MODERN PRINCIPLES OF ECONOMICS
Third Edition

Chapter 18

Fiscal Policy

Tyler Cowen • Alex Tabarrok

Outline

- Fiscal Policy: The Best Case
- The Limits to Fiscal Policy
- When Fiscal Policy Might Make Matters Worse
- So When Is Fiscal Policy a Good Idea?

Introduction

- In 2008, the U.S. economy was heading into a severe recession.
- In the third quarter of 2008, consumer spending dropped by 3.7%.
- To encourage spending, the government sent rebate checks to millions of US taxpayers.
- In 2009, hundreds of billions of dollars were spent on infrastructure.
- Both are examples of fiscal policy.

Introduction

- We will use aggregate demand and aggregate supply to understand fiscal policy.
- Two general categories of fiscal policy are used to fight a recession:
  1. The government spends more money.
  2. The government cuts taxes, giving people more money to spend.
- The first increases government spending while the second increases private sector spending.

Definition

Fiscal policy:

Federal government policy on taxes, spending, and borrowing that is designed to influence business fluctuations.

Why Should Fiscal Policy Work?

- When the economy is at full employment, spending more won't appreciably increase output.
- New production will pull resources from other sectors of the economy.
- At full employment, the increase in government spending will mostly ***crowd out*** production by the private sector.
- Net effect on GDP will be close to zero.

Definition

Crowding out:

The decrease in private spending that occurs when government increases spending.

Why Should Fiscal Policy Work?

- If resources used in new production would have otherwise been unemployed, then every dollar spent will add one dollar to GDP.
- Increased spending by the previously unemployed workers could increase GDP by more than the initial amount.
- The additional increase in spending is due to the ***multiplier effect***.
- Fiscal policy can work because when resources are unemployed, the economy is operating inefficiently.

Definition

The multiplier effect:

The additional increase in AD caused when expansionary fiscal policy increases income and thus consumer spending.

There is a large debate over how large the multiplier really is

Self-Check

An increase in government spending that causes a decrease in private spending is called:

