**FISCAL POLICIES**

**Fiscal policies** are policies of government related to taxes, transfers and purchase of goods and services, used to shift the AD curve.

The Basics:   
The government funds many programs through tax revenues. Some important terms:

* **Government transfers:** payments by the government to households for which no good or service is provided in return.
* **Social insurance programs**: government programs (transfer payments) intended to protect families against economic hardship

The Government Budget and Total Spending:

How do tax policy and government spending affect the economy?   
They have a strong effect on the total AD curve and can modify macroeconomic equilibrium.

If we define GDP as the sum of C, I, G and net exports (X – IM), **the government controls directly G and indirectly affects C and I through taxation** (households’ incomes are affected by taxes and transfers and business investment is affected by taxes and regulations). Since consumption is a function of disposable income, **government can shift the AD curve through taxes**.

**Fiscal Policy:**

***Fiscal policy:*** the use of taxes, government transfers, or government purchases of goods and services to shift the aggregate demand curve.

There are two kinds of fiscal policies:

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Descrizione generata automaticamente**Expansionary fiscal policies:** aimed at increasing aggregate demand through an **increase** in **government purchases**, a **cut** in **taxes** or an **increase** in **government transfers** (the last two affect positively disposable income and investments). They are an extra fuel for the economy since aimed at reactivating consumption and investments, moving real GDP through the effect of the multiplier.   
Expansionary Fiscal Policy can close a Recessionary Gap:   
Instead of waiting for the long run correction mechanism, policy makers can choose to stimulate AD and move the economy back toward a long-run equilibrium. If the recessionary gap is very large, the government can implement one of the three measures mentioned before, causing a positive shock in AD. After this intervention, the economy will go back to the potential output 🡪 higher prices and optimal output *already in the short run*.

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Descrizione generata automaticamente**Contractionary fiscal policy:** it decreases AD through a **reduction** in **government purchases** of goods and purchases (G component of GDP), an **increase** in **taxes** (reducing consumption) or a **reduction** in **government transfers**.   
  
Contractionary Fiscal Policy can close an Inflationary Gap:  
If we are in an inflationary gap, there is a low rate of unemployment and the government may implement one of the three policies mentioned before, causing a negative shock in AD curve, which will reach a new macroeconomic equilibrium corresponding to the potential output and lower prices. Contractionary fiscal policies are used to reduce budget deficits and public debt.

Can Expansionary Fiscal Policy actually work?

The appropriateness of fiscal policies is undermined by three drawbacks: The Critics

**Government spending always crowds out private spending**The statement is wrong because it assumes a zero-sum game in which the aggregate income earned in the economy is always a fixed sum—which isn’t true. It also assumes that resources in the economy are always fully employed—and the only way to increase government spending is at firms’ expense.  
When the economy is suffering from a recessionary gap, there are unemployed resources in the economy and output, and therefore income, is below its potential level.  
Government spending crowds out private spending only when the economy is operating at full employment.

**Government borrowing always crowds out private investment spending**This is true only part of the time: It depends upon whether the economy is depressed. If it is, a fiscal expansion will lead to higher incomes, which lead to increased savings. The Recovery Act of 2009 was a case in point: despite high levels of government borrowing, U.S. interest rates stayed near historic lows.   
Government borrowing crowds out private investment spending only when the economy is operating at full employment

**Government budget deficits reduce private spending**  
This is known as “Ricardian equivalence” (after the nineteenth-century economist David Ricardo).  
  
It assumes that consumers, seeing the higher debt levels, will cut their spending today to save for inevitable increases in future tax rates necessary to pay down the debt.  
Does this give too much credit to consumers’ foresight and budgeting discipline? Probably

To sum up:  
The extent to which we should expect expansionary fiscal policy to work depends upon the circumstances.

When the economy has a recessionary gap, economics tells us that expansionary fiscal policy helps the economy.

However, when the economy is already at full employment, expansionary fiscal policy is the wrong policy and will lead to crowding out and higher inflation.

A cautionary note: Lags in Fiscal Policy

In the case of fiscal policy, there is an important reason for caution: There are significant lags in its use. It takes time to:

1. Realize the recessionary or inflationary gap by collecting and analyzing economic data
2. Develop a plan
3. Implement the action plan (spending the money)

Fiscal Policy and the Multiplier

Multiplier effects of an increase in government purchases of goods and services:

Recall that (if we assume a simple case with no taxes or international trade)

Example: if MPC = 0.5, the multiplier would be 1/(1 − 0.5)= 2.  
So $50 billion of new government spending would create   
($50 billion) × 2 = $100 billion increase in real GDP.

