-bound interest rate problem vanishes as the rate of interest on government paper is strictly positive. The authorities might desire, for instance, that both the components of the balance sheets of banks grow in the period under consideration. The stability requirement is that the product of the two bracketed terms in both the expressions be less than unity. In that case, both the ratios will need to be calibrated period by period, a far cry from the universality of norms coming from Basel.

The difference equations can be expressed in high-powered money or the monetary base, H , through the reserve requirement, ρ . That is to say, through $H/M = \rho$, another control variable is introduced into the mix. None of this requires a structuralist approach. The feeling that credit growth and leverage and reserve and margin requirements must be reintroduced into the armoury of Central Banks is gaining ground among the profession's most respected scholars [19].

3. Conclusion

The fiscal deficit of a government must, in the end, be supported by the Central Bank. Academic economists are beginning to appreciate that deflation and deflationary processes are worse than the threat of inflation. Consequently, the monetary and the fiscal authorities must work as one. At the same time, banks are giving way to financial institutions accentuating the opacity and the fragility of economies. It is the task of the government to support commercial banks as they intermediate between investors and savers. The outcome is employment for the production of goods and services.

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