Fiscal Policy (I)
November 15, 2001
Essay on “Operation Fusion”

Goals of Program: five objectives

Assignment: An essay addressing these objectives

Approach: Use good economics, fine style, sound reasoning; counts double problem set

See discussion of writing essays on course web page.
Budget matters

What is a budget?
- Statement of spending and receipts
- Administrative aspects

Macroeconomic role of budgets
- Affect overall spending (AD) and savings-investment balance

Federal budget process
- Cash basis
- The politics of fiscal policy
- Example of fiscal stalemate in the stimulus package of 2001
Budgetary Facts

- Trends in federal spending, taxes, and surplus
- Structural v. cyclical budgets
- The emergence, and likely demise, of the federal budget surplus
The overall federal budget

Tax/GDP
Spend/GDP
More recent data on federal budget

![Graph showing Tax/GDP and Spend/GDP percentages over time from 1980 to 2005.](image-url)
**Structural v Actual Budget**

- Actual budget is actual spending and receipts
- Structural budget records spending, taxes, and deficit that would occur if economy at potential output
- Important because taxes, spending programs respond to state of economy
  - e.g., income taxes, unemployment insurance
- Alternatively, discretionary and automatic
  - Automatic stabilizers: tax payments, UI
  - Discretionary budget: changes in tax rates, defense, entitlement programs
Structural and Actual Budget
The two faces of fiscal policy

Keynes’ paradox of thrift: “Up to the point where full employment prevails, the growth of capital depends not at all on [high saving] but is, on the contrary, held back by it.” General Theory, p. 373.

Full employment: fiscal policy promotes \( S \) and \( I \) through running a surplus.

Recession: fiscal policy promotes high \( Q \) and \( E \) through running deficits.
Savings Accounting

Private domestic investment
\[ \equiv \]
Government surplus
+ 
Private saving
(personal and business)
+ 
Saving by foreigners
(net imports)

or

\[ I = S_g + S_p + S_f \]
Key to paradox of thrift: classical

In classical approach:

Have full employment.
Therefore, with lower T, C(Yd) is raised, C rises, and I must fall (through higher i).
More generally, higher “consumption G” or lower “consumption T” will raise i, lower I, lower K, and lower growth of potential output.
Can see in 45°diagram with fixed Q
Key to paradox: Keynesian

In Keynesian approach:

Have unemployed resources.
Therefore, with lower T, C(Y_d) is raised, C rises, and Q rises.
I can rise or fall depending upon accelerator and reaction of monetary policy.
Can see in 45° diagram with changing Q
Changing the Fiscal-Monetary Mix

Question: suppose you want to raise national I and lower national C, keep G constant, and maintain full employment. How?

Answer: Change the monetary-fiscal mix:

Maintain G; raise T, lowering Y^d, and lowering C;
Offset by expanding M, lowering i, and raising I

This is a change in the monetary-fiscal mix.

Examples:

- Bush I and Clinton: lower C and raise I
- Contrary example: Reagan and Bush II.
The Clinton/Rubin/Summers Deficit Doctrine

Simple and misleading view: “Cutting the deficit expands the economy.”

More complete view:
“The central objective of deficit reduction was and remains expenditure switching – away from consumption and government purchases toward investment. The lower interest rates brought about by deficit reduction are the way the market accomplishes this expenditure switching.” [ERP 1994, p. 36]

“Some people worry that deficit reduction might retard growth in the short run by siphoning off aggregate demand. Such a concern is justified. Deficit reduction by itself certainly does tend to contract the economy. After all, raising taxes and cutting government spending reduced the demand for goods and services. But deficit reduction accompanied by sufficient declines in long-term interest rates need not be contractionary.” [ERP 1994, p. 36]
Monetary v. Fiscal Policy

Should countries use monetary or fiscal policy to fight recessions?

1. Depends upon the exchange rate regime. Countries with fixed exchange rates cannot use monetary policy.

2. Presumption in U.S. is that monetary policy is the first resort:
   - quicker, less political, more easily reversed
   - Response to 9/11:
     - Federal Reserve eased money on 9/17
     - Still waiting for Congress on 11/15
3. But excessive reliance on M can be unbalanced
- Operates on narrow part of economy – interest sensitive sectors like housing and investment
- Can have large wealth effects on bonds, housing, and stocks
- Can run into liquidity trap as interest rate $\rightarrow 0$.
- Therefore, for deep recessions or depressions, probably want to combine with fiscal policy.
- But this means that may want to run surplus in “fat years” to prepare for fiscal emergencies in “lean years.”

Treas. Sec/H. Pres L. Summers (1999): paying down debt re-loads the fiscal cannon, preparing the government to respond to future contingencies such as recessions or threats from overseas.