Crowding Out and Fiscal Policy

HS202

What is Crowding out

- The term crowding out refers to the reduction in private expenditure (or invest) caused by an increase in government expenditure through deficit budget via a tax cut or increased money supply or bond issue.

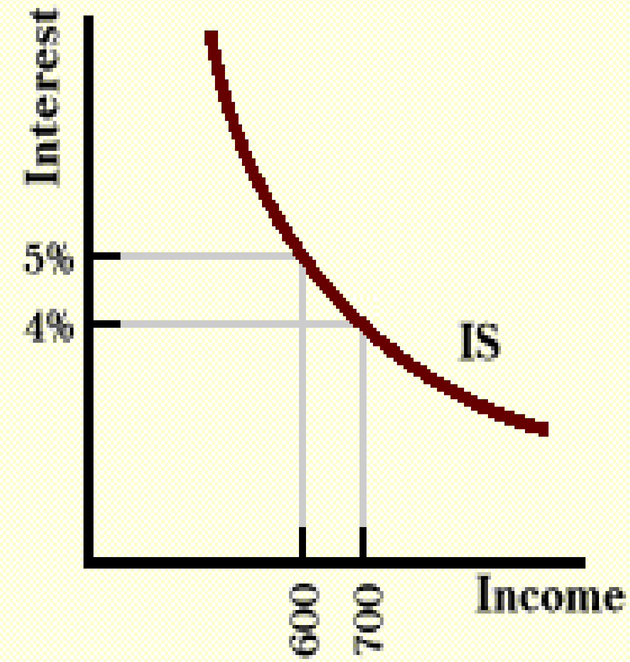
- There are three different ways that a national government can fund its spending, and the way it chooses affects the macroeconomic effects of that spending.

Cont.

- Pretty much everyone agrees that if a government funds additional spending with taxes, the macroeconomic effects are small.
- The tax increase cancels out any multiplier effect of the spending, so its overall effect is negligible.
- Also, everyone pretty much agrees that if a government funds additional spending by printing money, the effect on total spending will be large.
- No one's spending is cancelled out in this case, and both monetary and fiscal policy are working together.

IS curve

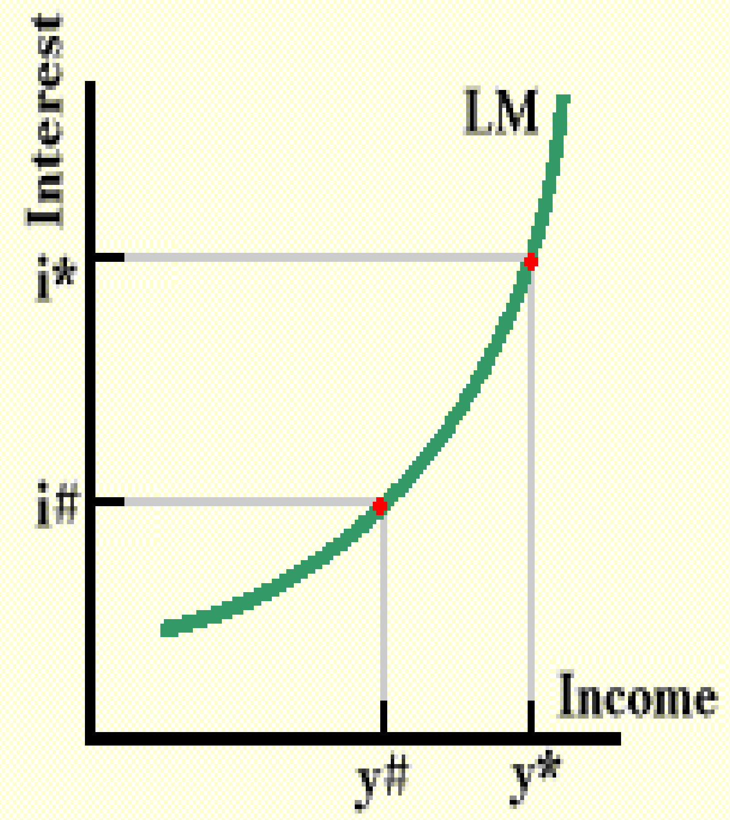
- (I) for investment (S) for savings When the central bank allows the banking system to create more money, banks increase their lending.
- This additional supply of funds reduces interest rates.
- Lower interest rates increase investment, which has a multiplier effect on total spending.
- A contraction of money will have opposite results.



The IS curve slopes downward.

LM Curve

- (L for **liquidity preference** (M) for money supply). If, for example, the government reduces taxes, thereby raising its deficit, it must borrow more.
- This added borrowing increases the demand for loanable funds and the price of these funds, which is the interest rate, should rise.
- The higher interest rate makes holding idle funds more expensive, and should result in an increased velocity of money.



The LM curve slopes upward.

Effective Fiscal policy

- For fiscal policy to be effective as a tool of macroeconomic policy, it must not crowded out other spending.