**Multiplier effects of changes in government transfers and taxes**

Will a $50 billion tax cut (or increase in transfers) have the same effect as a $50 billion increase in government purchases? No.   
Example: if the MPC=0.5, a change in tax or transfers is smaller than an equivalent change in government purchases from the outset.

The size of the shift of the aggregate demand curve depends on the type of fiscal policy.

Changes in government purchases have a more powerful effect on the economy than equal-sized changes in taxes or transfers.

A few notes:

* It’s actually more complicated, because (unlike most real tax policy) we use simple lump-sum taxes: taxes that don’t depend on the taxpayer’s income.
* If it’s not a lump-sum tax, the tax revenue will depend on the level of real GDP (and reduce the size of the multiplier).

Types of Fiscal Policy

Automatic stabilizers: government spending and taxation rules that cause fiscal policy to be automatically expansionary when the economy contracts and automatically contractionary when the economy expands (unemployment insurance).

In contrast, discretionary fiscal policy arises from deliberate actions by policy makers rather than rules (the Obama stimulus).

The Budget Balance measures fiscal policy (parr

How do surpluses and deficits fit into the analysis of fiscal policy? Are deficits ever a good thing and surpluses a bad thing? (And what’s the difference between deficit and debt?)

S(government) = T − G − TR

Government saving (Surplus) = tax revenues (T) – government purchases (G) and transfers (TR).

A budget surplus is a positive budget balance, and a budget deficit is a negative budget balance.

* Other things equal, discretionary expansionary fiscal policies reduce the budget balance for that year.
* Other things equal, discretionary contractionary fiscal policies increase the budget balance for that year.

DEFICITS VS. DEBT

**A deficit** is the difference between the amount of money a government spends and the amount it receives in taxes (tax revenues) over a given period (flow variable).

**A debt** is the sum of money a government owes at a particular time (stock variable).

Deficits and debt are linked, because government debt grows when governments run deficits. But they aren’t the same thing, and they can tell different stories.

**A widely used measure of fiscal health is the debt–GDP ratio.**

The budget balance measures fiscal policy (part 2)

Economists often consider the changes in the budget balance to measure fiscal policy. However, this “quick-and-dirty” way to assess whether current fiscal policy is expansionary or contractionary is sometimes misleading:

1. Two different changes in fiscal policy that have equal-sized effects on the budget balance may have quite unequal effects on the economy;

2. Often, changes in the budget balance are themselves the result, not the cause, of fluctuations in the economy.

The Budget Balance and the Business Cycle

Some of the fluctuations in the budget balance are due to the effects of the business cycle.  
The budget deficit as a percentage of GDP moves closely with the unemployment rate

Is this relationship between the business cycle and the budget balance evidence that policy makers engage in discretionary fiscal policy during expansions?

Not necessarily! To a large extent, the relationship between budget balance and business cycle reflects automatic stabilizers at work (i.e. unemployment benefit payments)

The Business Cycle and the Cyclically Adjusted Budget Balance  
To separate the effects of the business cycle from the effects of discretionary fiscal policy, governments estimate the cyclically adjusted budget balance: an estimate of the budget balance if the economy were at potential output.

Years of large budget deficits also tend to be years when the economy has a large recessionary gap.

Philosophies on Balancing the Budget

* Require an annually balanced budget… and lose the ability to help during a recession
* Balance the budget over the business cycle on average… and trust the politicians to keep the long-run budget healthy

Keynes and Hayek debated on the role of expansionary fiscal policies; are they good bc they bring economy into optimal output or the public debt is so dangerous in the long-run that they should not be carried out.

For example, the Maastricht Treaty asserts that the optimal threshold for GDP to public debt ratio is 60%.

Not many countries, however, respect this rule.

Especially Greece kept asking for international funds and had to accept very high interest rate to repay the existing rate. All international institutions and many countries within the EU are doubtful of the capability of Greece to repay their debt.

Many suggest supplying money to repay debt; this happened in Argentina and Venezuela, where inflation was huge.

Long-run Implications of Fiscal Policy

* Persistent budget deficits have long-run consequences because they lead to an increase in public debt (Greece’s street protests against austerity)

Problem Posed by Rising the Government Debt

Public debt may crowd out investment spending, which reduces long-run economic growth. And in extreme cases, rising debt may lead to government default, resulting in economic and financial turmoil.

Can’t a government that has trouble borrowing just print money to pay its bills?   
Yes, it can, but this leads to another problem: inflation