Topic 9
Fiscal Policy

(second half of the lecture)

Econ1102 section 028

Agenda

1. Automatic Stabilizers
2. Difficulties implementing Fiscal Policy
   – Timming
   – Temporary Changes
3. Balanced Budgets
   – US debt analysis
   – Encourage savings?
4. The Laffer Curve

1. Automatic Stabilizers

(sort of like training wheels on a bike)

Definition of Automatic Stabilizer

- Changes in fiscal policy that stimulate AD when the economy goes into a recession (or slows AD when economy goes into a boom) without policy makers having to take any deliberate action

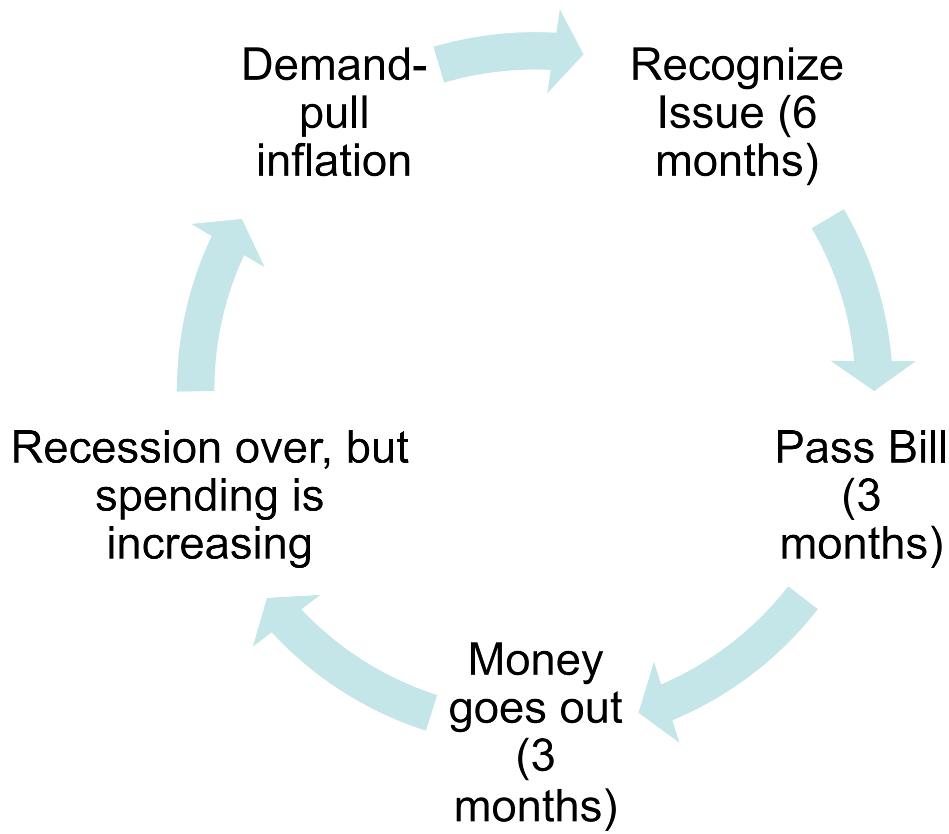
2. Fiscal Policy Issues

Fiscal Policy Issues
2.1 Timming

Timing Problems

1. Recognition Lag – takes time to confirm how economy is doing
2. Administrative Lag – Takes time to pass an economic package
3. Operational Lag – Takes time for the stimulus to actually happen – money to get to the right places, etc.

Timing is hard! Consider a 1-year recession



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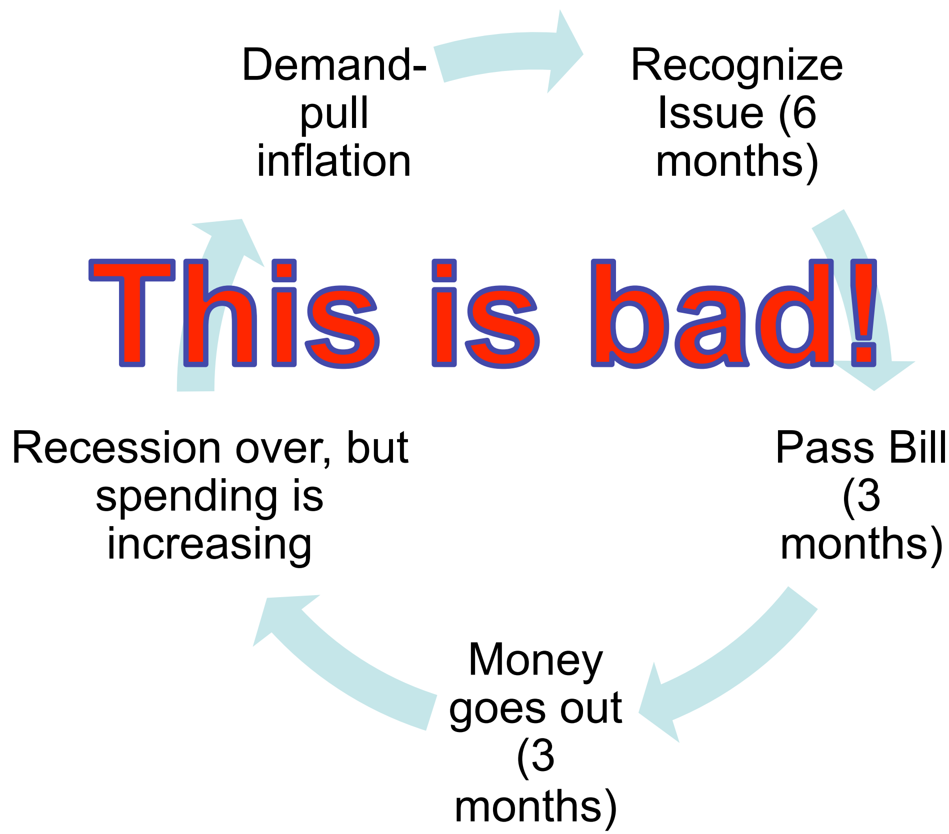

