Review of Fiscal Policy under Imperfect Competition: A Survey by Luis F. Costa and Huw Dixon

The paper surveys the historical development of the analysis of fiscal policy effects in general equilibrium models with imperfect competition. The effect of government spending on endogenous variables, in particular on output, consumption, and labor, is discussed first in a static framework (section 2), and then in an intertemporal perfect foresight framework in continuous time (section 3). In each case, the paper highlights the role of the degree of imperfect competition, parameterized by the markup ratio, in determining the size of the multiplier effect that changes in government spending have on the private sector. A large variety of different model specifications is reviewed, with particular emphasis on the precise nature of imperfect competition. As a transmission mechanism specific to models of imperfect competition, endogenous firm entry is analyzed.

As the paper makes clear, imperfect competition has been discussed as a potential new foundation of Keynesian Economics in a literature beginning in the 1980ies. It is quite interesting to note, from today's perspective, that this literature had a rather mixed success in the longer run. On the one hand, imperfect competition has been adopted in the mainstream of the macroeconomic literature. The now standard New Keynesian macro models routinely assume some form of imperfect competition, mostly monopolistic competition of the Dixit-Stiglitz variety. On the other hand, the largest part of this literature does not view imperfect competition as interesting in itself, but rather as a prerequisite for making price stickiness plausible. The reason is that if prices are sticky, firms must be willing to expand output if some expansionary (for example monetary) shock occurs, even if production costs increase. Thus, to prevent negative profits, the markup must be positive on average, which is why imperfect competition is essential. However, while models with monopolistic competition and stickiness are standard now, the literature has viewed the most interesting aspects of these models in the stickiness part, and not in the imperfect competition part at its basis.

The present survey makes clear why this is the case. The authors show in various examples that the way fiscal policy affects a flexible price economy does quantitatively depend on the degree of imperfect competition. However, the transmission mechanisms are generally very similar to neoclassical models without this feature. Thus, while imperfect competition was helpful at the birth of the New Keynesian macroeconomics, it was not the market structure in itself that gave rise to qualitatively new insights, but the associated possibility of devising coherent general equilibrium models with price frictions.

Apart from these historical considerations, one might thus ask how important a study of fiscal policy under imperfect competition in flexible price models is from today's perspective. Generally, the literature has developed in the direction of attempting to explain empirical time series evidence of the effects of fiscal shocks in a dynamic general equilibrium framework. As the present survey makes clear, in many cases the assumption of imperfect competition is not really necessary, nor particularly helpful in itself, in this endeavour. The neoclassical supply side effects that dominate the way in which fiscal policy works in general equilibrium are too similar under different market structures.

However, some authors have recently revived the interest in models of countercyclical markups for the explanation of fiscal policy (e.g. Ravn et al, 2007, Monacelli and Perotti, 2008). This is one aspect where imperfect competition might be promising for explaining the empirical effects of fiscal shocks. It is a little unfortunate, in my view, that this interesting recent literature is only briefly mentioned at the end of the paper.

To sum up, the paper is a useful survey of the older and some of the more recent literature. Whether imperfect competition turns out to be a crucial mechanism for explaining fiscal policy effects depends on whether these models can better explain the time series evidence that the recent literature has produced than alternative models with perfect competition. As I read the paper, most of the models discussed here do not fulfill this criterion, though some countercyclical markup models might.