

Principles of Macroeconomics

ECON 2002.01 - Chapter 13 Fiscal Policy

Introduction

In response to the economic downturn of 2008-2009, Congress passed the American Recovery and Reinvestment Act (ARRA) as an attempt to stimulate total planned expenditures through additional government spending. Although large portions of the federal funds authorized by ARRA were allocated to states, states spent no more than 5 percent of the total ARRA funds they received.

This chapter will help you explore the questions of what the government hoped to accomplish through ARRA and why states spent only a small fraction of their funds

Learning Objectives

- Use traditional Keynesian analysis to evaluate the effects of discretionary fiscal policy
- Discuss ways in which indirect crowding out and direct expenditure offsets can reduce the effectiveness of fiscal policy actions
- Explain why the Ricardian equivalence theorem calls into question the usefulness of tax changes
- List and define fiscal policy time lags and explain why they complicate efforts to engage in fiscal "fine tuning"
- Describe how certain aspects of fiscal policy function as automatic stabilizers for the country

Chapter Outline

- Discretionary Fiscal Policy
- Possible Offsets to Fiscal Policy
- Discretionary Fiscal Policy in Practice: Coping with Time Lags
- Automatic Stabilizers
- What do We Really Know About Fiscal Policy?

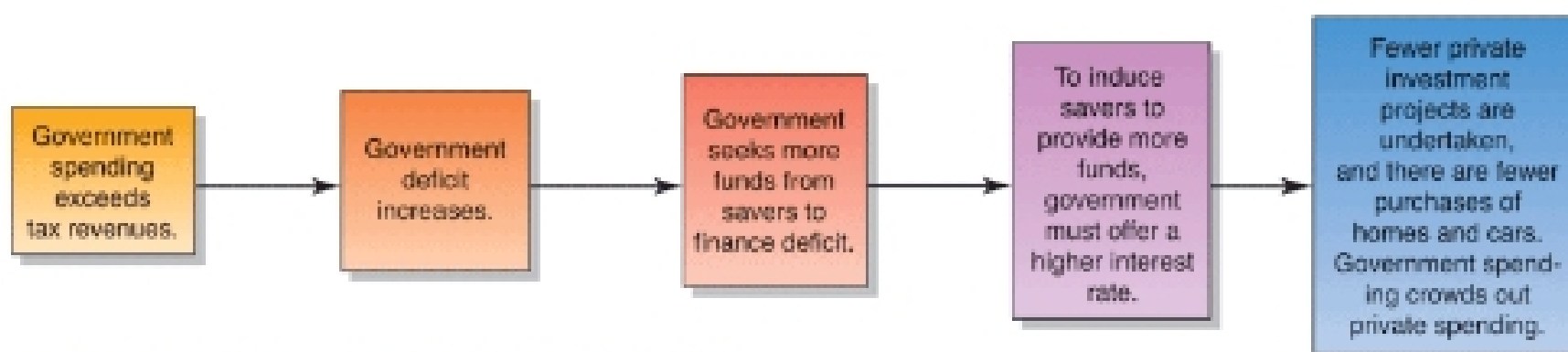
Discretionary Fiscal Policy

- **Fiscal Policy**
 - The discretionary changing of government expenditures or taxes in order to achieve national economic goals, such as:
 - a) High employment (low unemployment)
 - b) Price stability
 - c) Economic growth
 - An increase in government spending will stimulate economic activity
 - **Changes in government spending:**
 - Military spending
 - Education spending
 - Budgets for government agencies
- **Questions**

- Would the increase in government spending equal the size of the gap?
- What impact would expansionary fiscal policy have on the price level?
- What would be the long-run impact of a tax cut on real GDP if the economy is at full-employment equilibrium?
- **Change in taxes**
 - A rise in taxes causes a reduction in aggregate demand because it can reduce consumption spending, investment expenditures, and net exports
- **Expansionary Fiscal Policy**
 - Is established when there is high unemployment
 - Increases aggregate demand
- **Contractionary Fiscal Policy**
 - Reduces aggregate demand

Possible Offsets to Fiscal Policy

- **Fiscal policy does not operate in a vacuum and important questions must be answered**
 - How are expenditures financed and by whom?
 - If taxes are increased what does government do with the taxes?
 - What will happen if individuals worry about increases in future taxes?
- **Crowding-out effect**
 - The tendency of expansionary fiscal policy to cause a decrease in planned investment or planned consumption in the private sector
 - This decrease normally results from the rise of interest rate



- **Ricardian Equivalence Theorem**
 - The proposition that an increase in the government budget deficit has no effect on aggregate demand
 - Reason: people anticipate that a larger deficit today will mean higher taxes in the future and adjust their spending accordingly
- **Permanent income hypothesis**
 - The theory of consumption known as the *permanent income hypothesis* asserts that an individual's current consumption depends on anticipated lifetime income
 - Therefore, a temporary tax cut will have a restrained effect on aggregate consumption
 - People are not going to make a lot of purchasing decisions because of a small increase or decrease in tax rates
- **Direct Expenditures Offsets**
 - Actions on the part of the private sector in spending income that offset government fiscal policy actions
 - Any increase in government spending in an area that competes with the private sector will have some direct expenditure offset
- **The supply-side effects of changes in taxes**
 - Expansionary fiscal policy could involve reducing marginal tax rates
 - a) Advocates argue this increases productivity since individuals will work harder and longer, save more, and invest more
 - b) The increased productivity will lead to more economic growth

- Lower tax rates lead to an increase in productivity because individuals will work harder and longer, save more, and invest more
- Increased productivity will in turn lead to more economic growth, thus higher real GDP
- Results: Lower marginal tax rates will not necessarily reduce tax revenues due to a larger tax base

Discretionary Fiscal Policy In Practice: Coping with Time Lags

- Question
 - Is the conduct of fiscal policy as precise as it appears?
- Answer
 - The difficulty is that the conduct of fiscal policy involves a variety of lags
- Time lags
 - **Recognition Time Lag**: the time required to gather information about the current state of the economy
 - **Action Time Lag**: the time required between recognizing an economic problem and putting policy into effect
 - a) Particularly long for fiscal policy which requires congressional approval
 - **Effect Time Lag**: the time it takes for a fiscal policy to affect the economy
- Fiscal policy time lags are:
 - Long: a policy designed to correct a recession may not produce results until the economy is experiencing inflation
 - Variable in length: they can be from 1-3 years, and the timing of the desired effect cannot be predicted
 - a) Because fiscal policy time lags tend to be *variable*, policymakers have a difficult time fine-tuning the economy

Automatic Stabilizers

- **Automatic or Built-In Stabilizers**
 - Changes in government spending and taxation that occur automatically without deliberate action of Congress
 - a) The tax system
 - b) Unemployment compensation
 - c) Welfare spending
- **The Tax System**
 - Incomes and profits fall when business activity slows down, and the government's tax revenues drop as well
 - Some economists consider this an automatic tax cut, which therefore stimulates aggregate demand
- **Unemployment Compensation and Income Transfer Payments (Automatic)**
 - Unemployment compensation reduces changes in people's disposable income. Their disposable income remains positive, although at a lower level
 - In a recession, more people are eligible for income transfer payments and do not experience as dramatic a drop in disposable income
- **Stabilizing Impact**
 - The key impact of these systems is the ability to mitigate changes in disposable income, consumption, and the equilibrium level of GDP
 - If disposable income is prevented from falling as much as it otherwise would in a recession, the downturn will be moderated