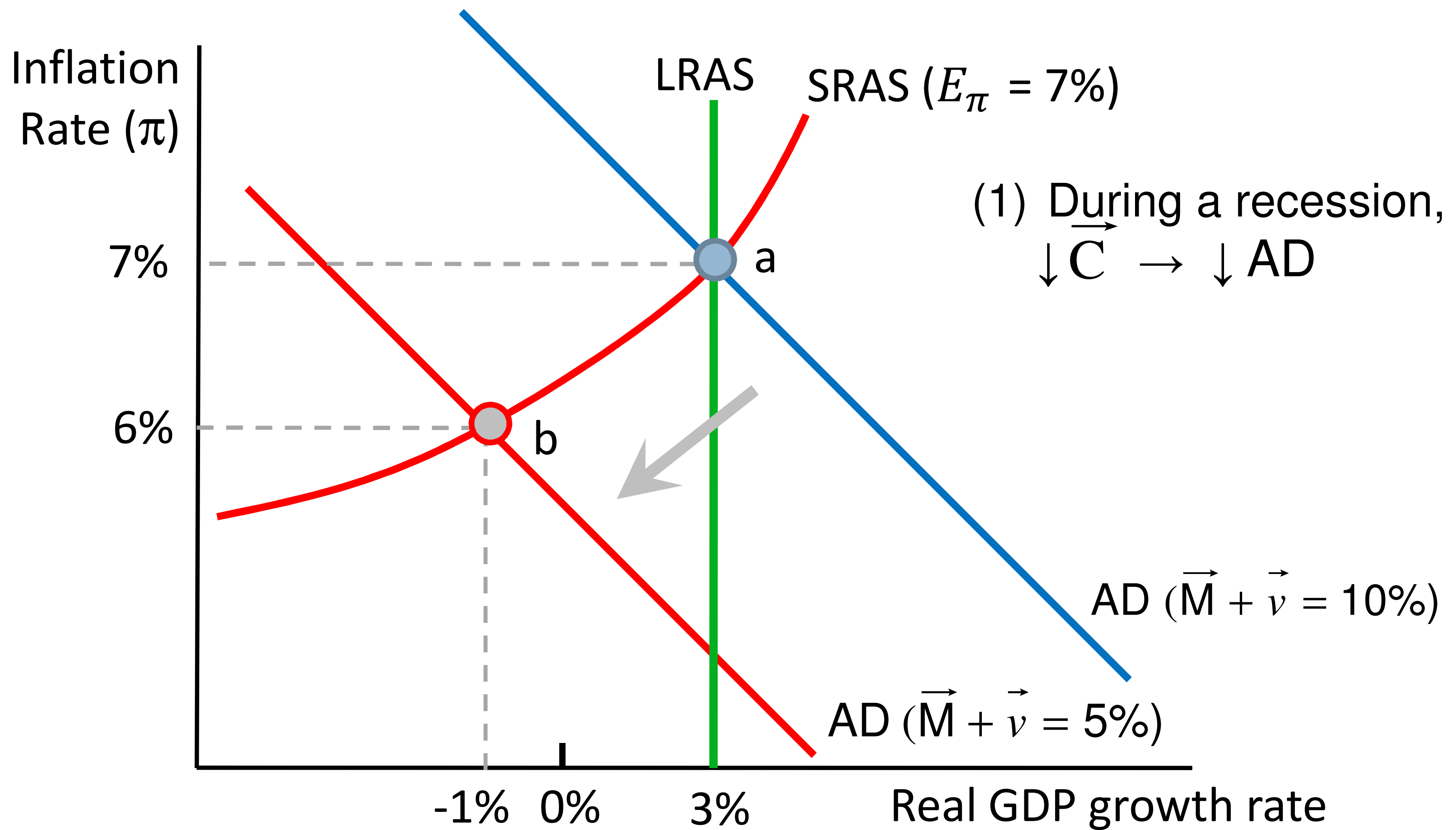
a. The multiplier effect.
b. Crowding out.
c. Fiscal policy.

Answer: b. An increase in government spending that causes a decrease in private spending is called crowding out.

Why Should Fiscal Policy Work?

- A decrease in consumer spending growth, $\downarrow \vec{C}$, is equivalent to a decrease in velocity, $\downarrow \vec{v}$.
- AD shifts to the left.
- The economy moves from a long-run equilibrium at point *a* to a short-run equilibrium at point *b*.
- At point *b*, the economy is in a recession.
- Because consumers want to hold more money, inflation decreases.
- Because wages are sticky, real growth decreases.

