The Modern Fiscal Policy Dilemma

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Chapter Goals

- Explain the logic of the Ricardian equivalence theorem
- Distinguish sound finance from 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 Modern Fiscal Policy Dilemma

- The modern fiscal policy dilemma is that when faced with the economy falling into a depression:
    - Governments need to run large deficits for limited periods
- A government that cannot easily sell its debt will either go bankrupt or have to resort to inflationary finance, with the central bank financing the government by printing money

Classical Economics and Sound Finance

- **Sound finance** was 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** is that 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 [illegible] t 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

- **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 and the multiplier model

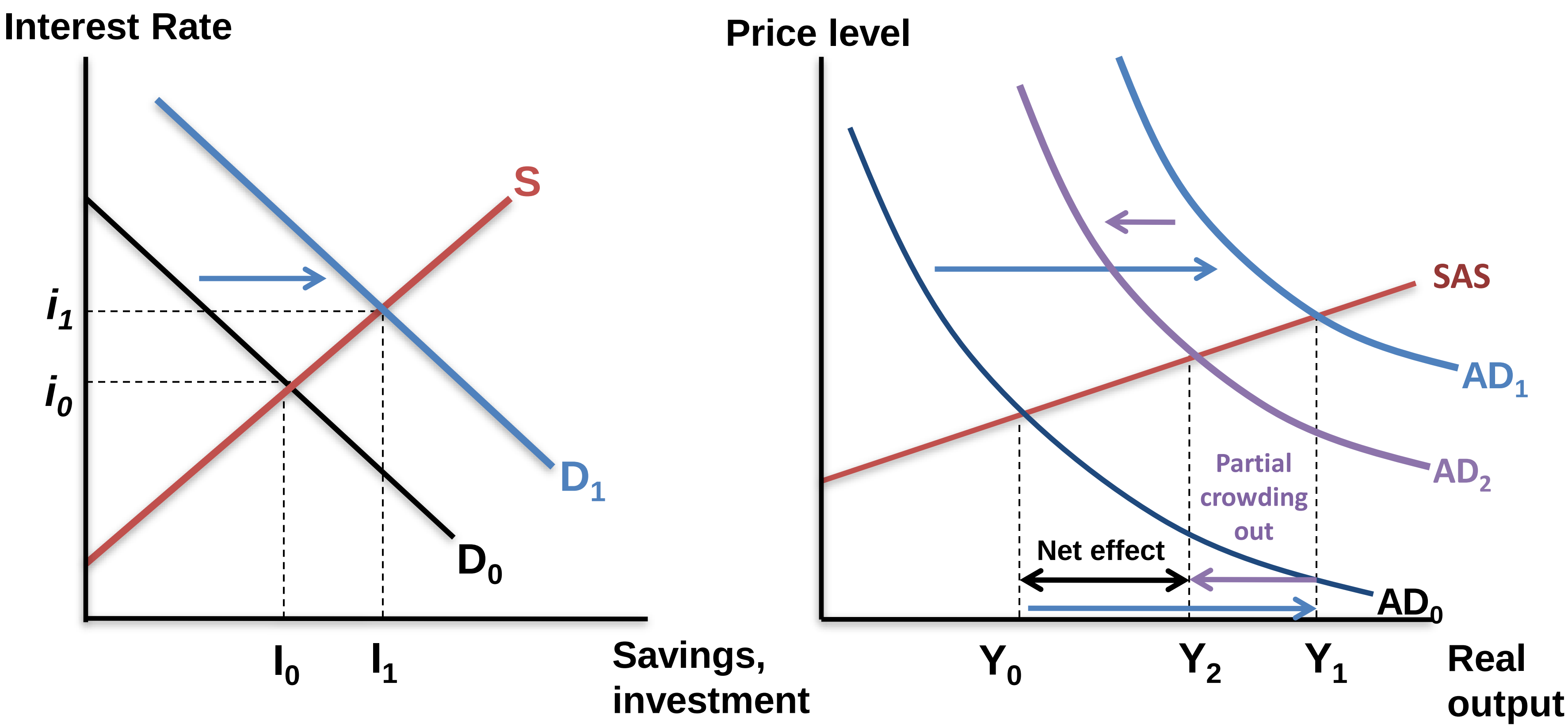
Functional Finance in Practice

Six assumptions of the multiplier 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

Financing the Deficit Doesn't Have Any Offsetting Effects

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



Knowing What the Situation Is

- 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 has large econometric models and leading indicators to predict where the economy will be in the future, but the forecasts are imprecise

Knowing the Level of Potential Income

- No one knows for sure the potential *full-employment* income
- Almost all economists believe that potential income is within an unemployment rate range of 3.5% to 10%
- 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

Flexibility in Changing Taxes and Spending

- Putting fiscal policy into place takes time and has serious implementation problems
- Numerous political and institutional realities make implementing fiscal policy difficult
- Disagreements between Congress and the President may delay implementing appropriate fiscal policy for months, even years

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 because:
    - Early activists favored not only fiscal policy, but also large increases in government spending
    - Politically it' s easier for government to increase spending and decrease taxes than vice versa

Fiscal Policy Doesn’t Negatively Affect Other 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 Policy 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

