

CHAPTER

32

The Fiscal Policy Dilemma

Chapter Goals

- Summarize the Classical view of sound finance.
- Summarize the Keynesian view of functional finance.
- List six assumptions of the *AS/AD* model that lead to potential problems with the use of fiscal policy.
- Explain how automatic stabilizers work.

The Fiscal Policy Dilemma

The fiscal policy dilemma is what to do in periods of structural stagnation when both deficits and a balanced budget are called for.

- When an economy falls into a structural stagnation, the effectiveness of expansionary demand-side policy is limited.
- International conditions, political considerations, and institutional issues make it impossible to achieve a sustainable growth rate consistent with the type of jobs and pay acceptable by most people.

Classical Economics and Sound Finance

Economists' view of public finance and fiscal policy before 1930's supported:

- **Sound finance**, a view of fiscal policy that the government budget should always be balanced except in wartime
 - This view was based on a combination of political and economic grounds, but primarily on political grounds

Ricardian Equivalence Theorem: Deficits Don't Matter

Classical economists also believed the argument for balanced budgets were weak. David Ricardo's theory is called the Ricardian equivalence theorem.

Ricardian equivalence theorem: Deficits do not affect the level of output because people increase savings to pay future taxes to repay the deficit.

Most economists felt that, in practice, deficits could affect output and that it mattered a lot.

The Sound-Finance Precept

Given the collapse of economic expectations in the 1930s, many economists of the time favored giving up the principle of sound finance, at least temporarily, and using government spending to stimulate the economy.

If the economy is in a small recession, do nothing.

If the economy is in a depression, use deficit spending.

Keynesian Economics and Functional Finance

In 1940's, economists view of public finance and fiscal policy changed with J.M Keynes' *The General Theory* and followed with Abba Lerner's *The Economics of Control*.

Functional finance held that governments should make spending and taxing decisions on the basis of their effect on the economy, not on the basis of some moralistic principle that budgets should be balanced.

If spending was too low, government should run a deficit; if spending was too high, government should run a surplus.

Functional finance nicely fits the *AS/AD* model.

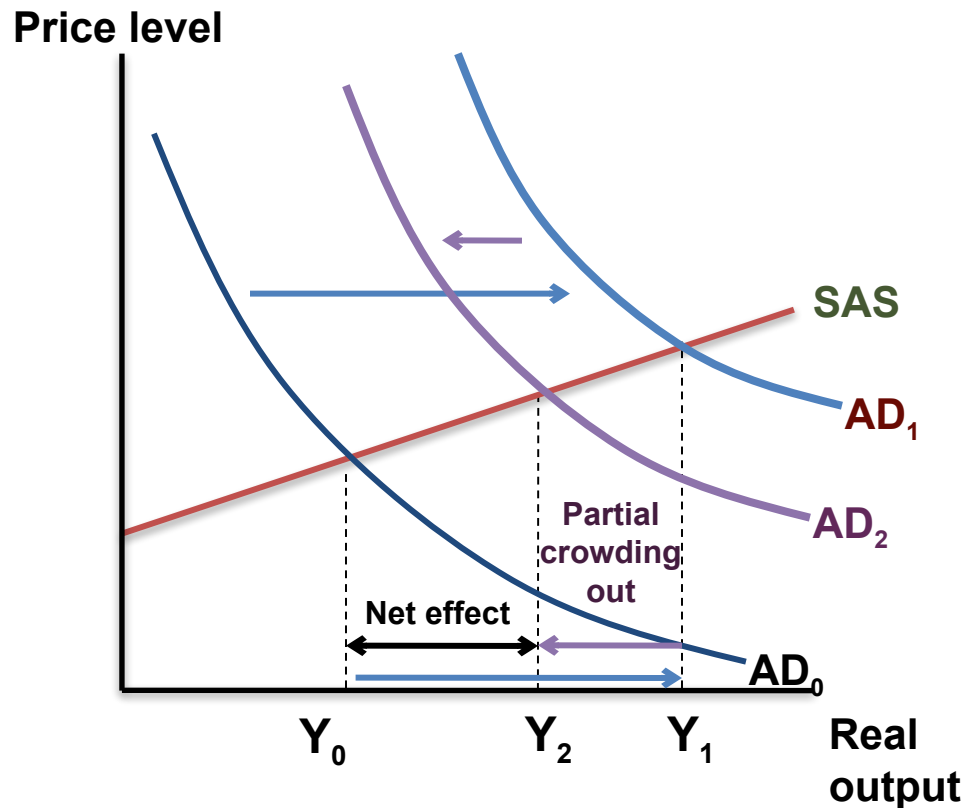
Assumptions of the *AS/AD* Model

Six assumptions of the *AS/AD* model that could lead to problems with fiscal policy are:

1. Financing the deficit doesn't have any offsetting effects.
2. Government knows what the situation is.
3. Government knows the economy's potential income level.
4. Government has flexibility in changing spending and taxes.
5. The size of the government debt doesn't matter.
6. Fiscal policy doesn't negatively affect other goals.

