Economics

Fiscal Policy

Exam Focus

- Fiscal policy
- Types of taxes
- Fiscal multiplier
- Ricardian equivalence
- Policy lags

Fiscal Policy Definition

- Discretionary fiscal policy: uses government spending (G) and taxation (T) to influence the level of aggregate demand
- Expansionary fiscal policy (budget deficit): G > T
- Contractionary fiscal policy (budget surplus): T > G
- **Automatic stabilizers** (taxes and transfer payments) tend to increase deficits during recessions and decrease deficits during expansions.

Fiscal Policy Tools: Spending

1. **Transfer payments**: cash payments by government to redistribute wealth
2. **Current spending**: spending on goods and services
3. **Capital spending**: to increase future productivity; on infrastructure, or to support research on and development of new technologies

Direct and Indirect Taxes

- **Direct taxes:** levied on income, wealth, and corporate profits; take considerable time to implement
- **Indirect taxes:** sales taxes; quick to implement

Direct and Indirect Taxes: Example

Which of the following statements is *most* accurate?

A. Direct taxes are useful for discouraging alcohol consumption.

B. Because indirect taxes cannot be changed quickly, they are of no use in fiscal policy.

C. Government capital spending decisions are slow to plan, implement, and execute and hence are of little use for short-term economic stabilization.

is much to implement than changes in

; and taxes affect alcohol consumption more directly than

taxes.

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Fiscal and Balanced Budget Multiplier

- Increased spending has a multiplied effect as it creates more spending

$$\text{fiscal multiplier (FM)} = \frac{1}{1 - MPC(1 - t)}$$

- An increase in government spending (ΔG) can increase aggregate demand by $\Delta G \times FM$

- *Balanced budget* refers to balancing spending and taxation

- Balanced budget multiplier is positive due to MPC < 1

Ricardian Equivalence

- With Ricardian equivalence, an increase in government spending funded by issuing debt will have no impact on aggregate demand.
- This would result if individuals view the additional debt as a future tax liability.
- A decrease in taxes resulting from greater government borrowing would not increase consumption.

Fiscal Policy Lags

- **Recognition lag**: to identify the need for fiscal policy change
- **Action lag**: to enact legislation
- **Impact lag**: for the policy change to have the intended effect

- Lags can cause fiscal policy changes to be destabilizing rather than stabilizing.

Fiscal Policy: Example 1

Fiscal expansions will *most likely* have the greatest impact on aggregate output when the economy is in which of the following states?

A. Full employment

B. Near full employment

C. Considerable unemployment

When an economy is employment, a fiscal expansion raising aggregate demand can have impact on output because there are unused resources (e.g., labor or idle factories); instead, there will be upward pressure on . The greatest impact on aggregate output will occur when there is considerable .

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Fiscal Policy: Example 2

Which one of the following is *most likely* a reason to *not* use fiscal deficits as an expansionary tool?

A. They may crowd out private investment.

B. They may facilitate tax changes to reduce distortions in an economy.

C. They may stimulate employment when there is substantial unemployment in an economy.

A frequent argument against raises in fiscal deficits is that the additional to the deficit in financial markets will displace for (i.e.,).

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Fiscal Policy: Example 3

Which of the following statements is *least* accurate?

A. Discretionary fiscal changes are aimed at stabilizing an economy.

B. Automatic fiscal stabilizers include new plans for additional road building by the government.

C. In the context of implementing fiscal policy, the recognition lag is often referred to as "driving while looking in the rearview mirror."

Solutions

Direct and Indirect Taxes: Example

Which of the following statements is *most* accurate?

A. Direct taxes are useful for discouraging alcohol consumption.

B. Because indirect taxes cannot be changed quickly, they are of no use in fiscal policy.

C. Government capital spending decisions are slow to plan, implement, and execute and hence are of little use for short-term economic stabilization.

Solution:

Capital spending is much slower to implement than changes in indirect taxes, and indirect taxes affect alcohol consumption more directly than direct taxes.

Fiscal Policy: Example 1

Fiscal expansions will *most likely* have the greatest impact on aggregate output when the economy is in which of the following states?

A. Full employment

B. Near full employment

C. Considerable unemployment

Solution:

When an economy is close to full employment, a fiscal expansion raising aggregate demand can have little impact on output because there are few spare unused resources (e.g., labor or idle factories); instead, there will be upward pressure on prices (i.e., inflation). The greatest impact on aggregate output will occur when there is considerable unemployment.

Fiscal Policy: Example 2

Which one of the following is *most likely* a reason to *not* use fiscal deficits as an expansionary tool?

A. They may crowd out private investment.

B. They may facilitate tax changes to reduce distortions in an economy.

C. They may stimulate employment when there is substantial unemployment in an economy.

Solution:

A frequent argument against raises in fiscal deficits is that the additional borrowing to fund the deficit in financial markets will displace private sector borrowing for investment (i.e., crowding out).

Fiscal Policy: Example 3

Which of the following statements is *least* accurate?

A. Discretionary fiscal changes are aimed at stabilizing an economy.

B. Automatic fiscal stabilizers include new plans for additional road building by the government.

C. In the context of implementing fiscal policy, the recognition lag is often referred to as “driving while looking in the rearview mirror.”

Solution:

New plans for road building are discretionary and not automatic.