

## Chapter 9

# FISCAL POLICY

*Macroeconomics in Context, 4th edition (Goodwin, et al.)*

### Chapter Overview

This chapter introduces you to a formal analysis of fiscal policy, and puts it in context with real-world data and examples. The basic analysis you will be presented here follows the Keynesian model, although you will also learn about the “classical” or “supply-side” perspectives. You will gain an understanding of the federal budgets and how it affects the economy. The chapter clarifies the difference between automatic stabilizers and discretionary policy, and discusses recent fiscal policies in terms of their economic impact. Finally, the chapter introduces policy issues, including concepts of "crowding out" and "crowding in", different multiplier effects, and infrastructure and social investment, presenting examples from the Obama, Trump, and Biden administrations’ fiscal policy initiatives.

### Chapter Objectives

After reading and reviewing this chapter, you should be able to:

1. Understand the impact of changes in government spending, taxes, and transfers on aggregate expenditure and output.
2. Carry out calculations using “multipliers.”
3. Describe the major types of government outlays, and major government revenue sources.
4. Distinguish between government deficits and government debt.
5. Describe the recent history of U.S. debt and deficits, and the controversies surrounding them.
6. Discuss the issue of lags in fiscal policy, and the relative advantages and disadvantages of automatic and discretionary policies.
7. Distinguish between cyclical deficits and structural deficits.
8. Explain the macroeconomic policy implications of both crowding out and crowding in.

### Key Terms

fiscal policy

government spending (G)

transfer payments

disposable income

tax multiplier

proportional income tax

progressive income tax

balanced budget multiplier

net taxes

expansionary fiscal policy

contractionary fiscal policy

on-budget expenditures

appropriation (of federal funds)

budget surplus

budget deficit

deficit spending

countercyclical policy

procyclical policy

automatic stabilizers

cyclical deficit (surplus)

discretionary fiscal policy

time lags

government outlays  
government bond  
off-budget expenditures

structural deficit (surplus)  
supply-side economics  
crowding out  
crowding in

### Active Review

#### *Fill in the Blank*

1. If the government uses tax cuts to expand the economy, it would be using \_\_\_\_\_ policy.
2. Social security payments that are paid by the government to households are an example of a \_\_\_\_\_.
3. Suppose a household receives a wage income of \$4,000 a month, and receives \$400 in transfers and pays \$800 in taxes per month. Then the household's \_\_\_\_\_ income (the income after paying taxes and receiving transfers) would be equal to \$3,600 per month.
4. To determine the impact on a change in lump sum taxes on equilibrium output, one would use the tax multiplier, which equals \_\_\_\_\_.
5. If one were to increase government spending by \$50 million, and simultaneously raise taxes by \$50 million in order to keep the government budget in balance, one would discover that the \_\_\_\_\_ multiplier is equal to positive one.
6. Government spending on goods and services (such as new bridges and mass transit) and government transfer payments (such as unemployment compensation and food stamps) are two categories of government \_\_\_\_\_.
7. The government can finance its deficits by selling \_\_\_\_\_, which are essentially promises to pay back, with interest, the amount borrowed at a specific time in the future.
8. The progressive income tax and transfer payments such as unemployment compensation are examples of \_\_\_\_\_, because these tax and spending institutions increase government revenues and lower government outlays during an expansion (and decrease government revenues and raise government outlays during a contraction) thereby smoothing out the business cycle.
9. Suppose the Congress passes a stimulus package, but it takes time for recipients of the stimulus payments to spend the money. The effect may not be seen on the wider economy for a period of time, due to the presence of \_\_\_\_\_.
10. The policies that use tax cuts and other incentives in an attempt to increase work, saving and investment, and thereby overall economic output, are called \_\_\_\_\_ economics.

