ECON 202 - MACROECONOMIC PRINCIPLES

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Chapter 17 - Macroeconomic Policy Debates

Macroeconomic Policy Debates - Topics

This chapter examines three key policy issues in macroeconomics:

1. Should the government balance its budget?
2. Should the Federal Reserve just target inflation and not worry about output and unemployment?
3. Should people be taxed on what they earn or what they spend?

Should We Balance the Federal Budget?

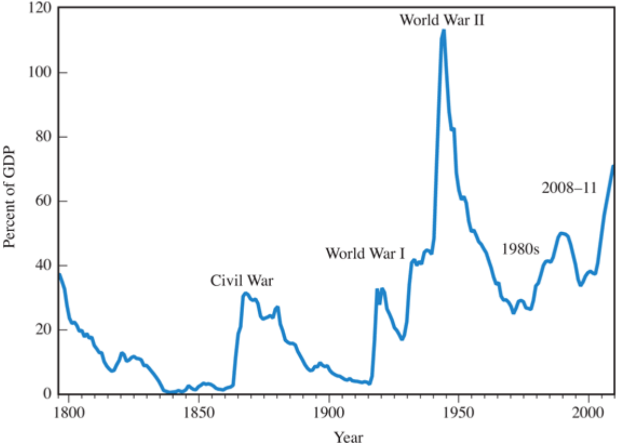
Should We Balance the Federal Budget?

- The purchase of goods and services by the government and the transfer payments (Social Security, welfare, and so on) it makes to its citizens are the government's expenditures
- A surplus occurs when the government's revenues exceed its expenditures
- The government runs a deficit when it spends more than it receives in revenues from either taxes or fees
- The government debt is the total of all of its yearly deficits

The Budget in Recent Decades

- Beginning in the 1980s and through most of the 1990s, the federal budget ran large deficits
- In fiscal year 1998, (during President Clinton's administration), the federal government ran a budget surplus of $69 billion
- The large surplus led President George W. Bush to propose substantial tax cuts be made
- The collapse of the stock market and the recession that began in 2001 after Bush's tax cuts were passed sharply reduced tax revenues
- Then, the terrorist attacks led to higher spending, and by fiscal year 2004, the government ran a budget deficit of over $400 billion

Federal Debt as a Percent of GDP, 1791-2011



Federal Debt as a Percent of GDP, 1791-2011 (cont.)

- The nation's debt/GDP ratio tends to rise sharply during wars because more spending is needed to finance them
- However, the ratio also can rise during peacetime, as it did during the Reagan presidency in the 1980s and since 2008

The Budget and Social Security

- Over the next decade, the Social Security portion of the budget is expected to run a surplus, but over the longer horizon, as our society grows older, the surpluses will turn to deficits
- These deficits will result in sharp increases in the debt-to-GDP ratio unless taxes are raised and/or spending is cut significantly

The Debates

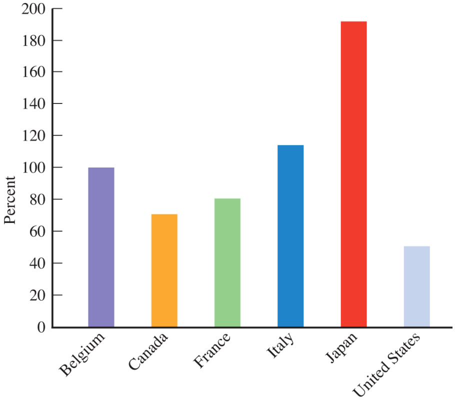
1. Do Deficits Lead to Inflation?

   government deficit=new borrowing from public + new money created

   - If the Federal Reserve purchases the government bonds issued by the Treasury Department to finance the deficit, that purchase creates money by taking debt out of the hands of the public in exchange for money
   - Economists call the purchase by a central bank of newly created government debt monetizing the debt
   - If a country has no options other than creating money to finance its deficits—in other words, if the public is unwilling to buy its bonds, those deficits will inevitably cause inflation

2. Is Government Debt a Burden on Future Generations?

The Debates (cont.)



- First, a large debt can reduce the amount of capital in the economy and thereby reduce future income and real wages for its citizens
  - Savings flow into capital formation and increase the economy's capital stock

The Debates (cont.)

- When the government runs a deficit, it sells bonds to the same savers who could have purchased the bonds of private firms
- Therefore, the selling of government bonds "crowds out" private investment spending

- Second, a large debt will mean that future generations will have to pay higher taxes to pay the interest that accumulates on the debt.
  - Economists who do not believe that government deficits impose a burden on society believe in the Ricardian equivalence, the proposition that it does not matter whether government expenditure is financed by taxes or by issuing debt because everyone understands that higher debt will result in higher taxes, so people save in anticipation of paying higher taxes in the future.
  - In sum, the Ricardian equivalence requires that savings by the private sector increase when the deficit increases

3. How Do Deficits Affect the Size of Government?

The Debates (cont.)

- Nobel Laureate James Buchanan has argued that people are less aware of government deficits than the taxes they're forced to pay, and this inevitably will lead to higher government spending and bigger government
- More recent thinking suggests that deficits can be used strategically to actually reduce the growth of government
- Lower taxes and higher deficits make it more difficult for other politicians to increase government spending

4. Can Deficits Be Good for an Economy?

- Over short periods, deficits can help the economy to cope with shocks, such as oil price increases or a collapse in the stock market
- They give the government some room to maneuver out of a recession
- Deficits can also play a role in tax smoothing
- Professor Robert Barro of Harvard University has argued that it is more efficient to keep tax rates relatively constant than to raise them sharply and then lower them later
- Thus, by running deficits and only gradually raising taxes later to service the debt, we avoid creating excess distortions in the economy

The Debates (cont.)

