Governments & fiscal policy

Principles of Macroeconomics // Fall 2024

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Readings

Recommended readings

Required readings:

- *Macroeconomics in Context*, 4th ed.
  - → Chapter 9, Introduction, sections 1.2—1.4, 2.1.

Words of the day

- Spending;
- Bonds;
- Budget.

When governments step in

When governments step in

In times of **recession**, solely relying on **monetary policy** to stimulate the economy may not be enough.

The usual recipe involves a *policy mix*:

- *Monetary* +
- *Fiscal* policies.

> **Fiscal** policy encompasses how governments manage their *budget*—namely what governments *spend*, how they *get* the money that they spend, and the *effects* of these activities on GDP levels.

When governments step in

Fiscal policy adds another component to *Aggregate Demand (AD)*:

$$\text{AD} = C + I + G$$

$$\text{AD} = \underbrace{C + I}_{\text{private sector}} + \underbrace{G}_{\text{public sector}}$$

For now, we are **ignoring** the *foreign* sector (*X* - *M*).

When governments step in

Especially in periods of **high uncertainty**, fiscal policy may reintroduce ***stability*** to economic activity and employment.

Fiscal policy can be implemented in ***several*** ways, namely:

- Raising/lowering ***government spending*** (G);
- Raising/lowering ***taxes*** (T);
- Raising/lowering ***transfer payments*** (TR).

When governments step in

Government expenditures (G)

- Infrastructure;
- Updating electrical grid;
- Renewable energy research.

Taxes (T)

- Tax cuts/increases to households and businesses.

Transfer payments (TR)

- Unemployment benefits;
- Food stamps;
- Social security.

When governments step in

While **government spending** (G) *directly* affects the economy, **tax** changes (T) and **transfer** payments (TR) have an *indirect* effect in the economy.

- This happens because events such as tax cuts or transfer payments are **not** expenditures *per se*.

When governments step in

There are **two** types of fiscal policy:

- *Expansionary*;
- *Contractionary*.

While ***expansionary*** fiscal policy aims to **stimulate** the economy, ***contractionary*** policies lead to **lowering** the level of economic activity.

- *Expansionary fiscal policies*: increases in government expenditures and transfer payments, tax reductions.
- *Contractionary fiscal policies*: reductions in government expenditures and transfer payments, tax raises.

The government budget

The government budget

Since fiscal policy involves changes in a government's **budget**, the latter can be defined as:

$$\text{Government budget} = \text{Taxes} - (\text{Government expenditures} + \text{Transfer payments})$$

The government budget

Since fiscal policy involves changes in a government's **budget**, the latter can be defined as:

$$\textbf{Government budget} = \underbrace{\textbf{Taxes}}_{\textbf{Revenue}} - \underbrace{(\textbf{Government expenditures} + \textbf{Transfer payments})}_{\textbf{Outlays}}$$

- When a government's revenues are **greater** than its outlays, it has a budget *surplus*.
- When a government's revenues are **lower** than its outlays, it has a budget *deficit*.

The government budget

- 🔗U.S. Government budget

- 🔗U.S. Government budget as a percentage of GDP

The government budget

When **revenues** (i.e., taxes) are not sufficient to **cover** outlays, the government *borrows* to cover the difference.

Q: But how do governments *finance* their debt?

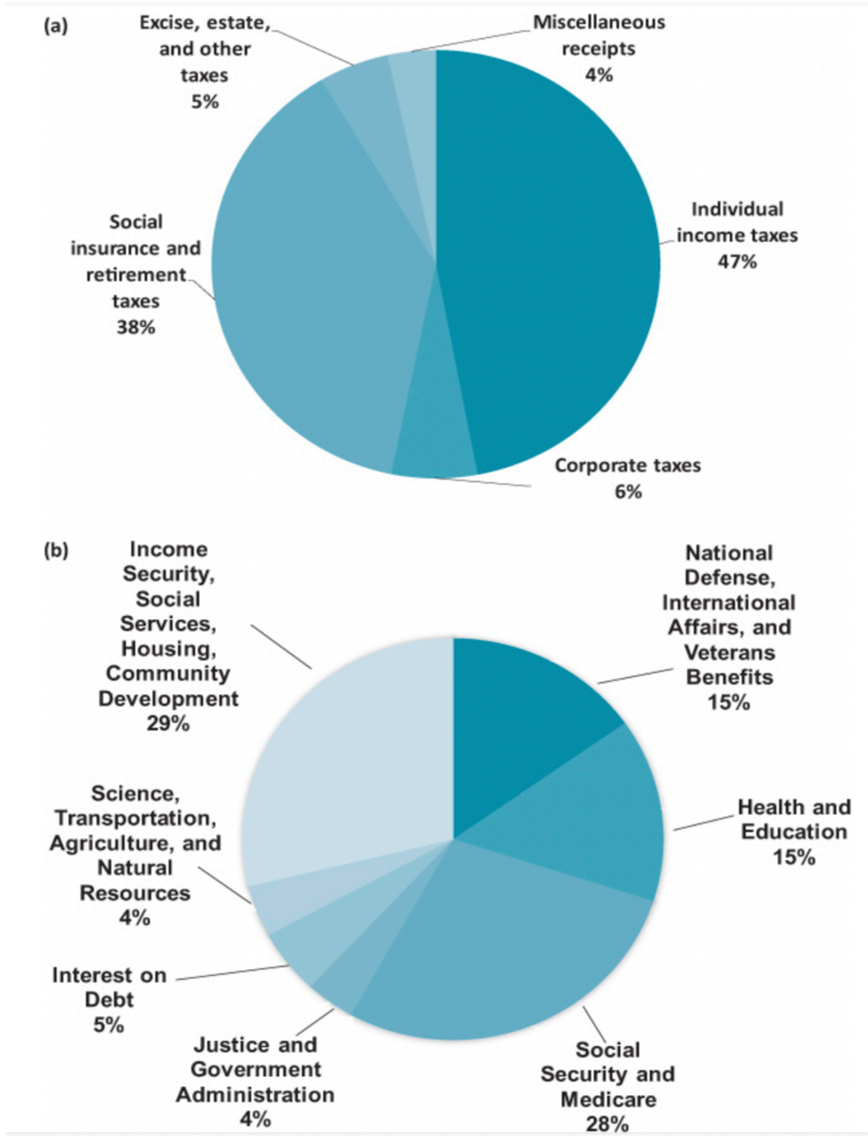
A: Through the sale of **government bonds**. (in the US, treasury bonds… bought by firms, households, foreign governments)

> A **government bond** is an interest-bearing *security* constituting a promise to pay at a specified future time.

The government budget

- 🔗 `Different U.S. Government bonds`

The government budget



Fiscal policy in practice

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- 🔗 American Recovery and Reinvestment Act (ARRA, 2009)
- 🔗 Tax Cuts and Jobs Act (TCJA, 2017)
- 🔗 Coronavirus Aid, Relief, and Economic Security (CARES, 2020)

Next time: Fiscal policy & reality