*True or False*

11. There is no way to expand an economy using fiscal policy without incurring (or increasing) a budget deficit.
12. With an *mpc* of 0.8, the multiplier for U.S. government spending is equal to a value of 5, and this value is a fairly accurate reflection of the multiplier in the real world.
13. A policy tool that can be used to fight inflation (brought about by excessive aggregate expenditure) is contractionary fiscal policy.
14. If  $T - (G + TR)$  is positive, there is a government budget surplus. If  $T - (G + TR)$  is negative, there is a government budget deficit.
15. The existence of budget deficits must mean that the government is conducting an expansionary fiscal policy.
16. The equation for aggregate expenditure with government in an open economy is:  $AE = C + I + G + NX$

*Short Answer*

17. What multiplier is used for calculating the change in output resulting from a change in government spending?
18. What are the three expansionary fiscal policy tools the government can use to expand an economy that is in a recession?
19. What are the three ways the government can finance its expenditures?
20. What are the largest two sources of federal revenues? What are the largest three categories of federal outlays?
21. What role does the size of the economy (GDP) have to play in whether or not a government deficit is burdensome to the economy?

22. What role did automatic stabilizers and discretionary fiscal policies have in the emergence of budget surpluses during the late 1990s?
23. Are tax cuts always directed at stimulating aggregate expenditure? Explain why some supply-siders think tax cuts may actually increase tax revenues.
24. Identify and describe the four types of inside lags as presented in the chapter.
25. Explain the difference between a cyclical deficit and a structural deficit.
26. Explain the difference between "crowding out" and "crowding in."

### **Problems**

1. Suppose in a simple economy with no foreign sector, the  $mpc$  equals 0.8. Intended investment spending has suddenly fallen, reducing  $AE$  and output to a level that is 100 million below  $Y^*$ .
  - a. If the government decided to try to get the economy back to full employment using only an increase in government spending ( $\Delta G$ ), by how much would  $G$  need to be increased?
  - b. If the government, instead, decided to try to get the economy back to full employment using only a lump-sum tax cut ( $\Delta T$ ), how big of a tax cut would be needed?
  - c. Alternatively, if the government decided to try to get the economy back to full employment using only an increase in transfers ( $\Delta TR$ ), how large would this increase need to be?

d. Which fiscal policy--increasing G, decreasing T, or increasing TR--would do the least amount of damage to the government budget deficit?

2. Suppose it was found that the *mpc* varied by income level in the following manner, with lower income households spending a greater portion of every dollar of income than higher income households.

Household income	<i>mpc</i>	<i>Income/spending multiplier</i>	<i>Tax multiplier</i>
0-\$30,000	0.9		
\$31,000 – 50,000	0.8		
\$51,000 – 80,000	0.75		
\$80,000 and above	0.6		

a. Calculate the government spending and tax multipliers for each income bracket, considered separately.

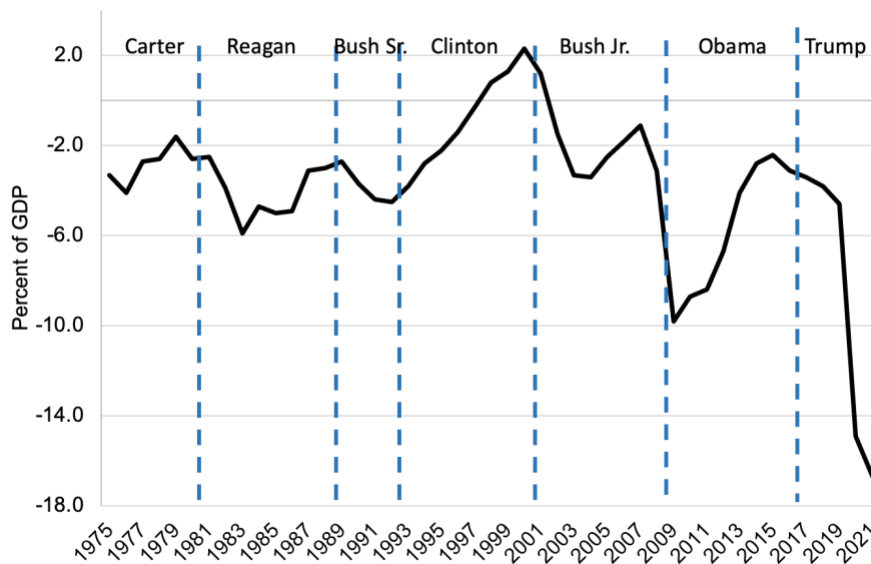
b. Suppose the government decided to use tax cuts to expand the economy, and was debating whether to direct tax cuts to high income households or low income households. Which choice would provide a greater stimulus? Thus, which would do the least amount of damage to the government budget deficit to achieve a given amount of stimulus?

