

## **Module C: Fiscal Policy and Budget Deficits**

**Note:** This feature provides supplementary analysis for the material in Part 3 of *Common Sense Economics*.

Fiscal and monetary policies are the two major tools available to policy makers to alter total demand, output, and employment. This feature will focus on fiscal policy, what it is and its potential and limitations as a tool with which to promote economic stability and strong growth.

### **What is Fiscal Policy?**

When the supply of money is held constant, government expenditures must be financed by either taxes or borrowing. Fiscal policy involves the use of the government's spending, taxing and borrowing policies. The government's budget deficit is used to evaluate the direction of fiscal policy.

When the government increases its spending and/or reduces taxes, this will shift the government budget toward a deficit. If the government runs a deficit, it will have to borrow funds to cover the excess of its spending relative to revenue. Larger budget deficits and increased borrowing are indicative of expansionary fiscal policy. In contrast, if the government reduces its spending and/or increases taxes, this would shift the budget toward a surplus. The budget surplus would reduce the government's outstanding debt. Shifts toward budget surpluses and less borrowing are indicative of restrictive fiscal policy.

It is important to note that a budget deficit is different from the national debt. A deficit occurs when government spending exceeds revenue during a period such as a year or a quarter. A deficit will increase the size of the national debt. Put another way, the deficit adds to the outstanding stock of IOUs issued by the U.S. Government. Conversely, a budget surplus will make it possible for the government to reduce the national debt -- the total amount it owes to those holding Treasury bonds and bills.

### **Keynesian View of Fiscal Policy**

The English economist, John Maynard Keynes (pronounced “canes”) popularized the use of fiscal policy as a stabilization tool. Writing during the Great Depression of the 1930s, Keynes argued that output and employment were well below their potential because there was insufficient total demand. If demand could be increased, output and employment could be expanded and the economy would return to its full employment potential. Moreover, Keynes believed this could be achieved with expansionary fiscal policy.

During a recession, Keynes argued that, rather than balancing its budget, the government should increase its spending, reduce taxes, and shift its budget toward a deficit. According to Keynes, higher levels of government spending would directly increase total demand. Further, lower taxes would increase the after-tax incomes of households and they would spend most of that additional income, which would also stimulate total demand. Thus, the Keynesian prescription to cure a recession was a larger budget deficit.

In contrast, if the economy was experiencing a problem with inflation during an economic boom, Keynesian analysis called for restrictive fiscal policy to temper excessive demand. In this case, reductions in government spending, higher taxes, and a shift of the budget toward a surplus would reduce total demand and thereby help to fight inflation.

Thus, Keynes rejected the view that the government’s budget should be balanced. He argued that appropriate budgetary policy was dependent on economic conditions. According to the Keynesian view, governments should run budget deficits during recessionary times and surpluses during periods when inflation was a problem because of excessive demand.

### **Can Fiscal Policy Be Used to Reduce Economic Instability?**

The Keynesian view of fiscal policy swept the economics profession and, by the 1960s, it was also widely accepted by policy makers. During that era, most economists believed that fiscal policy exerted a powerful impact on the economy and that it could be instituted in a manner that would smooth the ups and downs of the business cycle.

However, this is more difficult than was initially perceived. If changes in fiscal policy are going to exert a stabilizing impact on the economy, they must be timed correctly. Proper timing of fiscal changes is difficult. There will be a time lag between when an economy is dipping into a recession and when policy-makers figure out what is happening and what to do. It will also take time to develop a fiscal package on which the majority will agree and pass it through Congress. Finally, there will also be a time lag between when additional government spending is passed and when contracts are extended and the spending actually occurs. The combination of these time lags is long and variable, typically 12 to 24 months.

Given these time lags, if fiscal policy is going to exert a stabilizing influence, policy makers need to know what economic conditions are going to be like 12 to 24 months in the future. But this is a big problem. The ability to forecast when the economy is about to dip into a recession or experience an economic boom is extremely limited. Therefore, in a world of dynamic change and unpredictable events, macroeconomic policy-making is a little bit like lobbing a ball at a target that often moves in unforeseen directions. Predictably, policy-making errors will occur. Sometimes fiscal policy changes will end up adding stimulus during periods of strong demand and restraint during periods of recession. Changes of this type would add to, rather than reduce, economic instability.

