

# Lesson 7 Fiscal policy

# How does the Government Stabilizes the Economy?

**The Government has two different tool boxes it can use:**

## 1. Fiscal Policy-

Actions by Congress to stabilize the economy.

OR

## 2. Monetary Policy-

Actions by the Federal Reserve Bank to stabilize the economy.



# Categories of fiscal policy

# Two Types of Fiscal Policy

## Discretionary(自主) Fiscal Policy-

- Congress creates a new bill that is designed to change AD through government spending or taxation.
- Problem is time lags due to bureaucracy.
- Takes time for Congress to act.
- **Ex: In a recession, Congress increase spending.**

## Non-Discretionary Fiscal Policy

- **AKA: Automatic Stabilizers**
- Permanent spending or taxation laws enacted to work counter cyclically to stabilize the economy
- **Ex: Welfare, Unemployment, Min. Wage, etc.**
- **When there is high unemployment, unemployment benefits to citizens increase consumer spending.**

# **Contractionary Fiscal Policy (The BRAKE)**

**Laws that reduce inflation, decrease GDP**

**(Close a Inflationary Gap)**

- **Decrease Government Spending**
- **Tax Increases**
- **Combinations of the Two**

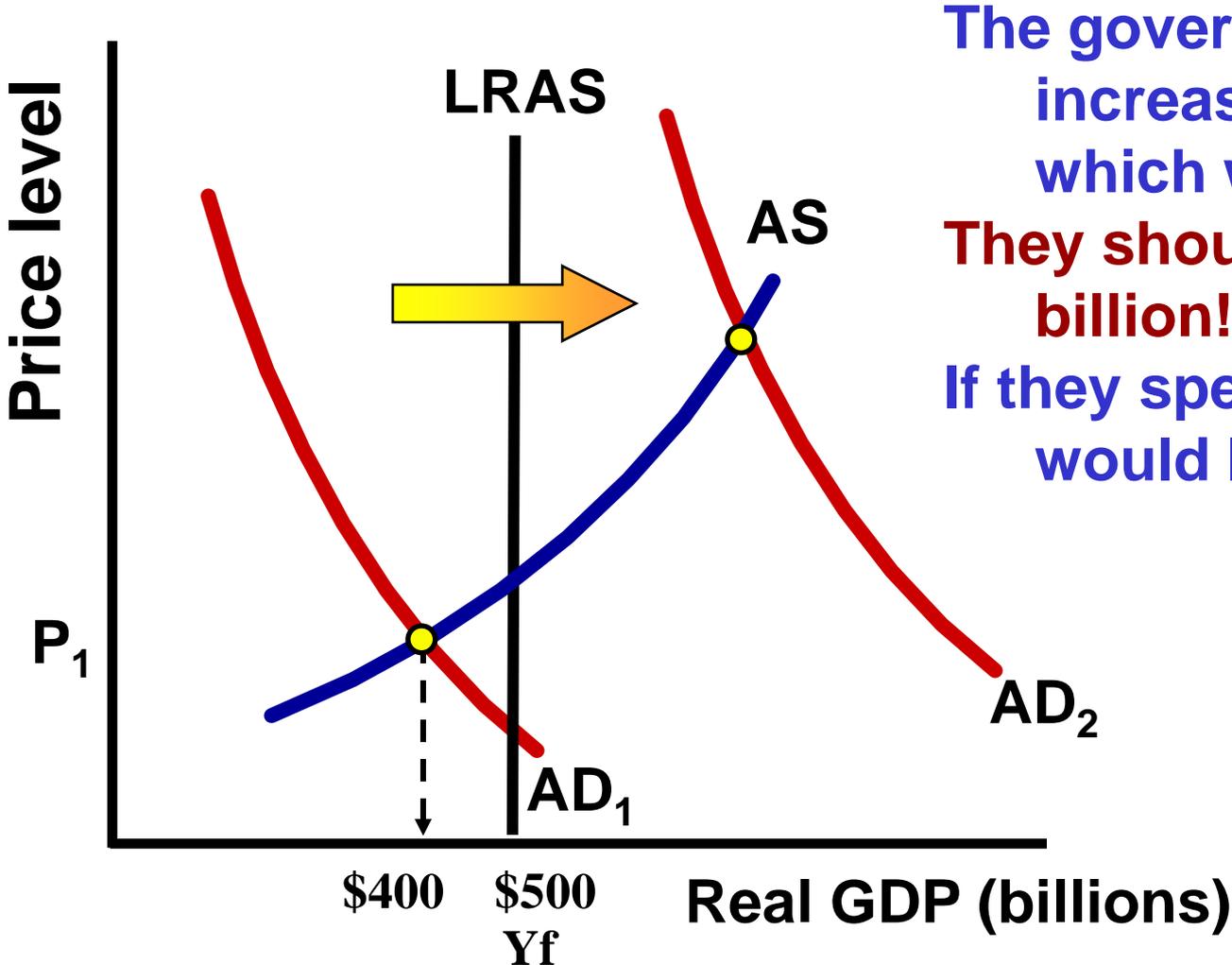
# **Expansionary Fiscal Policy (The GAS)**

