Fiscal policy

Fiscal policy involves changes in taxes and spending by the government

To achieve

1. Full employment
2. Price stability
3. Long-term economic growth

Federal Budget

The annual statement of the outlays (expenditures) and revenues of the government of Canada.

1. $\text{Budget Surplus} = \text{Revenues} - \text{outlays} > 0$

2. $\text{Budget Deficit} = \text{Revenues} - \text{outlays} < 0$

3. $\text{Balanced Budget} = \text{Revenues} - \text{outlays} = 0$

Government Revenues

1. personal income taxes
2. Corporate taxes
3. Indirect taxes (Taxes on gasoline)

Government Expenditures

1. Transfer payments (unemployment cheques)
2. Expenditures on goods and services
3. Debt interest payments

Deficit and Debt

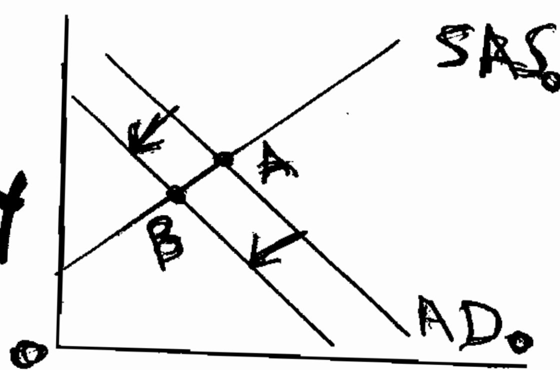
Budget deficits add to the gov't debt

The total amount of government borrowing

Demand-side Effects of tax changes

Tax increases decrease disposable income and decrease aggregate demand. As a result, AD curve shifts out and to the right.

Contractionary Fiscal policy



Supply-side effects of tax changes

1 Tax increases may also affect the supply-side of the economy.

Higher income taxes weaken the incentive to work and decreases the supply of labour

There is a smaller quantity of labour and a lower potential GDP

A tax cut would increase the supply of labour, increase the full-employment quantity of labour, and increase potential GDP.

2. Taxes and the incentive to save

A tax on interest income weakens the incentive to save and lend and decreases the supply of loanable funds.

Saving and investment decrease and slows the growth rate of real GDP.

Many economists recognize the power of tax cuts as incentives

They correctly argued that tax cuts would increase employment and increase output

But tax cuts without spending cuts would increase the budget deficit and cause serious problems.

Fiscal policy is used as a tool to stabilize the business cycle

Fiscal policy actions work by changing aggregate demand

1. Discretionary Fiscal policy

A change in a spending program or a tax law.

. A cut in income tax rates

It requires approval by the Parliament

2. Automatic Fiscal policy

Fiscal action triggered by the state of the economy

- An increase in unemployment induces an increase in payments to the unemployed
- A fall in incomes triggers an automatic decrease in tax revenues

Fiscal Policy Multipliers

1. Government Expenditure multiplier

$$= \frac{\text{change in Equilibrium income}}{\text{change in government expenditures}}$$

$$= \frac{\#200 \text{ billion}}{\#50 \text{ billion}} = 4$$

A #50 billion increase in government expenditures increase equilibrium real GDP by #200 billion