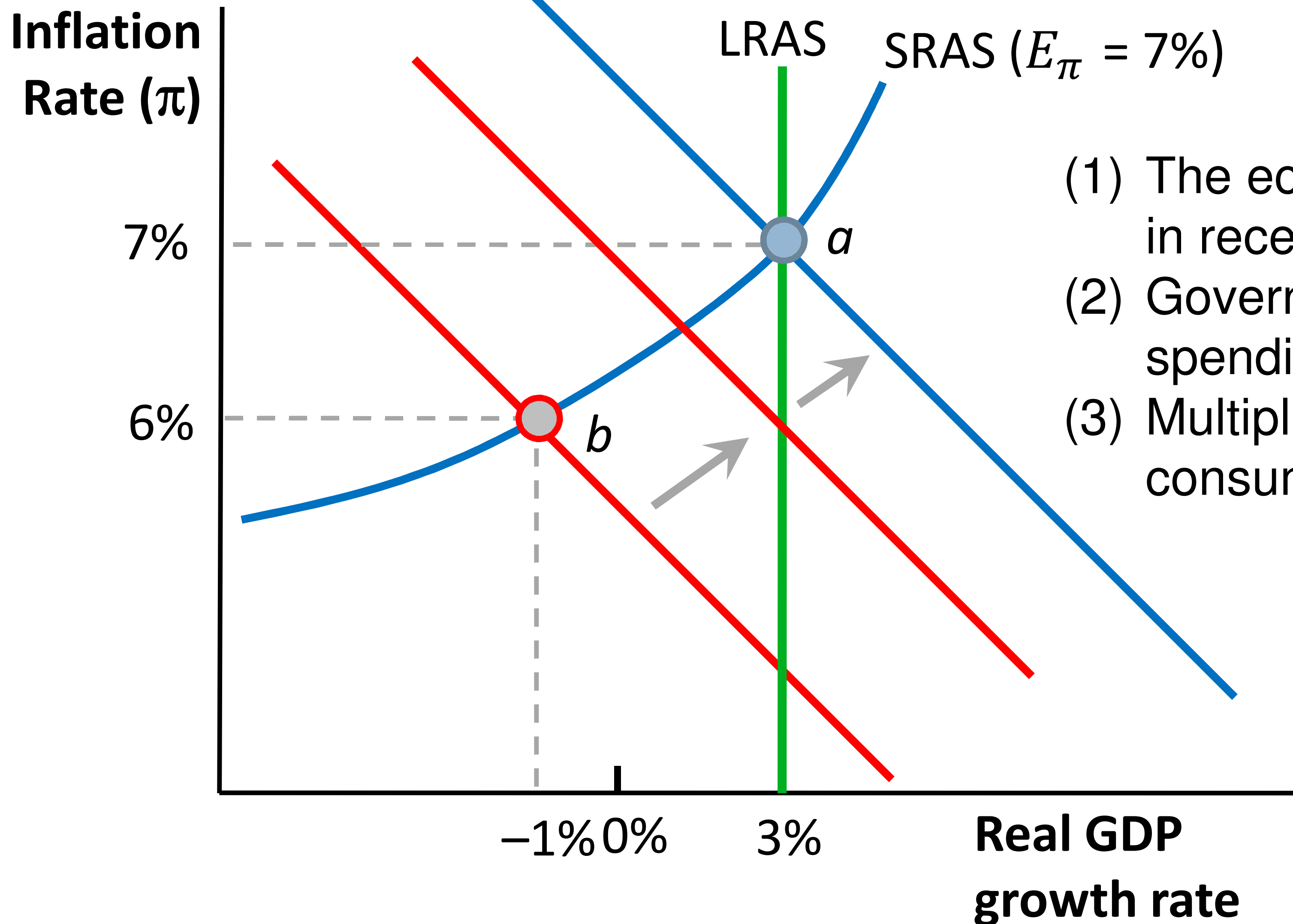
Why Should Fiscal Policy Work?



Fiscal Policy: The Best Case

- If government does nothing, in the long run wages will adjust.
- The economy will eventually return to its normal growth rate.
- Since the components of AD are $\vec{C}$, $\vec{G}$, $\vec{I}$, and $\vec{NX}$, the government can offset a $\downarrow \vec{C}$ by $\uparrow \vec{G}$.
- The increase in government spending doesn't have to be as large as the decrease in consumption because of the multiplier effect.

