Chapter 9: Fiscal Policy
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The purpose of this topic is to identify the needed policies when recession or inflation are present. Limitations of these policies are also studied. Nondiscretionary fiscal policies are presented.

FISCAL POLICY

Fiscal policy is the use of taxes and government spending to control the economic activity of a country. Such intent is explicitly stated in the Employment Act of 1946 and restated in the Humphrey-Hawkins Act of 1978.

> In 1981, the tax changes voted by congress were given the name of Economic Recovery Tax Act. This clearly shows that the government uses taxes as a method of controlling the economy. Along with spending, tax changes are what fiscal policy is.

GOVERNMENT SPENDING INCREASE

Government spending is an additional component of aggregate expenditure. The benefit of the multiplier effect can be derived as a one time increase in government spending to deal with a recession. Such was the case of the New Deal under Roosevelt. In the leakage-injection analysis, government spending is an injection and contributes to move the economy to a higher level of equilibrium.

> The Tennessee Valley Authority created in the 1930's was a combination of numerous major projects with thousands of new jobs. This new source of income, and thus aggregate expenditure, was a significant impetus for taking the economy out of the great depression.

TAX INCREASE

A tax increase reduces income, and thus, aggregate expenditure. If the tax increase is assumed to be a lump sum tax the aggregate expenditure will move downward in a parallel fashion. A tax increase may be warranted in the case of excessive demand causing inflation. In the leakage-injection analysis the tax increase is a leakage and is added to saving.

> In the late 1960's, a tax surcharge was enacted in the United States. Its purpose was to decrease the amount going to aggregate expenditure, i.e. create a negative multiplier effect, because the economy was experiencing an increasing inflation.

BALANCED BUDGET MULTIPLIER

If the increase in government spending is just equal to the increase in taxes, the budget is balanced. A balanced budget with simultaneous increases in spending and taxes is not neutral but expansionary. The reason for an increase in output is that the taxes reduce both consumption and saving, and the reduction from the taxes is smaller than the increase from the additional spending. The value of the balanced budget multiplier is one.

> During most of the earlier part of this century, the various American administrations believed in balancing the budget. Any increase in spending had to be matched by an increase in tax revenue. Over that period and until 1930, the economy grew at a very healthy pace. But in the 1930's, a balanced budget with reduced spending in the recession contracted (i.e. rather than expanded) the economy further.

KEYNESIAN FISCAL POLICY

Keynes recommends to use an expansionary fiscal policy in the case of a recession: reduce taxes and increase spending. In the case of inflation, the opposite is recommended.

> All western governments have adopted measures that have explicitly called for government policies using taxes and spending to control economic activity. For the United States, that evidence is present in the Employment Act of 1946.

FISCAL POLICY EFFECTIVENESS

Expansionary fiscal policy may be less effective than needed if a crowding-out effect takes place as government prefers to finance spending through borrowings rather than taxes or new money. Fighting inflation may also be ineffective with reduced spending and increased taxation if the budget surplus is used to repay debt.

> The tax surcharge enacted in the late 1960's to combat inflation was not effective to stop inflation because the revenues were spent immediately in the Vietnam war effort.

CROWDING-OUT EFFECT

A crowding-out effect occurs when the government borrows: private investment is curtailed because funds are lent to the government rather than to more risky private borrowers. Thus, the effect is to substitute government spending for potentially desirable private investment.

> Interest rates in the United States have been higher than those of other major western nations all through 1970-1980 period. One reason for these high interest rates is the large public debt, which needs to be refinanced regularly. The Treasury must offer a high enough return to sell its issues. These high interest rates have been blamed for the slow growth.

FISCAL POLICY LAGS

Fiscal policy effectiveness may also be reduced by the presence of various lags or delays in the impact of fiscal policy. Recognition lag relates to the identification of the real problem. Administrative lag arises from the time it takes to enact the needed statutes. Operational lag results from how much time it takes for the effect of tax changes to be realized and be felt.

> Kennedy became president in 1960, in the middle of a mild slow down of the economy. He immediately proposed a tax cut according to Keynesian fiscal policy. However, the tax cut was not enacted until 1964 and the effects of the tax cut were not felt until several years later. By then, the economy was starting to experience inflation and the opposite policy was needed.

NONDISCRETIONARY FISCAL POLICY

Nondiscretionary fiscal policy refers to various ongoing programs of government spending and taxation. These are primarily for income maintenance purpose. They are usually rarely changed. They include social security, welfare and unemployment compensation.

> The payment of unemployment benefits is a typical example of nondiscretionary fiscal policy. The payments necessarily increase when the number of unemployed increases, and that is during an economic slow down. The payments necessarily decrease when the unemployed return to work with an economic recovery.