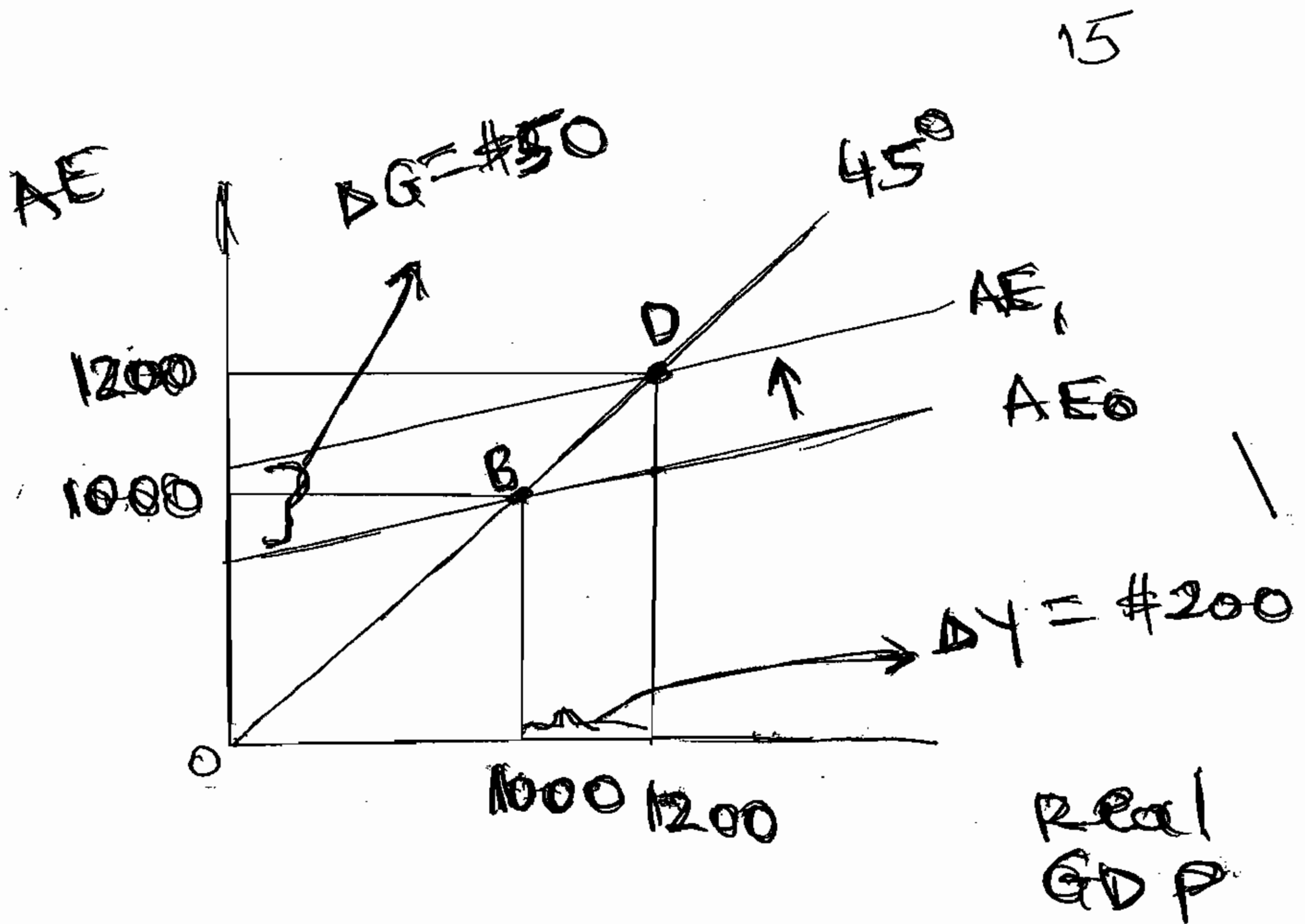
$$\Delta Y = \begin{pmatrix} \text{gov't} \\ \text{expenditure} \\ \text{multiplier} \end{pmatrix} \times \Delta G$$

ΔY → change in equilibrium real GDP

ΔG = change in gov't expenditures

$= (4)(50) = \$200$

The government can increase its expenditures on goods and services to stimulate the economy.



The AE curve shifts upward by the change in gov't expenditures, ΔG= #50

$$\frac{\Delta Y}{\Delta G} = \frac{1}{1-[b(1-t)-M]}$$

This is the government expenditures multiplier

Also,

$$\frac{\Delta Y}{\Delta G} = \frac{1}{1-\text{slope of AE Curve}}$$

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2. Autonomous tax multiplier

It captures the magnification effect of a change in autonomous taxes on equilibrium aggregate expenditures and real GDP

A decrease in autonomous taxes increases disposable income, which increase aggregate expenditures

Autonomous Taxes

Taxes that are levied (imposed) independently of the level of income

(a) Property tax depends on the value of the property

(b) User fees for government services

(c) The GST

Induced Taxes

They vary with income and real GDP

income taxes change because a person's income changes

3. Balanced Budget Multiplier

The magnification effect on real GDP of a simultaneous change in government expenditure and taxes that leaves the budget balance unchanged

When both gov't expenditure and taxes increase by $1, aggregate demand goes up.