(Note: Technically, while tax cuts can, by design of the policy, be targeted so that their initial impact is on the incomes of a particular group, the feedback effects represented by the multiplier probably in general depend on the *economy-wide average* value of the *mpc*. We abstract from this issue in this question.)

3. Assume a simple closed economy, with an  $mpc$  equal to 0.75. The government has passed a balanced budget amendment. The economy goes into a recession, so the government increases government spending by 40 million to try to expand the economy.
  - a. Calculate the change in output ( $\Delta Y$ ) from the increase in government spending ( $\Delta G$ ).
  - b. The balanced budget amendment requires the government to also raise taxes by 40 million. Calculate the change in output ( $\Delta Y$ ) from the tax hike.
  - c. What is the net effect on output from these two policies? Was there any expansionary effect?
  - d. Why is a balanced budget amendment problematic or undesirable?

4. Use the Figure below to answer the following questions:

**Federal Surplus or Deficit (as Percentage of GDP), 1975-2021**



- a. It is sometimes said that Republicans are the party of “small government,” whereas Democrats are the “big spenders” and the party of “big government.” Is this confirmed by the historical evidence of the 1975-2021 period?
- b. What changes in discretionary Government outlays ( $G$ ,  $TR$ ) and Tax revenues ( $T$ ) might explain the emergence of the huge deficits under Reagan, G. Bush Sr., G.W. Bush Jr, Obama and Trump years? And what might explain the surpluses under Clinton?
- c. Are changes in discretionary fiscal policy sufficient in explaining the emergence of deficits and surpluses? What role do automatic stabilizers play? Consider in your answer the figure of the U.S. real GDP growth rate, below.



- d. When Clinton came into office, he increased taxes (the top income bracket was raised somewhat) and cut government spending. These are both considered to be contractionary fiscal policies. And yet the economy boomed. What could explain this? Could the surpluses under his administration come about only from his discretionary fiscal policies?

- e. The G.W. Bush Jr. administration increased government spending and passed sizeable tax cuts, primarily benefitting the rich. Critics argue that these tax cuts will only lead to deficits and do little to stimulate the economy. Explain their point of view.
  
- f. The Obama Stimulus package consisted of tax cuts and increased government spending on education, health care, unemployment benefits, and job creation. What was the impact of this large expansionary fiscal policy on the economy?
  
- g. What factors explain the sharp increase in deficits during the Trump years?

### Self Test

1. Fiscal policy refers to ...
  - A. control of the money supply
  - B. decisions to alter market interest rates
  - C. government spending and taxation decisions
  - D. control of inflation rate
  - E. none of these
  
2. Which of the following is *not* a component of aggregate expenditure?
  - A. consumption
  - B. unsold inventories
  - C. intended investment
  - D. government spending
  - E. all of these are components of aggregate expenditure
  
3. Suppose in a simple economy with no foreign sector, the *mpc* is equal to 0.75. How much government spending ( $\Delta G$ ) would be needed to raise output by 100 million?
  - A. 25 million
  - B. 133.3 million
  - C. 75 million
  - D. 400 million
  - E. None of the above



