

LECTURE VIII

6 March 2012

TOPIC 9

Fiscal Policy

BIG PICTURE

- What is fiscal policy?
- Under what circumstances do we use fiscal policy?
- How do we implement fiscal policy and what are some costs?
- What role *should* fiscal policy play in stabilizing the economy?

WHAT IS FISCAL POLICY



Your son has a genetic inability to calculate. This forecasts for him a brilliant career in the Ministry of Finance.

FISCAL POLICY

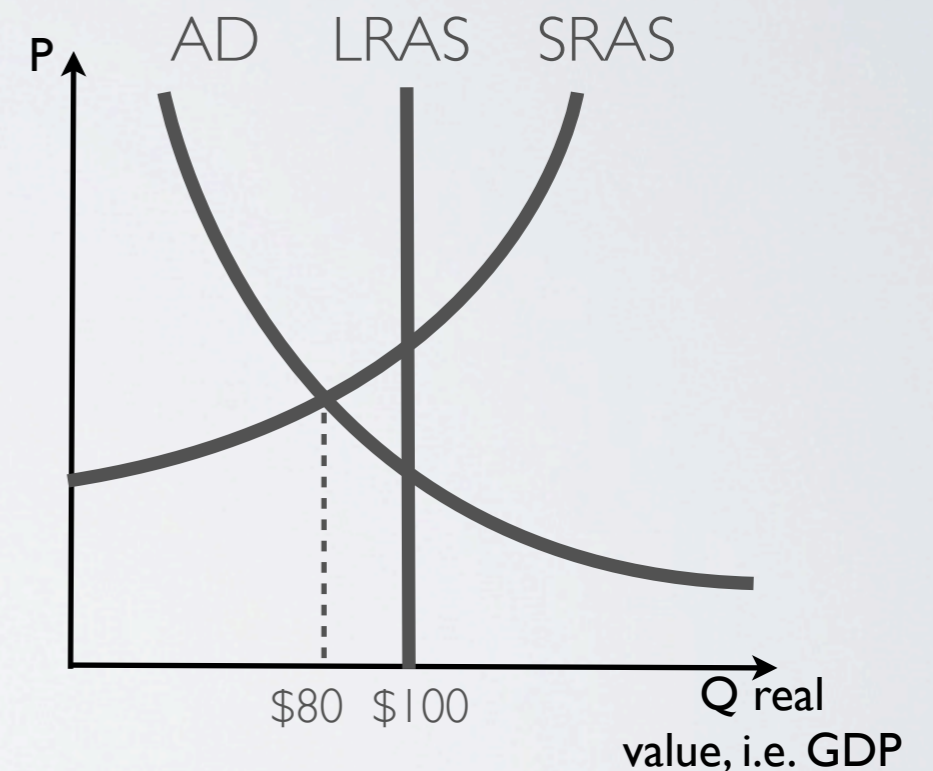
- **Fiscal policy:** Changes in government purchases and, or tax collection designed to achieve full employment and a noninflationary domestic output
 - Why noninflationary?
 - What other goals could we set?
- **Expansionary Fiscal Policy:** Increase in government purchases or decrease in taxes for the purpose of increasing AD
- **Contractionary Fiscal Policy:** A decrease in government purchases or increase in taxes for the purpose of decreasing aggregate demand
 - Why would we want a contractionary policy?
 - How do taxes impact AD?

CLOSING THE (GDP) GAP

- Any difference from the natural rate of output is a tenuous situation
- **GDP gap**: the difference between the NRO and short run GDP
- **Gap** = Short-run equilibrium quantity - NRO
- Will assume that most policies are geared toward (attempting) to close the GDP gap

