Fiscal Policy

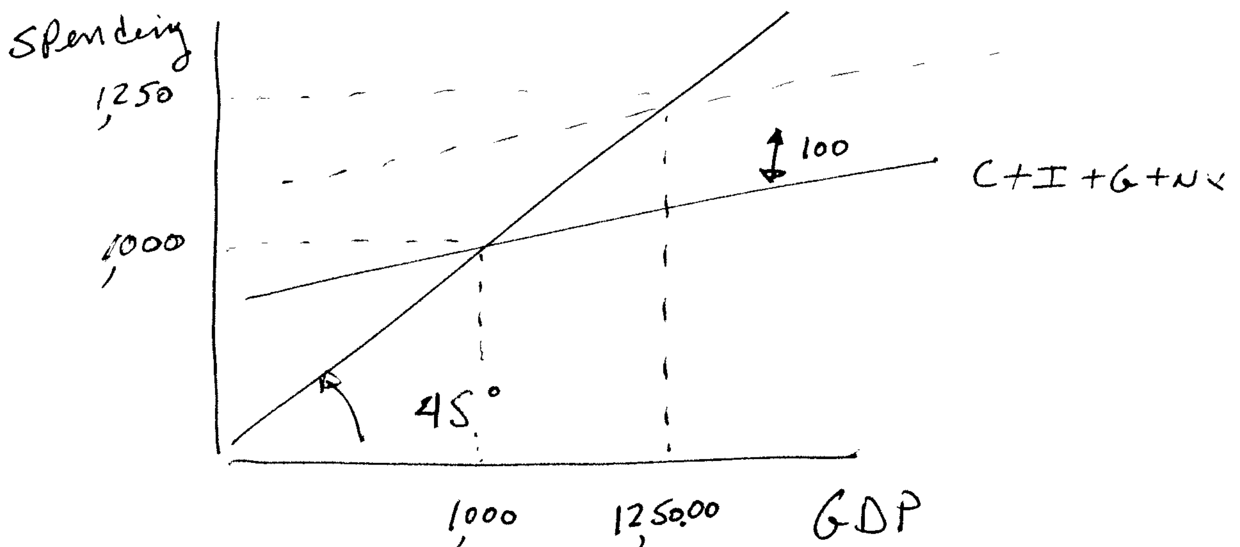
ΔG = purchases of goods & services by gov't (Federal, state, local) change.

$Y = C + I + G + NX$

$G\uparrow \rightarrow Y\uparrow \rightarrow C\uparrow \rightarrow Y\uparrow \rightarrow C\uparrow \rightarrow Y\uparrow$

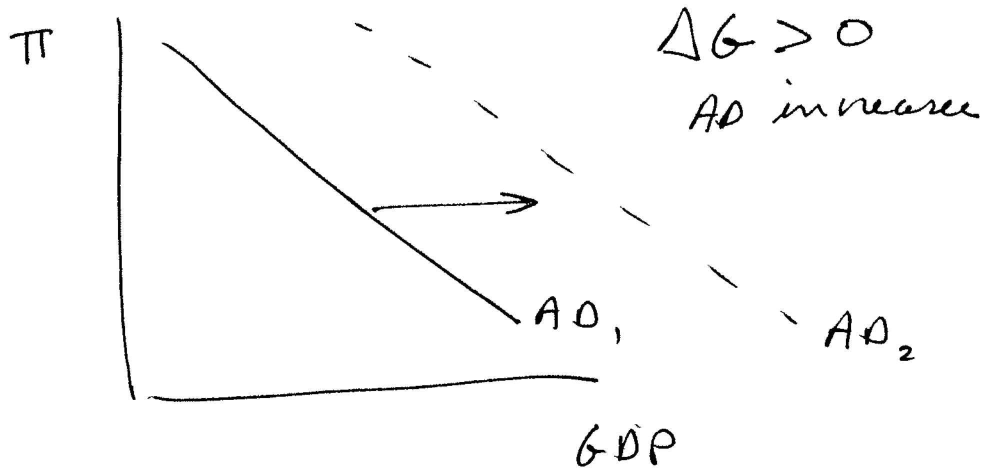
and so on....

