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Economic Policy

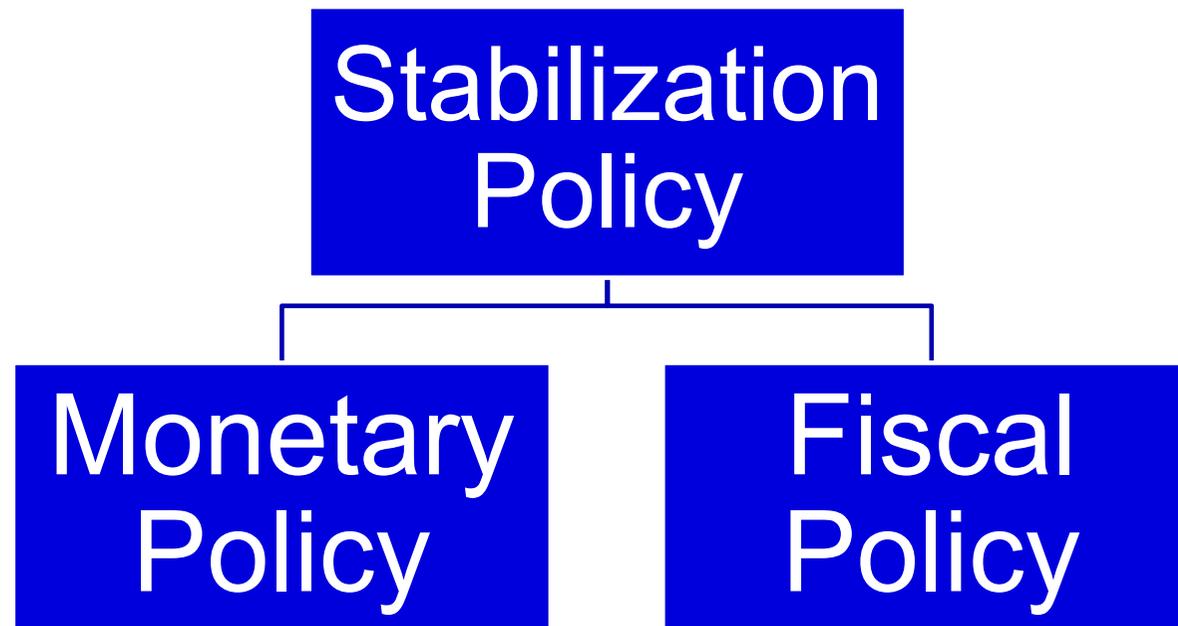
Fiscal Policy

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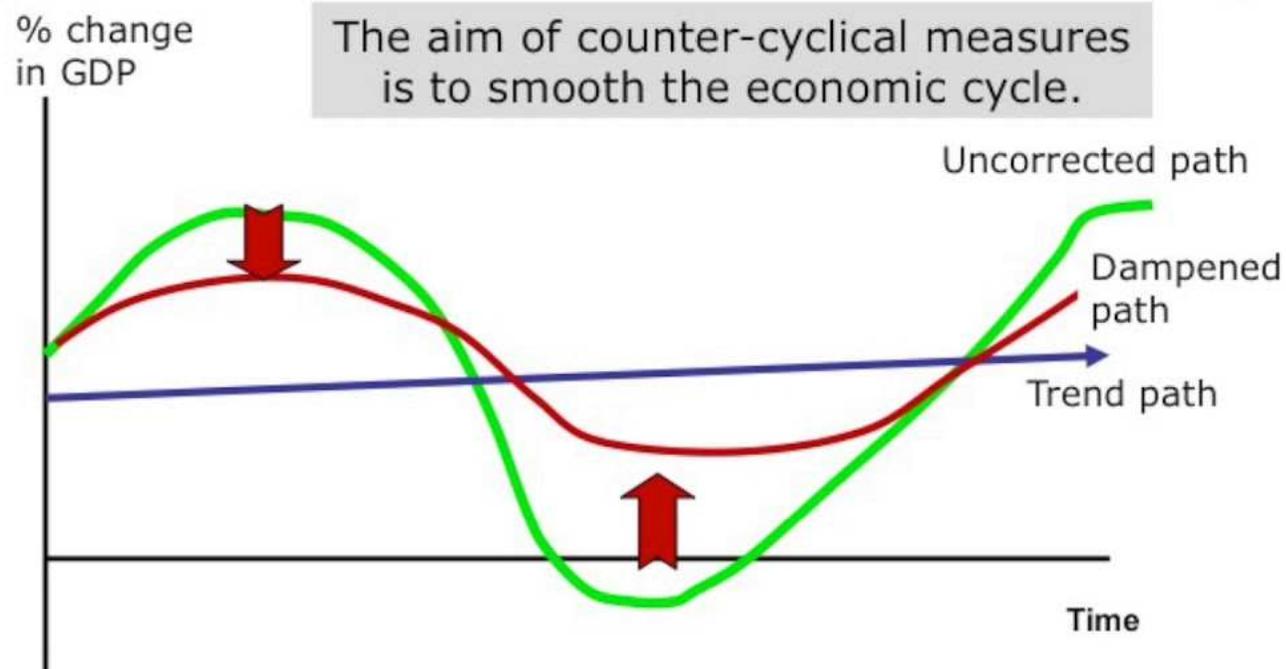
- Stabilization policy
- Concepts of fiscal policy
- Theories: Keynesian vs. neo-classical view
- FP during crisis
- Public debt
 - measurement
 - debt and deficit dynamics
 - how to reduce the debt burden
- Fiscal rules