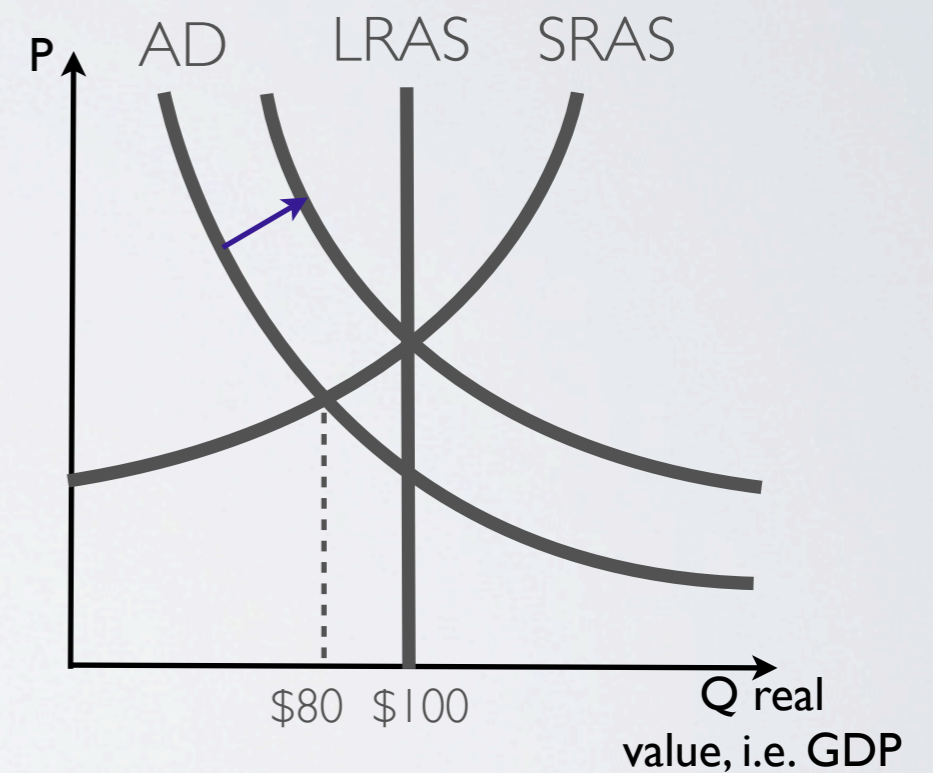
FP EXAMPLE

- Suppose the NRO is \$100 and Short-run GDP is \$80.
 - Gap is -\$20
- How do we close the gap? AD or SRAS
- If we just change spending (not taxes):
 - a. Spend \$20
 - b. More than \$20
 - c. Less than \$20



