


Fiscal Policy

Full Length Text — Part: 3 Chapter: 12
Macro Only Text — Part: 3 Chapter: 12

To Accompany “Economics: Private and Public Choice 11th ed.”
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Budget Deficits & Surpluses

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Budget Deficits and Surpluses

- **Budget deficit:**
Present when total government spending exceeds total revenue from all sources.
 - When the money supply is constant, deficits must be covered with borrowing.
 - The U.S. Treasury borrows by issuing bonds.
- **Budget surplus:**
Present when total government spending is greater than total revenue.
 - Surpluses reduce the magnitude of the government’s outstanding debt.

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Budget Deficits and Surpluses


- Changes in the size of the federal *deficit* or *surplus* are often used to gauge whether fiscal policy is stimulating or restraining demand.
- Changes in the size of the budget deficit or surplus may arise from either:
 - A change in the state of the economy, or,
 - A change in discretionary fiscal policy.
- The federal budget is the primary tool of fiscal policy.
- **Discretionary** changes in **fiscal policy**: deliberate changes in government spending and/or taxes designed to affect the size of the budget deficit or surplus.

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The Keynesian View of Fiscal Policy

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The Keynesian View of Fiscal Policy

- Keynesian theory highlights the potential of fiscal policy as a tool capable of reducing fluctuations in aggregate demand.
- Following the Great Depression, Keynesians challenged the view that governments should always balance their budget.
 - Rather than balancing their budget annually, Keynesians argue that counter-cyclical policy should be used to offset fluctuations in aggregate demand.
 - This implies that the government should plan budget deficits when the economy is weak and budget surpluses when strong demand threatens to cause inflation.

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Keynesian Policy to Combat Recession

- When an economy is operating below its potential output, the Keynesian model suggests that the government should institute **expansionary fiscal policy**, by:
 - increasing the government’s purchases of goods & services, and/or,
 - cutting taxes.

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Expansionary Fiscal Policy

Keynesians believe that allowing for the market to self-adjust may be a lengthy and painful process.

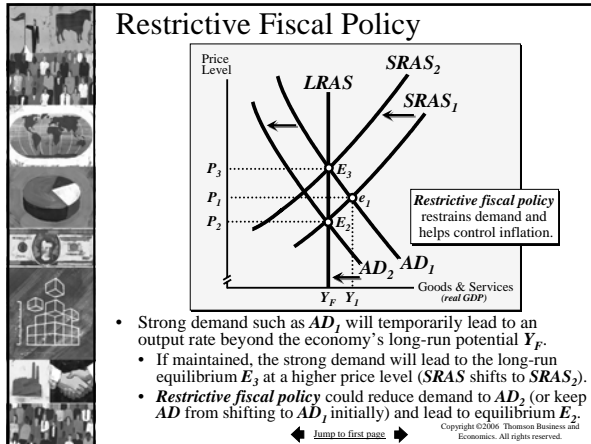
- At $e_1 (Y_1)$, the economy is below its potential capacity Y_F . There are 2 routes to long-run full-employment equilibrium:
 - Wait for lower wages and resource prices to reduce costs, increase supply to $SRAS_2$ and restore equilibrium to E_3 , at Y_F .
 - Alternatively, expansionary fiscal policy could stimulate AD (shift to AD_2) and guide the economy back to E_2 , at Y_F .