4. Which of the following is *not* an example of a transfer payment?
- Welfare payments to firms or individuals
  - Social Security payments
  - Unemployment compensation
  - A corporate tax cut
  - Payments of interest to holders of government bonds.
5. Suppose in a simple economy with no foreign sector, the *mpc* is equal to 0.9. How much of a lump sum tax ( $\Delta T$ ) would be needed to raise output by 100 million?
- 10 million
  - 11.1 million
  - 111.1 million
  - 900 million
  - None of the above
6. Suppose in a simple economy with no foreign sector, the *mpc* is equal to 0.8. If the government increased government spending by \$30 million, and it simultaneously raised taxes by \$30 million, how much will be the change in output ( $\Delta Y$ )?
- Output will increase by \$15 million
  - Output will increase by \$30 million
  - There will be no change in output
  - Output will decrease by \$30 million
  - None of the above
7. Government outlays ...
- are the sum of government spending and government transfer payments.
  - are always greater than government revenues
  - must, by law, exactly equal government revenues
  - are generally less than government revenues
  - none of these
8. Which of the following is *not* an example of a government outlay?
- Government spending on a national health care system
  - Government spending on light rail systems and bicycle paths
  - Housing subsidies for low-income households
  - Tax cuts for wind and solar energy producers
  - Child care vouchers for working single parents

9. Which of the following was one of the major sources of federal revenues in 2021?
- A. Personal income taxes
  - B. Corporate income taxes
  - C. Excise and estate taxes
  - D. Both A and B
  - E. None of the above
10. Which of the following was among the largest category of government spending in 2021?
- A. Income security, social services, housing and community development
  - B. Defense spending
  - C. Social security and Medicare
  - D. Net interest on the debt
  - E. Both A. and C.
11. Procyclical policy ...
- A. refers to the use of fiscal policy to improve the performance of the U.S. economy
  - B. refers to state/local governments tendency to exacerbate the business cycle.
  - C. refers to Federal Reserve policy designed to minimize economic downturns
  - D. refers to Chamber of Commerce efforts to encourage households to shop locally
  - E. none of these are descriptions of procyclical policy
12. During what period of time did the U.S. experience federal government budget surpluses?
- A. 1993 – 1997
  - B. 1998 – 2001
  - C. 2002 – 2008
  - D. 2009 – 2017
  - E. 2018 - 2021
13. Which of the following was responsible for the huge deficit between 2017 and 2021?
- A. The COVID-19 related recession
  - B. The 2017 Trump tax cuts
  - C. The increased government spending of the Trump administration
  - D. The CARES Act adopted in March 2020
  - E. All of the above.

14. The President drafts a budget proposal with new tax cuts and increases in government spending, and has it passed by Congress. This would be an example of:
- A. Automatic stabilizers
  - B. Discretionary policy
  - C. Contractionary fiscal policy
  - D. Supply side policy
  - E. None of the above.
15. Which of the following is *not* an example of an inside time lag?
- A. data lag
  - B. recognition lag
  - C. legislative lag
  - D. transmission lag
  - E. response lag
16. The Obama Stimulus Program ...
- A. is also known as the "American Recovery and Reinvestment Act."
  - B. added more than three million jobs according to the Congressional Budget Office
  - C. probably averted a 21<sup>st</sup> century "Great Depression" according to some economists
  - D. amounted to a major expansionary fiscal policy
  - E. all of these statements are accurate
17. The historical evidence of the supply side tax cuts (of the Reagan administration in the 1980s and Bush in the 2000s) is that:
- A. they were successful in increasing output, increasing tax revenues, and lowering deficits.
  - B. they led to lower tax revenues and higher deficits.
  - C. they left output, tax revenues, and deficits unchanged.
  - D. while the Reagan tax cuts were successful in increasing tax revenues and lowering deficits, those of the Bush administration were not.
  - E. None of the above.
18. Crowding out refers to ...
- A. intended investment squeezing unsold inventories
  - B. excess consumer spending competing with foreign demand for U.S. goods
  - C. the demand for exports making U.S. goods for expensive for consumers
  - D. government borrowing reducing the availability of private capital
  - E. none of these

19. Table 9.2 (Different Multiplier Effects) suggests that ...
- A. making the Bush income tax cuts permanent would have the biggest tax cut impact
  - B. a payroll tax holiday is not a very effective tax cut strategy
  - C. temporarily increasing food stamps is more effective than any permanent tax cut
  - D. cutting the corporate tax rate has a bigger impact than ANY other tax cut
  - E. none of these statements are accurate
20. Which of the following statements about the Biden administration's fiscal policy initiatives is FALSE?
- A. It focuses on improving the nation's infrastructure, such as broadband, and water and energy systems
  - B. It focuses on improving social conditions including childcare and housing.
  - C. Reduces taxes for large corporations with an incentive to encourage business investment.
  - D. Climate policy is a major component of the initiative with specific focus on reducing greenhouse gas emissions.
  - E. Includes incentives to switch to renewable energy sources and driving electric cars.