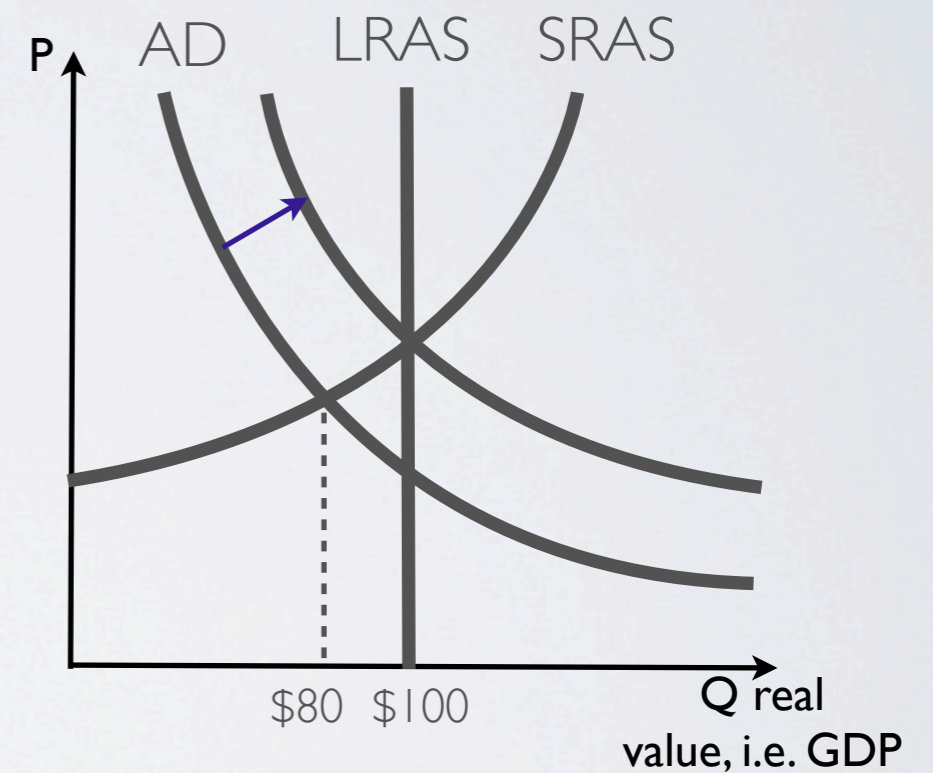
FP EXAMPLE: CASE I

- Let's increase RGDP by \$20 through increased G spending
- Remember?
 - Total change in AD = $1 / (1 - MPC) * \Delta ISOM$
 - What if $MPC = .5$?
 - Need change in spending of \$10



FP EXAMPLE: CASE 2

- Let's increase RGDP by \$20 through tax changes. Recall:
 - Taxes impact consumption
 - Consumption is part of AD so need Consumption to change by \$10
 - Original change in consumption is $MPC * \text{Change in income}$
 - Then can apply multiplier
 - Government needs to transfer **\$20** in tax cuts



FP EXAMPLE

- Theoretically, which is more effective?
 - What happens to the rest of the economy if spending increases and taxes do not change?
 - Remember, investment decreases by crowding out so GDP may not recover
 - What if taxes are cut without a change in spending?
 - Government may have to borrow, which requires spending more **later** to cover costs today
- How would a combination work?

COSTS AND BENEFITS OF FISCAL POLICY



AUTOMATIC STABILIZERS

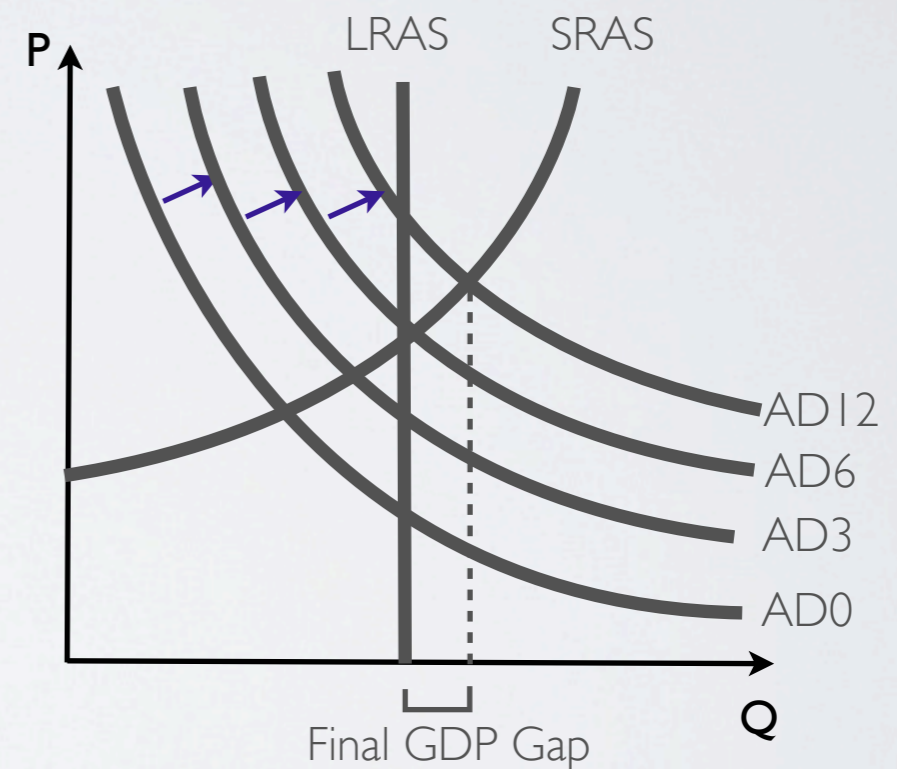
- Most costs from fiscal (and monetary) policies stem from implementation times (how long does it take for Congress to decide anything?)
- But an **automatic stabilizer** is a change in policy that stimulates AD when the economy goes into a recession without policy makers having to take a deliberate action
- Examples?
 - Consumers face a **progressive tax** system; as income falls, so too do taxes
 - Firms face progressive **profit taxes**; in recessions profits fall very quickly
 - **Unemployment benefits** are granted when someone loses their job
- These changes are obviously not always sufficient

TIMING PROBLEMS

- **Recognition lag:** Time to recognize recession (who does this?)
- **Administrative lag:** Time for Congress to agree on some stimulus program
- **Operational lag:** Time for bill to take affect, figure out where money goes, etc.

