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Notes – Topic 9

Topic 9: Fiscal Policy

I. What it Is
   a. Changes in government spending or taxes designed to influence aggregate demand and thus GDP or the price level.
   b. Large-scale changes explicitly intended to have such effects.
   c. Remember a change in government spending is about equal to an opposite change
   d. Expansionary Fiscal Policy: Increase in government spending. Designed to stimulate economy and boost aggregate demand.
   e. Contractionary Fiscal Policy: Decrease in government spending.
   f. Trademark of Keynesian economics is that government should use fiscal policy to manage the economy.
   g. Real-Life Example: Bush's Tax Cuts
      i. Booming economy through 1990s. Recession by 2002.
      ii. Tax cut partially sold as stimulus to boost economy
      iii. Business taxes decreasing means investment rises, which boosts aggregate demand.
      iv. Household taxes decreasing means consumer spending rises, which boosts aggregate demand.
   h. They were actually planning tax cut long before the recession for different reasons (obligation to return surplus to people). They really just want to cut taxes.

II. Keynesians vs. "New Classicals"
   a. New Classicals
      i. Anti-Keynesian View.
      ii. Want to emphasize continuity with pre-Keynesian "Classical" view.
      iii. Economy tends to be at equilibrium at or near potential output.
      iv. Economy will correct itself within a short time.
      v. Views have always been around, even when Keynesian views dominated.
      vi. Boils down to beliefs about the slope of the Aggregate Supply curve.
      vii. Deny that recessions would become self-perpetuating problems.
   b. Most modern economists draw from both views. Neither extreme is particularly dominant. Back closer to Keynesian thinking overall.
   c. Either point of view can be right at different times.
      i. Perhaps Aggregate Supply curve is indefinite: shallow below potential output and steep near it and above it.
      ii. Probably best to try adjusting only major problems and leave small problems alone.

III. Problems with Fiscal Policy
   a. *Everybody* acknowledges these.
   b. Supply-Side Shocks
      i. Stagflation. Fall in real output and increase in price level.
      ii. Expansionary policy would boost inflation.
      iii. Contractionary policy to address the inflation would decrease output.
      iv. Only works, even in theory, for Aggregate Demand side shocks. Supply-side shocks can't be corrected with fiscal policy.
   c. Politics
      i. Difficult to sell expansionary policy. Just worsens debt and deficit.
      ii. Difficult to convince public that deficit would be good – public thinks it's irresponsible.
      iii. Contractionary policy is even harder to sell – requires higher taxes or cutting government programs. Neither is very popular.
   d. Time Lags

i. Must first realize there's a problem. GDP data isn't real-time – available only quarterly.
ii. Then draft legislation to address the problem.
iii. Then get the legislation passed.
iv. Then the new policies must actually have their effect on the economy. Several months? Even more than a year?
v. By the time new policy actually has its effect the conditions it was designed to address may have changed.
vi. Keynesians used to talk about fine-tuning the economy. Analogy of high-performance sports car. Make a small change and it changes direction very quickly and accurately.
vii. Better analogy is an oil tanker. Very sluggish to respond.
viii. Governments rarely adjust spending for purposes of adjusting the economy Keynes style.
ix. Some Examples:
    1. Japan made efforts to address its recent stagflation, but with little success.
    2. US Fed passed fiscal stimulus bill to address the current recession a week ago.
        a. Perfect example of how NOT to do it.
        b. Took so much time and politicians cut so much from the original bill that it's now weak and irrelevant.

IV. Automatic Stabilizers
- a. Programs in government that work as fiscal policy on autopilot.
- b. Occur spontaneously without any need for government decision.
- c. Examples: Corporate profit tax and personal income tax.
    - i. Revenues drop automatically when a recession begins.
    - ii. Automatic reduction in taxes equates to expansionary policy.
- d. Works very well to help smooth business cycles.
- e. Agreement that without automatic stabilizers swings would be much worse.

V. Real World Fiscal Policy
- a. Taxes and spending are rarely changed for the purpose of changing aggregate demand.
- b. Levels of taxes and spending still have an influence on aggregate demand.
- c. Government spending is a very large part of GDP.
    - i. Taxes = 30% of GDP.
    - ii. Government Spending is just under 20% of GDP.
    - iii. The difference is in transfers (social security, welfare, etc)
- d. In other advanced nations, government takes even more of GDP. Japan is the only advanced nation similar to the United States.
    - i. Sweden taxes are 65% of GDP. (Extreme case)
    - ii. Not unusual to find 40% or 50%
- e. Aggregate Demand effects are side-effects. Spending and Tax decisions are made for microeconomic reasons.

VI. Deficits and Debt
- a. Technically a separate issue but deeply mixed with fiscal policy debates.
- b. Deficit is excess of government spending over tax revenues in a given year.
- c. Debt is the cumulative total of deficits at a particular point in time.
- d. Why are they bad?
    - i. Public finds deficits inherently bad.
    - ii. Economists find little problem with a government running a deficit during a recession.
    - iii. Government finance should be considered over the whole business cycle.
        1. Should run deficit during recession and surplus during expansion.
        2. Should balance out over the whole cycle.
        3. Called "Counter-cyclical" Fiscal Policy.

iv. Problems *will* arise from running chronic deficits.
    1. Means budget is perpetually accumulating debt.
    2. Crowding-Out Effect
        a. Occurs because there's a limited amount of savings available to everyone who wants money.
        b. The government will start to borrow savings that would otherwise go to the private sector.
        c. Direct effect: Funds taken that would otherwise have boosted growth.
        d. Indirect effect: Government borrowing might push up interest rates. Cost of borrowing money rises; lenders take advantage of having more competition.
        e. Ultimately it's a form of national dissaving.
        f. If deficits run only during downturn there's no crowding-out. Investment falls during downturns anyway.

v. Inflationary Implications
    1. Seignorage
    2. Even when deficits financed through bonds, aggregate demand is pushed rightward. Demand-pull inflation.
    3. Also not a problem if the deficit is only run during a downturn. There's inflation then anyway.

vi. Deficits themselves aren't bad. Can even be good, as long asthey're offset by surpluses.

e. Used to be balanced-budget amendment proposal. Turned down by economists.

f. By international standards, U.S. isn't too bad. Japan for example has debt of more than 100% of GDP. At worst, US had about 60%.