ACCADEMIA NAZIONALE DEI LINCEI

Attachment 3 - Growth and investments vs fiscal rigor and price competitiveness: a choice between two policies *

The debate on fiscal policy choices, both in Europe and in Italy, lies on a fundamental contrast between theses that have their roots in a debate, often overlooked, that pertains economic theory. Without going into details and oversimplifying a wide range of positions, the theories underlying the two main economic policy stances are recalled here.

On the one hand, some believe that the market essentially works well. Apart from temporary hitches and minor frictions or external shocks, such as the current Covid-19 pandemic, when a spontaneous trend towards full employment is assumed to operate (i.e. a situation in which anyone who is willing to work at the prevailing wages on the market, can find a job), public intervention aimed at modifying the market outcome would be generally useless, if not detrimental. On the other hand, some believe that the market does not automatically result into ideal situations, and there is room for improvement through public policies. The former group of economists believe that economic growth (and the rise in well-being that accompanies it) requires a balanced public budget and the containment of public spending; the latter group, the supporters of 'Keynesian' policies believe that it is advisable to intervene with demand support measures especially in periods of economic stagnation.

Almost everybody agree that strong public intervention is crucial to face the present-day crisis, born of a shock that originated outside the economic system. The divergence between the two growth strategies remains however important to explain why some of the main world economies, Italy in particular, were experiencing slow or zero growth already before the current crisis; moreover, it is important to be aware that such a sluggishness will inevitably reappear as soon as the hardest stage of the emergency is over.

In the field of public finance, the most important theoretical paradigms supported by the first line-up (those who are confident in the rebalancing capacity of the market) are the neoliberal one, widespread in the United States, and the ordoliberal one, characteristic of central European countries.[1]

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[1] Many who share this view use the definition "ordoliberal", while the word "neoliberal" is often rejected by the supporters of this approach, or is discarded as a generic and misleading name. Its use in this document refers exclusively to the history of economic thought; it appears for example in the works of Philip Mirowski. For more details and a summary of the history of recent economic thought, see Roncaglia A. (2019), *The age of disgregation. A history of contemporary economic thought*, Cambridge: Cambridge University Press.

Up to the 2008 financial crisis, the neoliberal approach rested on a macroeconomic theory that considers economic growth as essentially generated by technical progress and the ability to accumulate capital, which in these models is assumed to depend on families' propensity to save. "Unproductive" expenses (such as, at least beyond a certain limit, public expenditure, especially current expenditure) therefore constitute an obstacle to growth. According to many, public deficits induce economic agents to expect future increases in taxation, supposedly necessary for the sustainability of the public debt. In the presence of a trend towards the full utilization of production capacity, excessive public spending results in inflationary pressures. Even when involuntary unemployment is assumed to exist, many argue that public deficits cause a reduction in private investment, therefore a slowdown in growth.

Over the past decade, several economists who share this paradigm have supported the thesis of the so-called "expansionary austerity". When it was first formulated, this thesis stated that reducing, or even better eliminating public deficits can lead to an acceleration of economic growth. In the face of its poor empirical record, this theory was then modified to emphasize that austerity policies would have an expansive effect as a result of reductions in public spending rather than increases in tax revenues. In principle, a small or zero deficit can be compatible with any level of public expenditure, if public revenues are equally high; the economic policy tenet of the supporters of expansionary austerity is founded on the main target to reduce the public sphere of the economy. This approach had considerable influence in economic policy choices in the early years of our decade; however, its acceptance in the scientific debate is very limited: many economists that can be labelled as neoliberal have actually approved of expansionary fiscal policy measures, especially those aimed at reducing taxation, even where these produced an increase in the public deficit.

In the European context, especially in the design of the institutional architecture of the EU and the eurozone, the ordoliberal paradigm certainly has more weight, which does not imply a full denial of the role of public policy. According to this paradigm, two conceptual phases must be distinguished: first, the State has a crucial role to play in creating the set of rules and the institutional setup in which free competition can produce socially beneficial effects. Then, state intervention is not advisable in a second stage, in which private agents operate on the market under competitive conditions, except for public actions (such as antitrust measures) that preserve the overall environment, called the "social market economy". From this point of view, public deficits are not generally believed to reduce growth (unlike with the expansionary austerity theory); expansive fiscal policies are recognized to have the effect of increasing incomes and employment. The problem, according to ordoliberal authors, is that this typically ends up with "overheating" the economy, thus generating an excess demand that results in inflation. Furthermore, while recognizing its effects in the short term, the possibility that public spending can sustainably stimulate economic growth is rejected. On the contrary, according to this group of economists exports should be the source *par excellence* of economic growth. A trade balance surplus is thus considered to be a sign of the competitiveness of domestic companies. Especially in the European context, characterized by an aging population, countries should "save" for their old age by maintaining a positive trade balance. The objective of a surplus in the balance of payments is generally pursued through price competitiveness, that is, the ability to sell goods and services at lower prices than the competition, given the perceived quality of products.

