# Lesson 3: Fiscal Policy

## Roles and Objectives of Fiscal Policy

The main aim of fiscal policy is to regulate the economy's real GDP by influencing aggregate demand. Expansionary fiscal policy involves one or more of the following:

- Reducing personal income taxes to increase disposable income.
- Reducing indirect taxes to raise real income.
- Reducing corporate taxes to boost profits.
- Reducing taxes on saving to raise disposable income.
- Increasing expenditure on social goods and infrastructure, which increases personal incomes.

Keynesians believe that fiscal policy can have a powerful impact on aggregate demand, output and employment.
Monetarists believe that fiscal changes only have a temporary impact on the economy and that monetary policy is more effective in controlling inflation.
Further, monetarists do not advocate the use of monetary policy in regulating business cycles.

Fiscal policy is an important tool for economic stabilization through its impact on output.

- In a recession, governments can increase spending and/or reduce taxes (expansionary fiscal policy) to try to raise employment and output.
- In an expansion, governments can reduce spending and/or increase taxes (contractionary fiscal policy) to try to control inflation.

The budget surplus/deficit equals the difference between the government's revenue and expenditure over a period of time. Analysts look at the change in the budgetary position to determine whether fiscal policy is getting tighter or looser:

- An increase (decrease) in a budget surplus is contractionary (expansionary).
- An increase (decrease) in a budget deficit is expansionary (contractionary).

Automatic stabilizers work in the absence of explicit action by the government to bring the economy towards full employment. There are two automatic stabilizers embedded in fiscal policy:

- Induced taxes: Revenue from income taxes rises in an expansion and falls in a recession.

- Needs-tested spending: These are government programs that pay benefits to qualified individuals and businesses (e.g. unemployment benefits). Empirical evidence suggests that automatic stabilizers play a significant role in mitigating deviations from potential output. They reduce the severity of both expansions and recessions.

Discretionary fiscal actions are enacted by the government, and involve changing tax rates or the level of government spending. Basically, these actions are up to the government's discretion as opposed to automatic stabilizers, which act on their own to bring the economy towards full employment.

## Deficits and National Debt

Reasons to be concerned about national debt relative to GDP:

- High debt levels may lead to high tax rates (to service the debt) going forward. Higher expected future tax rates may serve as a disincentive for labor and entrepreneurial activity.
- If markets lose confidence in the government, the central bank may have to print money to finance the deficit.
- Government spending may crowd out private investment.

Reasons not to be concerned about national debt relative to GDP:

- The problem is not really a major issue if debt is owed to the country's own citizens.
- Some of the borrowed funds may have been used for capital investment projects, which would raise the economy's productive capacity (and tax revenues) going forward.
- The private sector may adjust to offset fiscal deficits by increasing savings in anticipation of future tax increases (to finance the deficit). If there is widespread unemployment in the economy, fiscal deficits will not be diverting any resources away from productive uses so total output will increase.
- Large fiscal deficits require tax changes, which may correct the distortions created by the current tax structure.

## Fiscal Policy Tools and the Macroeconomy

Government spending takes the following forms:

Transfer payments are welfare payments that include unemployment benefits, job search allowances and income support for poor families.

- They provide a way for the government to change the overall distribution of income in the economy.
- Note that these payments are not included in GDP.

Current government spending refers to spending on goods and services that are provided on a recurring, regular basis (e.g. health, education and defense).

- This type of spending has a significant impact on the quality of human capital and on labor productivity.

Capital expenditure refers to infrastructure spending.

- This type of spending contributes to the economy's capital stock and adds to its productive capacity.

Justifications for government spending:

- The government provides services such as defense that benefit all citizens equally.
- Infrastructure spending helps the country's economic growth.
- Helps redistribute wealth in society.
- Can be used as a tool to control inflation, unemployment and growth.
- Can be used to subsidize the development of innovative and high-risk new products (e.g. alternative energy).

## Types of Taxes

- Direct taxes are levied on income, wealth, and corporate profits and include capital gains taxes, labor taxes, corporate taxes, and income and property taxes.
- Indirect taxes are taxes on spending on goods and services (e.g. VAT, excise duties and taxes on fuel and tobacco).

Taxes can be justified in terms of raising revenue to finance government expenditure and in terms of income and wealth redistribution.