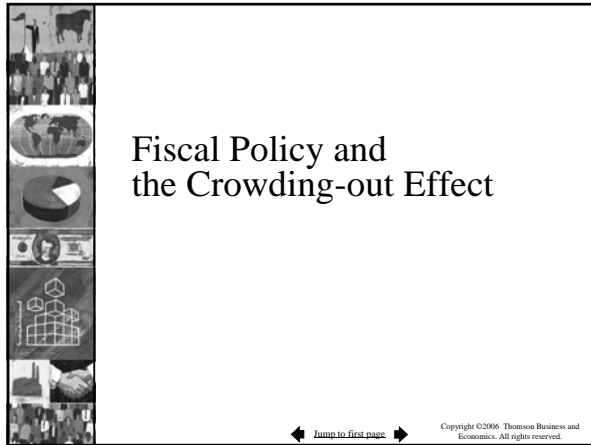
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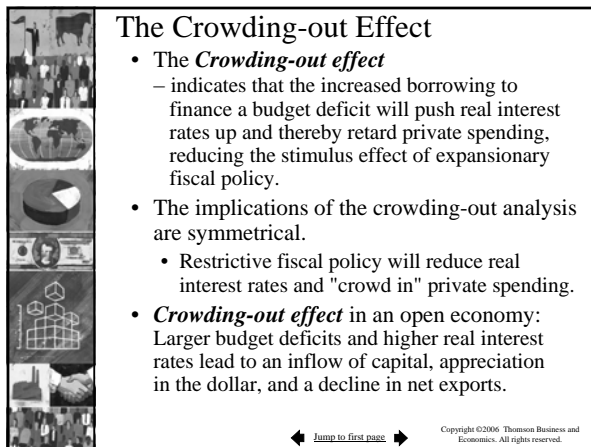
Keynesian Policy To Combat Inflation

- When inflation is a potential problem, Keynesian analysis suggests a shift toward a more **restrictive fiscal policy** by:
 - reducing government spending, and/or,
 - raising taxes.

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Crowding-Out in an Open Economy