It has a multiple effect. Size depends on "the size of the multiplier" for gov't purchases.

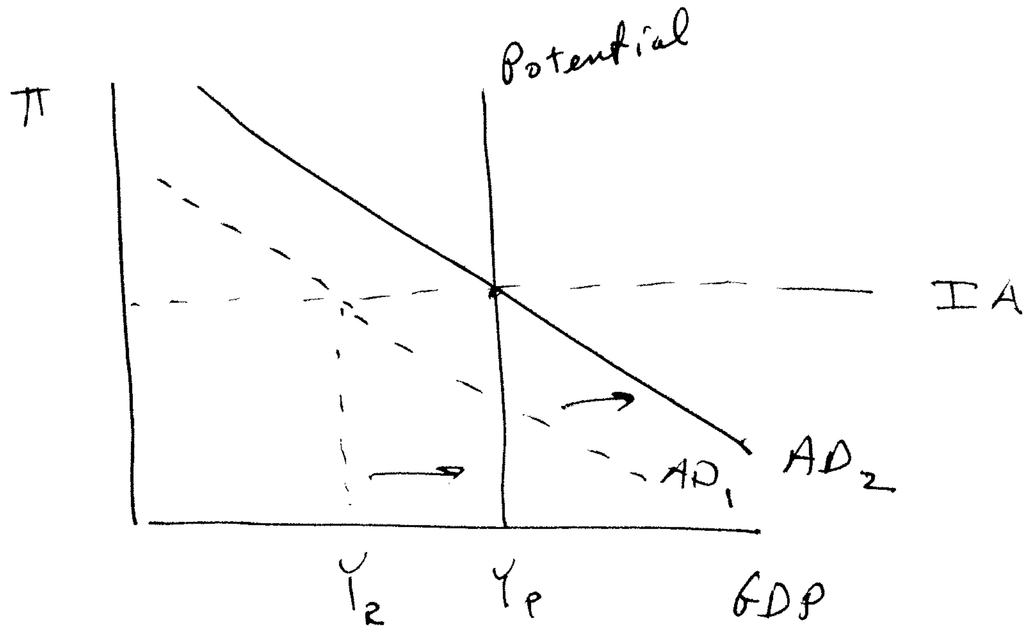


If $G\uparrow$ by \$100 we'd expect $Y\uparrow$ by \$250, provided the multiplier is 2.5

AS spending increases, AD increases.



Now, Add Potential and consider current inflation level as fixed (short-run)

