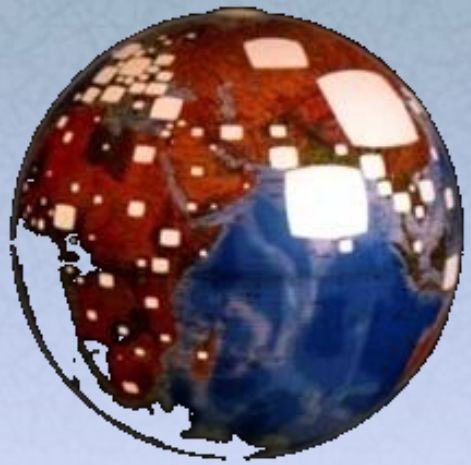


Fiscal Policy Part II

Much fiscal policy is implemented, not through spending increases, but through tax credits and other so-called tax expenditures. The markets should respond to them as they do spending cuts, with little contraction in economic activity.

Alan Greenspan

Tax Cuts

- By lowering taxes, the government increases the disposable income of the private sector.
  - Disposable income is the after-tax income of consumers; personal income less personal taxes.

Taxes and Consumption

- Tax cuts directly increase the disposable income of consumers.
- How much consumption increases depends on the marginal propensity to consume.

initial increase in consumption = MPC x tax cut

Taxes and Consumption

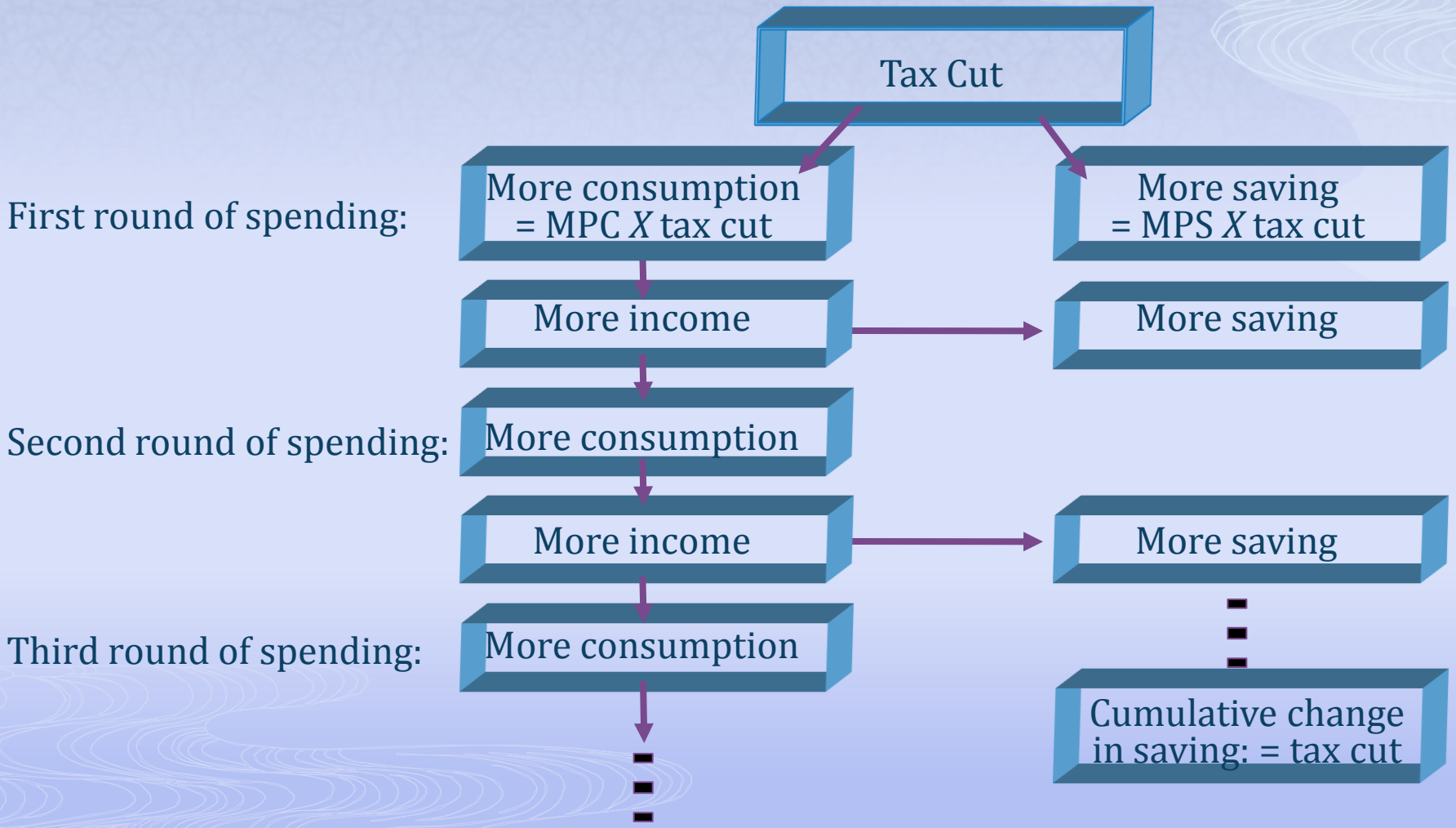
A dollar increase in tax cuts is less stimulative than a dollar increase in government purchases.

