Chapter 57: The role of fiscal policy (2.4)

Key concepts
- Fiscal policy – govt expenditure and taxes – effect on AD
  - Mind the gap – inflationary and deflationary gaps and fiscal policies
  - Effects of expansionary and contractionary fiscal policy
    - Keynesian model
- Automatic stabilisers
- Fiscal policy and LR growth (AS…interventionist S-side policies)
- Evaluation of fiscal policy
  - Advantages of demand-side policies
    - Target sectors of the economy
    - Effects on AD
    - Promoting economic activity during recession
  - Disadvantages of demand-side policies
    - Trade-off problems
    - Time lags
    - New-classical critique
      - Four key points
    - Political constraints
    - Limits of fiscal policy – S-side shocks cannot really be dealt with
The four ‘mainstream’ macro objectives and possible monetary and fiscal policy responses to various stages in the business cycle are given in figure 57.1. Notice, once again, that any use of monetary and fiscal policies aimed at demand management will have noticeable trade-offs, where adjusting aggregate demand in order to achieve a particular macro objective will have negative effects on some other objective. As briefly outlined in Chapter 48, it is quite evident that many of the macro objectives are very difficult to attain simultaneously, leading to conflicts and opportunity costs for the economy.

**Figure 57.1 Macro objectives and possible policy responses**

| Fiscal policy and short-term demand management | • Explain how changes in the level of government expenditure and/or taxes can influence the level of aggregate demand in an economy  
• Describe the mechanism through which expansionary fiscal policy can help an economy close a deflationary (recessionary) gap  
• Construct a diagram to show the potential effects of expansionary fiscal policy, outlining the importance of the shape of the aggregate supply curve  
• Describe the mechanism through which contractionary fiscal policy can help an economy close an inflationary gap  
• Construct a diagram to show the potential effects of contractionary fiscal policy, outlining the importance of the shape of the aggregate supply curve |
<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>The impact of automatic stabilizers</td>
</tr>
<tr>
<td>Fiscal policy and its impact on potential output</td>
</tr>
<tr>
<td>Evaluation of fiscal policy</td>
</tr>
</tbody>
</table>

“An economist’s guess is liable to be as good as anybody else’s.” Will Rogers
### Macro objectives

<table>
<thead>
<tr>
<th>Objective</th>
<th>High/stable growth</th>
<th>Stable prices, i.e. low inflation rate</th>
<th>Low level of unemployment</th>
<th>Trade balance (X = M)</th>
<th>Possible fiscal policies</th>
<th>Possible monetary policies (Chapters 58 and 59)</th>
<th>Positive effects of policies</th>
<th>Negative effects of policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>High growth rate</td>
<td>High or increasing inflation rate</td>
<td>Low unemployment</td>
<td>M often larger than X; trade deficit</td>
<td>$\Delta T, \Delta G/\text{transfer payments}$</td>
<td>Tight monetary policy; $\Delta Sm, \Delta r$</td>
<td>Lower inflation, relieves pressure on tight labour market, possible improvement in trade balance</td>
<td>Growth rate falls back, lower investment can harm long run potential growth</td>
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<td>2.</td>
<td>Falling growth rate or negative growth</td>
<td>Low(-er) inflation rate, possibly deflation</td>
<td>Increasing/high unemployment</td>
<td>M falling; possible trade surplus</td>
<td>$\Delta T &amp;/\ or \Delta G/\text{transfer payments}$</td>
<td>Loose monetary policy; $\Delta Sm, \Delta r$</td>
<td>Decrease in unemployment, increased output (or slower negative growth), societal benefits</td>
<td>Inflationary pressure, increase in imports might cause trade deficit</td>
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### Fiscal policy – govt expenditure and taxes – effect on AD

Governments can influence aggregate demand in the economy by using taxes (T) and/or government spending (G).

An increase in **income taxes** lowers households’ disposable income which in turn lowers consumption and aggregate demand. Increased **expenditure taxes**, e.g. VAT, have the same effect due to the decrease in real income.

- $\Delta T \Rightarrow \Delta C \Rightarrow \Delta AD \ldots \text{or} \ldots \Delta T \Rightarrow \Delta C \Rightarrow \Delta AD$

The automatic stabilising effect of taxes and social benefits (see below) are enhanced by the intentional adjustments of government spending and/or changing taxes, known collectively as **discretionary fiscal**
policies as they are ‘at the discretion’ of government.