Fiscal Policy: The Best Case

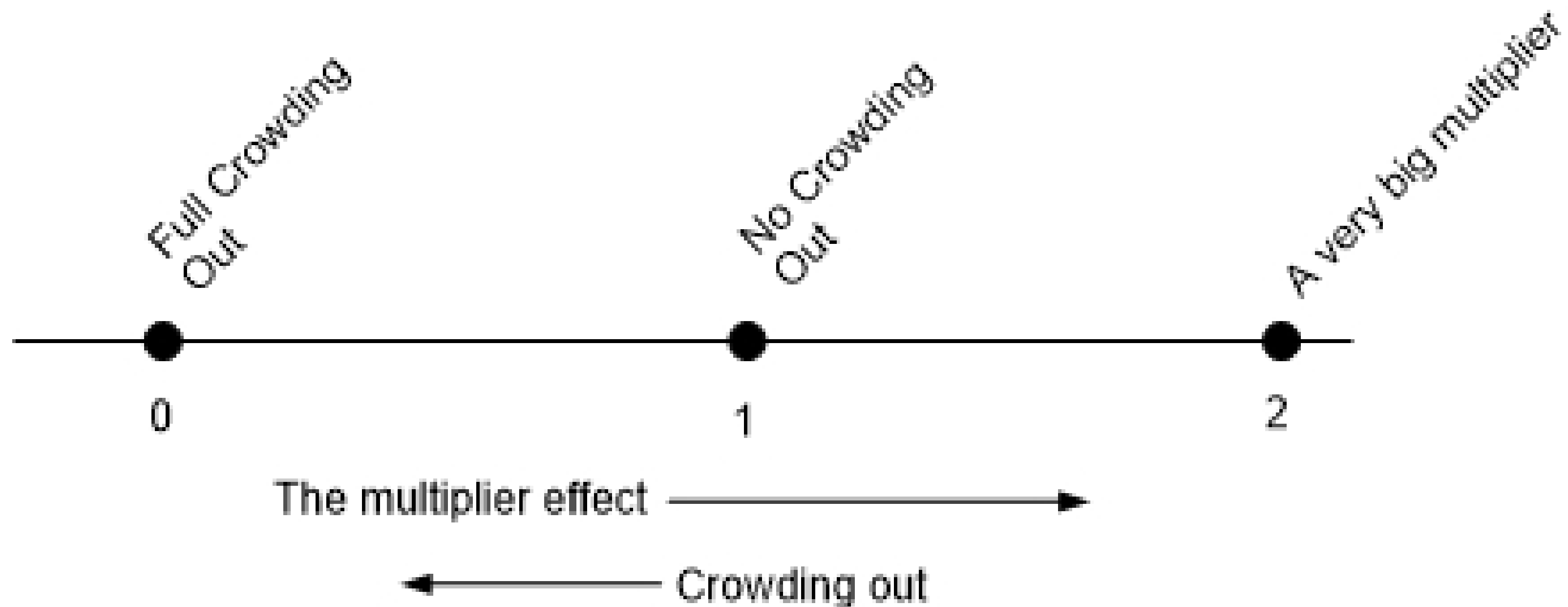


(1) The economy is in recession at *b*.
(2) Government spending ↑.
(3) Multiplier effect – consumption ↑.

The Size of the Multiplier

- The debate over fiscal policy is about the balance of two opposing forces: ***crowding out*** versus the ***multiplier effect***.
- If additional government spending crowds out equivalent spending from the private sector, then the multiplier is zero.
- If no amount of private sector spending is crowded out, the multiplier is 1.
- If the increase in government spending causes additional private spending, the multiplier is greater than 1.

The Size of the Multiplier



The debate over fiscal policy: The crowding out effect pushes the multiplier lower. The multiplier effect pushes the multiplier higher. The higher the multiplier the more effective is fiscal policy.

The Size of the Multiplier

- Fiscal policy is much more successful when the multiplier is big.
- The size of the multiplier is bigger when:
  - There are lots of unemployed resources.
  - The government can target spending on the unemployed.
  - Tax cuts go to people who want to spend immediately.
  - The government can tax savings.
  - Government borrowing doesn't crowd out private consumption or investment.

Definition

Ricardian equivalence:

Occurs when people see that lower taxes today means higher taxes in the future, so instead of spending their tax cut, they save it to pay future taxes. When Ricardian equivalence holds, a tax cut doesn't increase aggregate demand even in the short run.

Estimating the Multiplier

Type of Activity	Estimated Multiplier: Low Estimate	Estimated Multiplier : High Estimate
Purchase of goods and services by the federal government	0.5	2.5
Transfer payments to state and local Governments for infrastructure	0.4	2.2
Transfer payments to state and local governments for other purposes	0.4	1.8
Transfer payments to individuals	0.4	2.1
Two-year tax cuts for lower- and middle-income people	0.3	1.5
Onetime payments to retirees	0.2	1
One-year tax Cut for higher-income people	0.1	0.6

Self-Check

The government can increase AD by:

a. Increasing taxes and government spending.
b. Decreasing taxes and government spending.
c. Decreasing taxes and increasing government spending.