WHY ARE TIMING PROBLEMS AN ISSUE?

- Suppose we have the following hypothetical situation...:
 - T=0: Enter recession
 - T=3: Realize the recession exists, economy has begun to recover
 - T=6: Issue tax breaks; economy has reached old equilibrium
 - T=12: Economy has overheated (Demand-pull inflation)
- In a short recession (how do we know *a priori*?), fiscal policy is probably too slow
- Now what? A business cycle caused by politicians



FUTURE POLICY REVERSALS

- There are also differences in the impact of permanent and temporary policy changes
 - If the government promises to permanently remove taxes (and you believe it), how would you change your spending and saving
 - If the government is implementing a temporary tax cut but you know taxes will increase next year?
- Temporary fiscal policies have a smaller impact on the economy than permanent

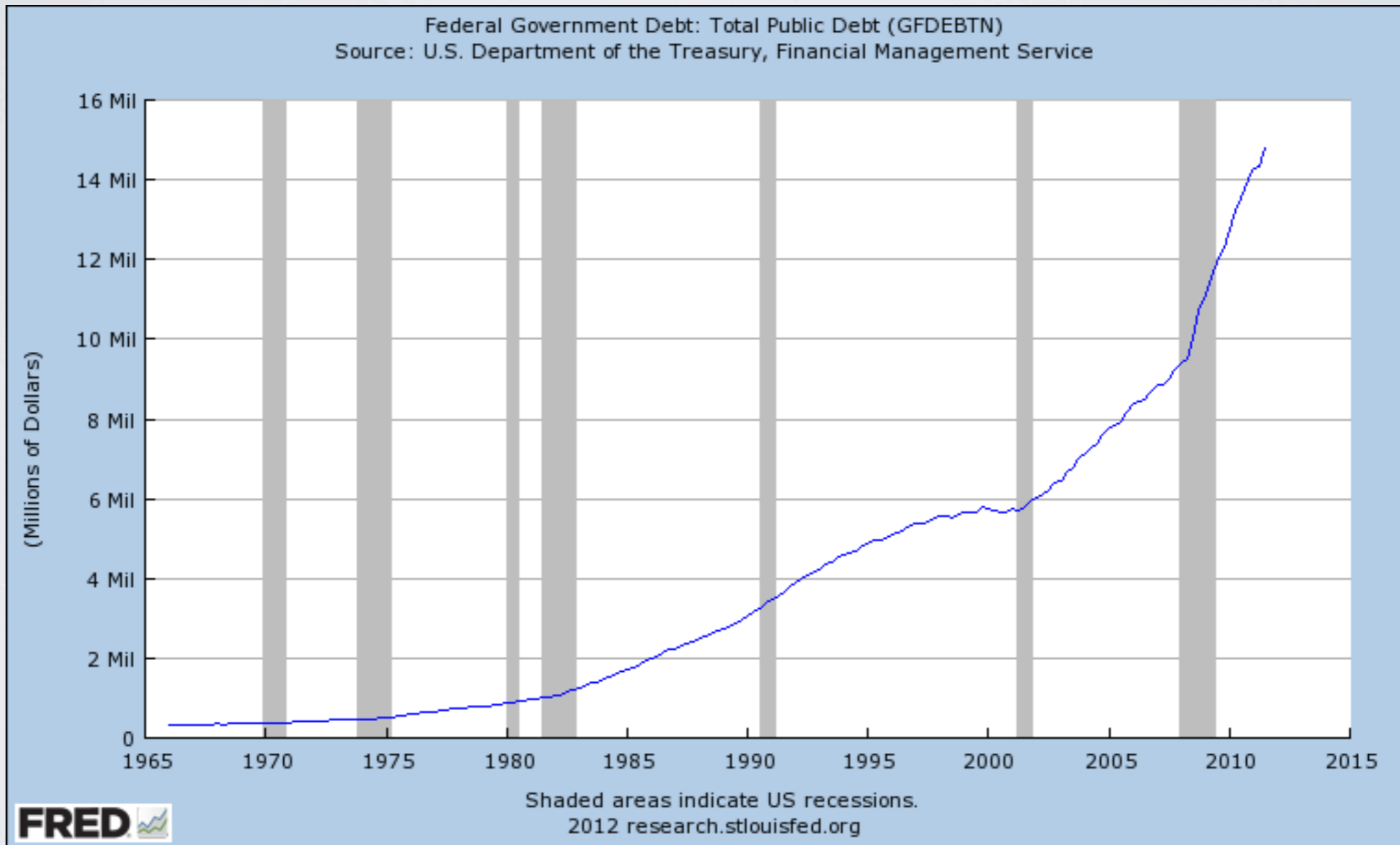
BALANCE BUDGET ISSUES

- When does the government spend more money?
 - Counter-intuitively, we want the government to spend *more* when in recession
 - If spending increases when income decreases, this forces accumulation of debt
- Does this problem exist at the state level?
 - Most states have **balanced budget** amendments
 - So during recessions, debt does not accumulate, but spending must decrease or taxes must increase
 - What are some alternatives to these bad fiscal policies with a balanced budget amendment?