**Laws that reduce unemployment and increase GDP (Close a Recessionary Gap)**

- **Increase Government Spending**
- **Decrease Taxes on consumers**
- **Combinations of the Two**

**How much should the Government Spend?**

- What type of gap and what type of policy is best?
- What should the government do to spending? Why?
- How much should the government spend?

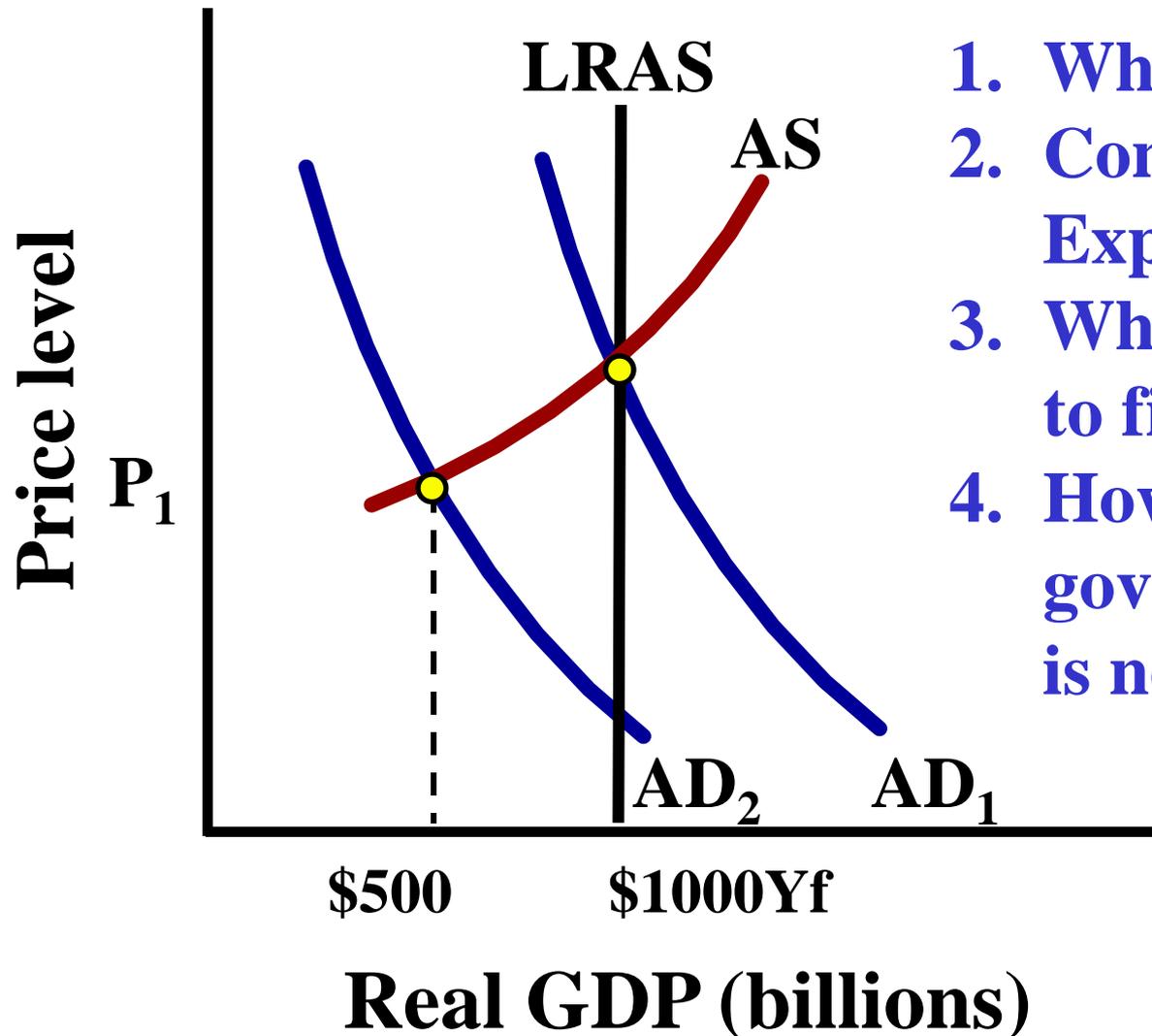


The government should increasing spending which would increase AD  
 They should NOT spend 100 billion!!!!!!!!!!!!!!  
 If they spend 100 billion, AD would look like this:

**WHY?**

# Fiscal Policy Practice

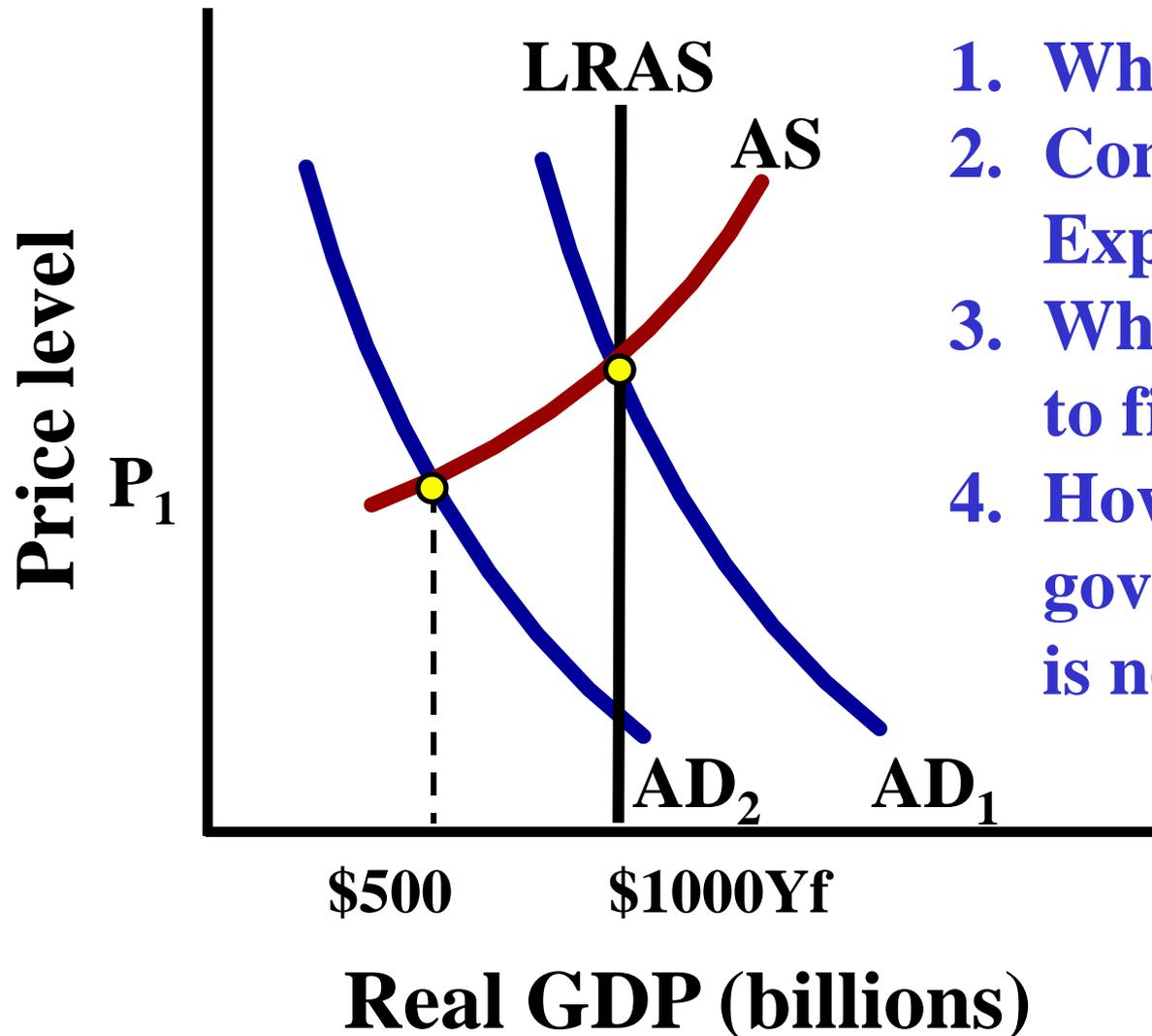
Congress uses discretionary fiscal policy to the manipulate the following economy (MPC = .8)



1. What type of gap?
2. Contractionary or Expansionary needed?
3. What are two options to fix the gap?
4. How much initial government spending is needed to close gap?