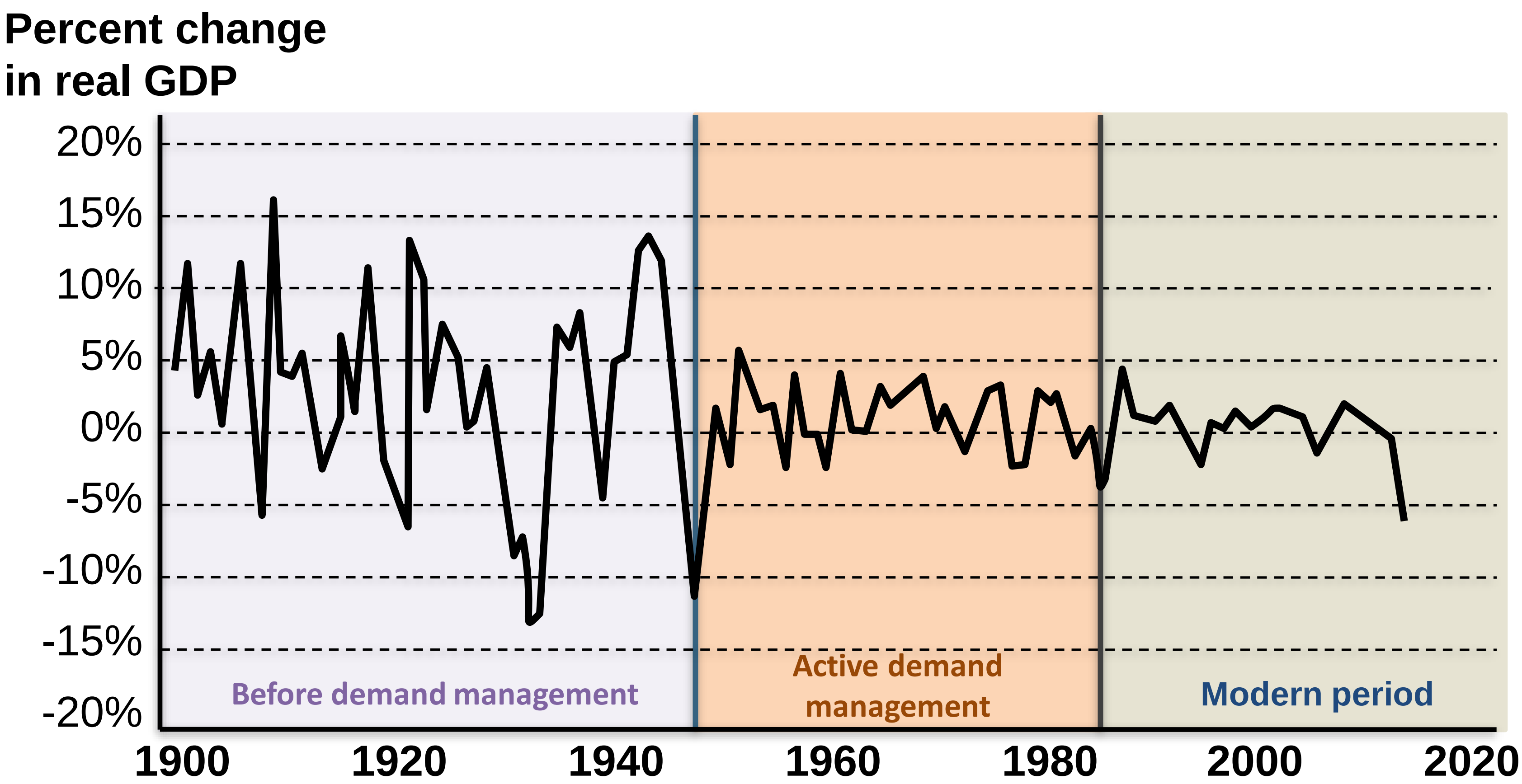
- Economists have suggested alternatives to state government procyclical budget policy
- States can establish rainy season funds which are reserves kept in good times to offset declines in revenues during recessions
- States could use a five-year rolling-average budgeting procedure as the budget they 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



Modern Macro Policy Precepts

- 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
- But if the economy is falling into a severe recession or depression, then the government should run expansionary fiscal policy

Fiscal Policy in 2009 and Beyond

The general agreement of economists is that:

- If the economy is headed toward a depression, the appropriate fiscal policy is functional finance; fiscal policy should be expansionary
- If the economy is headed toward hyperinflation, the appropriate fiscal policy is functional finance; fiscal policy should be contractionary; government should be running surpluses and paying off debt
- If the economy is in normal times, the appropriate fiscal policy is sound finance; balance the budget

Chapter Summary

- 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 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

- 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 assumptions that make functional finance difficult to implement are:
  1. Interest rate crowding out
  2. The government may not know what the situation is
  3. The government may not know the economy's potential income
  4. Government can not respond quickly
  5. The size of the government debt does matter
  6. Economic goals may conflict

Chapter Summary

- Activist policy is now built into U.S. institutions through automatic stabilizers
- Economists agree that if the economy is headed toward a depression or hyperinflation, follow the precepts of functional finance to use 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