Countries belonging to the European Monetary Union have agreed to follow a path of fiscal discipline, keeping government spending in line with tax receipts.

Under what conditions would a government be tempted to allow expenditures to exceed receipts?

Learning Objectives
- Use traditional Keynesian analysis to evaluate the effects of discretionary fiscal policy
- Discuss ways in which indirect crowding out and direct expenditure offsets can reduce the effectiveness of fiscal policy actions

Learning Objectives
- Explain why the Ricardian equivalence theorem calls into question the usefulness of tax changes
- List and define fiscal policy time lags and explain why they complicate efforts to engage in fiscal “fine tuning”
Learning Objectives

- Describe how certain aspects of fiscal policy function as automatic stabilizers for the country

Chapter Outline

- Fiscal Policy
- Possible Offsets to Fiscal Policy
- Discretionary Fiscal Policy in Practice
- Automatic Stabilizers
- What Do We Really Know About Fiscal Policy?

Did You Know That...

- Federal government dollars are used to fund a variety of endeavors, such as the Rock and Roll Hall of Fame and the National Cowgirl Museum?
- There are economy-wide effects from changes in the level of government spending.

Fiscal Policy

- Discretionary Fiscal Policy
  - The discretionary changes in government expenditures and/or taxes in order to achieve certain national economic goals
    - High employment
    - Price stability
    - Economic growth
    - Improvement of international payments balance
Fiscal Policy

- An increase in government spending will stimulate economic activity
- Changes in government spending
  - Military spending
  - Education spending
  - Budgets for government agencies

Expansionary Fiscal Policy: Changes in G

- The recessionary gap is caused by insufficient AD
- To increase AD, use expansionary fiscal policy to increase government spending
- With an increase in G, AD increases and real GDP increases to full employment

Expansionary Fiscal Policy: Changes in G

- The recessionary gap is caused by insufficient AD
- To increase AD, use expansionary fiscal policy to increase government spending
- With an increase in G, AD increases and real GDP increases to full employment

Fiscal Policy

- Questions
  - Would the increase in government spending equal the size of the gap?
  - What impact did the expansionary fiscal policy have on the price level?
The inflationary gap is caused by SR equilibrium > full employment. To decrease AD, use contractionary fiscal policy to decrease government spending. With a decrease in G, AD decreases and real GDP decreases to full employment.

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**Fiscal Policy**

- Change in taxes
  - A rise in taxes causes a reduction in aggregate demand because it can reduce consumption spending, investment expenditures, and net exports.

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**Expansionary Fiscal Policy: Changes in Taxes**

- The recessionary gap is caused by insufficient AD.
  - To increase AD, use expansionary fiscal policy to increase taxes.
  - With a decrease in taxes, AD increases and real GDP increases to full employment.

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**Contractionary Fiscal Policy: Changes in Government Spending**

- The inflationary gap is caused by SR equilibrium > full employment.
  - To decrease AD, use contractionary fiscal policy to decrease government spending.
  - With a decrease in G, AD decreases and real GDP decreases to full employment.

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Figure 13-1, Panel (b)

Figure 13-3, Panel (b)
Expansionary Fiscal Policy: Changes in Taxes

- The recessionary gap is caused by insufficient AD.
- To increase AD, use expansionary fiscal policy to decrease taxes.
- With a decrease in taxes, AD increases and real GDP increases to full employment.

![Figure 13-3, Panel (b)](slide13-17)

Expansionary Fiscal Policy: Changes in Taxes

- The inflationary gap is caused by SR equilibrium > full employment.
- To decrease AD, use contractionary fiscal policy to increase taxes.
- With an increase in taxes AD decreases and real GDP decreases to full employment.

![Figure 13-3, Panel (a)](slide13-18)

Fiscal Policy

- Question
  - What would be the long-run impact on of a tax cut on real GDP if the economy is at full-employment equilibrium?

Fiscal Policy

- Tax rates and tax revenues
  - Will an increase in tax rates always raise tax revenue?
Possible Offsets to Fiscal Policy

- **Indirect crowding out**
  - Increases in government spending without raising taxes creates additional borrowing

Possible Offsets to Fiscal Policy

- **Crowding-Out Effect**
  - The tendency of expansionary fiscal policy to cause a decrease in planned investment or planned consumption; this decrease normally results from the rise of interest rates

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The Crowding-Out Effect

- Equilibrium GDP below full-employment GDP—recessionary gap
- Expansionary policy causing deficit spending initially shifts AD from AD1 to AD2
- Equilibrium GDP below full-employment GDP—recessionary gap
- Due to crowding out, AD shifts inward to AD3