5. How Would a Balanced Budget Amendment Really Work?
    - Proponents of the balance budget amendment say that it will finally exert discipline on the federal government
    - We can also avoid the effects that deficits have: reduced capital formation and shifting tax burdens onto future generations
    - Critics of a balanced budget amendment say that it may not allow enough flexibility for the government to effectively deal with recessions
    - They also argue that the Constitution is not the right mechanism to try to enforce complicated budget rules

Should the Federal Reserve just target inflation?

Should the Fed Target Inflation?

The costs of inflation include:

- Menu costs—the costs firms incur to change their posted prices
- Shoe-leather costs, the costs individuals and firms pay for the time spend trying to reduce their holdings of money
- Distortions in our tax and banking systems because inflation isn't yet factored into them
- Arbitrary redistributions of money between debtors and creditors from unanticipated inflation

The Debate about Inflation Targeting

- Proponents of inflation targeting argue that the Fed should have only one primary goal: controlling inflation
  - Commitment to a single goal would give the Fed more credibility and help to keep it free from political pressures
  - Many other economists strongly object to having the Fed concentrate solely on controlling inflation
  - There are legitimate questions about what constitutes "stable prices"
  - It is difficult to isolate from prices changes the technological improvements that change the quality of goods rapidly
  - Some economists like the idea of the Fed having to meet targets, such as to target the growth rate in nominal GDP and thereby both the growth in real GDP as well as the growth in prices (inflation).
- Critics of stabilization policy believe that attempts to stabilize the economy have done more harm than good over the years by making fluctuations worse

The Debate about Inflation Targeting (cont.)

- Difficulties include lags, uncertainties about the strength and timing of policies, and difficulties in estimating the natural rate of unemployment

- Who should set the inflation target?
  - In the United Kingdom, it is ultimately the elected government that decides on the inflation target for the central bank
  - In other countries, such as New Zealand, the central bank has the responsibility of "achieving and maintaining stability in the general level of prices" without any competing goals
  - In the United States, the Fed has considerable power to use monetary policy to stabilize output as well as to fight inflation as it pleases
  - However, changing the current system to give Congress and the president more power over monetary policy might lead to more inflation, not less

Should people be taxed on what they earn or what they spend?

Should We Tax Consumption Rather than Income?

- The United States is a country with a low savings rate
- Colleges, welfare programs, and even the U.S. tax system discourage savings
- Tax systems based on consumption do not penalize individuals who save
- Sales taxes and value-added taxes are examples of consumption taxes
- The key feature of a consumption tax is that you do not face any additional taxes if you decide to save more of your income
- In practice, the U.S. tax system is a hybrid system: halfway between an income tax and a consumption tax

Debates about Consumption vs Income Taxes

- Will Consumption Taxes Lead to More Savings?
  - It is clear that individuals will allocate their savings to tax-favored investments, such as IRAs, over investments that are not favored
  - What is not clear if whether the funds are new savings—meaning reduced consumption—or merely transfers from other accounts
  - Corporate income is taxed twice, first when it is earned by the corporation and again when it is paid out to shareholders
  - These corporate taxes may lead to less efficient investment because they result in capital flowing to sectors that do not suffer from double-taxation
- Are Consumption Taxes Fair?
  - Moving to a consumption tax system could have a major impact on the distribution of income in the economy
  - If we exempt savings from the income tax, wealthy and high-income individuals who save the most would clearly be favored
  - Capital gains are the profits investors earn when they sell stocks, bonds, real estate, or other assets

Debates about Consumption vs Income Taxes (cont.)

TABLE 17.1 Distribution of Capital Gains and Dividends by Income Class, 2009

Cash Income Level	Share of Capital Gains and Dividends
Less than $40,000	0%
$40,000 to $50,000	0.1
$50,000 to $75,000	0.9
$75,000 to $100,000	1.4
$100,000 to $200,000	8.2
$200,000 to $500,000	19.5
$500,000 to $1,000,000	13.8
Greater than $1,000,000	55.9

SOURCE: Estimates from the Urban-Brookings Tax Policy Center Microsimulation Model, http://www.taxpolicycenter.org/index.cfm (Accessed May 28, 2012).

- If capital gains and other types of capital income were not taxed, the government would have to raise tax rates on everyone to maintain the same level of spending

Debates about Consumption vs Income Taxes (cont.)

- Certain types of taxes, however, would not cause sharp changes in the relative tax burdens
- The "flat tax" designed by Robert E. Hall of Stanford University and Alvin Rabushka of the Hoover Institute brings the personal income tax and corporate income tax into a single, unified system
- The tax would allow a deduction for investment spending, and only extraordinary gains would be taxed

VAT Tax

- Virtually all developed countries use a value-added tax; a VAT.
- The United States is a prominent exception.
- A VAT is essentially a sales tax added at each stage of production.
  - It is embedded and easy to collect, however it tends to be high;
  - 17.5 percent in the United Kingdom
- A VAT would be regressive and might impinge on state taxing authority
- Why WAT
  - With a sales tax, a business selling goods is responsible to make a subjective decision about the intent of the buyer, one which it may not be fully competent to make
  - If buyers intend to consume the goods themselves, then the seller must collect a tax on the purchase price
  - If instead buyers intend the goods as capital goods, to be resold at a profit after adding value to them, then the seller must not collect the tax
  - Sellers thus have an incentive to claim that a sale is non-taxable, in order to please customers, creating an incentive to under-collect taxes