Transfer payments

(a) Autonomous transfer payments

They do not vary with income and real GDP.

- Farm subsidies
- welfare payments
- Unemployment Cheques

(b) Induced ~~transfer~~ payments

depend on the economic state of individuals and businesses

- Government Programs that entitle suitably qualified people and businesses to receive benefits.

Limitations of Discretionary Fiscal policy

Discretionary fiscal policy is limited by time lags

1. Recognition lag
   It takes time to understand that fiscal policy actions are needed

2. Law-making lag
   It takes time for the parliament to vote and change the law.

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3. impact lag
It takes time for gov't expenditures to have an impact on the economy

Automatic stabilizers

Mechanisms that stabilize real GDP without explicit action by the government

If real output begins to decrease, tax revenues also fall and induced transfer payments rise ⇒ Budget deficit increases

Automatic fiscal stabilizers work to make output fluctuations less severe.

Budget Deficit over the Business cycle

The budget deficit fluctuates with the business cycle because both tax revenues and transfer payments fluctuate with real GDP

Cyclical Deficit

A cyclical deficit occurs when there is a deficit due to the fact real GDP is less than potential GDP.

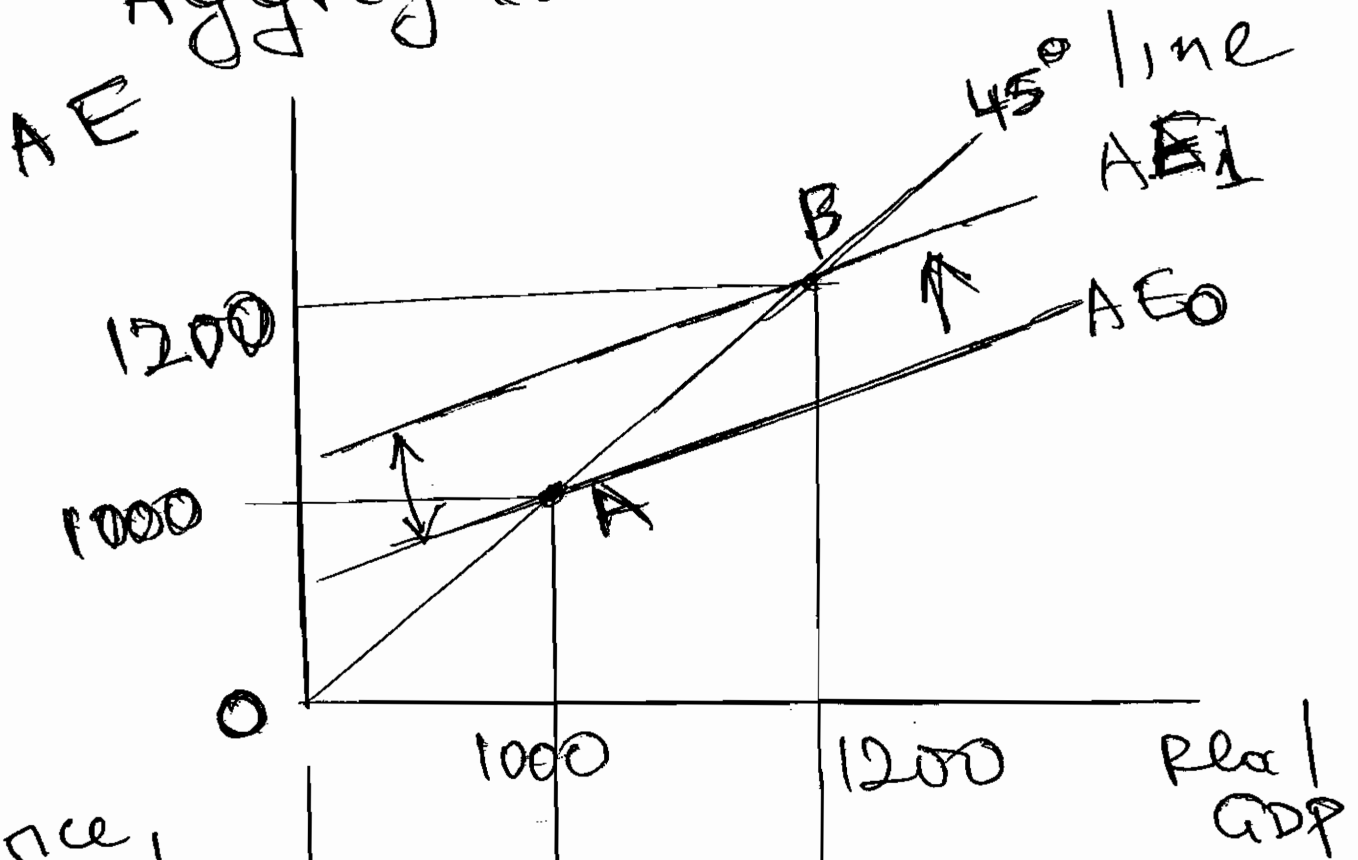
Structural Deficit

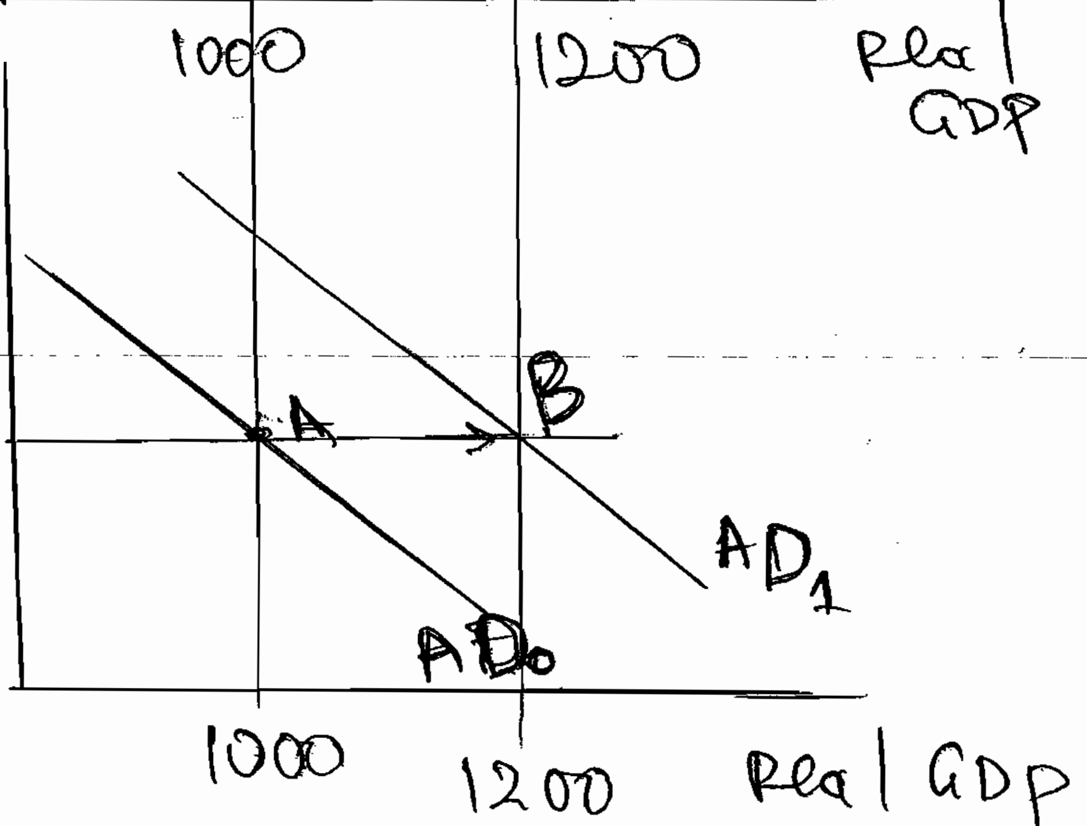
The deficit that remains at potential GDP (at full employment).