Because of these timing problems, most economists, including many Keynesians, now believe that it is a mistake for policy makers to be constantly changing fiscal policy in response to minor changes in economic conditions. Such constant changes are likely to be timed incorrectly and add to the uncertainty with regard to future business conditions. Put another way, it is unrealistic to expect that political decision-makers will consistently alter fiscal policy in a manner that will add stimulus during recessions and restraint during inflationary booms.

### **Automatic Stabilizers**

However, there are a few fiscal programs that tend automatically to apply demand stimulus during a recession and demand restraint during an economic boom. Programs of this type are called automatic stabilizers. They are automatic in that, without any new

legislative action, they tend to increase the budget deficit (or reduce the surplus) during a recession and increase the surplus (or reduce the deficit) during an economic boom.

The unemployment compensation system provides an example. This system levies a payroll tax on employment and uses the revenues to provide benefits to workers who are unemployed. When an economy begins to dip into a recession, the government will pay out more money in unemployment benefits as the number of laid-off and unemployed workers expands. Simultaneously, the revenues derived from the employment tax will decline because fewer workers are paying into the system. Therefore, this program will automatically run a deficit during a recession. In contrast, during an economic boom, the tax receipts from the program will increase because more people are now working, and the amount paid out in benefits will decline because fewer people are unemployed. As a result, the program will automatically tend to run a surplus during good times. Thus, without any legislative action, the unemployment compensation system will tend to shift the budget toward a deficit during a recession and toward a surplus during a boom.

The corporate income tax and progressive nature of the personal income tax also tend to act as automatic stabilizers. Automatic stabilizers minimize the problem of appropriate timing. They help keep the economy on track even without any legislative action. They are important because they shift the budget toward deficit during recessions and surplus during booms without having to depend on politicians to time a policy change in an appropriate manner.

### **Current Debate About the Potency of Fiscal Policy**

Will increases in government spending, reductions in taxes, and large budget deficits stimulate output and employment? Fifty years ago during the heyday of Keynesian economics, most all economists believed that expansionary fiscal policy exerted a strong impact on total demand and output. But this is no longer the case. Today, many economists argue that there are important incentive and secondary effects that largely erode the potency of expansionary fiscal policy.

There are two major reasons why Keynesian critics believe that expansionary fiscal policy is not very potent. First, there is the interest rate effect. Budget deficits will have to be financed by increased borrowing. But when the government borrows more in

the loanable funds market, this will increase interest rates. In turn, the higher interest rates will “crowd out” private investment and consumption and this reduction in private spending will largely, if not entirely, offset the stimulus effects of the increase in government spending. Second, other non-Keynesians stress that the budget deficits will result in a larger government debt and higher taxes to cover the interest costs. These economists believe that the expectation of the higher future taxes will dampen private spending and thereby offset the stimulus effects of deficit spending.

The potency of expansionary fiscal policy is a hot topic of current debate among economists. Even though they recognize that it is extremely difficult to time fiscal changes correctly, modern Keynesians believe that increased government spending and enlarged budget deficits will help promote recovery from a serious recession like that of 2008-2009. On the other hand, many non-Keynesians argue that higher interest rates and expected future taxes accompanying the higher levels of government borrowing will largely offset the expansionary impact of the budget deficits. Even if the government is able to borrow at low interest rates during a recession, as was the case during 2008-2009, some combination of higher interest rates and higher taxes will be required for the financing and re-financing of the larger debt as the economy recovers. Non-Keynesians believe that these higher interest rates and tax rates will reduce private investment, weaken the recovery, and lead to a slower rate of long-term growth.