Answer: c – *decreasing taxes and increasing government spending.*

A Drop in the Bucket

- Government spending does not change very much year-to-year in percentage terms.
- Most of the federal budget is determined well in advance and is remarkably stable.
- Any changes are not large enough in the short run to boost aggregate demand very much.
- Stimulus plan passed in 2009 was spread over 3-4 years
- At its peak, it was only about 2% of annual GDP
- Unemployment rate remained high for years

Timing

- Fiscal policy is subject to many lags:

1. Recognition lag - The problem must be recognized.

2. Legislative lag: Congress must propose and pass a plan.

3. Implementation lag: Bureaucracies must implement the plan.

4. Effectiveness lag: The plan takes time to work.

5. Evaluation and adjustment lag: Did the plan work? Have conditions changed?

Timing

- Tax cuts, the other major form of fiscal policy, also involve lags and uncertainties.
- Monetary policy is also subject to lags, but these are generally much shorter than for fiscal policy.
- Once the Federal Reserve recognizes a problem, it can act very quickly to implement changes.
- Fiscal policy, in contrast, is rarely adjusted in response to changes in economic conditions. The only place where fiscal policy might have an advantage over monetary policy is through the effectiveness lag.
- Automatic stabilizers are built right into the tax and transfer system.
- They take effect without significant lags.

Definition

Automatic stabilizers:

Changes in fiscal policy that stimulate AD in a recession without the need for explicit action by policymakers.

Automatic Stabilizers

- Fiscal policy automatically changes to keep private spending higher during bad economic times.
- When the economy is doing poorly:
  - Income, capital gains, and profits are all down, so everybody lower taxes.
  - More people apply for welfare, food stamps, and unemployment insurance.
- Consumption smoothing and credit (private sector) also act as automatic stabilizers.

Government Spending vs Tax Cuts

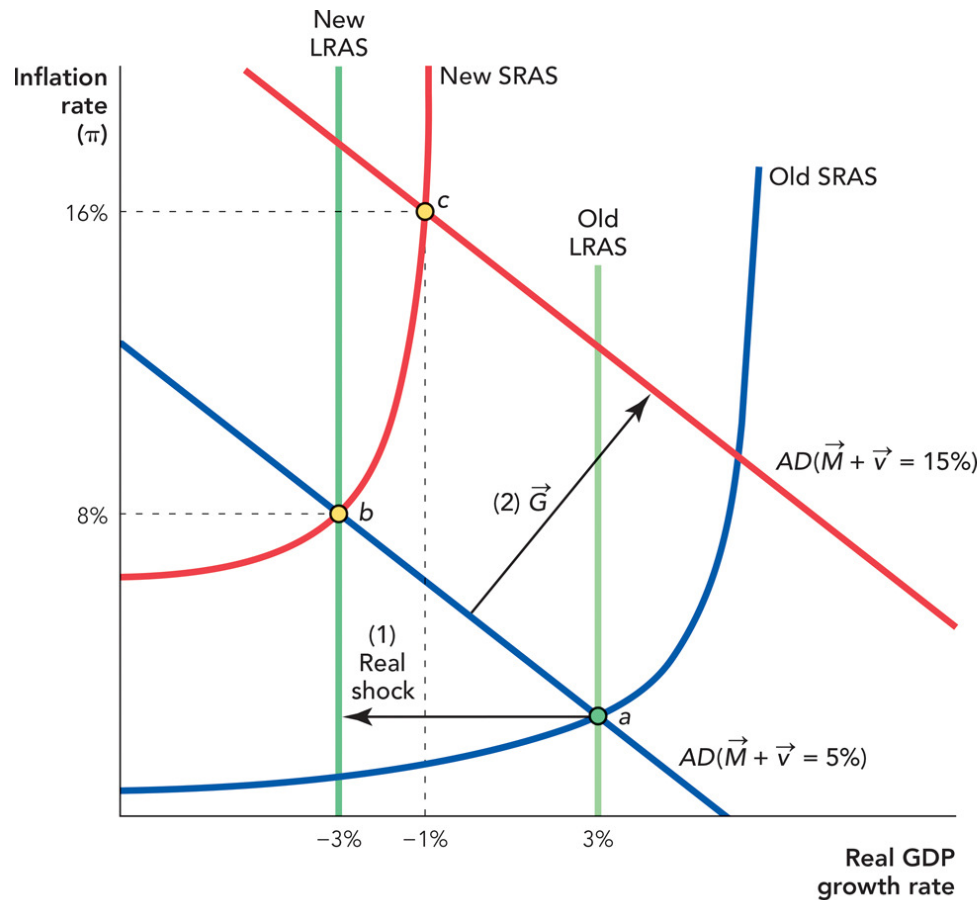
- The two types of fiscal policy differ politically and economically.
- A tax cut or tax rebate puts more spending in the hands of the private sector.
- An increase in government spending puts more spending in the hands of the government.
- If we can find productive public investments such as improvements to schools, science funding, and infrastructure, then the case for public investment is strong.
- Debt financing can be a good idea if spent on needed infrastructure and productivity improvements

