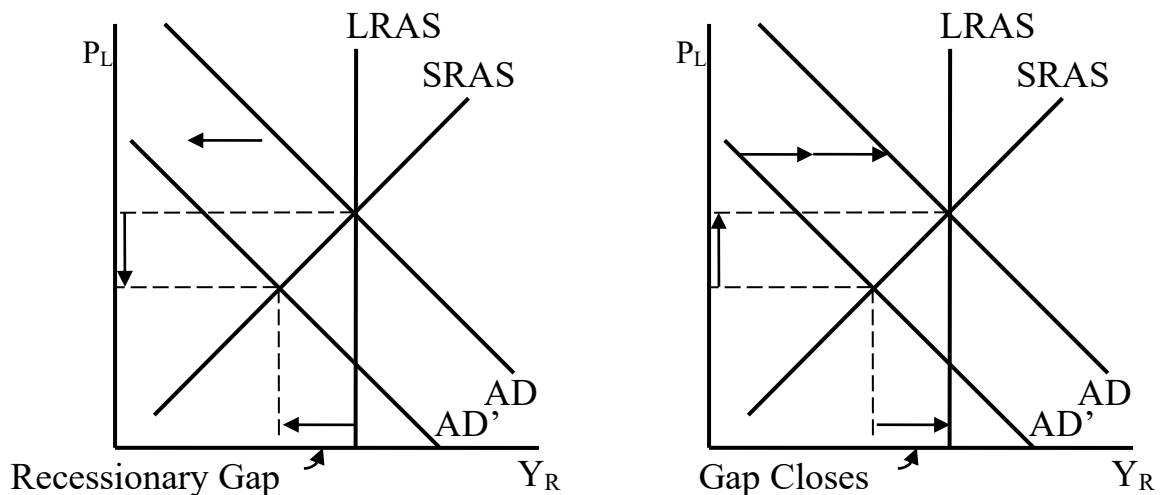


TOPIC 24: FISCAL POLICY

I. Fiscal Policy

- a. The Keynesian multiplier plays a big role in fiscal policy. Fiscal policy is when the government shifts AD using the budget.
 - 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*. The government responds to a leftward shift in AD (creating a “recessionary gap”) by shifting AD back to the right.
 - iii. The nice thing about this strategy is the Keynesian, or fiscal, multiplier. The government doesn’t have to spend X , where X is the size of the recessionary gap. They have to just spend the much smaller Z , where Z equals X divided by the multiplier.
 1. The bigger the multiplier, the more effective fiscal policy. **The fiscal multiplier helps determine how far AD shifts; a larger multiplier means a larger shift.**



- iv. 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.

II. Automatic 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. *Some 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.
- d. Fiscal policy has challenges and we'll discuss five of them: demand and supply side crowding out, real shocks, lag, and persistent deficits.

III. Challenge: Crowding Out (Demand Side)

- a. When the government increases its spending, it must fund that spending somehow. We discussed how increasing spending can't be funded with taxes because there'd be no net effect (AD will shift right because of the spending but will shift back left because of the taxes).
- b. The danger is what we call *crowding out*—an increase in government spending is offset by a decrease in private spending.
- c. So the government funds such spending with borrowing, thus called we call it deficit spending. But this also comes with a danger of crowding out. The effect is twofold.
 - i. As the government borrows, it uses savings that would have gone to private-sector investment. The government might build a bridge, but as a result there's one less factory. The government is simply substituting one kind of spending or investment for another.

- ii. As the government borrows, it puts upward pressure on interest rates which causes more saving (and thus less consumption) and less private-sector borrowing.
- iii. Crowding out private-sector spending is less of an issue during a recession because people are already reluctant to invest and spend. The money in the banks is just sitting there, doing nothing. So the government lays claim to it.

IV. Challenge: Crowding Out (Supply Side)

- a. The American Recovery and Reinvestment Act (ARRA) was an \$800 billion stimulus package passed in 2009. It set out to do what all stimulus packages set out to do: put people back to work and increase GDP.
 - i. It includes money to food banks, elderly care, health research, and many other places.
- b. The big issue during recessions is unemployment. In 2011, Garrett Jones and Daniel Rothschild completed a study of the ARRA to determine where the money went and the effect it had.¹ We'll focus on their employment results.²
- c. The companies that benefited from the stimulus were busy despite the recession. This is because the bureaucracies usually went to trusted firms, firms they typically work with (to avoid the potential of a scandal). Such firms are already busy.
- d. Moreover, Jones and Rothschild found 42% of the workers hired because of the stimulus came from the unemployed; 47% came from other jobs.
 - i. Now for some context: in normal economic circumstances in the United States, about half of the people hired come from unemployment.
 - ii. Shouldn't it be easier to hire workers from unemployment when the economy's weak? The stimulus apparently had a harder time.
 - iii. Why did it have a hard time? Because a lot of the money went to high-skilled sectors such as engineers and medical researchers. Of the Jones/Rothschild survey respondents, half had at least bachelor's degree and one-fourth had a graduate degree.