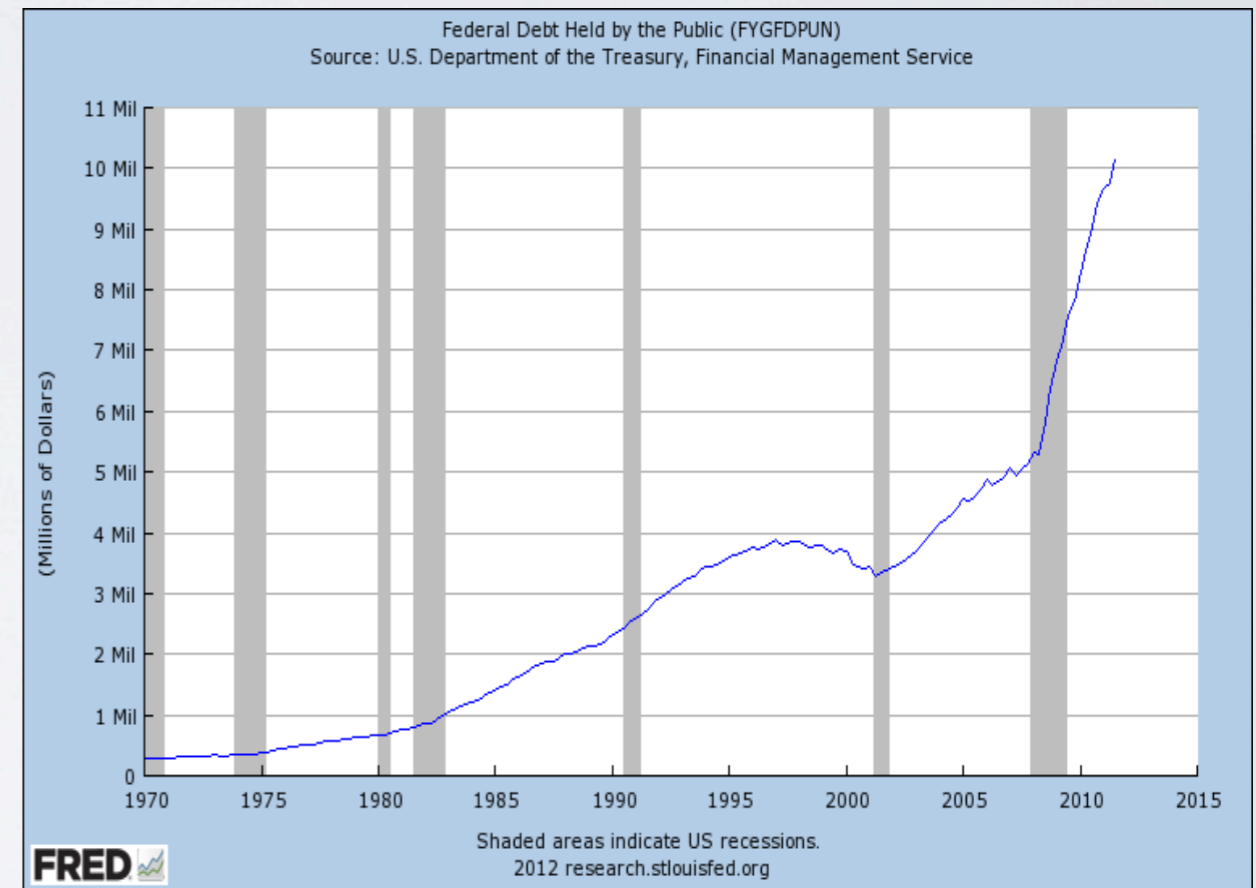