Taxes and Consumption

An AD shortfall can be closed with a tax cut.

$$\text{desired tax cut} = \frac{\text{desired fiscal stimulus}}{\text{MPC}}$$

Diagram: The Tax Cut Multiplier



Taxes and Investment

- A tax cut may also be an effective mechanism for increasing investment spending.
- Tax cuts have been used numerous times to stimulate the economy.

Increased Transfers

- Increasing transfer payments stimulates the economy.
- The initial fiscal stimulus (injection) of increased transfer payments is:

$$\text{initial fiscal stimulus} = \text{MPC} \times \text{increase in transfer payments}$$

Fiscal Restraint

- There are times when the economy is expanding too fast and fiscal restraint is more appropriate.
  - Fiscal restraint is using tax hikes or spending cuts intended to reduce (shift) aggregate demand.

The Fiscal Target

- The **AD excess** is the amount by which aggregate demand must be reduced to achieve price stability after allowing for price-level changes.
- The AD excess exceeds the GDP gap.

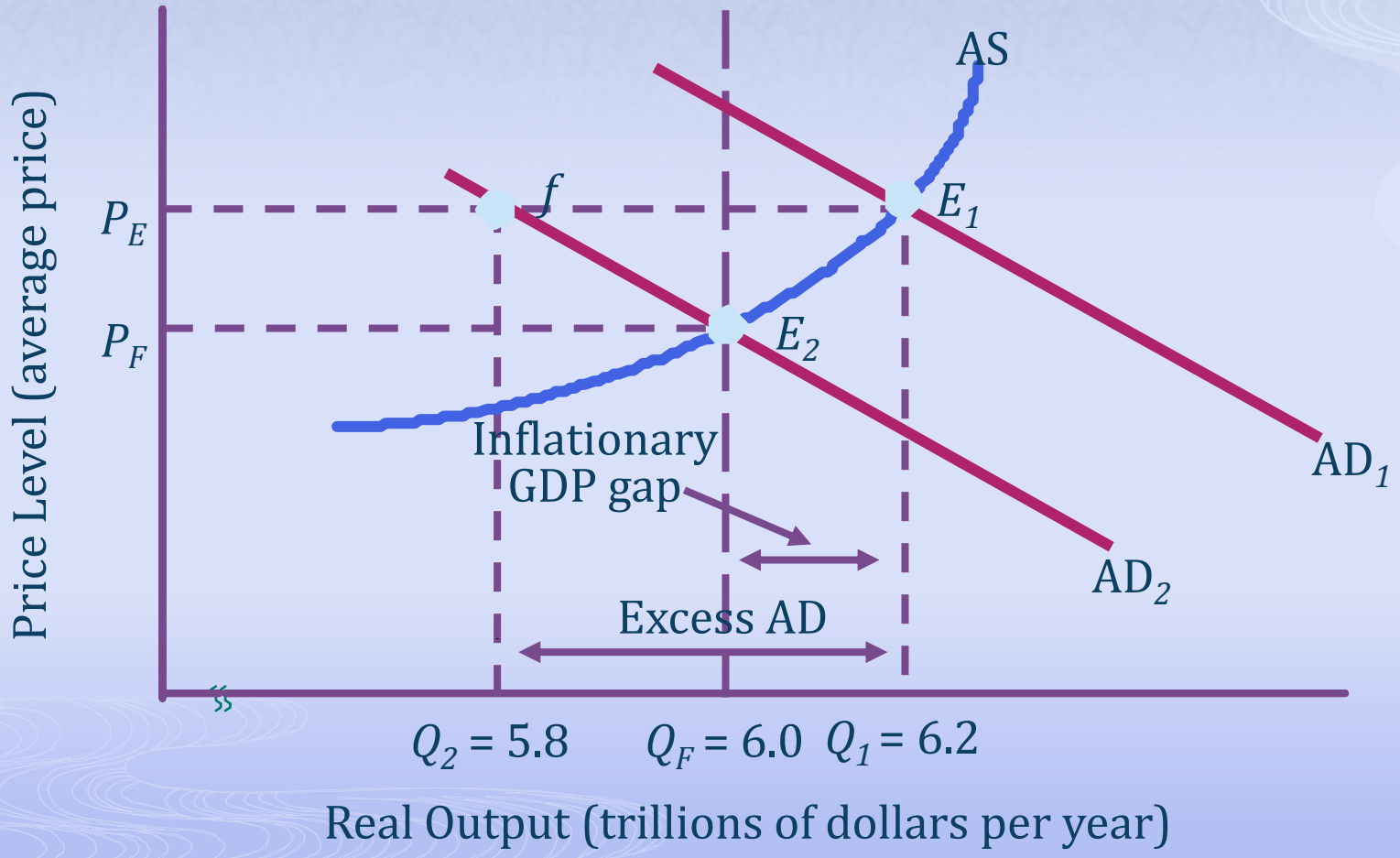
The Fiscal Target

The first task is to determine how much AD needs to fall:

$$\text{desired fiscal restraint} = \frac{\text{desired AD reduction}}{\text{multiplier}}$$

$$= \frac{\text{excess AD}}{\text{multiplier}}$$

Chart: Excess Aggregate Demand



Budget Cuts

Budget cuts reduce government spending and induce cutbacks in consumer spending.

cumulative reduction in spending = multiplier x initial budget cut

Tax Hikes

- Tax hikes can be used to shift the AD curve to the left.
- The direct effect of tax increases is a reduction in disposable income.

Tax Hikes

Taxes must be increased more than a dollar to get a dollar of fiscal restraint.

$$\text{desired increase in taxes} = \frac{\text{desired fiscal restraint}}{\text{MPC}}$$

Reduced Transfers