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graph TD; A[Increase in budget deficit] --> B[Higher real interest rates]; B --> C[Decline in private investment]; B --> D[Inflow of financial capital from abroad]; D --> E[Appreciation of the dollar]; E --> F[Decline in net exports];
```

- An increase in government borrowing to finance an enlarged budget deficit places upward pressure on real interest rates.
- This retards private investment and **Aggregate Demand**.
- In an open economy, high interest rates attract foreign capital.
- As foreigners buy more dollars to buy U.S. bonds and other financial assets, the dollar appreciates.
- The appreciation of the dollar causes net exports to fall.
- Thus, the larger deficits and higher interest rates trigger reductions in both private investment and net exports, which limit the expansionary impact of a budget deficit.

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The New Classical View of Fiscal Policy

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The New Classical View of Fiscal Policy

- The **New Classical** view stresses that:
 - debt financing merely substitutes higher future taxes for lower current taxes, and thus,
 - budget deficits affect the timing of taxes, but not their magnitude.
- **New Classical** economists argue that when debt is substituted for taxes:
 - people save the increased income so they will be able to pay the higher future taxes, thus,
 - the budget deficit does not stimulate aggregate demand.

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The New Classical View of Fiscal Policy

- Similarly, *New Classical* economists believe that the real interest rate is unaffected by deficits as people save more in order to pay the higher future taxes.
- Further, they believe fiscal policy is completely impotent – that it does not affect output, employment, or real interest rates.

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Expansionary Fiscal Policy

- *New Classical* economists emphasize that budget deficits merely substitute future taxes for current taxes.
- If households did not anticipate the higher future taxes, aggregate demand would increase (from AD_1 to AD_2).
- However, when households fully anticipate the future taxes and save for them, demand remains unchanged at AD_1 .


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Expansionary Fiscal Policy

Here, fiscal policy exerts no effect on the interest rate, real GDP, or unemployment.

- To finance the budget deficit, the government borrows from the loanable funds market, increasing the demand (to D_2).
- Under the *new classical* view, people save to pay expected higher future taxes (raising the supply of loanable funds to S_2 .)
- This permits the government to borrow the funds to finance the deficit without pushing up the interest rate.


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Questions for Thought:

1. "When the federal government runs a budget deficit, it finances the deficit by issuing additional U.S. Treasury bonds."
-- Is this statement *true*?
2. When an economy is operating below its potential capacity, Keynesian economists argue that
 - a. taxes should be raised if the government is currently running a budget deficit.
 - b. the government should cut taxes and/or increase expenditures in order to stimulate aggregate demand.
 - c. government spending should be cut and the budget shifted toward a surplus.


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Questions for Thought:

3. The *crowding out effect* indicates that budget deficits ...
 - a. will stimulate **aggregate demand** and so exert a strong impact on both output & employment.
 - b. will lead to additional borrowing and higher interest rates that will reduce the level of private spending.
4. "New classical economists stress that an increase in government expenditures financed by borrowing rather than taxes will lead to higher interest rates."
-- Is this statement *true*?

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Fiscal Policy Changes and Problems of Timing

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Problems with Proper Timing

- There are three major *reasons* why *it is difficult to time fiscal policy changes* in a manner that produces stability:
 - It takes time to institute a legislative change.
 - There is a time lag between when a change is instituted & when it exerts significant impact.
 - These time lags imply that sound policy requires knowledge of economic conditions 9 to 18 months in the future. But our ability to forecast future conditions is limited.
- **Discretionary fiscal policy** is like a two-edged sword; it can both harm and help:
 - *If timed correctly*, it may reduce economic instability.
 - *If timed incorrectly, however*, it may increase economic instability.

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Timing of Fiscal Policy is Difficult

The graph shows the AD-AS model. The vertical axis is Price Level and the horizontal axis is Goods & Services (real GDP). A vertical LRAS curve is at Y_0 . An upward-sloping SRAS curve is labeled $SRAS_1$. Two downward-sloping AD curves are shown: AD_0 and AD_1 . AD_1 is to the left of AD_0 . The initial equilibrium E_0 is at the intersection of AD_0 and $SRAS_1$, with price level P_0 and output Y_0 . The new equilibrium E_1 is at the intersection of AD_1 and $SRAS_1$, with a lower price level P_1 and lower output Y_1 . A point e_1 is marked on the AD_1 curve at price level P_0 .

- Consider a market at long-run equilibrium E_0 where only the natural rate of unemployment is present.
- An investment slump and business pessimism result in an unanticipated decline in AD (to AD_1). Output falls (to Y_1) and unemployment increases.

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Timing of Fiscal Policy is Difficult

This graph is identical to the previous one, but includes a callout box pointing to the AD_1 curve that says: "Suppose that shifts in AD are difficult to forecast."