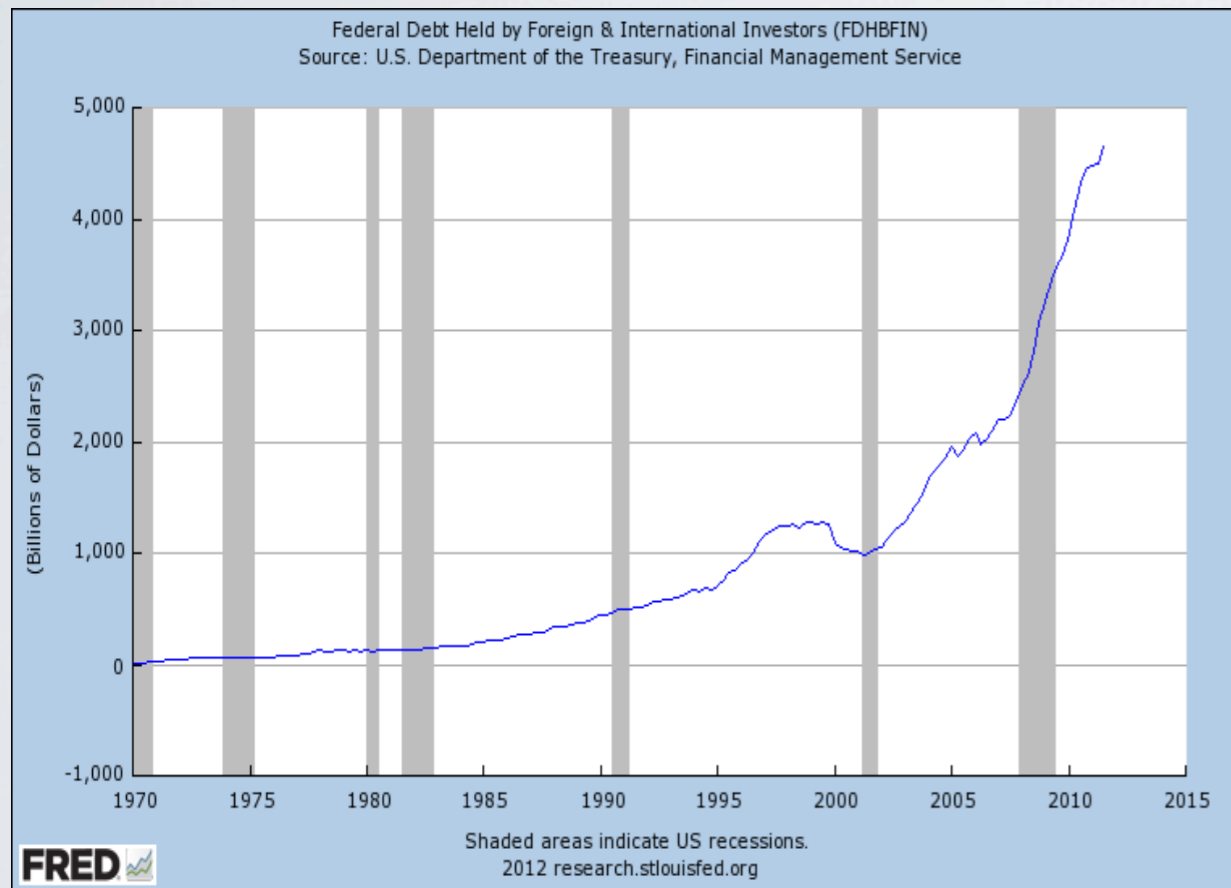
POLICY: INCREASE G, REDUCE T