- During a recession, the government increases spending on roads, education and such, and this has the effect of increasing aggregate demand – of which government expenditure is a component – and taxes can also be adjusted downwards in order to increase disposable income and induce increase consumption. This is called expansionary fiscal policy.

- When the economy shows signs of overheating, government can cut back on spending and increase taxes in order to lower aggregate demand. The aim is also to even-out the business cycle, as in figure 57.2, bringing cyclical variations closer to the long term trend. (The extent to which this actually works is hotly debated and we will look at this briefly under the heading ‘Time lags’ below.) These are contractionary fiscal policies.
- Mind the gap— inflationary/deflationary gaps and discretionary fiscal policies

Figure 57.2 I, II and III; Demand management, business cycle and AD

- Cooling the economy: When real GDP increases beyond the long run trend of potential GDP ($t_0$ in the business cycle diagram) there are negative influences on several of the main macro objectives, such as rising inflation and possibly a trade deficit (exports $<$ imports). The government can try to countermand this by **contractionary fiscal policies**:

- Stimulating the economy: An economy in recession will warrant stimulatory demand management policies, **expansionary fiscal policies**:
If successful, the fiscal policies will serve to keep the economy ‘in line’ with long run potential real GDP, shown by the business cycle’s lower amplitude around the trend line and the economy moves closer to the long run equilibrium shown in diagram 3.4.2:1.

- **Effects of fiscal policies – Keynesian model**

I have used the new-classical model above to illustrate the effects of fiscal policies on inflationary and deflationary gaps. The Keynesian model yields other possibilities and insights, as seen in figure 57.4.

**Figure 57.3 Fiscal policies and the Keynesian AS curve**

- **Automatic stabilisers – safety nets**

When the economy starts to ‘heat up’, a number of stabilising effects will automatically kick in – mechanisms which are built-in to the economic system and social welfare system.

- Government spending in the form of social benefits is one such stabiliser.

- The other stabiliser, taxes, influences net income (income after tax) of households and therefore their consumption. Most countries have some element of progressive income taxation, meaning that the percentage paid in income tax increases when gross personal income rises.
The effect of automatic stabilisers over time is that the swings in economic activity, the amplitude of real GDP cycles, are somewhat milder than without, shown by the blue cycle in Figure 57.4 I. Note that automatic fiscal stabilisers do not solve recessions or overheating but merely lessen the impact of them somewhat.
Evaluation of fiscal policy
  o  Advantages of demand-side policies
    ▪  Macro goals
    By adjusting monetary and fiscal policies, it is possible to influence the level of economic activity and therefore output, unemployment, inflation and the trade balance.
    ▪  Target sectors of the economy
    Fiscal policies can target specific industries, regions and labour groups – and often all three since there is a considerable overlap (revise structural unemployment in Chapter 51).
    ▪  Effects on AD
    Keynesian economics also stresses the element of self-perpetuation is stimulating aggregate demand via fiscal policy during recessionary periods; the multiplier effect (a HL concept, see Chapter 47).
  ▪  Promoting economic activity during recession
    Discretionary fiscal policies in turn allow governments to steer the economy in line with both consensus views of economic goals and ideological underpinnings and ideals of social/economic welfare.

  o  Disadvantages of demand-side policies

However, during the early 1970s, a number of weaknesses of demand management became evident.

  •  The business cycles were often erratic and ‘untamed’ or even aggravated by demand management policies – there were increasing indications of politically inclined business cycles over the course of changes in governments.
  •  Inflation rose to hitherto unseen levels and budget deficits grew since government spending during recessionary periods was evermore seldom made up for during booms.
  •  This increased government indebtedness led to most debilitating exchange rate problems (see Chapter 67). Increasingly open economies meant that government spending and/or lower taxes would not have the same multiplicative effect on the domestic economy, as an increased proportion of disposable income gains flowed out of the country to buy imports.

These main weaknesses in using demand management to control the economy are given below under five headings: Trade-off problems; time lags; new-classical critique; political constraints; and limits of fiscal policies in dealing with supply-side shocks.

**Definition: Recession – revisited and criticised**
A goodly number of my colleagues adamantly (= stubbornly) claim that the textbook definition of a recession (“…two falling quarters of real GDP…”) is not only unrealistic but highly out of date. There is merit in this view. The NBER (National Bureau of Economic Research – a very powerful US non-profit organisation where, amongst 16 other Nobel Laureates, Milton Friedman has submitted research) uses key monthly indicators of economic output, including employment, industrial production, real personal income, and wholesale and retail sales - to determine when economic growth has turned negative, rather than relying solely on two quarterly declines in GDP.
Trade-off problems

- **Growth and inflation**: High growth and low unemployment are key macroeconomic goals. Governments can use expansionary fiscal policy to stimulate the economy where there is below full employment.