- If $5 billion deficit would remain at full employment, it would be due to the structure of tax and spending programs rather than to the state of the economy.

Structural deficits are persistent

Fiscal policy and Aggregate Demand





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An increase in gov't expenditures shifts the AE curve to AE_1

Equilibrium real GDP increases to $1,200 billion.

The AD curve shifts rightward to AD_1 (at the same price level)

This is called an expansionary Fiscal policy

Expansionary Fiscal policy

- A decrease in Taxes
- An increase in Trans-fers
- An increase in go-vernment expendi-tures

Contractionary Fiscal policy

- An increase in Taxes
- A decrease in Trans-fers
- A decrease in govern ment expenditures

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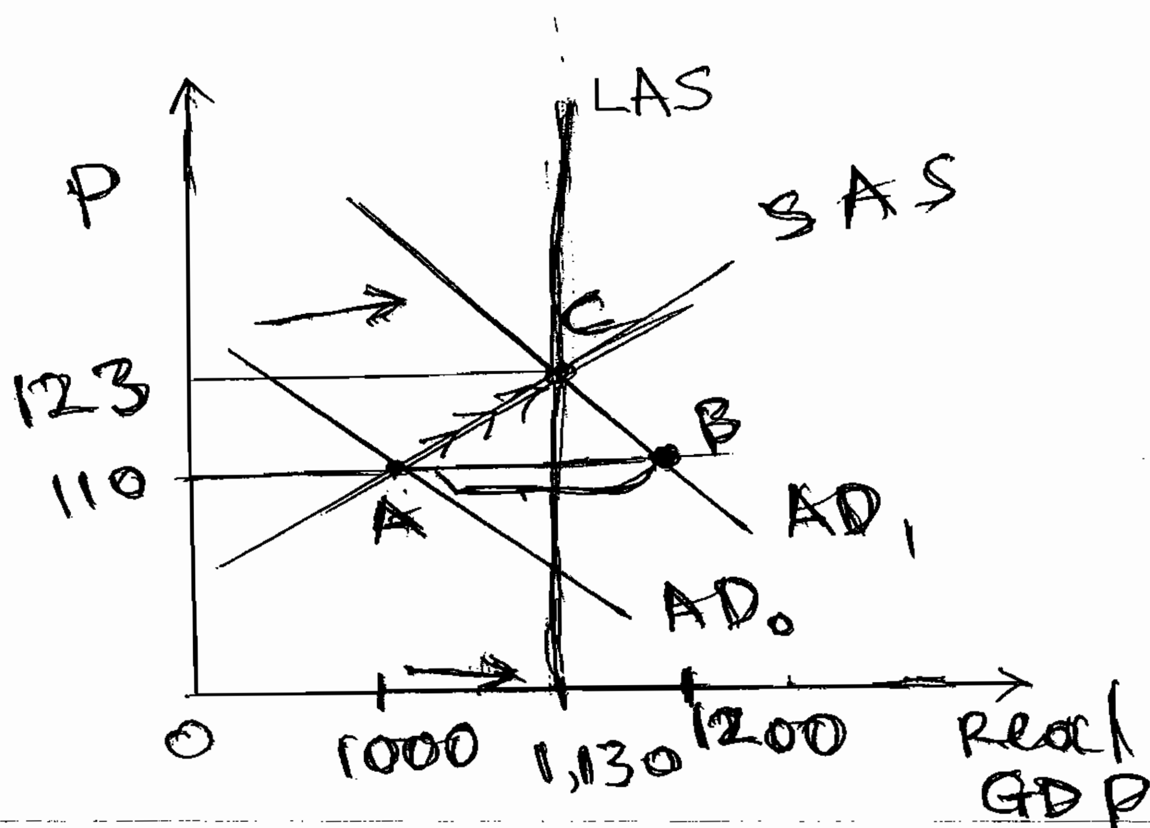
points

The shift in AD Curve is smaller for a decrease in taxes than for an increase in gov't expenditures of the same size.

why?

