Keynesian Fiscal Policy as the Engine of Growth and Prosperity

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Most mainstream macroeconomics proposes fiscal policy to stabilize economies in the short run; temporary stimulus should respond to transitory weakness in demand. In contrast, our approach, grounded in heterodox Keynesian macroeconomics, explores fiscal policy as an engine of growth and prosperity "beyond the short run."

We begin from a key result in our forthcoming *Cambridge Journal of Economics* article, "Demand-Led Growth and Accommodating Supply." Empirically reasonable linkages between the demand-determined state of the economy and both labor force and productivity growth create a wide range of growth rates over which supply accommodates the path of aggregate demand. There are no "natural" rates of growth or unemployment dictated by supply conditions alone. Instead, demand leads supply. Because stagnant demand drags supply down with it, we argue this result helps explain the disappointing recovery, and possible "secular stagnation," of recent years.

Aggregate demand dynamics modeled our forthcoming article depend on the growth of generic "autonomous demand." Our new paper connects autonomous demand explicitly to fiscal policy. Government spending is at least partially independent of the current state of the economy (which defines "autonomous" in this context). We include the effects of taxes on demand and also track the dynamics of government debt and interest payments with stock-flow consistent accounting. Our model explicitly recognizes how tax and interest transfers differ across income classes to analyze how rising economic inequality interacts with the macroeconomics of fiscal policy.

Preliminary results strongly support a heterodox view of fiscal policy. For empirically realistic cases, we show steady-state government debt-output ratios *will be unaffected* by permanent fiscal stimulus designed to approach full employment. We show the growth rate of the economy depends positively on the growth rate of government spending and the steady-state debt-output ratio *necessarily declines* when government spending growth rises. The intuition behind these results is fundamentally Keynesian: the effects of persistent demand stimulus on output are large enough to offset effects of higher government spending on government deficits and debt.

A qualification to these results, following from our forthcoming article, is that demand not exceed levels supply can accommodate. Therefore, higher government spending cannot raise output arbitrarily high. But under empirically realistic conditions, our results show fiscal stimulus can likely raise growth well above the disappointing “new normal” of the past decade without inflationary demand pressures or unsustainable government debt dynamics.

In coming months, we will analyze transitional dynamics in the model to assess medium-run effects on the economy and government debt. We plan to study how tax policy could be used to reach macroeconomic targets with emphasis on how economic inequality affects the results. We will also consider supply effects from government spending on productive infrastructure.

While this work has fundamental implications for anyone interested in the macroeconomic effects of fiscal policy, we believe our findings will be immediately engage economists who work in heterodox Keynesian macroeconomics. Our new results validate and extend the relevance of the heterodox approach to critical current policy choices.