- **Budget and unemployment**: When unemployment rises the government can decrease taxes and/or increase government spending in order to increase aggregate demand.

- **Growth and trade balance**: In stimulating the economy, incomes increase and for reasons explained earlier imports will also increase due to the propensity of citizens to import goods and services. An economy experiencing a trade deficit (or, more correctly, a current account deficit; see Section 4.5) might use fiscal policy to adjust the trade imbalance.

- **Interest rates and exchange rate**: Finally, there is both a domestic and foreign sector trade-off arising from monetary policy. When the Central Bank decreases interest rates in order to stimulate the economy, there will be downward pressure on the exchange rate as foreign investors/speculators pull some of their funds out of the country in order to place them elsewhere at a relatively better rate of interest.

Five possible macroeconomic trade-offs emerge from the discussion above:

A. Growth ⇔ price stability
B. Unemployment ⇔ price stability
C. Unemployment ⇔ balanced budget
D. Growth ⇔ trade balance
E. Domestic monetary policy (interest rate) freedom ⇔ stable (or fixed) exchange rate

Time lags and exacerbation of the business cycle

Identification lags arise simply because it is always difficult to see where you are on the business cycle, i.e. the depth of a boom/recession and the length. In figure 57.6, the recognition stage when contractionary policies should be instigated is at point I.

It will take time for the political and administrative process to result in actual policy decisions, leading to decision and implementation lags. Say that the government decides to tighten fiscal policy to deflate the overheating economy at point II…

…it will still take time before the effects of higher taxes and/or lower government spending actually has an impact on the economy. Effect and impact lags are possibly the most heavily weighted of all three, since the resulting change in aggregate demand might deflate an already contracting economy. This is shown by point III in the diagram, where tighter fiscal policies kick in and lower real GDP at a faster rate than would otherwise be the case.
I will limit the discussion here to three main points of criticism central to the supply-side reaction against demand management; *inflation* in the long run, market *inefficiency* and *crowding out*.

- **Inflation vs. long run growth**
  
  Classical economics points to the *stagflationary* (= rising inflation and low/falling GDP) demand-side period of the 1970s and the period of price stability and growth of the supply-side 1980s. Demand-side policies ultimately failed quite drastically in balancing budgets over a cycle, as deficit spending during recessions was never countered during boom periods. Demand-side policies therefore have their place in combating inflation, not in increasing output, according to the new-classical view.

- **Demand-side policies lessen market efficiency**
  
  The new-classical school prescribes the use of production incentives such as lowering corporate taxes and labour incentives such as decreasing income taxes and lowering social/unemployment benefits. The short run social and economic costs of these policies would be more than compensated for by increased long run output and full employment levels. One could say that new-classical economists are inclined to let the golden eggs hatch and produce more geese rather than using the golden eggs.

- **Crowding out**
  
  The argument goes as follows: Assume that the government borrows money (by issuing government securities, i.e. bills and/or bonds) in order to fund government spending in line with demand-side fiscal policies. The increase in government borrowing increases the demand for loanable funds which drives up interest rates and causes investment expenditure to fall. Thus, the potential increase in aggregate demand due to government spending is negated – ‘crowded out’ – by the increase in interest rates and concomitant fall in investment; hence the name *crowding out*. The concept has frequently been used as another new-classical/monetarist argument against fiscal policies.
**Definition: Crowding out**

When government expenditure is financed by increased government borrowing interest rates may be driven up. This might cause a decrease in investment in the private sector as firms scale back on capital expenditure. The increase in government expenditure and borrowing has “crowded out” an amount of investment.

1. Firstly, the economy has to be operating at or above the full employment level of output in order for complete crowding out to take place.

2. Secondly, real borrowing has to take place; the government’s increased borrowing from either households or the financial sector cannot be compensated by pumping additional money out into the market via the printing press.

**Figure 57.7 Crowding out – Keynesian and new-classical view**

**Summing up in economic shorthand:** \( \Delta \uparrow G \rightarrow \Delta \uparrow D_{\text{loanable funds}} \rightarrow \Delta \uparrow r \rightarrow \Delta \downarrow I \rightarrow \Delta \downarrow AD \ldots \) the increase in government spending drives up interest rates which “crowds out” investment. The question of crowding out is largely one of degree. Most economists would agree that there is some crowding out when government borrows money to fund additional spending, but there is a great deal of contention as to the extent to which investment funding is affected.