Fiscal Policy Issues

2.2 Temporary vs permanent policy decissions

What is the impact of temporary versus permanent policy decisions?

World 1

- Government permanently reduces taxes

World 2

- Government reduces taxes for 1 year

- In world 2 people will save some of the extra money of this year to pay for the increased taxes next year. Hence the policy won't be as effective.
- For this reason if people think fiscal policy changes are only temporary they wont have a lot of effect in the economy.

3. Should we balance the budget?

Is the government like a household? i.e. “live within our means” or “debt is bad”

3.1. Problem of balanced budgets

- The government would like to spend counter-cyclically
  - Increase spending in down times (to shorten recession)
  - Decrease spending in expansion(to avoid inflation)
- A balanced budget amendment makes fiscal policy work exactly in the wrong direction!

3.2. But what about debt? It can't grow forever!

- US Public Debt - $16.75 trillion
  - $4.8 trillion – government owes itself (mostly the federal reserve)
  - $11.8 trillion – owed to public
    - $6.2 trillion – held in domestic institutions
    - $5.6 trillion – held by foreign institutions
      - $1.2 trillion – held by China
      - $1.1 trillion – held by Japan

Numbers obtained here: http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt

Debt analysis (foreigners)

- Only 33% of debt is held by foreigners
  - 7% by China and Japan, less by others
- Is this a problem?
  - typical financing limits for a household is: no more than 36% of yearly income should go to financing debt (i.e. interest payments)
  - US gov't: ~6% of annual budget

Debt Analysis - international

- Is the *international* component too high?
- Net International Investment Position

Country	% GDP
Portugal	-108%
Ireland	-98%
Greece	-93%
Spain	-87%
Australia	-64%
United States	-17%

Debt Analysis – total debt

- How about total debt. Is it too high?
- Debt as % of GDP (from IMF)

Country	2011	2016 (projected)
Japan	233%	253%
Greece	166%	162%
Italy	121%	114%
United States	80%	115%
Canada	84%	72%
Spain	67%	77%

3.3 Should the government balance its budget?

Pros of a deficit

- Tax burden is not large compared to lifetime income (approx. $31K today)
- Depends on the big picture (in recession, can be good)
- Deficits can rise forever – as long as income rises faster!

Cons of a deficit

- Places a burden on future taxpayers – debt eventually must be paid. ***May*** result in increased taxes
- Lowers national savings – So higher interest rates, lower investment, so lower productivity, wages, and production

3.4. Regarding savings: Should tax laws encourage it?

Pros

- More resources available for investments, increasing productivity, wages and incomes

Con

- Benefits higher income households – rich people save a higher % of income than poor.
  - Tax breaks for savings then favour the rich (less progressivity in taxes)
- Tax policy may not be effective in encouraging savings (substitution vs income effects)

Can tax cuts pay for themselves?

i.e. Our previous assumption about Investments staying the same is just plain wrong. Tax cuts SPUR investments, so I goes up and GDP goes up.

The Laffer Curve

- Do tax cuts pay for themselves?
  - i.e. If I reduce tax rates, will it grow the economy enough to collect the same number of dollars (i.e. revenue neutral)?
- We need to consider two things:
  - Maximizing revenue in the short-run
  - Maximizing growth

The Laffer Curve – Short Run

Wages are $10 per hour

Income Tax Rate	Reported hours worked	Worker Income	Tax Revenue
0%	40	$400	$0
25%	30	$300	.25*$300 = $75
50%	20	$200	.5*$200=$100
75%	10	$100	.75*$100=$75
100%	0	$0	1*0=$0

- Increasing tax from 25% to 50% raises total revenue
- Decreasing tax from 75% to 50% also raises total revenue

The Laffer Curve – Short Run

- Where does this kink (in the short-run curve) actually take place?
- Most economists agree it is around 70%
- i.e. Can keep increasing taxes (upto average rate of 70%) and increase revenue
- Alternatively, decreasing taxes **reduces** revenue if rate is <70%

The Laffer Curve – Long Run

Income Tax Rate	Worker Income	Tax Revenue	Savings + Consumption
0%	$400	$0	$400
25%	$300	.25*$300 = $75	$225
50%	$200	.5*$200=$100	$100
75%	$100	.75*$100=$75	$25
100%	$0	1*0=$0	$0

- Which situation is best for growth?
- Balancing the short-run and long run is important

Key Ideas and Things To Think About

Note: This is NOT a study guide – i.e. do not limit yourself to these items when studying

Things to think about

- Draw a graph that shows the situation where increasing debt *doesn't* place greater tax burdens on citizens.
- When should the government pay off its debt?
- In a recession, are interest rates high or low? Is this a good time for the government to borrow?