## Answers to Active Review Questions

1. fiscal
2. transfer payment
3. disposable
4.  $-(mult)(mpc)$
5. balanced budget
6. outlays
7. government bonds
8. automatic stabilizers
9. outside lag
10. supply side
11. False. It is still possible to expand an economy with a balanced budget. The balanced budget multiplier equals 1.
12. False. In the real world the multiplier is rarely this large. Econometric studies of the U.S. economy have suggested the multiplier is 2.0 or lower.
13. True.
14. True.
15. False. The existence of deficits does not necessarily mean an expansionary fiscal policy is being implemented. It could be that the economy is going through a downturn, so the automatic stabilizers are kicking in, with government outlays increasing and tax revenues declining.
16. False. It is:  $AE = C + I_r + G + NX$
17. The multiplier used in this case is the same as the multiplier introduced in chapter 8:  
multiplier =  $1/(1-mpc)$
18. The government could increase government spending, increase transfer payments, or cut taxes.
19. It can either raise taxes, borrow, or print money.
20. The two largest sources of federal revenues are: personal income taxes and social security taxes. The three largest categories of federal outlays are: Social security and Medicare, social programs, and defense spending.
21. The larger the economy, the easier it is to handle a deficit. A larger economy means higher incomes, and a greater ability for the government to collect tax revenues or sell government bonds to finance its deficit.
22. As the economy boomed, the automatic stabilizers kicked in and tax revenues rose. The Clinton administration also used discretionary policy, by raising taxes and thereby raising revenues that helped turn deficits into surpluses.
23. No, tax cuts have also been a component of supply-side policy, which attempts to use tax cuts to stimulate work, saving, investment, and thereby output. Some supply-siders think that the growth in output can actually lead to an increase of tax revenues into the government coffers.
24. The four types of inside lags presented in the chapter include: data lags, recognition lags, legislative lags, and transmission lags.
25. A cyclical deficit is caused by fluctuations in the business cycle while a structural deficit is the result of tax and spending policy decisions.
26. "Crowding out" is a reduction in the availability of private capital resulting from federal

borrowing. “Crowding in” occurs when government spending boosts expectations and therefore induces intended investment.

### Answers to Problems

1.

a. the income/spending multiplier =  $1/(1 - 0.8) = 5$

So solving for  $\Delta Y = \text{mult} \times \Delta G$ ,

100 million =  $5 \times \Delta G$

$\Delta G = 20$  million

b. now we need to use the tax multiplier, - *mpc (mult)*

So solving for  $\Delta Y = -\text{mpc (mult)} \times \Delta T$

100 million =  $-0.8 \times 5 \times \Delta T$

$\Delta T = 100 \text{ million} / -4$

$\Delta T = -25$  million (a tax cut of 25 million would be needed)

c. the calculation is like part b, above, except instead of  $\Delta T$  we have  $\Delta TR$ . Thus, transfers of +25 million would be needed.

d. Increasing *G* (government spending) would do the least damage to the deficit, raising it by 20 million, rather than 25 million.

2.

a.

Household income	<i>mpc</i>	<i>Income/spending multiplier</i>	<i>Tax multiplier</i>
0-\$30,000	0.9	10	9
\$31,000 – 50,000	0.8	5	4
\$51,000 – 80,000	0.75	4	3
\$80,000 and above	0.6	2.5	1.5

b. Directing the spending increase or tax cuts to the lower income households would provide a greater stimulus, because it has a higher tax multiplier. Thus, it would do less damage to the budget deficit to achieve a given amount of stimulus. In other words, if the government directed tax cuts to the low-income households, it would need a smaller tax cut to expand the economy by a given amount, and this would do less damage to the deficit.