Crowding Out

Crowding out is the offsetting of a change in government expenditures by a change in private expenditures in the opposite direction.



The Government Knows the Situation

Data problems limit fiscal policy for fine tuning.

- Getting reliable numbers on the economy takes time.
- We may be in a recession and not know it.

The government relies on large macroeconomic models and leading indicators to predict where the economy will be like in the future, but the forecasts are imprecise.

The Government Knows the Economy's Potential Income Level

No one knows for sure the potential *full-employment* income.

Economists now see full employment to be closer to 4 percent.

Differences in estimates of potential income often lead to different policy recommendations.

In most cases, the U.S. economy is in an ambiguous state where some economists are calling for expansionary policy and others are calling for contractionary policy.

The Government has Flexibility in Changing Taxes and Spending

Putting fiscal policy into place takes time and has serious implementation problems.

Numerous political and institutional realities in the U.S. today make implementing fiscal policy difficult.

Disagreements between Congress and the President may delay implementing appropriate fiscal policy for months, even years.

The Size of the Government Debt Doesn't Matter

Although there is no inherent reason why activist functional finance policies should have caused persistent deficits, increases in government debt have occurred for three reasons:

1. Early activists favored not only fiscal policy, but also large increases in government spending.
2. Politically it's easier for government to increase spending and decrease taxes than vice versa.
3. Most economists believe that a country's debt becomes a problem somewhere around 90 to 100 percent of a country's GDP.

Fiscal Policy Doesn't Negatively Affect Other Government Goals

A society has many goals: achieving potential income is only one of those goals.

National economic goals may conflict.

For example, when the government runs expansionary fiscal policy, the trade deficit increases.

Building Fiscal Policies into Institutions

To avoid the problems of direct fiscal policy, economists have attempted to build fiscal policy into U.S. institutions.

An **automatic stabilizer** is any government program or policy that will counteract the business cycle without any new government action.

Automatic stabilizers include:

- Welfare payments
- Unemployment insurance
- The income tax system

How Automatic Stabilizers Work

When the economy is in a recession, the unemployment rate rises.

Unemployment insurance is automatically paid to the unemployed, offsetting some of the fall in income.

Income tax revenues also decrease when income falls in a recession, providing a stimulus to the economy.

Automatic stabilizers also work in reverse.

- When the economy expands, government spending for unemployment insurance decreases and taxes increase.

State Government Finance and Procyclical Fiscal Policy

State constitutional provisions mandating balanced budget act as automatic destabilizers.

- During recessions states cut spending and raise taxes.
- During expansions states increase spending and cut taxes.

Procyclical fiscal policy is changes in government spending and taxes that increase the cyclical fluctuations in the economy instead of reducing them.

State Government Finance and Procyclical Fiscal Policy

Economists have suggested alternatives to state government procyclical budget policy.

States can establish ***rainy-day funds*** which are reserves kept in good times to offset declines in revenues during recessions.

States could use a five-year rolling-average budgeting procedure as the budget they are required to balance.