Stabilization Policy

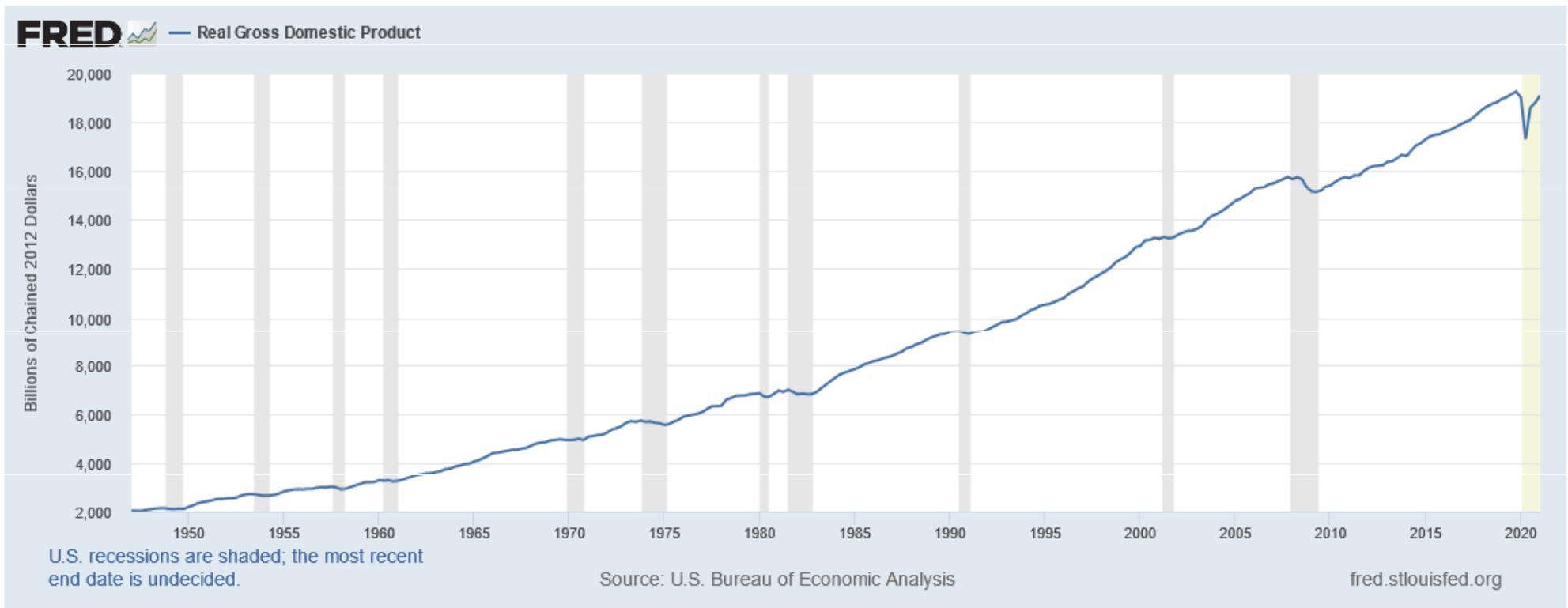
- aim: maintain a healthy level of economic growth and minimal price changes; to **smooth** the **economic cycle**



Stabilization Policy



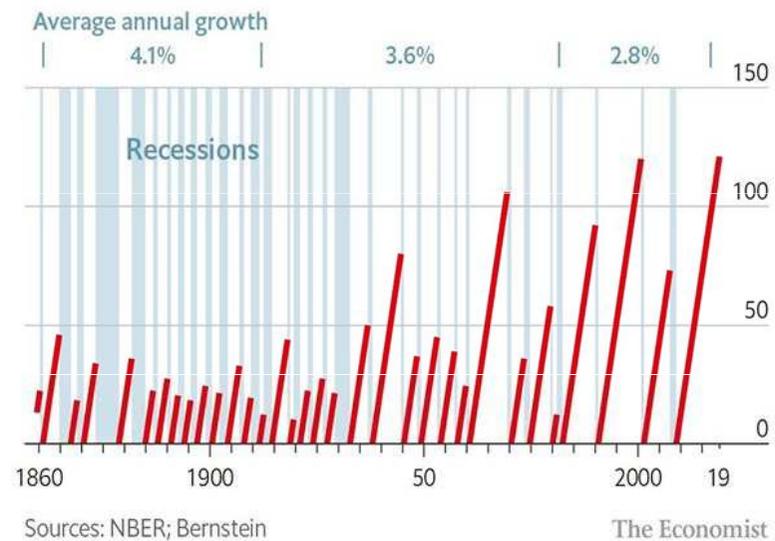
Stabilization Policy



Stabilization Policy

The length of US economic expansions over the past 150 years

Economic expansions, months



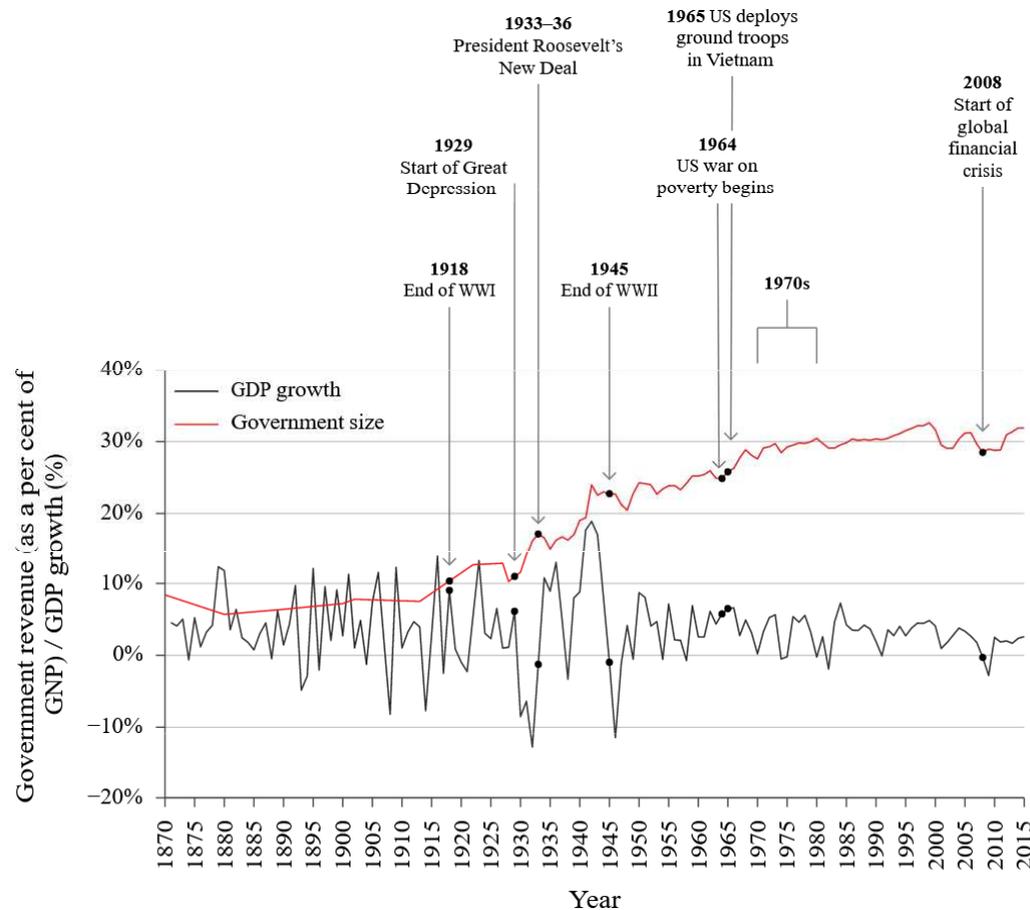
Three key facts about economic fluctuations

- Fact 1: Economic fluctuations are irregular and unpredictable
- Fact 2: Most macroeconomic quantities fluctuate together
 - e.g., investment, unemployment, consumption
- Fact 3: As output falls, unemployment rises