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The Crowding-Out Effect

- Equilibrium GDP below full-employment GDP—recessionary gap
- Expansionary policy causing deficit spending initially shifts AD from AD1 to AD2
- Equilibrium GDP below full-employment GDP—recessionary gap
- Due to crowding out, AD shifts inward to AD3
The Crowding-Out Effect, Step-By-Step

Possible Offsets to Fiscal Policy

- Direct crowding out
  - Direct Expenditures Offsets
    - Actions on the part of the private sector in spending money that offset government fiscal policy actions
    - Any increase in government spending in an area that competes with the private sector

Planning for the future:
- The Ricardian equivalence theorem
  - The Ricardian Equivalence Theorem
    - The proposition that an increase in the government budget deficit has no effect on aggregate demand

Planning for the future:
- The Ricardian equivalence theorem
  - The reason for the offset
    - People anticipate that a larger deficit today will mean higher taxes in the future and adjust their spending accordingly
Policy Example: The Direct Offset of Government Grants

- Some scientific and engineering research is conducted by private companies that receive government grants as part of their funding.
- To the extent that this research would be conducted anyway, even without the grant, then the public expenditure is simply replacing a private one.

Possible Offsets to Fiscal Policy

- The supply-side effects of changes in taxes
  - Expansionary fiscal policy involving the reduction of marginal tax rates in order to:
    - increase productivity, since individuals will work harder and longer, save more, and invest more
    - increase productivity, which will lead to more economic growth

Possible Offsets to Fiscal Policy

- Supply-Side Economics
  - Creating incentives for individuals and firms to work more or to increase productivity will shift the aggregate supply curve to the right.

Possible Offsets to Fiscal Policy

- Question
  - Would a tax increase cause you to work more or less?
Possible Offsets to Fiscal Policy

Tax rates and tax revenues rise together
Tax revenues are at a maximum
Tax rates and tax revenues fall together

Figure 13-6

Discretionary Fiscal Policy in Practice

Question
– Is fiscal policy as precise as it appears?

Time lags
– Recognition Time Lag
  • The time required to gather information about the current state of the economy

Time lags
– Action Time Lag
  • The time required between recognizing an economic problem and putting policy into effect
    – Particularly long for fiscal policy
Time lags

- **Effect Time Lag**
  - The time it takes for a fiscal policy to affect the economy

Fiscal policy time lags are long. A policy designed to correct a recession may not produce results until the economy is experiencing inflation.

Fiscal policy time lags are variable in length (1–3 years). The timing of the desired effect cannot be predicted.

Federal income taxes are collected based on the dollar amount of wages and salaries.

As employees have accepted more of their compensation in the form of health benefits, this has dampened growth of the tax base.

Automatic Stabilizers

- Changes in government spending and taxation that occur automatically without deliberate action of Congress
  - Examples:
    - The tax system
    - Unemployment compensation
    - Welfare spending
Automatic Stabilizers

The automatic changes tend to drive the economy back toward its full-employment output level.

What Do We Really Know About Fiscal Policy?

- Fiscal policy during normal times
  - Congress ends up doing too little too late to help in a minor recession.
  - Fiscal policy that generates repeated tax changes (as it has done) creates uncertainty.

- Fiscal policy during abnormal times
  - Fiscal policy can be effective
    - The Great Depression
    - Wartime
What Do We Really Know About Fiscal Policy?

- The “soothing” effect of Keynesian fiscal policy
  - Assume
    - We know how to use fiscal policy to prevent another depression
  - Results
    - Stable expectations encourage a smoothing of investment spending

Issues and Applications: U.S. Government Budget Projections

- Despite having agreed to certain terms of fiscal discipline, both France and Germany have allowed government spending to exceed tax receipts.
- Marginal tax rates were reduced in order to stimulate aggregate demand and to boost productivity.
- Because neither government reduced spending in the short term, both countries found that expenditures were exceeding tax receipts.
- This stimulative effect led to higher growth in real GDP and a reduction in unemployment.

Summary Discussion of Learning Objectives

- The effects of discretionary fiscal policy using traditional Keynesian analysis
  - Increases in government spending and decreases in taxes increase aggregate demand.
  - Decreases in government spending and increases in taxes decrease aggregate demand.
- How indirect crowding out and direct expenditure offsets reduce the effectiveness of fiscal policy
  - Deficits increase interest rates
  - Some government spending replaces private spending
- The Ricardian equivalence theorem states that government borrowing to finance deficits causes people in anticipation of higher interest rates to repay the loans.
Summary Discussion of Learning Objectives

- Fiscal policy time lags and the effectiveness of fiscal “fine tuning”
  - The time lags for fiscal policy are the recognition time lag, action time lag, and the effect time lag.
  - The time lags are long and variable.

- Automatic stabilizers are changes in tax payments, unemployment compensation, and welfare payments that automatically change with the level of economic activity.