The Negative Side of Automatic Stabilizers

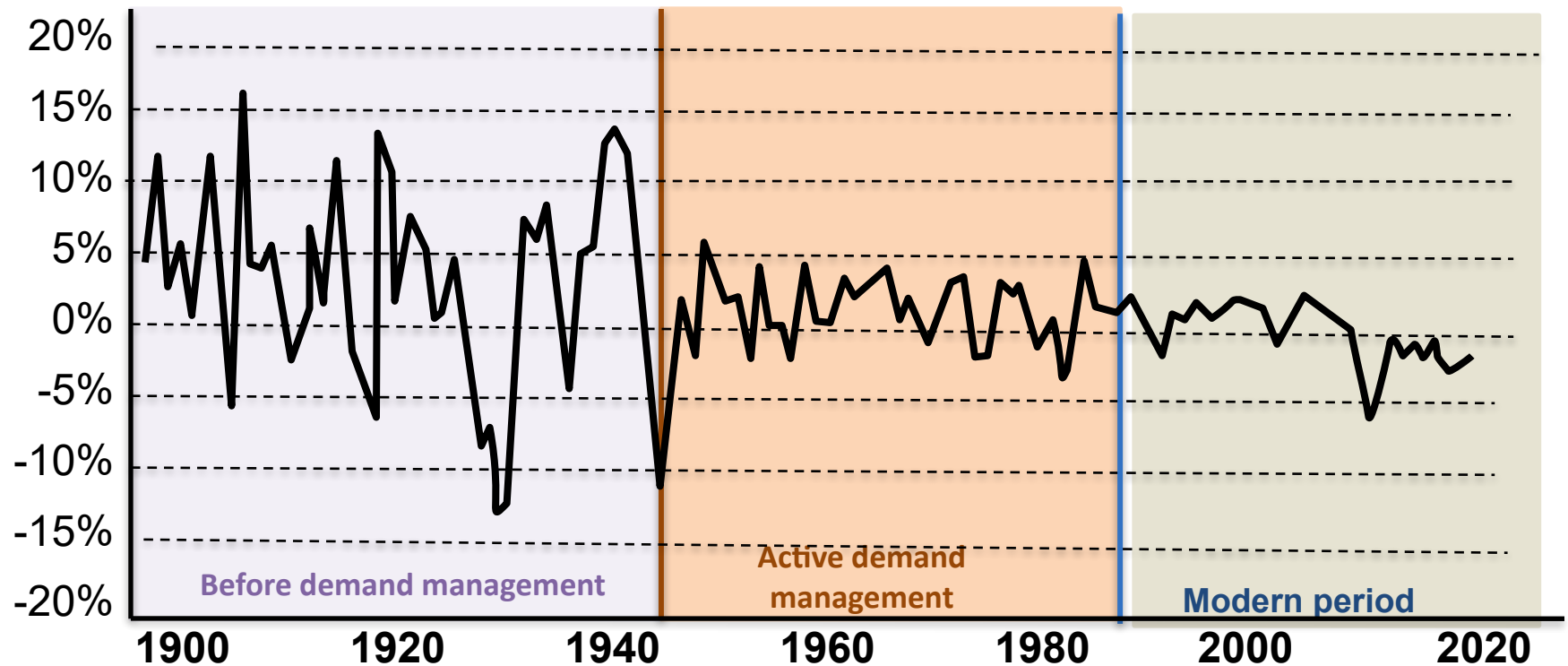
When the economy is first starting to climb out of a recession, automatic stabilizers will slow the process, rather than help it along, for the same reason they slow the contractionary process.

As income increases, automatic stabilizers increase government taxes and decrease government spending, and as they do, the discretionary policy's expansionary effects are decreased.

Decrease in Fluctuations in the Economy

Compared to the early 1900s, fluctuations in the economy have decreased; this suggests that policy makers have done something right.

**Percent change
in real GDP**



Conclusion

The modern macro policy precept is a blend of functional and sound finance.

Modern economists' suggestion of government policy in a recession is to do nothing in terms of specific tax or spending policy, but let the automatic stabilizers in the economy do the adjustment. The two exceptions to this rule:

1. When falling into a severe recession or depression, then the government should run expansionary fiscal policy.
2. When experiencing a hyperinflation, the government should run a contractionary fiscal policy.

Chapter Summary (1 of 3)

Sound finance is a view that the government budget should always be balanced except in wartime.

The Ricardian equivalence theorem states that it doesn't matter whether government spending is financed by taxes or deficits; neither would affect the economy.

Although proponents of sound finance believed the logic of the Ricardian equivalence theorem, they believed deficit spending could affect the economy.

Still, because of political and moral issues, proponents of sound finance promoted balanced budgets.

Chapter Summary (2 of 3)

Functional finance is the theoretical proposition that governments should make spending and taxing decisions based on their effect on the economy, not moralistic principles.

Six problems that make functional finance difficult to implement are:

1. Interest rate crowding out.
2. The government not knowing what the situation is.
3. The government not knowing the economy's potential income.
4. Government's inability to respond quickly enough.
5. The size of government debt not mattering.
6. Conflicting goals.

Chapter Summary (3 of 3)

Activist fiscal policy is now built into U.S. economic institutions through automatic stabilizers.

Economists agree that if the economy is headed toward a depression or hyperinflation, follow the precepts of functional finance—expansionary fiscal policy to offset a depression and contractionary fiscal policy to offset hyperinflation. If the economy is experiencing moderate fluctuations, follow the precepts of sound finance—balance the budget.