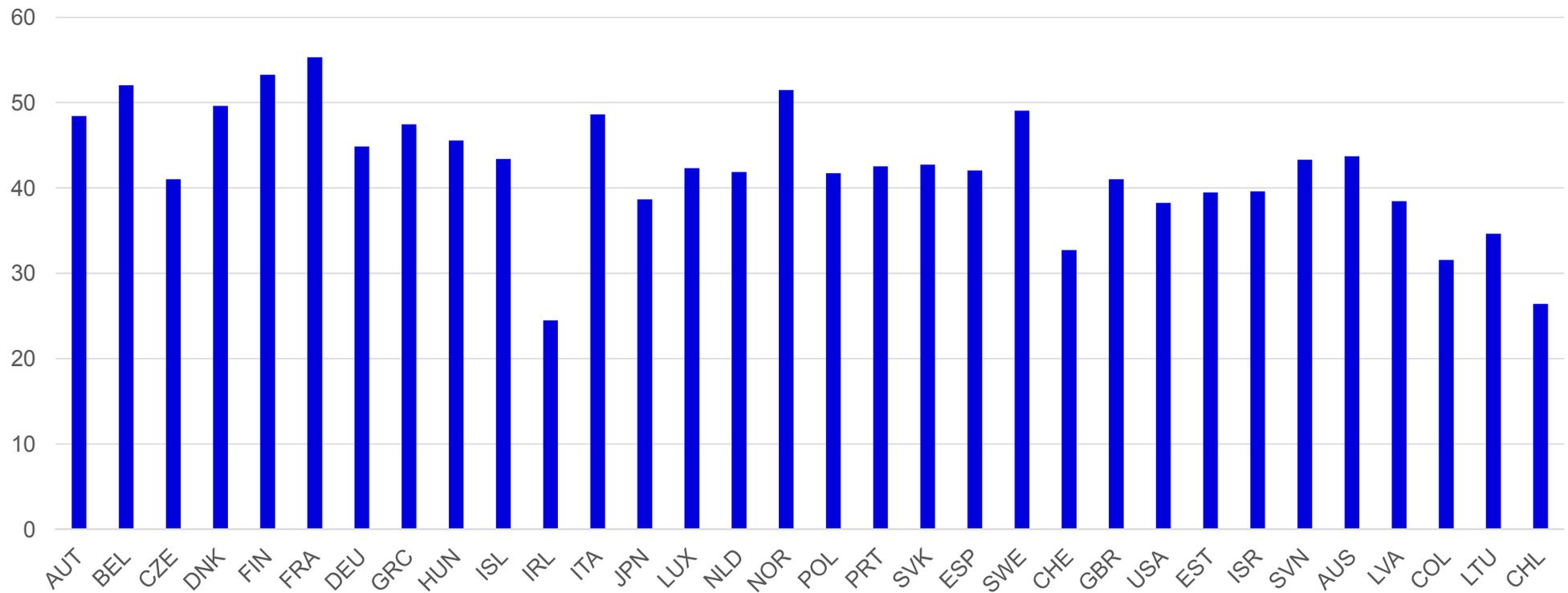
Concepts and measurements

- **Fiscal policy** (FP) – set of decisions and rules regarding taxes and public expenditures for purposes of smoothing the fluctuations of economic cycle in order to keep unemployment close to its equilibrium value and avoid the build-up of deflationary and inflationary pressures (Samuelson, 1948)
- Theoretically inspired by J.M. Keynes
- Now in many countries the key point of FP is public debt sustainability.

Fluctuations in output and the size of government in the US (1870–2015)



Public expenditures in various countries (% of GDP)



Keynesian view: AS – AD model

- macroeconomic model that explains price level and output through the relationship between AD and AS
- aggregate demand
 - total amount of demand for goods and services produced in the economy
 - combinations of price level and level of output (GDP)
 - AD slopes downward
 - The Wealth Effect (when prices fall consumers are wealthier which encourages to spend more)
 - The Interest-Rate Effect (lower price level reduces the interest rate which encourages greater spending on investment goods)
 - The Exchange-Rate Effect (lower interest-rate depreciate the real exchange rate which stimulates exports)

Keynesian view: AS – AD model

- long-run aggregate supply

- determines the quantity of goods and services supplied in the long run
- in the long run it depends on labour, capital, natural resources and technology

- short-run aggregate supply

- combination of price level and level of goods and services supplied in the short run

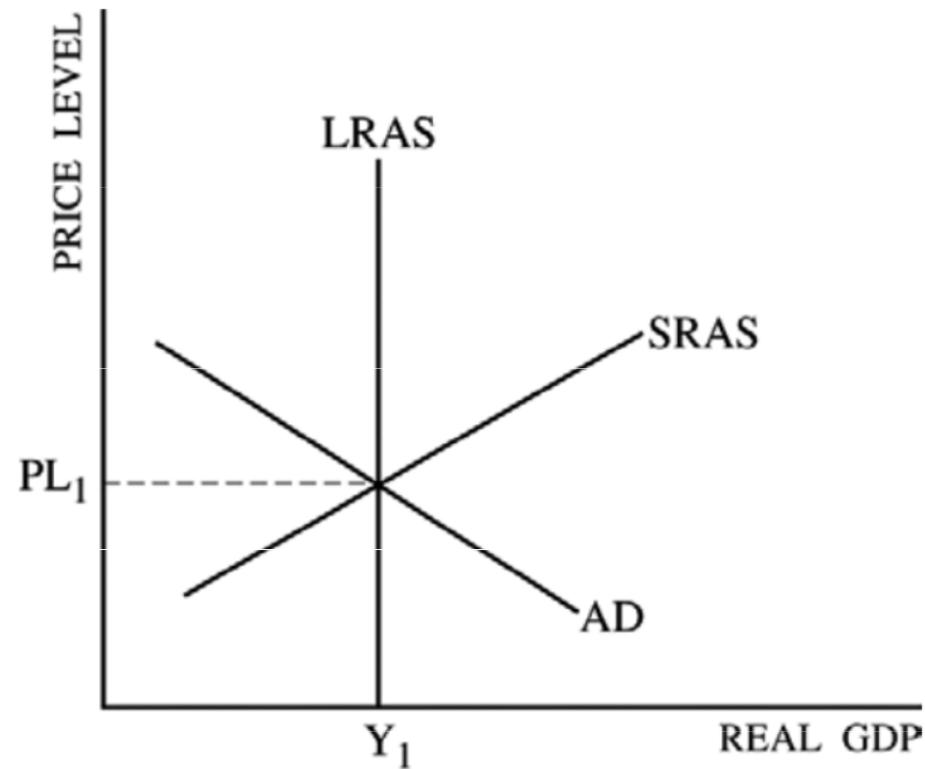
- SRAS slopes upward

The Sticky-Wage Theory (nominal wages are slow to adjust, or are „rigid“ in the short run)