# Fiscal Policy Practice

Congress uses discretionary fiscal policy to the manipulate the following economy (MPC = .8)

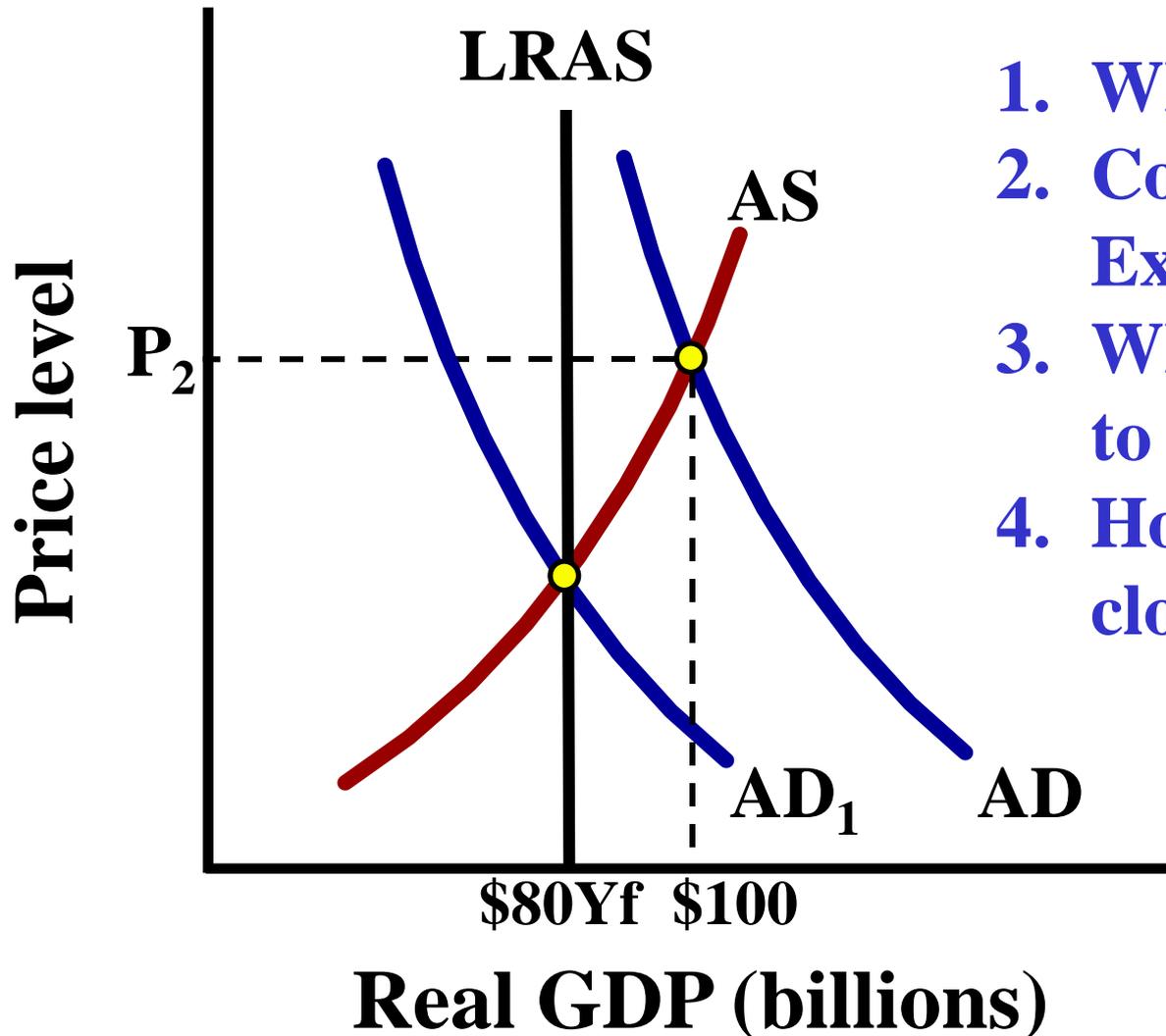


1. What type of gap?
2. Contractionary or Expansionary needed?
3. What are two options to fix the gap?
4. How much initial government spending is needed to close gap?

**\$100 Billion**

# Fiscal Policy Practice

Congress uses discretionary fiscal policy to the manipulate the following economy (MPC = .5)



1. What type of gap?
2. Contractionary or Expansionary needed?
3. What are two options to fix the gap?
4. How much needed to close gap?

**-\$10 Billion**

# What about taxing?

- The multiplier effect also applies when the government cuts or increases taxes.
- But, changing taxes has less of an impact of changing GDP. Why?

