Ch 30 Fiscal Policy

Principles of Macroeconomics

Econ 102

Outline

- Budget Balance and Debt
- Supply-side effects of Fiscal Policy
- Generational Effect of Fiscal Policy
- Fiscal Stimulus

Fiscal Policy

- Fiscal policy is when the government decides to control the economic performance of the country using its fiscal tools
- The tools/instruments are: tax and government spending
- From AD-AS model, we know that:
  - To fight a recession, the government can lower tax or increase G or both
  - To fight an expansion, the government can increase tax or lower G or both
- However, fiscal policy directly affect the government budget balance (T-G)

Government Budget Balance

- The government revenues are from receipts
- The government expenditures are from outlays
- When:
  - receipts > outlays → surplus
  - receipts < outlays → deficit
  - Receipts = outlays → balanced
- When the government is running a deficit, it increases the government debt and have to borrow money

Supply-side effects of Fiscal Policy

- We have examined the effect of tax on aggregate spending in previous chapters
- Economists that believe more on the supply-side argued that there are tax-effect on productivity
  - Income tax shock will have an effect on labor market
    - The tax will decrease the supply of labor → workers need to be paid more in order to compensate the increase in income tax
    - Results in lower quantity of labor employed and higher real wage rate
  - Since the quantity of labor employed is less, the potential GDP will be lower as well
  - Creates a gap between before-tax income and after-tax income (tax wedge)

Tax-effect

- Taxes on expenditure will rise the prices paid for consumption goods and services → equivalent to a cut in the real wage rate
    - Increasing the tax wedge
- Tax on interest income or capital income will discourage savings and investment
    - The effect will be on loanable funds market
    - There will be less supply of loanable funds, causing a gap in the before-tax interest rate and after tax interest rate
    - The loanable funds available will decrease

Tax Revenues

- The only reason why tax has to be implemented is to generate government revenue (for budget balance)
  - If there is no tax and only government spending, then the government will always run a deficit
- The amount of Tax Revenue is related with the tax rate
  - Some might believe that in order to have higher tax revenue, the tax rate should be increased
  - Laffer curve suggest that it is true until it reaches a peak. Afterwards, increasing the tax even more would just lower the tax revenue
    - Income tax lowers the number of people working → lower number of people working means lower tax accumulation

Generational Effects of Fiscal Policy

- When the fiscal policy results in a budget deficit, the government would have to borrow money
  - The government has to somehow pay back the money borrowed
  - The government can only pay it back through its revenue → revenue is coming from tax
- The government needs to pay back the loans as well as continue running its program
  - There maybe fiscal imbalance between the current generation and the future generations

Fiscal Stimulus

- Fiscal stimulus is the use of fiscal policy to increase production and employment
  - The focus is not about budget balance. The focus is about changing real GDP
- Fiscal stimulus can be automatic or discretionary
  - Automatic fiscal policy → without the government doing anything, it already respond to changes in economic performance
    - An example is unemployment benefits. More unemployment benefits will be given when the economy is in recession
  - Discretionary fiscal policy → the government specifically implement fiscal policy
    - An example is when the government decides to increase its spending during a recession

Automatic Fiscal Policy

- Budget balance is somewhat like an automatic fiscal policy (automatic stabilizer)
  - When the economy is experiencing a recession:
    - The tax revenue from income tax would be lower.
    - The government benefits (unemployment for example) would be higher
    - Overall, tax revenue decreases and government spending increases
  - When the economy is experiencing an expansion:
    - The tax revenue from income tax would be higher.
    - The government benefits (unemployment for example) would be lower
    - Overall, tax revenue increases and government spending decreases
- When the government has the idea of running a balanced budget, then it no longer becomes an automatic fiscal policy

Cyclical and Structural Budget Balance

- Government is more likely to run a budget deficit when the economy is in recession
- However, there is a difference in structural and cyclical deficit
  - Cyclical deficit → actual deficit minus the structural deficit
  - Structural deficit → a deficit that happens even when economy is at full employment
- Similar concept happens for when the government is having a surplus

Discretionary Fiscal Stimulus

- During a recession:
  - The government can increase its spending or lower income tax or both
  - Expansionary fiscal policy
- During an expansion:
  - The government can decrease its spending or increase income tax or both
  - Contractionary fiscal policy
- In practice, changing the government spending will involve government expenditure multiplier
  - Remember the multiplier effect in Ch. 29!
- Changing the income tax will involve changing the multiplier as well
  - The demand-side effect of a tax cut are likely to be smaller compared to an increase in government expenditure

Limitations of fiscal policy

- Even though on paper fiscal policy is easy and straightforward, in practice it is very difficult
- The magnitude of the stimulus have to be accurate, otherwise it can be:
  - insufficient (not enough to fight the business cycle)
  - wasting too much resources (too much resources wasted to fight the business cycle that will actually results in even more fluctuations)
- There are also lags associated with fiscal policy
  - Recognition lag → assessing accurately the current state of economy takes time
  - Law-making lag → the time it takes to approved the fiscal policy
  - Impact lag → it itakes time for the fiscal policy to be implemented and feel the impact