The Sticky-Price Theory (prices of some goods and services are slow to adjust in the short run)

The Misperceptions Theory (lower price level causes misperceptions about relative prices; these misperceptions induce suppliers to respond to the lower price level by decreasing the quantity of goods and services supplied)

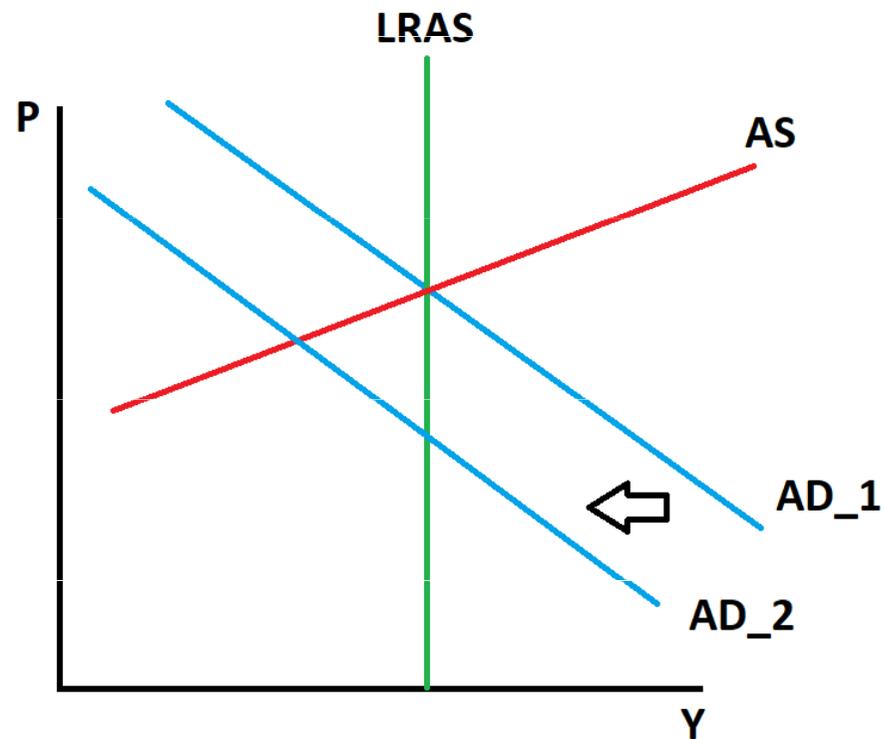
Keynesian view: AS – AD model



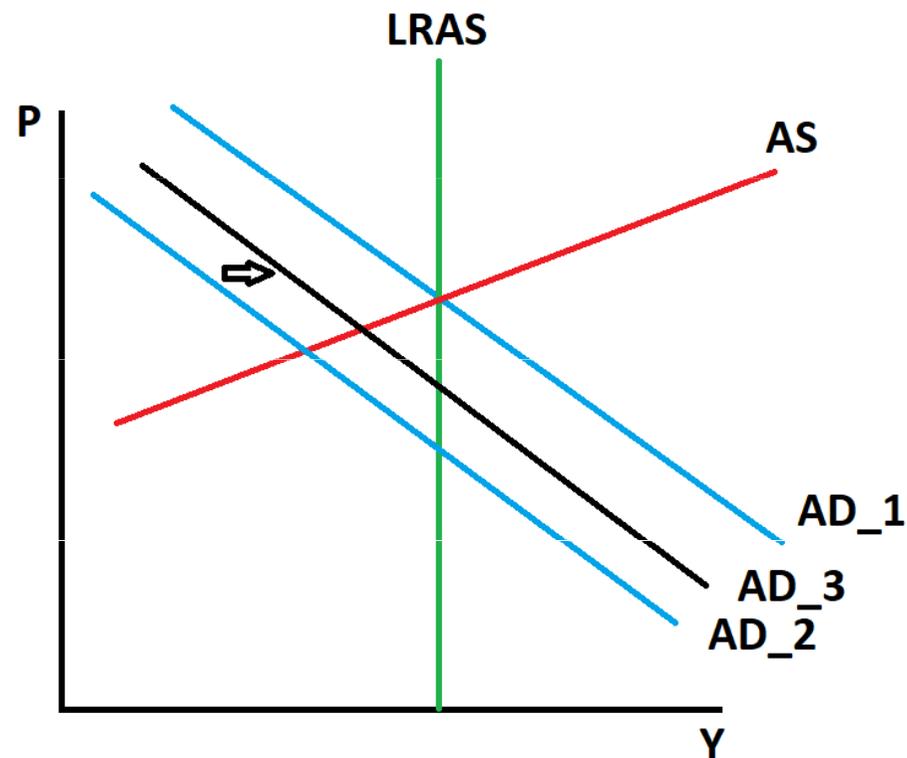
Economic Fluctuations in AS – AD model

- suppose a wave of pessimism in the economy
- people lose confidence in the future
 - ⇒ households cut back on their spending
 - ⇒ firms put off buying new equipment
- fall in AD
 - ⇒ decrease of output
 - ⇒ decrease in prices