Keynesian view of *partial crowding out*: Keynesians traditionally largely disregarded any possible crowding out effects, operating as they were under the assumption that investment levels were largely unaffected by interest rates. Modern-day Keynesians accept a degree of crowding out, but still regard investment demand as relatively inelastic, shown in diagram 57.7II as \( I_K \).

New-classical view of *complete or near-complete crowding out*: This view claims that complete – or near-complete – crowding out will indeed occur (as long as there is real borrowing taking place) since the demand for investment is highly responsive to changes in interest rates.
- **Political constraints**

Anyone who saw some TV news during 2011 probably saw the demonstrations in Greece, where thousands of demonstrators converged at Syntagma Square in Athens. That’s what happens when government cuts spending and lays off thousands of public employees because debt is over 150% of GDP, the public sector employs close to 25% of the labour force and spends 80% of public monies on wages, pensions and social security benefits for public employees. The facts indicated that the government needed far harsher measures than were politically possible and this is a situation most politicians can appreciate.

Who took my pension plan?! (Syntagma Square, Athens, June 2011)  
(Rory, yeah, I stole it. Think you can find something similar?)

- **Limits of fiscal policy – S-side shocks cannot really be dealt with**

The limitations of demand-side policies became notoriously clear during the stagflationary period after the first ‘oil shock’ in 1973/74. Thirty years of reasonably successful demand management left little preparedness for a situation that meant rising unemployment and rising inflation. (Revise Chapter 53.) Any fiscal demand-side policies means choosing the lesser of two evils:
Summary and revision

1. **Expansionary fiscal policies** include lowering taxes (for example income and profit taxes) and increasing government expenditure – both increase AD. **Contractionary fiscal policies** thus decrease AD.

2. Fiscal policies are **discretionary** (decisions made by government) and **automatic** (marginal tax effects and transfer payments) which are built into the system.

3. Government can **decrease inflationary gaps using contractionary policies** and **close a deflationary gap using expansionary policies**.

4. The **effects of fiscal policies** on real GDP and inflation vary along the Keynesian AS curve:
   a. **At low levels of income** and high unemployment, an increase in AD might increase GDP without inflation
   b. **Nearing the full employment** rate of output, AD stimulation renders a trade-off between inflation and unemployment
   c. At the **full employment level** of output any fiscal expansionary policies will be purely inflationary

5. Modern economies have so-called **automatic stabilisers** built in to the system. Increasing AD and higher incomes automatically lower social and unemployment benefits and increase taxes on income and profits – all of which have a dampening effect on AD. Conversely, falling AD means higher unemployment and social/unemployment benefits kick in automatically while income and profit taxes fall – this serves to stimulate AD during downturns in the economy.

6. **Fiscal policies can also affect AS** by increasing the stability of the economy to incentivise investment. Spending on education and infrastructure are also supply-side (interventionist) policies.
Summary and revision…continued

7. The Keynesian AS-AD model shows that stimulating LRAS might have zero or limited effect at very low levels of income – e.g. if macro equilibrium is along the horizontal portion of the Keynesian LRAS curve.

8. Advantages and strengths of demand-side policies:
   a. Government can to some extent achieve the main macro goals
   b. Sectors and regions of the economy can be targeted
   c. There is a possible multiplicative effect of increased government spending (HL)
   d. Both discretionary and automatic fiscal policies can help limit recessions and periods of overheating

9. Disadvantages and weaknesses of demand-side policies:
   a. The 1970s taught governments that demand-side policies often result in inflation, stop-go cycles and deficits/debt
   b. Numerous trade-offs exist in implementing demand side policies, the most obvious ones being growth↔inflation and unemployment↔inflation
   c. Time lags can actually exacerbate business cycle fluctuations
   d. Political constraints often limit the degree and speed of implementing much-needed fiscal austerity measures
   e. Fiscal policies are inadequate in dealing with supply-side shocks
   f. The new-classical school of economics criticises demand management on several counts; long run inflation and resulting lack of competitiveness, decreased market efficiency and...

10. …crowding out. A key new-classical/monetarist argument proposing that any increase in real borrowing by government to fuel AD will drive up interest rates and ‘crowd out’ an amount of private sector investment. This will of course lessen the degree to which the demand-side stimulation works.