Fiscal Stimulus

A **fiscal stimulus** is the use of fiscal policy to increase production and employment.

Fiscal stimulus can be either

- Automatic
- Discretionary

Automatic fiscal policy is a fiscal policy action triggered by the state of the economy with no government action.

Discretionary fiscal policy is a policy action that is initiated by an act of Parliament.

Automatic Fiscal Stimulus

Two items in the government budget change automatically in response to the state of the economy.

- Tax revenues
- Transfer payments

Let's look at how tax revenues automatically responds to the state of the economy.

Tax Revenue = Tax rate x Income

- Tax revenue depends on tax rates and incomes.
- Parliament sets the tax rates that people must pay.
- Let us suppose that the tax rate is constant – that is, flat tax rate.

Tax Revenue = Tax rate x Income

http://www.cra-arc.gc.ca/tx/ndvdls/fq/txrts-eng.html

Canadian Federal tax rates for 2015

- 15% on the first $44,701 of taxable income, +
- 22% on the next $44,700 of taxable income (on the portion of taxable income over $44,701 up to $89,401), +
- 26% on the next $49,185 of taxable income (on the portion of taxable income over $89,401 up to $138,586), +
- 29% of taxable income over $138,586.

Discretionary Fiscal Stimulus

Most discretionary fiscal stimulus focuses on its effects on aggregate demand.

Changes in government expenditure and taxes change aggregate demand and have multiplier effects.

Two main fiscal multipliers are

- Government expenditure multiplier
- Tax multiplier

The **government expenditure multiplier** is the quantity effect of a change in government expenditure on real GDP.

Because government expenditure is a component of aggregate expenditure, an increase in government expenditure increases real GDP.

When real GDP increases, incomes rise and consumption expenditure increases. Aggregate demand increases.

The **tax multiplier** is the quantity effect of a change in taxes on aggregate demand.

The demand-side effects of a tax cut are likely to be smaller than an equivalent increase in government expenditure.

Time Lags

The use of discretionary fiscal policy is also seriously hampered by three time lags:

- Recognition lag—the time it takes to figure out that fiscal policy action is needed.
- Law-making lag—the time it takes Parliament to pass the laws needed to change taxes or spending.
- Impact lag—the time it takes from passing a tax or spending change to its effect on real GDP being felt.