- After a time, policymakers consider and implement expansionary fiscal policy seeking to shift AD_1 back to AD_0 .
- But it will take time to institute changes in taxes and expenditures. Political forces will slow this process.

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Timing of Fiscal Policy is Difficult

- By the time a more expansionary fiscal policy is instituted and begins to exert its primary effect, private investment may have recovered and decision makers may therefore be increasingly optimistic about the future.
- Hence, the more expansionary fiscal policy may over-shift AD to AD_2 .

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Timing of Fiscal Policy is Difficult

- The price level in the economy rises (from P_1 to P_2) as the economy is now overheating. Thus, incorrect timing leads to inflation.
- Unless the expansionary fiscal policy is reversed, wages and other resource prices will eventually increase, shifting $SRAS$ back to $SRAS_2$ (driving the price level up to P_3).

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Timing of Fiscal Policy is Difficult

- Alternatively, suppose an investment boom disrupts the initial equilibrium shifting AD out to AD_2 , and prices upward to P_2 .
- Policymakers consider and eventually implement an increase in taxes and a cut in government expenditures.

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Timing of Fiscal Policy is Difficult

- By the time the more restrictive fiscal policy takes affect, investment may have returned to its normal rate (shifting AD_2 back to AD_0).
- In this case, the incorrect timing of the shift to the more restrictive fiscal policy to deal with potential inflation throws the economy into a recession (by over shifting AD to AD_1).

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Why Timing of Fiscal Policy Changes Are Difficult: A Summary

- Because fiscal policy does not work instantaneously, and since dynamic forces are constantly influencing private demand, proper timing of fiscal policy is not an easy task.
- Further, political incentives also influence fiscal policy. Public choice analysis indicates that legislators are delighted to spend money on programs that directly benefit their own constituents but are reluctant to raise taxes because they impose a visible cost on voters.
 - There is a political bias towards spending and budget deficits. Predictably, deficits will be far more common than surpluses.
- Incorrectly timed policy changes may, themselves, be a source of economic instability.

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Automatic Stabilizers

- **Automatic Stabilizers:** Without any new legislative action, they tend to increase the budget deficit (or reduce the surplus) during a recession and increase the surplus (or reduce the deficit) during an economic boom.
- The major advantage of automatic stabilizers is that they institute counter-cyclical fiscal policy without the delays associated with legislative action.
- Examples of **automatic stabilizers:**
 - Unemployment compensation
 - Corporate profit tax
 - A *progressive* income tax

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Fiscal Policy as a Stabilization Tool: *A Modern Synthesis*

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Fiscal Policy: A Modern Synthesis

- A **modern synthesis view** about the efficacy of fiscal policy emerged from the economic debates of the 1970s and 1980s.
- The **key elements** of that view are:
 - Proper timing of discretionary fiscal policy is both difficult to achieve and of crucial importance.
 - Automatic stabilizers reduce the fluctuation of aggregate demand and help to direct the economy toward full-employment.
 - Fiscal policy is much less potent than the early Keynesian view implied.
 - Each of the 3 demand-side models of fiscal policy is valid under some circumstances but not others. Thus, all 3 are necessary for a comprehensive view of fiscal policy.

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Questions for Thought:

1. Why is the proper timing of changes in fiscal policy so important? Why is it difficult to achieve?
2. Which of the following will make it more difficult to institute discretionary changes in fiscal policy in a manner that will exert a stabilizing impact on the economy?
 - a. the lengthy time period required for passage of a fiscal policy change under a political system with substantial checks and balances
 - b. improvements in forecasting devices that provide information about the future direction of the economy

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Questions for Thought:


3. "Both the crowding out and new classical views indicate fiscal policy is substantially less potent than the Keynesian view implies."
-- Is this statement *true*?
4. Automatic stabilizers are government programs that tend to:
 - a. bring expenditures and revenues automatically into balance without legislative action.
 - b. shift the budget toward a deficit when the economy slows but shift it towards a surplus during an expansion.
 - c. increase tax collections automatically during a recession.

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Supply-side Effects of Fiscal Policy

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Supply-side Effects of Fiscal Policy

- From a *supply-side* viewpoint, the marginal tax rate is of crucial importance:
 - A reduction in marginal tax rates increases the reward derived from added work, investment, saving, and other activities that become less heavily taxed.
- High marginal tax rates will tend to retard total output because they will:
 - discourage work effort and reduce the productive efficiency of labor,
 - adversely affect the rate of capital formation and the efficiency of its use, and,
 - encourage individuals to substitute less desired tax-deductible goods for more desired non-deductible goods.