## Expansionary Policy (Cutting Taxes)

- Assume the MPC is .75 so the multiplier is 4
- If the government cuts taxes by **\$4 million** how much will consumer spending increase?
- NOT 16 Million!!**
- When they get the tax cut, consumers will save \$1 million and spend \$3 million.
- The \$3 million is the amount magnified in the economy. **Tax multiplier=MPC/MPS=MPC/(1-MPC)**
- \$3 x 4 = \$12 Million increase in consumer spending**

# **Non-Discretionary Fiscal Policy**

# The Case Against Active Stabilization Policy

- ◆ Some economists argue that monetary and fiscal policy destabilizes the economy.
- ◆ Monetary and fiscal policy affect the economy with a substantial lag.
- ◆ They suggest the economy should be left to deal with the short-run fluctuations on its own.

# Automatic Stabilizers

- ◆ **Automatic stabilizers** are changes in fiscal policy that stimulate aggregate demand when the economy goes into a recession without policymakers having to take any deliberate action.
- ◆ Automatic stabilizers include the **tax system** and some forms of **government spending**.

# **Non-Discretionary Fiscal Policy**

**Legislation that act counter cyclically without explicit action by policy makers.**

*AKA: Automatic Stabilizers*

**The U.S. Progressive Income Tax System acts counter cyclically to stabilize the economy.**

- 1. When GDP is down, the tax burden on consumers is low, promoting consumption, increasing AD.**
- 2. When GDP is up, more tax burden on consumers, discouraging consumption, decreasing AD.**

**The more progressive the tax system, the greater the economy's built-in stability.**

Crowding-out effect

# The Crowding-Out Effect

- ◆ Fiscal policy may not affect the economy as strongly as predicted by the multiplier.
- ◆ An increase in government purchases causes the interest rate to rise.
- ◆ A higher interest rate reduces investment spending.

# The Crowding-Out Effect

- ◆ This reduction in demand that results when a fiscal expansion raises the interest rate is called the **crowding-out effect**.
- ◆ The crowding-out effect tends to dampen the effects of fiscal policy on aggregate demand.

# Additional Problems with Fiscal Policy

## Crowding-Out Effect

- In basketball, what is “Boxing Out”?
- Government spending might cause unintended effects that weaken the impact of the policy.

### Example:

- We have a recessionary gap
- Government creates new public library. (AD increases)
- Now but consumer spend less on books (AD decreases)

### Another Example:

- The government increases spending but must borrow the money (AD increases)
- This increases the price for money (the interest rate).
- Interest rates rise so Investment to fall. (AD decrease)

**The government “crowds out” consumers  
and/or investors**

# Problems With Fiscal Policy

- When there is a recessionary gap what two options does Congress have to fix it?
- What's wrong with combining both?

## Deficit Spending!!!!

- A **Budget Deficit** is when the government's expenditures exceeds its revenue.
- The **National Debt** is the accumulation of all the budget deficits over time.
- If the Government increases spending without increasing taxes they will increase the annual deficit and the national debt.

Most economists agree that budget deficits are a necessary evil because forcing a balanced budget would not allow Congress to stimulate the economy.

# Additional Problems with Fiscal Policy

## **1. Problems of Timing**

- **Recognition Lag- Congress must react to economic indicators before it's too late**
- **Administrative Lag- Congress takes time to pass legislation**
- **Operational Lag- Spending/planning takes time to organize and execute ( changing taxing is quicker)**

## **2. Politically Motivated Policies**

- **Politicians may use economically inappropriate policies to get reelected.**
- **Ex: A senator promises more welfare and public works programs when there is already an inflationary gap.**

# Supply-side policy

# Supply-side Policy

- Some economists believe that supply-side policies have the potential to increase productivity, and therefore economic growth.
- So far the discussion of fiscal policy is centered on changing AD
- The main idea behind **supply-side fiscal policy** is that **tax reductions targeted to AS increase AS** so that real GDP increases with very little inflation.
- policies that lower, or remove, taxes on income earned from savings.** This would encourage saving and increase the supply of loanable funds, decrease the real interest rate, and increase the amount of money that firms invest.

# Supply-side Policy

• **Reasons that lower taxes can increase AS as well as AD:**

• **Productivity incentives.** Lower taxes mean workers take more of their pay home, which might prompt wage earners to work harder and be more productive.

• **Risk taking.** Entrepreneurs take big risks to start businesses and invest in new capital. Lowering the tax rate on profits increases the expected rate of return and encourages more investment.