- Mentioned theoretical problems with both types of policies
 - In general, spending estimated to more effective; \$1 of spending generates \$1.59 increase in demand, and \$1 tax cut generates \$.99 increase in demand
 - But what if you see the government as an inefficient, bureaucratic slug?
 - T versus G comes down to a political question

US NATIONAL DEBT



US NATIONAL DEBT



US NATIONAL DEBT

- So of \$14.19 trillion in debt, a third is held by Federal agencies that owe to each other
- 2/3 is owned by the “public”
 - Half is held by banks, individuals, local governments
 - Half is held by foreign institutions
 - So 66% of debt is held by Americans
- Although debt is huge and accumulating, public debt is still *relatively* small compared to GDP (60% of GDP); compare to over 100% during WWII
- Expectation is that eventually the government will pay back more than interest on debt

NORMATIVE ANALYSIS



SHOULD THE GOVERNMENT BALANCE THE BUDGET

- ~ \$47,000 in debt per person
- Should balance
 - Avoids burden on future taxpayers
 - National savings is lower with more spending, which raises interest rates, decreasing investment, etc.
- Should not balance
 - Burden is small compared to lifetime income
 - Debt can always rise without huge cost if income rises fast enough
 - Cost of cutting other programs

ENCOURAGE SAVINGS ELSEWHERE?

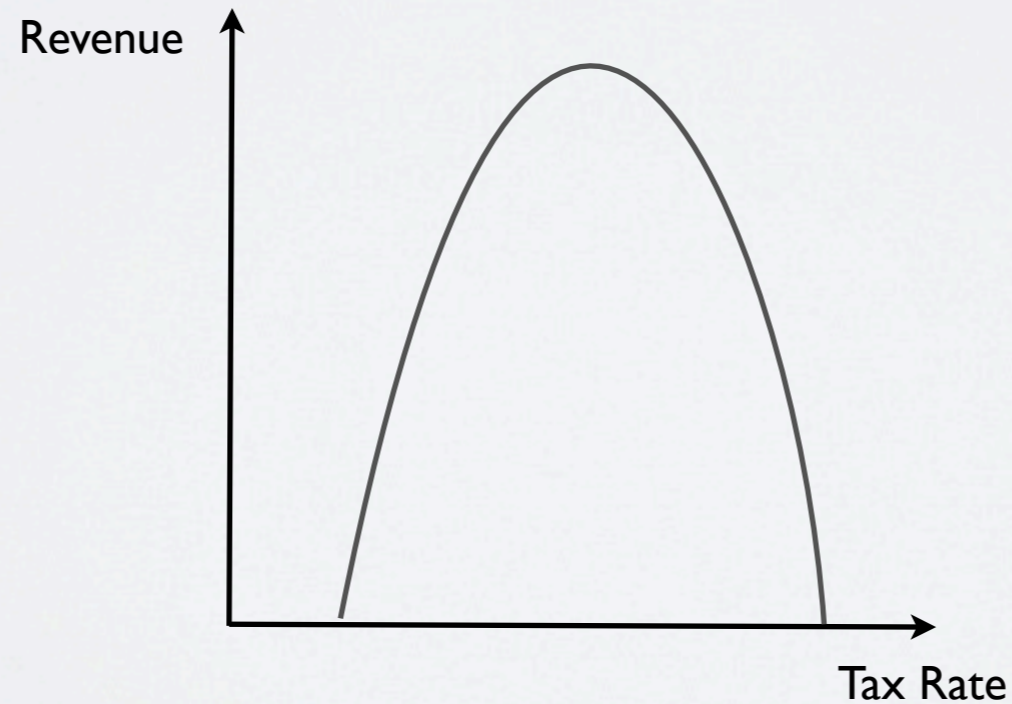
- Should encourage saving
 - Resources are available for investment
- Should not encourage
 - High income households already save more so saving incentives will favor the rich
 - Higher returns may encourage savings (why?) but also lowers the need by the income effect