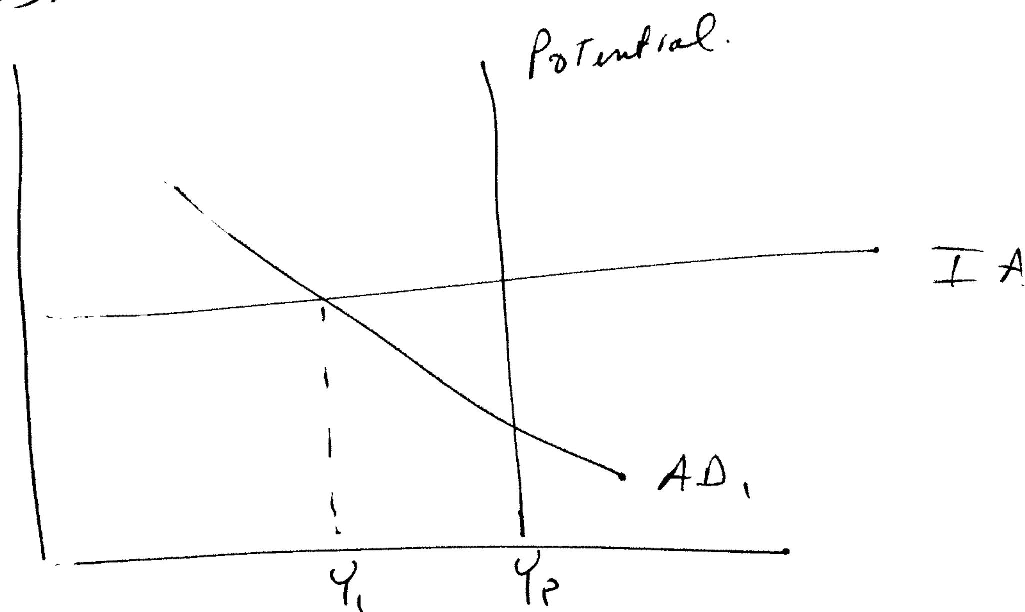


AT OLD AD₁, GDP is Below potential. An increase in G will shift AD right as spending rises. As long as IA doesn't change, we should get closer to Potential.

Note: Doing <u>nothing</u> will cause IA to slowly shift down, thus alleviating the recession. Whether ΔG or doing nothing is better is an empirical question. Depends on how flexible prices are (IA speed of adjustment) and the size of the Govt purchases multiplier.

The <u>CEA</u> estimated the spending multiplier for the <u>ARRA</u> 2009 at about 1.5. (which was probably much too high). The Tax multiplier was estimated to be about .75 after 1 year.

TAxes. ΔT. ~~RA~~ in ~~Recession~~



lowering Taxes will increase the amount consumers have to spend on C and I (new houses) AD shifts right and recessionary ($Y_1 < Y_p$) GAP closes.

Again, doing nothing will eventually reduce IA and end recession.

Discretionary changes in F.P.

These require specific changes in Tax or spending policy due to legislative action or, in rare instances, presidential administrative action.

Ex. CASH for Clunkers

Automatic changes in F.P.

automatic changes in Taxes or spending over the course of the business cycle.

Recession:
- Incomes fall and Taxes go down with it.
- unemployment compensation rises, keeping C higher than it might otherwise be.
- Welfare Payments rise

Boom - Tax Rates are Progressive and gov't take increases as a % of income As Incomes Rise.

T ↑

- welfare & disability & SS Tend to fall As well.
- More people employed and paying unemployment insurance Premiums against fewer Claims

Discretion vs. Automatic

Discretionary Policy takes A long time to actually have any meaningfull effect. It is often Mistimed. It occurs after The economy is well on its way to Recovering By itself.

LAGS

Recognition Lag

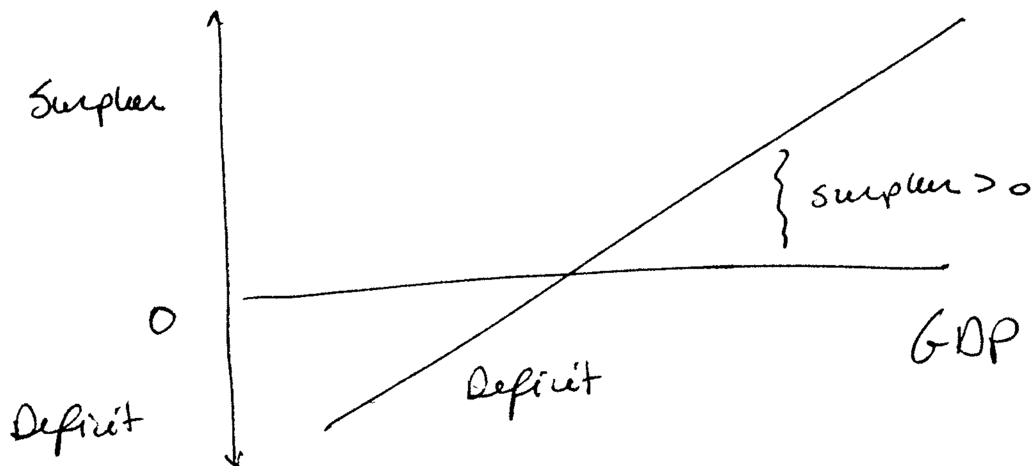
Implementation or Administrative Lag

Impact - Lag.