AUTOMATIC STABILIZER

The nondiscretionary fiscal policy acts as an automatic stabilizer for the economy because when the economy is in recession the payments tend to increase, while the collection of contributions decreases with lower income. When the economy is prosperous the collections increase while the payments decrease. The surplus in prosperity and deficit in recession correlate with the needed policy and act to reduce (but not entirely correct) the existing economic condition.

> The largest unemployment benefits are paid out when unemployment is the highest. Thus, the benefits offset the decreasing income of those out of work. But the benefits are only a small portion of the income foregone: it is only a partial corrective measure.

FULL-EMPLOYMENT BUDGET

Since the automatic stabilizer of nondiscretionary fiscal policy creates deficits and surpluses which are insufficient, the size of the needed additional policy action must be determined. This is done with the help of the full employment budget, which calculates what would have been the budget surplus or deficit had the economy been at full employment.

> During the period 1970-1980, the American budget was in deficit. During this period of time, because of high rates of unemployment in the middle 1970's and early 1980's, the full-employment budget was in surplus (because had the unemployed worked in those years, the taxes they would have paid would have been larger than the spending). Thus, even greater actual budget deficits could have been defended.

FISCAL DRAG

The automatic stabilizer of nondiscretionary fiscal policy creates surpluses in periods of prosperity. Such surpluses may however be acting as an impediment or drag on further economic growth (if such growth is desirable).

> As part of the very desirable programs under the New Deal, social security was enacted. At that time, however, the retirees qualifying for payments were few while the contributions were collected on all salaries. At that time, social security prevented a faster recovery of the economy from the great depression.

BUDGET DEFICIT

Budget deficits occur when government spending exceeds government revenues. The U.S. federal budget has been in deficit every year except one in the 1970's and 1980's. These deficits are essentially the product of Keynesian expansionary fiscal policies. However, in the 1980's the deficits grew even larger as a result of tax cuts inspired by supply side economics. Reducing budget deficits became then a political priority (e.g. Gramm-Rudman-Hollings Act).

BUDGET PHILOSOPHY

A budget philosophy of balancing the budget annually is not popular because it is procyclical (it makes business cycles worse). A functional budget philosophy (deficits whenever needed) is attributable to Keynesian employment theory (it has produced excessive debt). A cyclically balanced budget philosophy is a third often proposed alternative.

> The most devastating effects of a balanced budget philosophy were learned from Hoover's administration efforts to balance the budget in the early 1930's in the United States (and similar efforts in Great Britain). The cut in spending contributed significantly to the severity of the great depression.

PUBLIC DEBT

The continuous budget deficits of the 1970'a and 1980's produced a very large public debt (in excess of $2,000 billions in early 1990's). Economists argued whether the debt affects current (crowding-out-effect) and future (necessity to repay the debt) economic conditions. The most undoubtful impacts were the need to service the debt (pay interest) and the external threat from foreigners who own a large proportion of the debt and thus are able to affect the exchange rate of the dollar.

> The stock market crash of October 19, 1987, was in part attributable to the large public debt (in the opinion of some economists). The reason for this was the need to offer higher interest rates to refinance the debt which caused inflation to pick up. Higher interest rates decreased the value of financial assets and prompted investors to sell, which drove prices further down.

FISCAL POLICY AND POLITICS

Fiscal policy is enacted by elected officials. Although economic stability is an important goal of the government, it is not its sole objective. National security, provision of public goods and services, and redistribution of income are just some of the other important considerations. Strong evidence suggests that elected officials are often more concerned with getting reelected than just maintaining economic stability.

FISCAL POLICY AND POLITICS

Expansionary fiscal policies such as tax cuts or increased government spending are often implemented before elections to produce favorable economic indicators. Expansionary fiscal policies however tend to produce inflation, and soon after elections are over a contractionary fiscal policy has to be implemented. In addition, expansionary fiscal policies have a tendency to increase budget deficits.

NET EXPORT EFFECT

The net export effect reduces the effectiveness of fiscal policy. When an expansionary fiscal policy is implemented, net exports usually decline which decreases aggregate output. This decrease in aggregate output partially offsets the expansionary fiscal policy. When a contractionary fiscal policy is implemented, net exports will usually increase. This increase in aggregate output partially offsets the contractionary fiscal policy.

INDEX OF LEADING INDICATORS

The Index of Leading Indicators is used to eliminate or shorten recognition lags. These indicators provide economists with a clue to where the economy is heading. None of the indicators alone can predict the future course of the economy. The eleven leading indicators are averaged or indexed to provide a comprehensive forecast of the economy. An Index of Leading Indicators which declines or increases three consecutive months or more is indicative that the economy is moving in a particular direction.