Lesson 7: Fiscal Policy
Reading: Chapter 12

In this lesson we will:
- Learn about the consumption function and the expenditure multiplier
- Discuss the classical, the Keynesian and the new classical views on fiscal policy
- Explain the crowding-out, automatic stabilizers and the supply-side effects

The relationship between disposable income and consumption can be illustrated using a consumption function, figure 8-1. What type of relationships is this?

Patterns of Consumption:
- Even when our disposable income ($Y_d$) is zero, we must consume in order to survive – this is called autonomous consumption. How can we consume if we make no income?
  - Autonomous Consumption: The amount consumed in the economy when $Y_d$ is zero.
- As income increases so does consumption. When $Y_d$ increases by a dollar, $C$ increases, but by less than a dollar. What do we do with the rest of the money?
  - Marginal Propensity to Consume (MPC): The fraction of an increase in disposable income that is consumed. $MPC + MPS = 1$. Define MPS
- If $Y_d$ is higher than $C$ (Consumption) we will end up saving; if $Y_d$ is lower than $C$ than we will dissave. Saving = $Y_d - C$. $C_0 = $200, $Y_d = $500, $MPC = .8$, Saving = ?.

When autonomous expenditure changes, the equilibrium income changes by much more due to the multiplier effect. $m = 1/(1-MPC) = 1/MPS$ (Assuming no imports)

Example: If MPC = .9 and the government increases its expenditure by $100 million, $90m of those $100m would be spent. Then$81m out of the 90m, will be spent again.

$Y_{\text{new}}^* = Y_{\text{old}}^* + m(\Delta A)$ where $\Delta A$ is the change in autonomous expenditure

The U.S. government uses two types of policies to achieve various macroeconomic goals: fiscal policy (changing G and Taxes) and monetary policy, which involves changing the money supply in order to influence the interest rate. Who manages each policy?
The U.S. congress votes on a budget. When G equals its revenue it has a balanced budget:

- When government revenue exceeds G the government has a ...
- When G exceeds revenues the government has a ...
- The national debt is the sum of the government deficits minus all its surpluses
- The government began accumulating significant budget deficits in the 70s. It became large in the 80s (about 8% annually) & turned into surplus in late 90s.

Suppose that in 2000 Taxes (T) = $3 trillion & Gov. Spending (G) = $4 and in 2001 T = $4t & G = $3.5t, what is the government debt assuming that it had no debt in 1999.

The Fiscal Policy Debate:
- Keynesian economists believe that the government should use an expansionary fiscal policy during recessions and restrictive fiscal policy during rapid expansions
- The total effect of a fiscal expansion or contraction can be considerably larger than the initial change because of the multiplier effect. \( \Delta Y = m_e \Delta G \)
- However, an increase in government spending can raise the interest rate by increasing the demand for loanable funds, thus crowding out I and C
- Keynesian economists argue that this crowding-out effect is small during recessions because businesses are not using their capacity to the fullest and do not take many loans
- Keynes called for a counter-cyclical policy regardless of the government’s budget, while most politicians until the 1960s believed the budget should remain balanced

If you were given $1m now that you have to return in 10 years, would your C change?

Crowding-out Effect: When the government increases spending it will increase the demand for loanable funds. Draw this on a graph. Who demands loanable funds and who supplies them? What is the price of loanable funds?

Perhaps the biggest problem with using fiscal policy to stabilize the economy is that the effects of the policy may come at the wrong time because: it takes time to recognize what condition the economy is in, it takes time for policymaker to pass new legislations and it takes time for the policies to affect the economy.
- Automatic stabilizers act more quickly than discretionary policies (policies that have to be proposed and usually voted on). These stabilizers include: unemployment compensation & welfare payments, corporate taxes and progressive income tax.

Explain what happen to each stabilizer during recessions and expansions.

In the 1980s, under the Reagan administration, some economists began to argue in support of supply-side incentives. They argued that a reduction in corporate and income taxes would stimulate work and investment and help increase potential GDP.
- High tax rates can discourage people from working and adversely affect capital accumulation (why?).
- Interestingly, when the top tax bracket was cut from 70% to 50% in 1982 the share of tax paid by the top .5% of earners increased from 14% to over 20% of the total.