

## REVIEW OF “FISCAL POLICY UNDER IMPERFECT COMPETITION”

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The consequence of departures from perfect competition for aggregate outcomes is an issue first raised in the macroeconomics literature more than seventy years ago. Nevertheless, it took until the 1980s, and the advent of New Keynesian thinking, before imperfect competition became systematically integrated into mainstream macroeconomic modelling. The deviation from Pareto-optimality to which imperfect competition gives rise no doubt raised hopes amongst economists with Keynesian sympathies that the new research agenda might provide a sounder micro-founded basis for traditional Keynesian policy prescriptions. However, as is clear from this authoritative survey, these hopes have largely been disappointed, at least insofar as they related to the possibility of Pareto-improving fiscal policy.

While imperfectly competitive goods markets play a central role in the modelling approach characteristic of the ‘New Keynesian Synthesis’, this role relates primarily to the provision of a mechanism, which via asynchronous price adjustment by price-setting firms, is capable of generating nominal inertia. In a stochastic environment, such inertia opens up the possibility of effective monetary policy intervention: hence the enormous volume of literature within the New Keynesian mould concerned with optimal monetary policy design. However, so far as fiscal policy is concerned, and despite the finding of a multiplier-type process particular to imperfectly competitive economies, the potential for increased government purchases to enhance welfare seems limited.

Notwithstanding this somewhat negative conclusion, the literature concerned with fiscal policy in imperfectly competitive economies has substantial intrinsic interest, as is evident from this paper. The main body of the text (that is, the introduction and conclusions apart) is divided into two sections. The first (Section 2) deals with static models in which households maximise an atemporal utility function and where labour is the only input into the production process. In the second (Section 3), an explicitly dynamic framework is employed in which output is produced using constant returns to scale technology with both labour and capital as inputs; households optimise over an infinite horizon and their saving choices then determine the evolution of the capital stock over time. Each of the two sections begins with an encompassing general equilibrium framework which nests the models employed in many of the relevant key contributions. The reader is then guided through the principal issues on which these contributions focus.

An extensive treatment of the main issues is provided in Section 2, which begins with the analysis of the multiplier effect as identified in two of the early analyses of fiscal policy in an imperfectly competitive context (Dixon, 1987; Mankiw, 1988). Particularly useful here is the clear explanation of why the parallel drawn with the Keynesian income-expenditure model multiplier should be viewed with some circumspection. The degree to which the effects of government spending on output and welfare are dependent on the underlying model specification is then considered in some detail. Specific issues considered include the nature of the government’s tax function and the form of household preferences. The possibility of

free entry and exit of firms in response to super- or sub-normal profits for the relationship between the short-run equilibrium (with the number of firms fixed) impact of fiscal policy and its long-run (with the zero-profit condition satisfied) effects is also examined. Further to its direct implications, free entry and exit raises further issues relating both to the potential welfare effects of households' 'love for variety', and to the endogeneity of mark-ups as the degree of market power enjoyed by an individual firm varies with the mass of its competitors.

The treatment of the intertemporal framework of Section 3 covers much the same issues, though the increased complexity of the model leads the authors to impose some simplifying restrictions; for example, assuming that taxes are entirely lump-sum in nature and abstracting from any love for variety effects. Furthermore, in order to avoid increasing the order of the dynamics of the model, the entry or exit of firms, if allowed, is assumed to be instantaneous. Following the investigation of its steady-state properties and adjustment dynamics, the model is used to identify the long-run effects of fiscal policy, and to examine the nature of the economy's associated transition path. In fact, the long-run comparative statics of an increase in government spending essentially replicate, in a qualitative sense, those of the static model of Section 2. With regard to the short-run dynamics, the principal focus here is on how the possibility, or otherwise, of the entry and exit of firms influences the nature of the adjustment process and, in particular, the impact effect of a fiscal shock. One particular finding of interest here is the likelihood that free entry or exit will exacerbate the immediate decline in consumption associated with increased government spending.

The exposition and content of this survey paper are likely to make it useful to a wide audience. It represents an excellent source of reading material for an advanced undergraduate/ first year postgraduate macroeconomics course. Beginning research students will no doubt gain from it ideas for possible thesis topics. Finally, it provides an ideal point of entry for practising academics whose main research interests have hitherto lain outside the area of 'macroeconomics with imperfect competition' but are looking for an overview of key results relating to an important aspect of this broad field. As someone whose own interests in this topic had rather lapsed in recent years, this paper both provided a reminder of why I was initially drawn to it and informed me that it continues to represent a lively and developing body of research.

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## **References**

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