The main strategy to stimulate price competitiveness is represented by the so-called structural reforms, a term that refers to privatization and market liberalization measures, especially the labour market, in order to make prices and wages more flexible downwards. As part of this approach, austerity policies are also useful (although less advisable) because, by reducing income, they reduce imports and because, possibly generating unemployment, they induce a decrease (or slow down the rise) in wages, which would allow firms to reduce (or not increase) prices, thus enhancing price competitiveness. The reduction in income and employment are obviously negative side effects in the short term, but they act as a bitter medicine to correct a previous situation in which a country has lived "beyond its means". Gradually, with the return to a positive balance of foreign trade there would be both a return to growth and the restoration of solid financial conditions.

In open contrast to both these paradigms, Keynesian policies stem from criticism of the theoretical assumption of automatic rebalancing mechanisms towards full employment. In various cases, the thesis is upheld that market economies would tend towards situations of persistent unemployment and stagnation, if aggregate demand support measures – which may come from public spending – were not taken. According to these authors, the long-term trend towards the expansion of the public sector in the economy and the broadening and strengthening of the tasks and tools of central banks have allowed the periodic crises that characterized the capitalism of the first two centuries to be significantly limited since World War II. If in the economy there is unused productive capacity (for example involuntary unemployment), then the impact of public spending on the national product will be greater than its cost (the principle of the income multiplier). This would make "the means" on which a country can live endogenous. It would therefore be possible to consume more without producing inflation (although as a by-product the current account deficit might increase).

According to this paradigm, instability of the real economy and crises are often triggered by the financial markets, which are highly unstable and dominated by speculation. Contrary to what the efficient markets theory holds, prices just do not reflect on average the 'fundamental' data of the economy; they vary from day to day, indeed from minute to minute, driven by each market participant's expectations of what other operators think will happen in the near future. This might explains, for example, the misalignment between the stock market trends, in particular in the USA, and the trend in the real economy in recent months.

Furthermore, periods of stagnation or crisis can reduce employment not only in the short term, but also the growth prospects in a longer period. This happens because of the so-called hysteresis. For instance, a firms' bankruptcy generates loss of organizational capacity and know-how that takes time to be reconstituted. Another example is when workers, who have been unemployed for a long time, loose productivity and therefore attractiveness for companies and/or they become structurally inactive, that is, they drop out of the labour market for good.

Various economists who uphold the Keynesian approach underline the importance of cumulative phenomena thanks to which, for example, increases in the demand for goods and services produce increases in firms' productivity. This happens because, operating on a larger scale, companies become more efficient and/or can amortize fixed costs (static and dynamic increasing returns to scale). The impact on productivity is obviously stronger in the case of investments aimed at products or process innovation. In short, according to Keynesian economists, productivity, and not the nominal level of costs and prices, is the key determinant of competitiveness.[2]

Of course, there are several intermediate positions between the neoliberal and ordoliberal approaches and the Keynesian approach. In the scientific debate, many economists would probably take one of these intermediate positions, which are also useful in finding compromises for the formulation of economic policy strategies. For example, the automatic trend towards full employment can be recognized as ineffective or lacking in the short term, thus leaving room for 'Keynesian' policies, even if in the long run the market is assumed to find an efficient equilibrium (the so-called 'neoclassical synthesis'). In the specific case of the Italian economy, Keynesian economists can also be expected to call for caution in the recurse to deficit spending. Such caution is based on the need to avoid an excessive expansion of public debt, especially given the mechanisms of "financial markets discipline" in the eurozone illustrated in Attachment 2. Economists of all orientations will also have a marked preference for capital expenditure over current expenses (such as, in the present situation, a program of renovation of public school buildings and connection infrastructures, or a program for the modernization and redevelopment of the healthcare infrastructure, especially public health services, in addition of course to expenses in basic and applied research). The importance of measures of demand support in times of crisis, and more generally that of investments, are certainly aspects on which compromises in economic policy are more easily reached than on issues more closely linked to specific paradigms of economic theory, such as the "ideal level" of taxation or of public debt.

In the present situation, although many economists have highlighted the problems on the "supply" side, attributing less importance to the drop in consumption and investments in the face of the pandemic, and favouring explanations of the crisis as a consequence of the lock-down measures, there is still a substantial agreement on the advisability of public measures to support the economy on the demand side. The debate referred to here, therefore, will become relevant again in the next few months, when, we hope, the health emergency will be over.

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* Attachment 3 to the Statement "The Covid crisis and a possible turning point for the European Union" by the Lincei Committee on Covid-19

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[2] The most commonly used indicator is generally the cost of labour per unit of product (unit labour costs), obtained as a ratio between average wages and average productivity. Ordoliberal economists focus on the numerator, Keynesian economists on the denominator.