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Supply-side Effects of Fiscal Policy

- So, changes in marginal tax rates, particularly high marginal rates, may exert an impact on **aggregate supply** because the changes will influence the relative attractiveness of productive activity in comparison to leisure and tax avoidance.
- Impact of **supply-side effects**:
 - Usually take place over a lengthy time period.
 - There is some evidence that countries with high taxes grow more slowly—France and Germany versus United Kingdom.
 - While the significance of supply-side effects are controversial, there is evidence they are important for taxpayers facing extremely high tax rates – say rates of 40 percent or above.

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Supply Side Economics and Tax Rates


- What are the supply-side effects of a cut in marginal tax rates?
- Lower marginal tax rates increase the incentive to earn and use resources efficiently. AD_1 shifts out to AD_2 , and $SRAS$ & $LRAS$ shift to the right.
- If the tax cuts are financed by budget deficits, AD may expand by more than **supply**, bringing an increase in the price level.

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Share of Taxes Paid By the Rich

- The share of personal income taxes paid by the top one-half percent of earners is shown here.
- During the last four decades, the share of taxes paid by these earners has increased as the top tax rates have declined. This indicates that the supply side effects are strong for these taxpayers.


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Have Supply-siders Found a Way to Soak the Rich?


- Since 1986 the top marginal personal income tax rate in the United States has been less than 40% compared to 70% or more prior to that time.
- Nonetheless, the top one-half percent of earners have paid more than 25% of the personal income tax every year since 1997.
- This is well above the 14% to 19% collected from these taxpayers in the 1960s and 1970s when much higher marginal personal income tax rates were imposed on the rich.

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Fiscal Policy of the United States


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U.S. Fiscal Policy, 1960-2004

- During the 1960s & 70s, budget deficits were generally small except during recessions.
- Budget deficits generally increased during recessions and shrank during expansions, primarily as the result of automatic stabilizers rather than discretionary policy changes.
- Reductions in income tax rates and sharp increases in defense expenditures led to large deficits during the 1980s.


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U.S. Fiscal Policy, 1960-2004

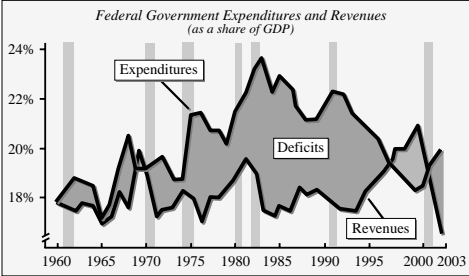
- While increases in defense spending expanded the deficit in the 1980s, the opposite was true during the 1990s.
- The deficit shrank during the 1990s and by the end of the decade federal budget surpluses were present.
- The combination of the 2001 recession and the economy's sluggish recovery, the Bush Administration's tax cut, and increases in defense spending quickly moved the budget from surplus to deficit at the beginning of the new century.

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Federal Expenditures and Revenues


Federal Government Expenditures and Revenues (as a share of GDP)



Source: Economic Report of the President, 2004, tables B-1 and B-7c. Note, recessions are indicated by shaded bars.

- The federal deficit or surplus as a share of the economy is shown here. Note the growth of budget deficits during the 1980s and the movement to surpluses during the 1990s.
- A mix of factors (a recession, sluggish recovery, tax cut, & increased defense spending) have led to deficits since 2001.


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Fiscal Policy & Economic Performance: The 1980s versus the 1990s

- Even though the federal deficits were large during the 1980s and small during the 1990s, real economic growth was strong and the inflation rate low during both decades.
- This result is consistent with the view that fiscal policy exerts only a modest impact on aggregate demand, much like the *crowding-out* and *new classical* models imply.


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Questions for Thought:

1. How does the supply-side view of fiscal policy differ from the demand-side view? Does the supply-side view stress the potential of fiscal policy as a tool to smooth the ups and downs of business cycles? What does it stress?
2. "The share of personal income taxes collected from high income taxpayers has steadily declined during the last 20 years." -- Is this statement *true*?
3. "Public choice theory indicates that vote-maximizing politicians severely restrain govt. spending because they have a strong incentive to achieve and maintain budget surpluses." -- Is this statement *true*?


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Questions for Thought:

4. The following quotation is from the mid-1980s by Paul Samuelson, a leading American Keynesian:
"In the early stages of the Keynesian revolution, macro-economists emphasized fiscal policy as the most powerful and balanced remedy for demand management. Gradually, shortcomings of fiscal policy became apparent. The shortcomings stem from timing, politics, macro-economic theory, and the deficit itself."
Explain what Samuelson means by each of the shortcomings he refers to.


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Questions for Thought:

5. The supply-side effects of a reduction in taxes are the result of:
 - a. increases in the disposable income of households accompanying reductions in tax rates.
 - b. the increased attractiveness of productive activity relative to leisure and tax avoidance.
 - c. reductions in interest rates that generally accompany expansionary fiscal policy.

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**End
Chapter 12**

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