TAXES V. REVENUE

- Logical to believe that taxes decrease government revenue?
- There is a miraculous idea that decreasing taxes pays for itself by higher GDP generated as a result
- There is *theoretical* support in the **Laffer Curve**
 - Idea is based on observation that desire to work should decrease with higher taxes

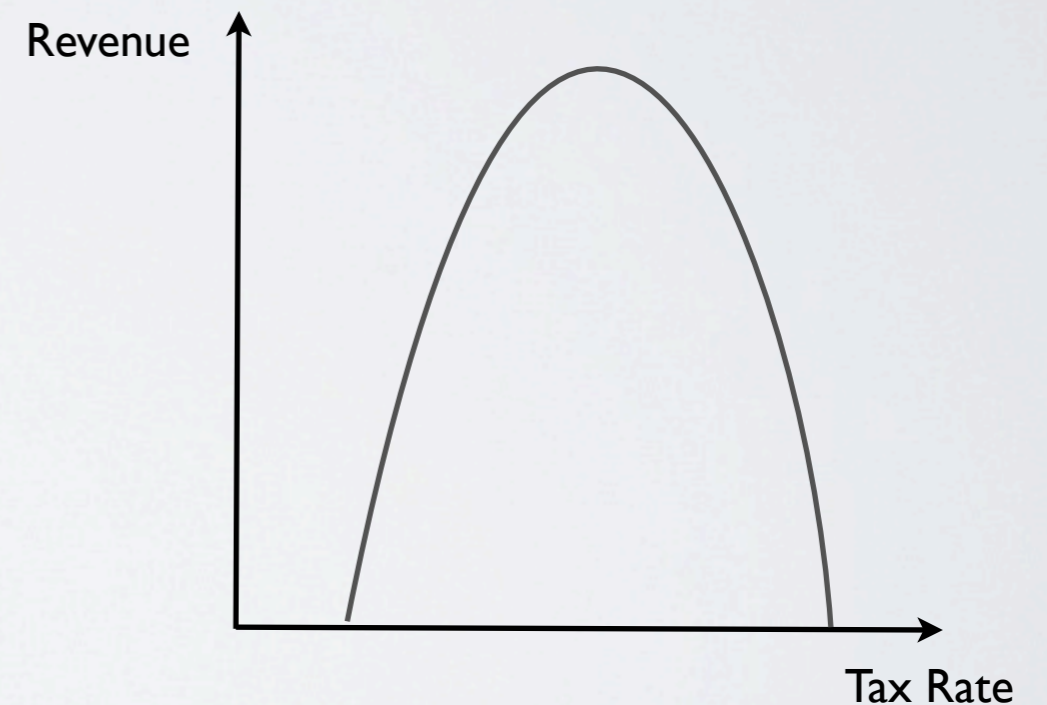
LAFFER EXAMPLE

Tax Rate	Hours Worked	Worker Income	Tax Revenue
0%	40	\$400	\$0
25%	30	\$300	\$75
50%	20	\$200	\$100
75%	10	\$100	\$75
100%	0	\$0	\$0



LAFFER EXAMPLE

- The government can increase revenue by tax reduction if they have a rate higher than 50%
- Being “on the right side” is generally bad; you can have more money with lower taxes
- US has been on the left side since at least the 80s



OVERVIEW

- Fiscal policy includes the tools the government has to change the dynamics of the macroeconomy, typically through taxes and spending
- FP typically comes down to a political, rather than economic, questions and frequently is too slow to make a difference in a recovery
- Automatic stabilizers, however, can play an important role in returning the economy to equilibrium