Fiscal Policy and Real Shocks

- When a real shock reduces the productivity of labor and capital, LRAS decreases.
- An increase in government spending will increase aggregate demand.
- But the economy is now less productive, so most of the increase will be felt in higher inflation rather than increased growth.
- Fiscal policy is therefore not always an effective method of combating a recession.

Fiscal Policy and Real Shocks

Fiscal Policy Is Less Effective at Combating a Real Shock



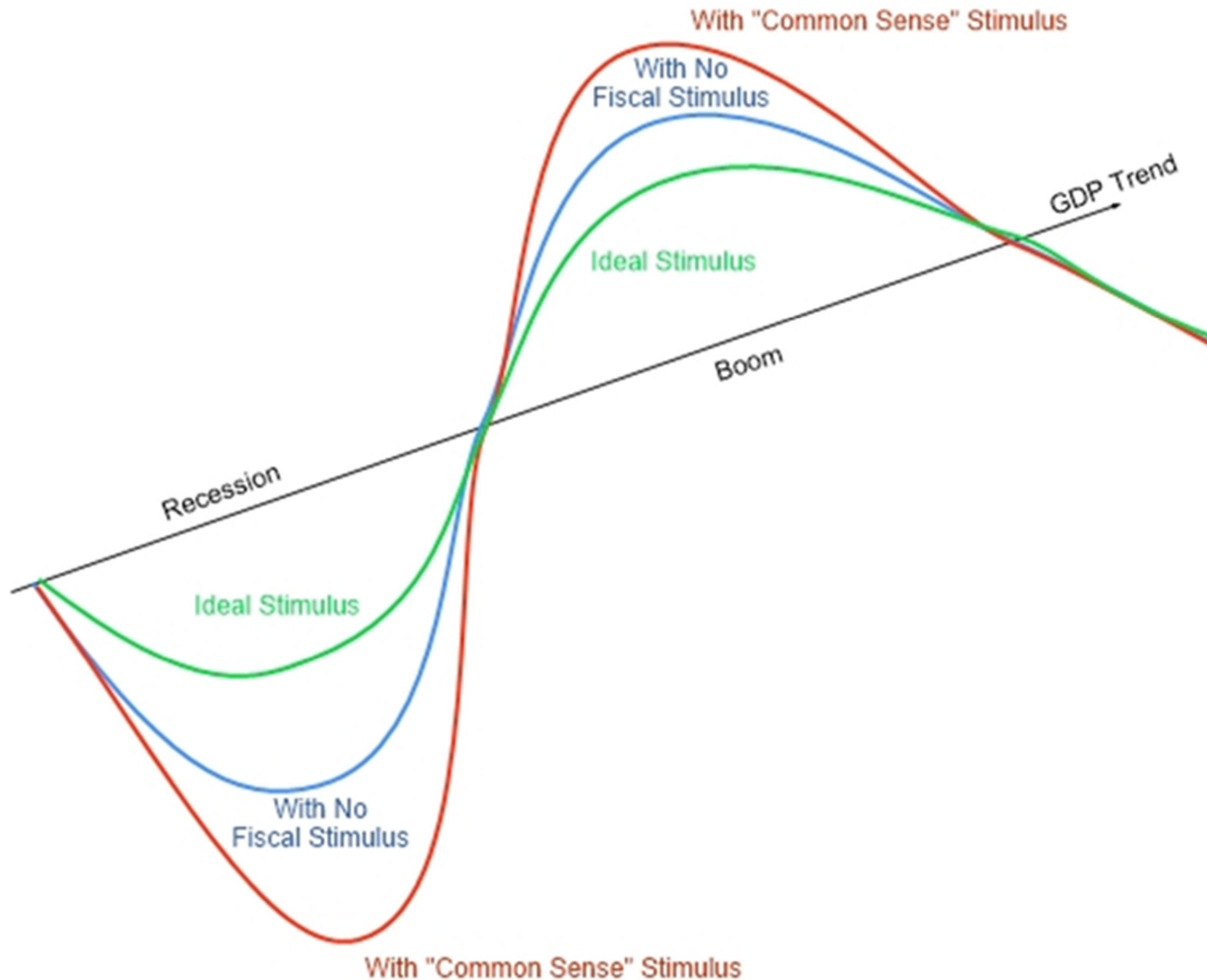
A real shock shifts the long-run aggregate supply curve (LRAS) to the left (step 1), moving the economyfrom point *a* to a recession at point *b*.

