Fiscal Policy

Government Sector

• We will treat government purchases of goods and services as exogenous – not affected by income
• Taxes, are assumed to be related to income
  – Tax revenue = (tax rate) * (income)
  – TR = t * y

US Tax Systems

• Who implements taxes in our economy?
  – Federal government
  – State government
  – Local governments
• What kinds of taxes exist in the US?
  – Personal and Corporate Income Taxes
  – Property Taxes
  – Payroll Taxes
  – Sales Taxes
  – Capital Gains Taxes
  – Others
Important Aspects of Tax Schemes

1) Tax Neutrality
   Neutral – Pay same % of Y to tax as Y increases
   Progressive – Pay larger % of Y to tax as Y increases
   Regressive – Pay smaller % of Y to tax as Y increases
2) Tax Incidence – who bears “burden” of tax
3) Equity – “Fairness”
4) Incentive Effects – “Loopholes”

Fiscal Policy

- Fiscal policy – manipulation of G and net T for the purpose of stabilizing the economy
- Can affect both demand side and supply side
- Short-term goals: prevent excessive inflation/unemployment
- Long-term goals: provide for adequate growth
- Expansionary fiscal policy – eliminate recessionary gaps
- Contractionary fiscal policy - eliminate inflationary gaps

Demand Side Fiscal Policy

- Expansionary FP –
  - Increase G
  - Increase transfer payments
  - Decrease tax rates
- Contractionary FP –
  - Decrease G
  - Decrease transfer payments
  - Increase tax rates
Automatic Stabilizers

• Fiscal Policy has built-in features that adjust net taxes to stabilize AD as the economy expands/contracts
• The most important of these is the income tax
  – Also AFDC, unemployment benefits, Soc. Sec.
• The income tax dampens the effect of an AD fall and limits the rise of AD

Supply Side Fiscal Policy

• While manipulating G and T, the government can try to influence AS as well
  1) Government subsidies/tax breaks
  2) Tax breaks to increase savings
  3) Investment subsidies

Fiscal Policy in Action

• What happens when the government uses fiscal policy to influence the macroeconomy?
• Suppose, with the economy in a recessionary gap, the government decides to pursue an expansionary fiscal policy?
  – What is the mechanism for which this influences the economy?
Fiscal Policy and the Multiplier

1) Changes in autonomous government spending leads to a change in output
2) Changes in output lead to changes in income and disposable income.
3) Some of the new income is saved (leakage); the rest is spent (induced spending)
4) This new spending leads to a second-round change in output.
5) Continue with step 1

Multiplier Effect

• Note that there is a circular-relationship to the effect of an autonomous factor – this is the **multiplier effect**
• This suggests that the overall affect of an injection into the economy is greater than the injection itself

\[ \Delta GDP = (\text{multiplier})(\text{injection}) \]

Where the multiplier = \( \frac{1}{\text{leakages}} \)

Note that leakages include taxes, imports, and savings

Fiscal Policy and the Budget

• A budget deficit is positively related to policy considerations
  – Expansionary policy increases the deficit
  – Contractionary policy decreases the deficit

• The deficit is countercyclical to economic conditions
  – Deficits will rise during recessions
  – Deficits will fall during expansions
Budget Deficits

• 3 types of deficits:
  1) Actual deficit – takes into account actual income figures
  2) Structural Deficit – reflects policy concerns only – deficit that would be present if we were at potential output
  3) Cyclical deficit – takes into account only economic conditions

Financing the Deficit

• How can we pay off the deficit?
  – Monetize the deficit
    • Expand the monetary base – print more money, buy back government bonds (Can be Inflationary)
  
  – Borrow the funds
    • The government can simply borrow the funds
    • This will drive up the interest rate
    • “Crowding-out” of private investment?

Twin Deficits

• To whom does the US owe money?
  1) Internal Debt – portion of the debt owed to the nation’s citizens
  2) External Debt – portion of the debt owed foreign nation’s citizens