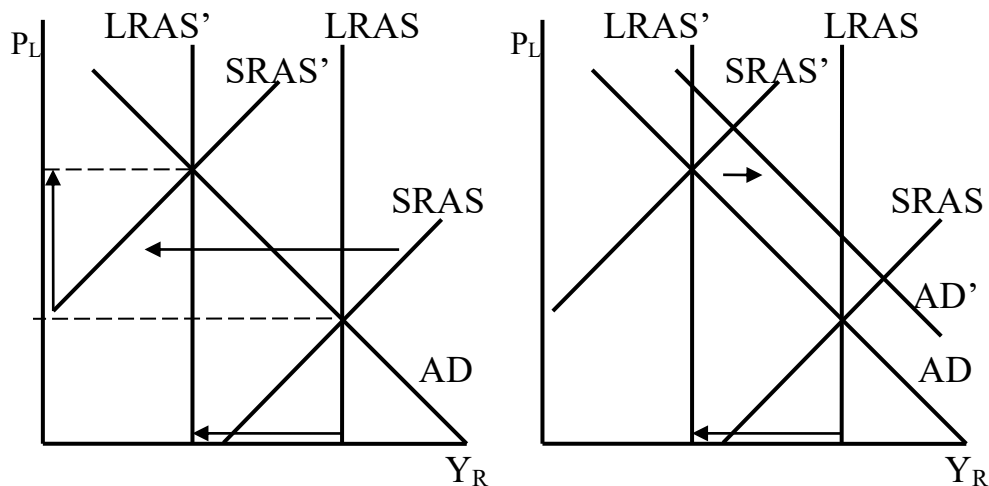
¹ <http://mercatus.org/publication/did-stimulus-dollars-hire-unemployed>

² For more information about the study, see http://www.econtalk.org/archives/2011/09/garett_jones_on_1.html

- iv. The data suggests there was labor-market tightness. Qualified people were hard to find after the recession; not something you'd expect. If the stimulus was well-targeted, it should have been easy to find qualified people.
- e. You can quibble with the results—the surveys might have had some systemic bias—but the underlying idea rings true: there was a lot of crowding out.
 - i. This is a different form of crowding out. It's not a matter of government borrowing crowding out private-sector borrowing (demand-side crowding out). Here, it's the government hiring people who would otherwise be hired by the private sector (supply-side crowding out). But the basic idea is the same.

V. Challenge: Real Shocks

- a. Shifts in LRAS (real shocks) typically cause SRAS to shift with it.
 - i. Note the reverse is not true: if input prices change, SRAS will shift but LRAS won't shift.



- b. As this illustrates, deficit spending can't handle real shocks well. You'll only get crowding out. You must address the root of the problem.

VI. Challenge: Lag

- a. Drops in AD are not permanent; the economy will recover if the government does nothing. Fiscal policy is good for assuaging the pain of a recession in the meantime.
- b. Automatic/built-in stabilizers happen immediately, but they are relatively small to what needs to be done. Law makers must act.
- c. But in practice, it takes time for fiscal policy to take effect. It faces several different lags:
 - i. Recognition lag—It takes times to identify a problem

- ii. Legislative lag—The government must propose and pass a plan
- iii. Implementation lag—Bureaucracies must implement the plan
- iv. Effectiveness lag—It takes time for the plan to work
- d. In practice, it can take years for the policy to actually influence the economy. By then the crisis might have already passed and now the additional spending creates problems rather than solves them.
 - i. As President Obama would later say, “There’s no such thing as shovel-ready projects.”³

VII. Challenge: Persistent deficits

- a. When there’s a recession, the political incentives are strong to cut taxes and raise spending. Voters, and thus politicians, like doing that. It’s the median voter theorem in action.
- b. The problem is that the debts incurred during recessions have to be paid off and voters don’t like more taxes and lower spending. Even in times of inflation, when surplus spending would shift AD to the left and mitigate the problem, there’s little political interest in taking these steps.
 - i. In 2022, President Biden signed the Inflation Reduction Act in an effort to curtail high levels of inflation, but the Act included hundreds of billions of dollars in green energy and other environmental-related issues.
- c. Government deficits were once rare, occurring only during wartime and were quick to pay them off. But Keynesian-style macroeconomics, which rejected the deficit taboo, became popular during the Great Depression and everything changed.
 - i. As we discussed, the U.S. has run budget deficits every year for decades and [total debt continues to grow](#). Debts and deficits are now the norm among 4th level countries.
- d. One short-term effect of persistent deficits is demand-side crowding out. While such crowding out isn’t a big deal during recessions (there isn’t much private-sector interest in borrowing money then), there certainly is crowding out when deficits occur even in good times.
- e. While economists disagree on the severity of high persistent debts, and what constitutes “high,” economists agree that this trend cannot continue forever. It is unclear what will happen when the appetite for sovereign debt is finally satiated, but it will not be good.

³ <http://www.wnyc.org/story/286037-shovel-ready-projects-obama-admits-theres-no-such-thing/>