## Desirable Properties of Tax Policy

Simplicity: Taxpayers should find it easy to comply with tax laws and the authorities should find it easy to enforce them.
Efficiency: Tax policy should minimize disincentives to work and invest. The aim of attaining "efficient" outcomes must be balanced against the urge to promote "good" economic activities or the urge to discourage "bad" activities (e.g. smoking).
Fairness: While the concept of fairness remains subjective, it is generally believed that people in similar situations should pay similar taxes (horizontal equity) and richer people should pay more taxes (vertical equity).
Revenue sufficiency: This aim may at times be in conflict with fairness and efficiency, so the government must find the right balance.

## Advantages and Disadvantages of Different Fiscal Policy Tools

### Advantages:

- Indirect taxes can be adjusted very quickly. They are very effective in influencing spending behavior and in generating revenue at little cost to the government.
- Social objectives (e.g. reducing alcohol or cigarette consumption) can easily be met by raising indirect taxes.

### Disadvantages:

- Direct taxes, and welfare and other social transfers are difficult to change without significant notice. However, they begin to have an impact on behavior soon after their announcement.
- Capital spending decisions are slow to plan, implement and execute.

In addition to their direct effects on the economy, the above-mentioned fiscal policy tools also have strong expectational effects on the economy. For example, an announcement that income taxes will be raised next year would have an impact on spending patterns almost immediately.

Also note that:

- Direct government spending has a much bigger impact on aggregate spending and output than income tax cuts or transfer increases.
- However, if transfer increases, target the poorest in society (whose marginal propensity to consume is highest), they can have a relatively strong impact on spending.

## The Fiscal Multiplier

# The Balanced Budget Multiplier

## Issues in Fiscal Policy Implementation

### Deficits and the Fiscal Stance

The size of a fiscal deficit cannot be used to determine whether fiscal policy is expansionary or contractionary.

- Economists look at the structural or cyclically-adjusted budget deficit as an indicator of the government's fiscal stance.
- The structural deficit is the deficit that would exist were the economy working at full-employment.

Government expenditure includes the cash amount of payments on debt, which inflates the actual deficit.

- This is because the real value of outstanding debt falls with inflation.
- Therefore, it would be more appropriate to include real (or inflation-adjusted) interest payments in expenditure.

## Difficulties in Executing Fiscal Policy

Recognition lag: This refers to the time that it takes the government to figure out that the economy is not functioning at potential output.

Action lag: The government might have recognized the need for action, but its implementation may be delayed in obtaining the necessary approvals.

Impact lag: This refers to the time it takes for a fiscal stimulus to flow through the economy and generate the changes in spending patterns that are desired.

**Other macroeconomic issues:**

- If an economy is suffering from high unemployment and high inflation, raising aggregate demand will lead to higher prices.
- A government with a high national debt-GDP ratio may face difficulties in raising funds to further stimulate demand.
- The economy may already be operating at full employment (without the government knowing it).
- Private investment may be crowded out as government borrowing leads to high interest rates.
- The fact that there may be unused resources in the economy could be down to low labor supply (not necessarily low aggregate demand). In such a case, a fiscal stimulus will simply bring inflationary pressures to the economy.

## The Relationships between Monetary and Fiscal Policy

Fiscal and monetary policies both affect aggregate demand, but use different channels.

Easy fiscal policy/tight monetary policy:

Tight fiscal policy/easy monetary policy

Easy fiscal policy/easy monetary policy

Tight fiscal policy/tight monetary policy

Fiscal and monetary policies are not interchangeable. Further, they can work against each other unless the government and central bank coordinate their objectives.

## Factors Influencing the Mix of Fiscal and Monetary Policy

If the government is primarily concerned with growing the economy's potential output, it should aim to keep interest rates low and keep fiscal policy relatively tight to ensure that free resources are available in the growing economy.

If the government's main concern is to build infrastructure and develop high quality human capital, it should focus on spending in those areas. If monetary policy is kept loose during this time, inflation may result.

An IMF study concluded that:

When not accompanied by monetary accommodation:

- Increases in government spending have a much larger effect on GDP than similar-sized social transfers because transfers are not believed to be permanent.
- Social transfers to the poorest citizens have more of an impact than non-targeted transfers.
- Labor tax reductions have a slightly greater impact than non-targeted transfers.

When accompanied by monetary accommodation:

- Fiscal multipliers are larger than when there is no monetary accommodation.
- These larger multipliers result from falling real interest rates, which in turn lead to additional private sector spending.