It is interesting to observe the response to the 2008-2009 recession. During 2009-2011, the United States ran budget deficits of nearly 10 percent of GDP, levels only present in the midst of World War II. Keynesian analysis indicates that these large deficits would exert a powerful impact on total demand and help propel the economy to a strong recovery. This did not happen. In fact, the recovery from the 2008-2009 recession was the weakest of the post-World War II era. But, this did not resolve the debate about the potency of fiscal policy. Keynesians merely argued that the recession would have been deeper and the recovery weaker if the government had not run the large deficits. Thus, the potency of budget deficits is a continuing topic of debate among economists.

## **Tax Cuts Versus Spending Increases**

When using expansionary fiscal policy to promote recovery from a recession, would it be better to reduce tax rates or increase government spending? There are at least four reasons why a tax cut is likely to be more effective than a spending increase as a tool with which to promote recovery and long-term growth.

*First, a tax cut will generally stimulate aggregate demand more rapidly.* As recent experience illustrates, the federal government is able to get checks to people in just two or three months. Even if a substantial portion of the funds is not spent quickly, there will be an immediate positive impact on the financial position of households. In contrast, spending projects are often a lengthy process spread over several years. For example, the Congressional Budget Office estimated that only 15 percent of the spending funded by the stimulus package passed in February 2009 would occur during the initial year while nearly half (48 percent) would not be spent until 2011 and beyond.

*Second, compared to an increase in government spending, a tax cut is less likely to increase structural unemployment and reduce the productivity of resources.* New government spending programs generally change the structure of total demand more than a tax cut. Other things constant, larger changes in the composition of demand will mean more unemployment, at least in the short run. Moreover, the additional government spending is likely to be less productive. Government has a tendency to become heavily involved in allocating scarce resources through spending programs that favor sectors, businesses, and interest groups. By contrast, households will tend to purchase items that are valued more than the cost of producing them when their spending increases as the result of lower taxes.

*Third, a tax cut will be easier to reverse once the economy has recovered.* Once started, the interests undertaking a government project and benefiting from it will lobby for its continuation. Therefore spending projects started during a crisis are likely to continue long after the crisis is history.

*Fourth, a reduction in tax rates will increase the incentive to earn, invest, engage in business activity, and employ others.* From a supply-side view, the marginal tax rate imposed on income is particularly important. The marginal tax rate determines the breakdown of a person's additional income between tax payments on the one hand and

personal income on the other. Lower marginal tax rates mean that individuals get to keep a larger share of their additional earnings. This incentive effect will encourage more productive activity and help speed a recessionary economy toward recovery.

### **Concluding Thoughts**

During the past 70 years, views about fiscal policy have come full circle. Prior to the Keynesian Revolution, it was widely believed that governments should balance their budget during times of peace. Keynes changed all of this and, by the 1960s, fiscal policy was perceived of as a powerful tool that could be used effectively to reduce economic fluctuations. But during the past four decades, both analysis of political incentives and real world experiences have convinced many economists that it is unrealistic to expect political decision-makers to institute fiscal changes in a stabilizing manner. Greater recognition of the secondary effects of budget deficits has also caused many to question the potency of fiscal policy. Further, the persistence of large budget deficits and growth of government debt as a share of the total economy has generated fears that, if unconstrained, the political process will result in excessive debt that will threaten the solvency of even wealthy countries like the United States, Japan, and those of Western Europe. As we have noted, debate continues with regard to how fiscal policy can best be used to promote growth and prosperity. But once again, many economists, particularly those with expertise in public choice, are now calling for something like a balanced budget constraint as a means to control government spending, excessive debt, and the political incentive structure that undermines the sound use of fiscal policy. For an analysis of how the political incentive structure promotes debt financing, See, *Common Sense Economics*, Part 3, Element 6, “Unless restrained by constitutional rules, legislators will run deficits and spend excessively.”

**Short response questions**

1. Can fiscal policy changes be instituted in a manner that will reduce economic fluctuations? Explain.
2. Will increases in government spending financed by borrowing help promote recovery from a recession? Why or why not?
3. If there is a shift to a more expansionary fiscal policy during a recession, does it make any difference whether tax rates are cut or government expenditures are increased? Explain your answer.

**The answer key is available to instructors who adopt *Common Sense Economics* (St. Martin's Press). Details on how to adopt are provided at: <http://commonsenseeconomics.com/adopt>**