Economic Fluctuations in AS – AD model

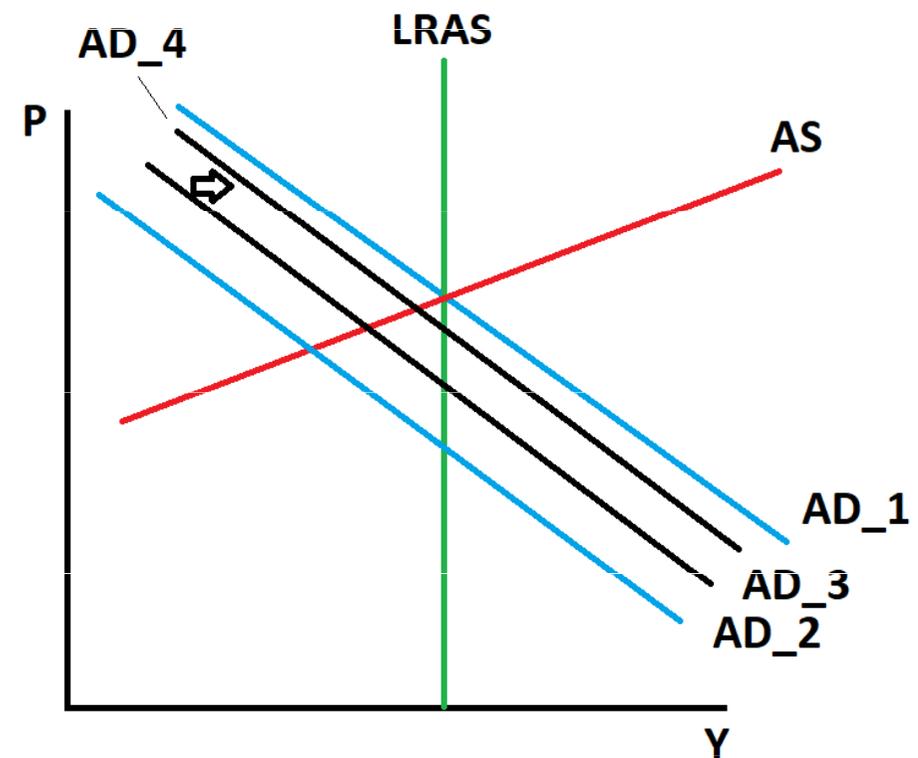


The role of government in AS – AD model



Multiplier

- The US government buys \$20 billion of goods from Boeing => increase in employment and profits of Boeing.
- Workers and firm owners see higher profits, they respond to this increase in income by raising their own spending.
- Increase in government spending => increase the demand for the products of many firms in the economy.
- **Multiplier** = „The additional **shifts** in **aggregate demand** that result when expansionary fiscal policy increases consumer spending“.



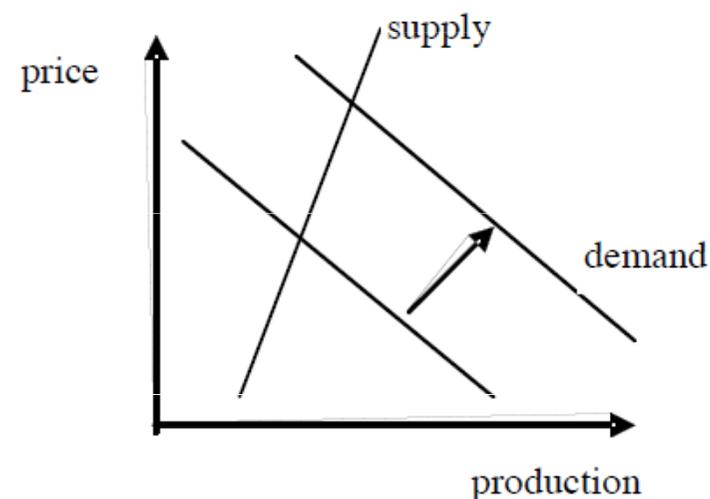
The Crowding-Out Effect

- increase in government spending => increase in government deficit => increase in interest rate => decrease in private investment
- **The crowding-out effect** = the **offset** in **aggregate demand** that results when expansionary fiscal policy raises the interest rate and thereby reduces investment spending

The neoclassical critique

- Critique of the multiplier
 - Full financial crowding-out
 - Supply rigidity
- Fiscal expansion
 - Rise in the interest rate => penalizes private investment
 - Fiscal policy effectiveness is limited in time (data shows that multiplier is close to zero after one year)

Effect of an expansionary fiscal policy



Public budget

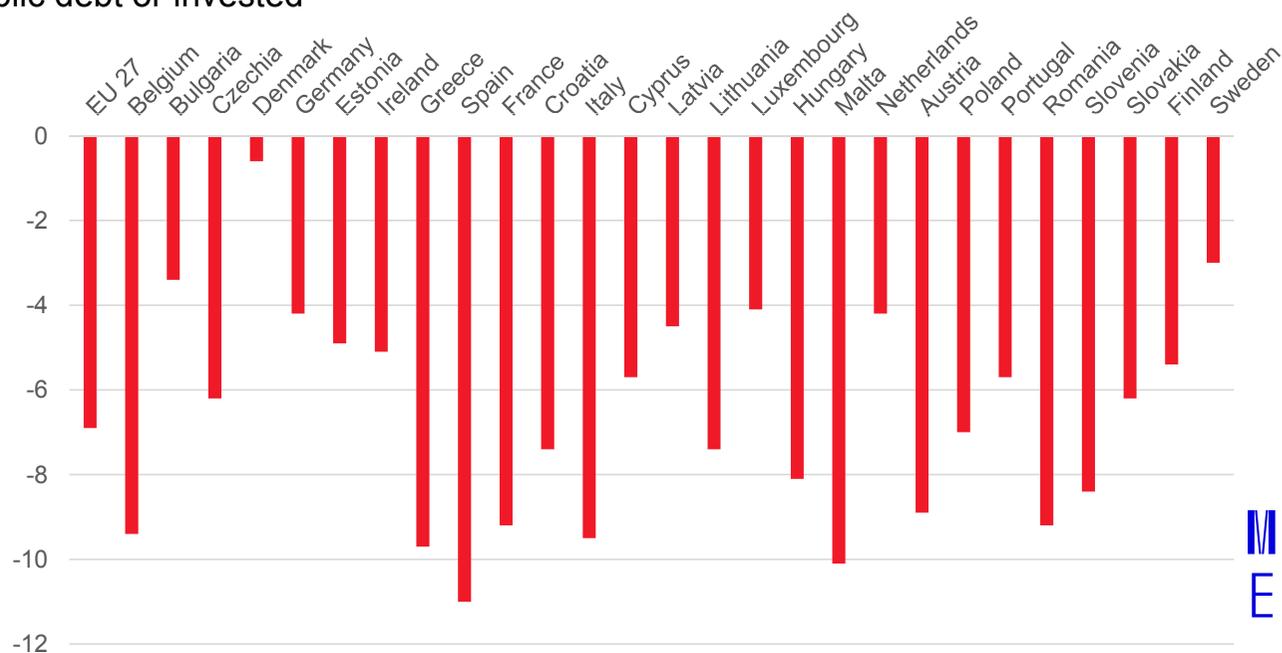
- Public budget is a document that specifies the origin and volume of both income (“receipts”) and intended spending over a certain horizon (usually a year)
- Public budget
 - Budget of central government
 - Budgets of local governments
- Functions: allocation, redistribution and **stabilization**

Public budget

- **Revenue:** income from direct and indirect taxation, social contributions, income from public assets, income from provision of public services and, possibly, income from disposal of public assets
- **Spending:** defence, police, justice, education, research, support to the economy, social policy, health, foreign policy, development assistance, etc.
- Budgets for different level of government, cities to central government