When Fiscal Policy Might Make Matters Worse

- Increased spending and tax cuts today tend to be followed by decreased spending or tax increases tomorrow.
- When spending falls and taxes rise, AD will fall—this is one reason why long-run or net multipliers are smaller than short-run multipliers.
- Spending more in bad times when the multiplier is big, and taxing more in good times when the multiplier is small, will lead to higher GDP overall.

Making Matters Worse

When Fiscal Policy Might Make Matters Worse



Definition

Counter-cyclical Fiscal Policy:

Fiscal policy that runs opposite or counter to the business cycle—spending more when the economy is in a recession and less when the economy is booming.

When Fiscal Policy Might Make Matters Worse

- Some countries are so heavily in debt that any more borrowing *leads to anxiety*, not expansion.
- Aggregate demand falls because uncertainty causes people to save or hoard their money in anticipation of hard times.
- People may put their wealth into bank accounts in other countries.
- The flight of capital hastens economic collapse.

When is Fiscal Policy a Good Idea?

The stimulus under President Obama:

- A lot of the tax cuts were saved or used to pay off debts, rather than spent.
- This boosted economic security for some people but didn't reemploy a lot of workers.
- The grants to the states prevented a large number of state government layoffs, which was good for economic output.

Fiscal Policy

- The expenditures covered a wide range, from medical research to home insulation to high-speed rail.
  - Some of these projects will do the world good while others were perhaps not the best use of funds.
  - But these multipliers were higher than for other parts of the fiscal stimulus.

Fiscal Policy

Fiscal policy is most likely to be effective:

1. When the economy needs a short-run boost, even at the expense of the long run.

2. When the problem is a deficiency in aggregate demand rather than a real shock.

3. When many resources are unemployed.

4. When government spending is effective and productive

Fear the Boom and Bust: http://youtu.be/d0nERTFo-Sk

Takeaway

- Fiscal policy is most effective in times of emergency, when there are unemployed resources due to a fall in AD, and when the economy needs a short-term boost.
- Fiscal policy is not usually a good means of boosting long-term growth.
- Crowding out, or replacing private spending with government spending, can make fiscal policy less effective.

Takeaway

- Most changes in government spending aren't big enough, or quick enough, to have a significant impact.
- Automatic stabilizers help to stabilize aggregate demand.
- Even if good fiscal policy doesn't always do a lot of good, bad fiscal policy can do a great deal of harm.