(Note: If one takes into account that *mult* may depend on an economy-wide average *mpc*, this answer would still be correct, but the difference would not be as large.)

3.
  - a. the income/spending multiplier =  $1/(1-0.75) = 4$   
 $\Delta Y = \text{mult} \times \Delta G$   
 $\Delta Y = 4 \times 40 \text{ million}$   
 $\Delta Y = 160 \text{ million}$
  - b. the tax multiplier =  $-0.75 (4) = -3$   
 $\Delta Y = -3 \times \Delta T$   
 $\Delta Y = -3 \times 40 \text{ million} = -120 \text{ million}$
  - c. The net effect of the two policies is:  
 $\Delta Y (a + b) = 160 \text{ million} - 120 \text{ million}$   
 $\Delta Y (a + b) = 40 \text{ million}$   
 Yes, it expanded output by 40 million
  - d. A balanced budget rule means that one can't respond to severe emergencies, such as a natural disaster, war, or deal with a severe recession. Because the multiplier is only equal to one, it provides a fairly weak stimulus.
  
4.
  - a. A large deficit was created during the Obama years, when the government responded to the deep economic crisis of 2008 with large increase in spending and tax cuts; this raised the government deficit. An even larger deficit was created during the Trump years, with the implementation of the Tax Cut and Jobs Act followed by the stimulus package (CARES Act) for relief from the COVID-19 pandemic related recession. Even in the years before 2008, the Republicans (Reagan, G. Bush Sr., G.W. Bush Jr.) appear to be the big spenders, with their accumulation large deficits. The only period with some surplus and relatively low deficits occurred during the Clinton administration.
  - b. The emergence of the huge deficits under Reagan, G. Bush Sr., G.W. Bush Jr., Obama, and Trump could be from increasing government outlays ( $G$  and  $TR$ ), and/or cutting taxes ( $T$ ). The surpluses under Clinton could be from cutting government outlays ( $G$  and  $TR$ ), and/or raising taxes ( $T$ ).
  - c. No, changes in discretionary fiscal policy are not sufficient in explaining the emergence of deficits and surpluses, because a recessionary economy could trigger automatic stabilizers (increases in  $G$  and  $TR$ , and falling tax revenues), whereas a booming economy could bring forth increases in tax revenues and cuts in government outlays. Indeed, the figure of the U.S. real GDP growth shows a deep recession in 1981-82, 2008 and 2020 which could help explain the emergence of deficits in the early Reagan period as well as during the Obama and Trump years. And the figure shows strong growth rates in the late 1990s, which could help explain the emergence of surpluses under Clinton.

- d. The economy under Clinton could have boomed for other reasons, such as the increased investor and consumer confidence, leading to increases in investment and consumption spending. There is also evidence that the easy availability of credit and low interest rates during this period encouraged a lot of spending that was based on borrowing under risky conditions. These could have outweighed the contractionary effect of his fiscal policies. The surpluses came about not only from the tax increases of his discretionary policies, but also from the booming economy, which brought in increases in tax revenues as the automatic stabilizers kicked in.
- e. The tax cuts for the rich will do little to stimulate the economy because they are directed to households with relatively lower *mpcs*, and thus have a smaller multiplier effect.
- f. The large expansionary fiscal policy during the Obama years added to the overall government debt and the immediate impact was not clear as the 2008 recession was severe, but empirical evidence shows that the stimulus prevented the economy from going into a deep recession created millions of jobs.
- g. The increase in deficits during the Trump years is partly explained by the 2017 Trump tax cuts that largely benefitted corporations and wealthy individuals. The high levels of government spending as well as the stimulus package passed in 2020 to address the COVID-19 pandemic all added to the deficit during Trump years.

### Answers to Self Test Questions

- |       |       |
|-------|-------|
| 1. C  | 11. B |
| 2. B  | 12. B |
| 3. A  | 13. E |
| 4. D  | 14. B |
| 5. B  | 15. E |
| 6. B  | 16. E |
| 7. A  | 17. B |
| 8. D  | 18. D |
| 9. A  | 19. C |
| 10. E | 20. C |