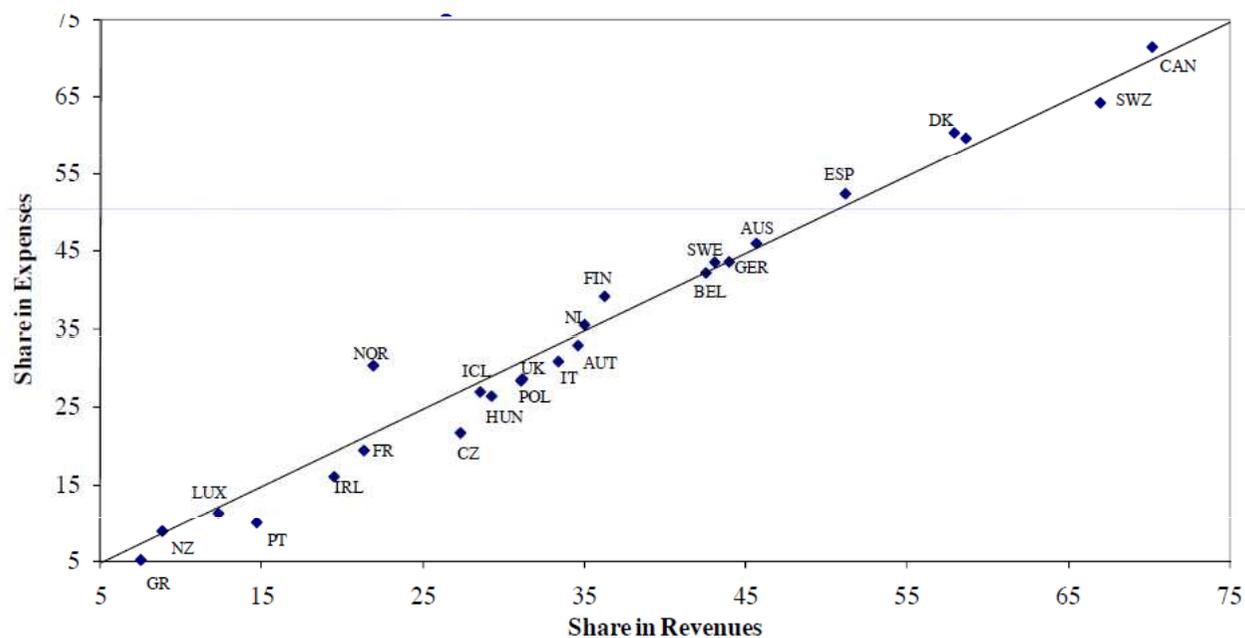
Public budget

- The fiscal (budgetary) balance – difference between income and expenditure
 - Fiscal (budget) surplus
 - Can be used to pay down public debt or invested
 - Fiscal (budget) deficit



Various degrees of public finance centralization

Fig. Ratio of local to general government expenses and revenues



Source: Bénassy-Quéré (2012)

Budget imbalance

- Budget balance = income – expenditures: surplus (+) or deficit (-)
 - **Central or general government** balance
 - **Financial** (overall) balance (= net lending); includes net interest payment
 - **Primary balance**: excluding net interest payments
 - **Cyclically-adjusted (structural) balance**: excluding cyclical balance => FP stance
 - FP stance
 - expansionary
 - contractionary

Budget balance in the Czech Republic

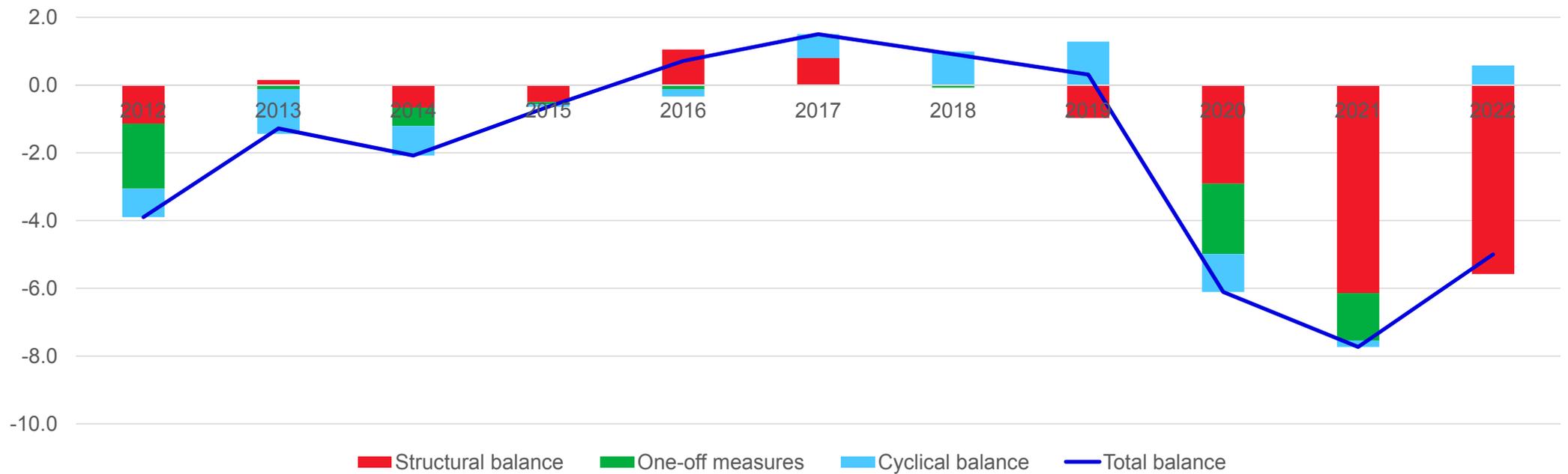




Table 17.3 Government Budget Balances, Various Countries, 1975 – 2010 (% of GDP)

	1975	1980	1985	1990	1995	2000	2005	2010	Average 1970–2010
Austria	-2.4	-2.0	-3.0	-2.5	-5.9	-1.9	-1.8	-4.6	-3.0
Belgium	-6.4	-10.2	-9.9	-6.7	-4.5	-0.1	-2.8	-4.2	-5.6
Denmark	-2.4	-3.5	-2.1	-1.3	-2.9	2.2	5.0	-2.9	-1.0
Finland	5.1	3.8	3.5	5.4	-6.2	6.8	2.5	-2.8	2.3
France	-1.9	-0.1	-3.0	-2.4	-5.5	-1.5	-3.0	-7.0	-3.0
Germany	-5.6	-2.9	-1.1	-1.9	-9.7	1.3	-3.3	-3.3	-3.3
Greece	-2.6	-2.3	-10.4	-14.0	-9.1	-3.7	-5.3	-10.4	-7.2
Ireland	-11.2	-11.2	-10.8	-2.8	-2.1	4.8	1.6	-32.4	-8.0
Italy	-10.3	-7.0	-12.4	-11.4	-7.4	-0.9	-4.4	-4.5	-7.3
Japan	-2.0	-3.2	-0.6	2.1	-4.7	-7.6	-6.7	-8.1	-3.9
Netherlands	-3.4	-4.2	-3.7	-5.3	-9.2	2.0	-0.3	-5.3	-3.7
Norway	3.0	5.4	9.7	2.2	3.2	15.4	15.1	10.5	8.1
Spain	-0.2	-3.0	-7.3	-4.1	-6.5	-1.0	1.0	-9.2	-3.8
Sweden	5.1	-5.8	-3.7	3.4	-7.3	3.6	1.9	-0.3	-0.4
UK	-5.2	-3.7	-3.3	-1.8	-5.8	3.7	-3.3	-10.3	-3.7
USA	-5.2	-2.6	-5.0	-4.2	-3.3	1.5	-3.3	-10.6	-4.1

Source: OECD, *Economic Outlook*.