- A cut in transfer payments works like a tax hike, reducing the disposable income of transfer recipients.
- The desired reduction in transfers is the same as a desired tax increase.

Fiscal Guidelines

The essence of fiscal policy is the deliberate shifting of the aggregate demand curve.

A Primer: Simple Rules

- The steps required to formulate fiscal policy are:
  - Specify the amount of the desired AD shift.
  - Select the policy tools needed to induce the desired shift.

Table: Fiscal Stimulus

$$\text{Desired fiscal stimulus} = \frac{\text{AD shortfall}}{\text{the multiplier}}$$

Policy Option	Amount
Increase government purchases	desired fiscal stimulus
Cut taxes	$\frac{\textit{desired fiscal stimulus}}{\textbf{MPC}}$
Increased transfers	$\frac{\textit{desired fiscal stimulus}}{\textbf{MPC}}$

Table: Fiscal Restraint

$$\text{Desired fiscal restraint} = \frac{\text{excess AD}}{\text{the multiplier}}$$

Policy Option	Amount
Reduce government purchases	desired fiscal restraint
Increase taxes	$\frac{\textit{desired fiscal restraint}}{\textbf{MPC}}$
Reduce transfers	$\frac{\textit{desired fiscal restraint}}{\textbf{MPC}}$

A Warning: Crowding Out

- Some of the intended fiscal stimulus may be offset by the crowding out of private investment expenditure.
  - **Crowding out** is a reduction in private-sector borrowing (and spending) caused by increased government borrowing.

Time Lags

- It takes time to recognize that a problem exists and then formulate policy to address the problem.
- The very nature of macro problems can change if the economy is hit with other internal or external shocks.

Pork-Barrel Politics

- Members of Congress want their constituents to get the biggest tax savings.
- They don't want spending cuts in their own districts.
- They don't want a tax hike or spending cut *before* an election.

The End