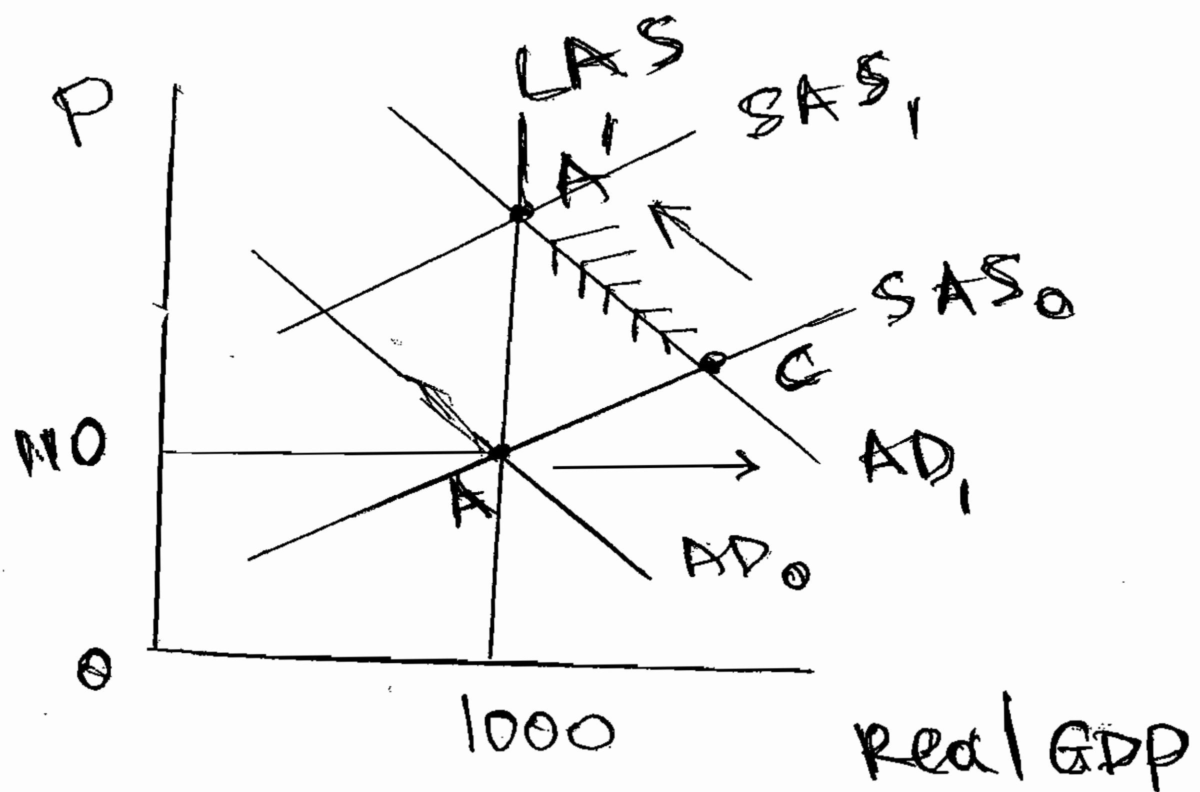
Fiscal policy with unemployment in the short run



An increase in gov't spending shifts the AD curve to AD_1.

- The price level rises
- The economy moves to point C.

Fiscal policy with full employment



If we start at point A, the economy is at full employment equilibrium.

An increase in gov't spending

The AD curve rightward to AD_1.

Real GDP exceeds potential GDP (at point C).

Money wage rises

Price level rises.

The SAS curve shifts leftward to SAS_1

In the long run, the economy moves to A'.

Real GDP unchanged at potential GDP.

- A temporary increase in real GDP and a permanent rise in the price level
- The long run fiscal policy multiplier is zero.