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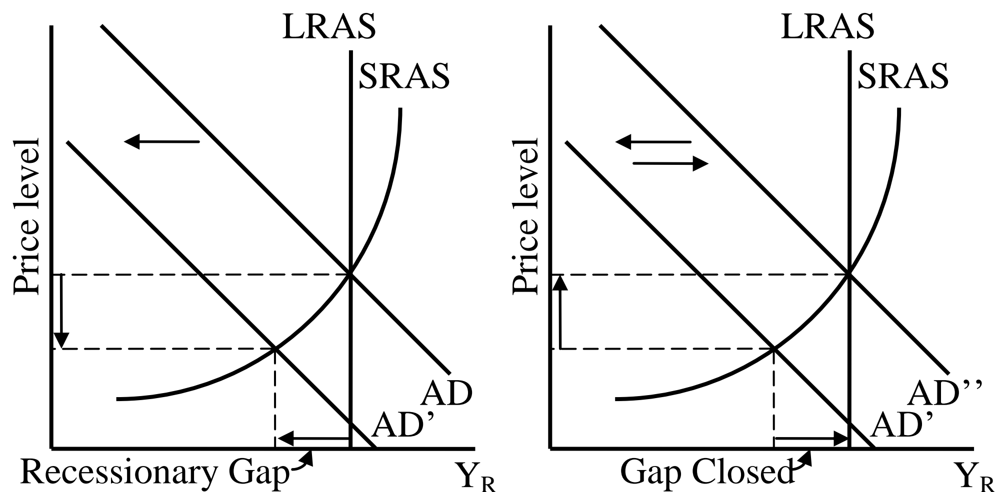
LECTURE 32: FISCAL POLICY I

I. The Legacy of Great Depression
   a. The Great Depression continues to be one of the most discussed economic events in economic circles. Many economists, both now and then, see its cause originating from a drop in aggregate demand.
   b. During the Great Depression, John Maynard Keynes suggested the government either cut taxes or increase spending to shift AD back out.
      i. For this to work, lower taxes cannot be offset by reducing spending, nor can increased spending be offset by increasing taxes.
      ii. Thus, this is referred as *deficit spending*. In theory, it works like this:



      iii. The government responds to a leftward shift in AD by shifting AD back to the right.
      iv. Because the adjustment is made via government spending, it is called *fiscal policy*.
      v. The nice thing about this strategy is the Keynesian, or fiscal, multiplier. The government doesn't have to spend X, where X is the different between the desired GDP and the actual GDP. They have to just spend the much smaller Z, where Z equals X divided by the multiplier. The bigger the multiplier, the more effective fiscal policy. **The fiscal multiplier determines how far AD shifts; a larger multiplier means a larger shift.** There's a lot of debate concerning how big the multiplier is.

vi. Any spending the government does would be paid for later, when there's a recovery. Indeed, you'll need *surpluses* to combat any inflationary gaps.

c. It's impossible to tell exactly how effective the New Deal was and this leads us to the big issue in economics, especially macroeconomics, especially major events in macroeconomics.
    i. We can't run controlled experiments. Therefore it's really, really, really hard to use evidence to support a theory.
    ii. There are so many other things going on, it's impossible to tell if the economic recovery after the Great Depression was **because of** or **in spite of** the New Deal.

II. Automatic/Built-In Stabilizers

a. A *built-in stabilizer* is anything which increases deficit spending (either by cutting taxes or increasing spending) anytime when there's a recession and decreases the deficit when there's an expansion. It requires no explicit action from policy makers.

b. *Progressive Taxes*. A progressive tax means the higher your income, the larger percent of taxes you pay. When a recession hits, people's income falls and thus they pay a smaller percent in taxes. But they also pay a smaller portion to taxes, mitigating the drop of disposal income.
    i. This rate can even be negative. The earned income tax credit (EITC) means the government pays low income working individuals (especially ones with kids) rather than such individuals paying the government.
    ii. Economists generally agree that the EITC is a good system. Because one must be working to get it, there's a small disincentive effect of working. And because it's a cash payout, recipients can allocate based on their unique circumstances.

c. *Certain Entitlements*. Some entitlements—or a government benefit with guaranteed access—kick in more often when a recession hits. For example, welfare, food stamps, and unemployment insurance payouts skyrocket during recessions. Since these payments have a large MPC, many economists favor them since the resulting shift in AD would be quite large.