Discretionary FP vs. automatic stabilizers

- **Discretionary FP** includes changes in government spending and taxation that need specific approval (usually requires legislative action)
=> risk of time lags
- **Automatic stabilizers** increase (decrease) budget deficits during times of recession (booms) without specific new legislation => no time lags:
e.g., unemployment insurance program, progressive income taxes

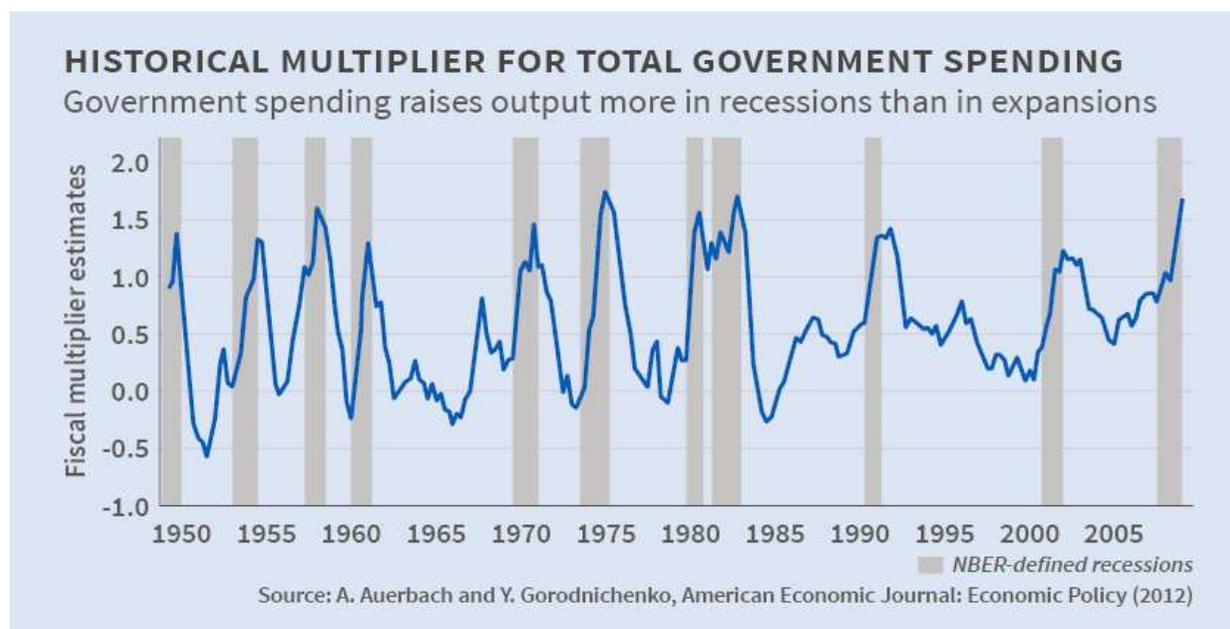
Automatic stabilizer (Czech Republic)

	2008	2009
GDP (y/y change)	2,5%	-4,1%
Unemployment	5,4%	8,7%

Expenditure	2008 (bil. euro)	2009 (bil. euro)	y/y change
The state budget	43	47	8%
Pensions	13	13,6	9%
Unemployment benefit	0,3	0,6	112%

Empirical assessment of fiscal multipliers

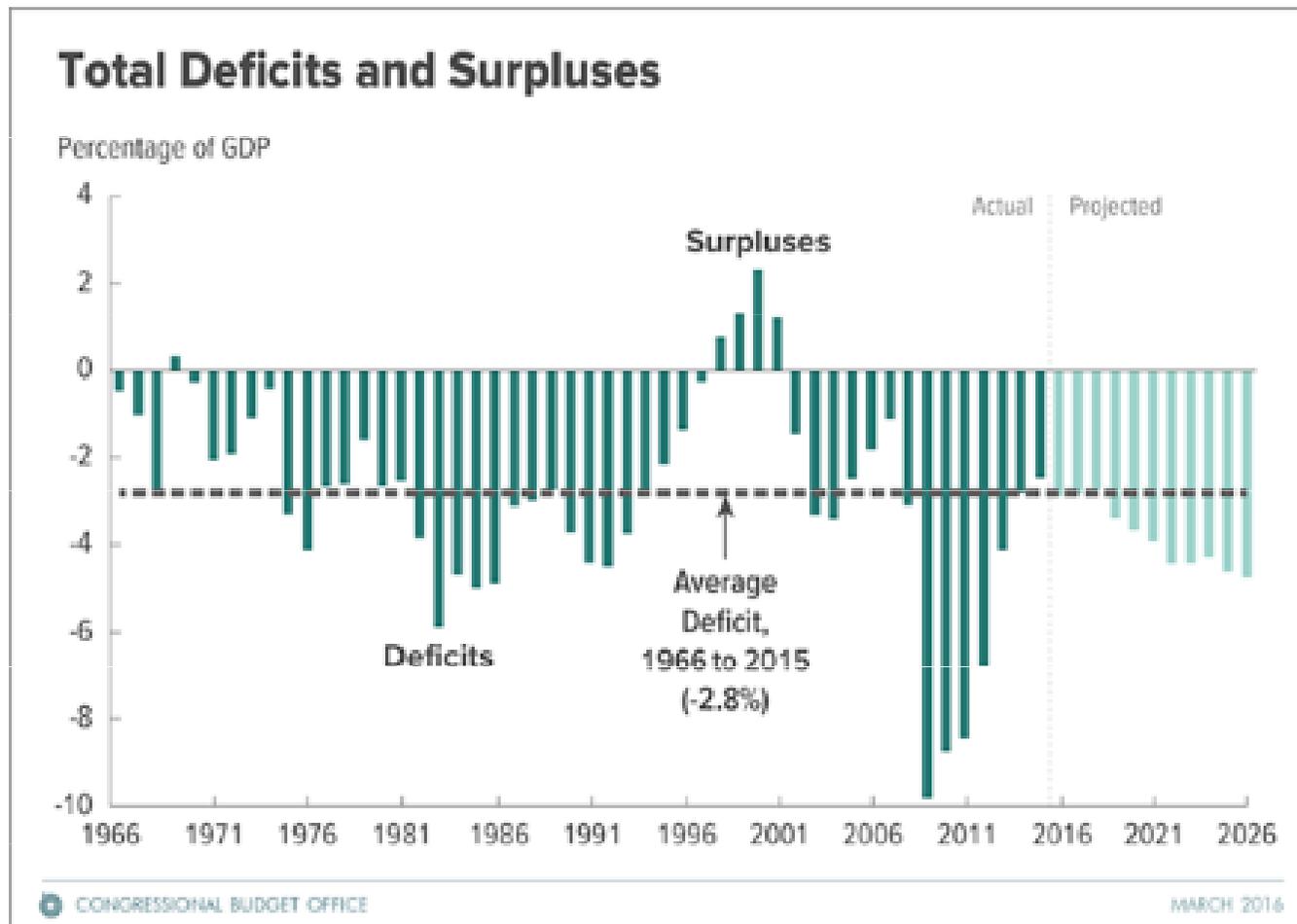
- Effectiveness of fiscal policy depends on the amount of fiscal multiplier
- Studies lead to wide range of estimates for fiscal multipliers from less than zero to more than four