Automatic stabilizers are much less prone to these lags. They work automatically with changes in income.. (They do affect potential GDP though)

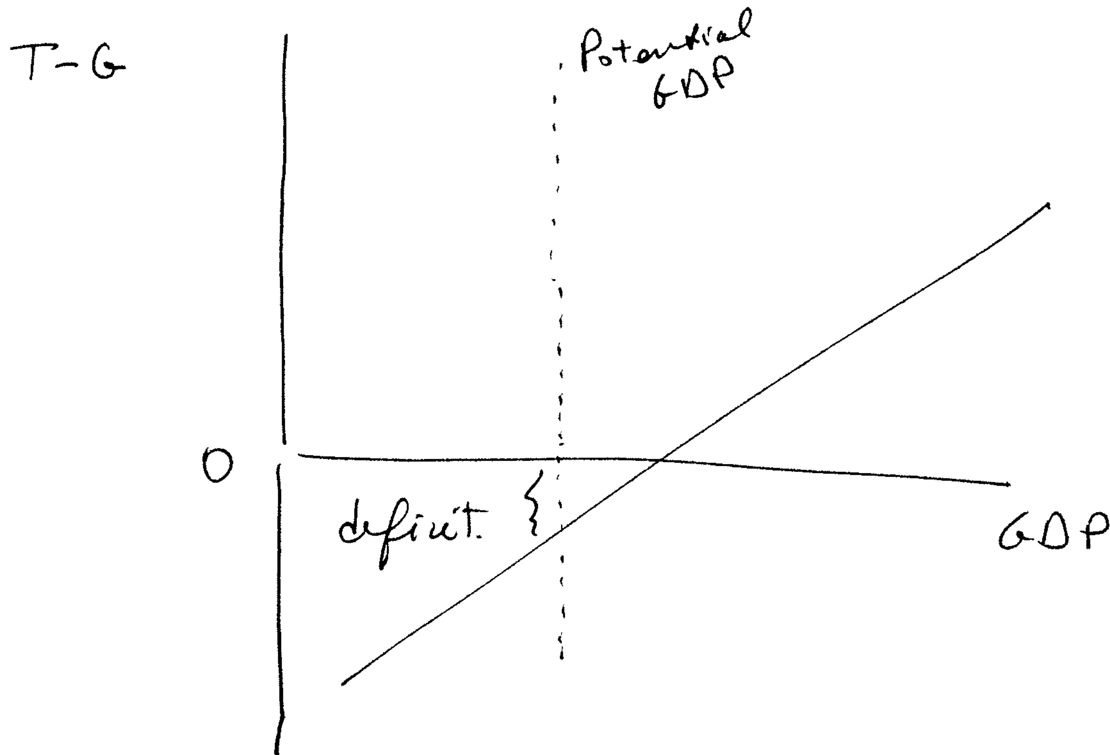
Structural Surplus & Deficit.

Structural Surplus or Deficit is the degree to which the Budget is out-of-balance when GDP = Potential and the economy is at full employment (unemployment = Natural Rate of unemployment).



As GDP rises, Revenue rises for given spending so we move into surplus. As ~~output~~ GDP spending falls, Tax Revenue falls and spending ↑ ⇒ deficit.

Whether The Surplus or Deficit is Structural depends on where Potential GDP is.



In THIS picture, there is a deficit when GDP = Potential. Taxes are not sufficient to cover spending.

Solution: (1) Raise Revenue
(2) Reduce Spending
(3) Increase Potential GDP (Economic Growth)