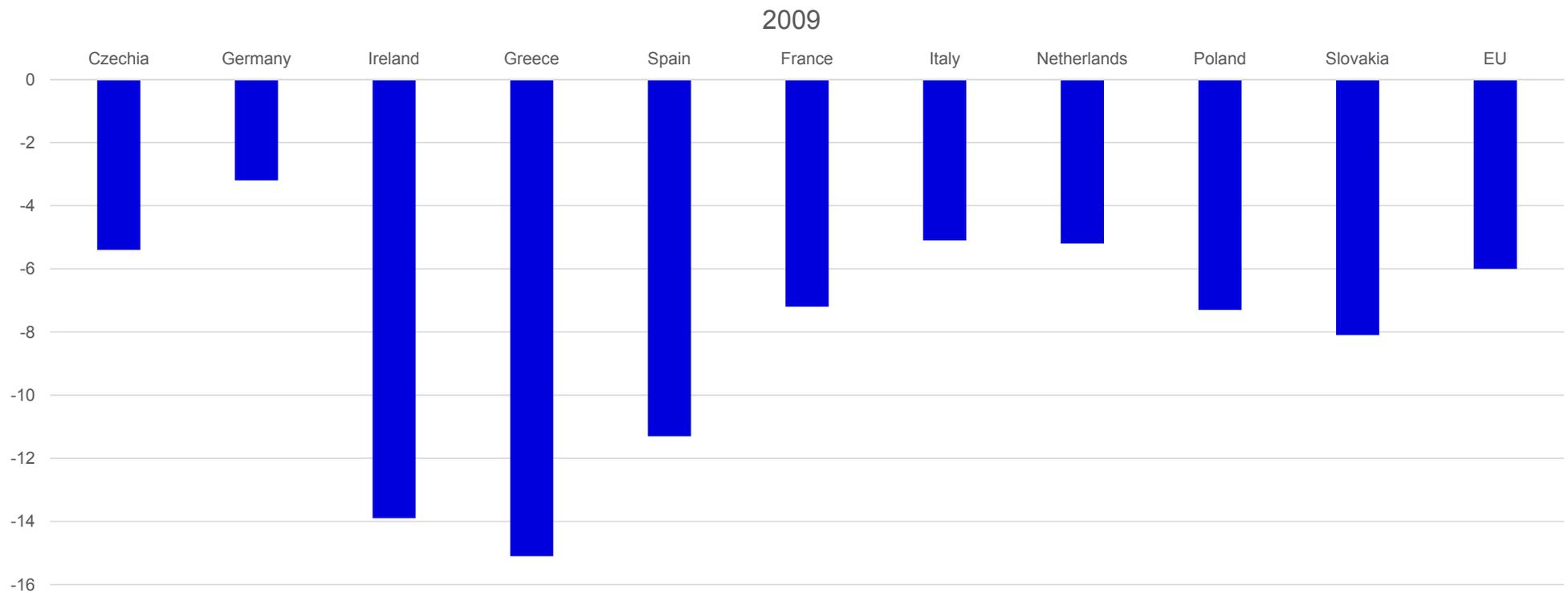
FP during the 2008-2009 crisis

- Arguments in favor of 2009 stimulus:
 - Risk of depression (recession with a decline of GDP more than 10 %)
 - Ineffectiveness of monetary policy (transmission through financial system clogged, in addition to zero band)
- Exceptional effectiveness of fiscal policy because of:
 - General excess supply
 - Excess savings and flight to safety resulting in ultra-low bond rates
 - Focus of agents on short-term horizon, credit constraints
 - Symmetric character of shocks, therefore, gains from coordinated action

FP during the 2008-2009 crisis - USA



FP during the 2008-2009 crisis

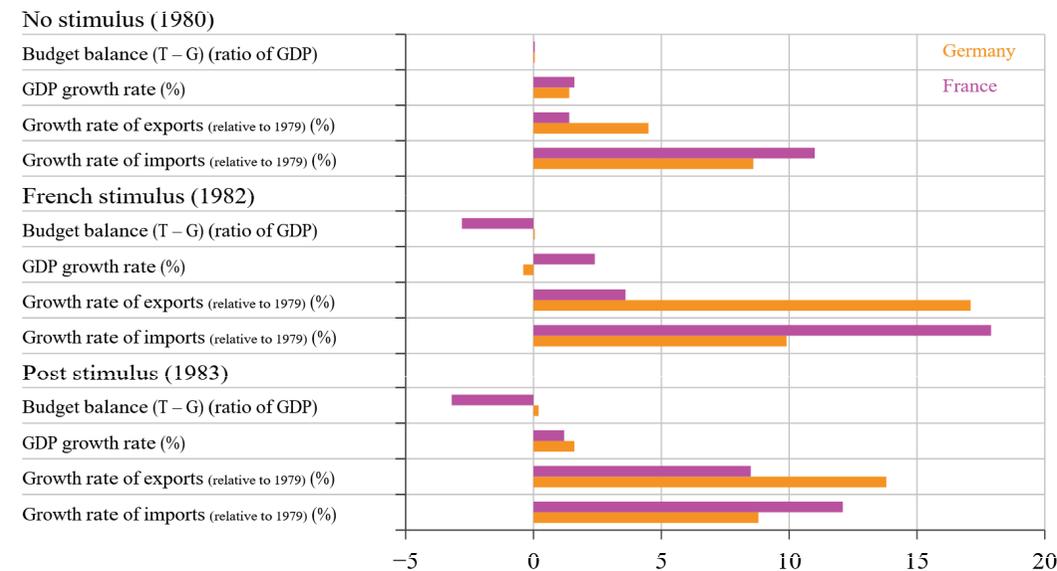


CS: Trade constrains the use of fiscal policy

- trade with other countries constrains the ability of FP
- France
 - 1980: weak economic growth
 - 1981: François Mitterrand won the presidential election
 - program to stimulate aggregate demand through increased government spending and tax cuts

CS: Trade constrains the use of fiscal policy

- The French budget balance negative
- German budget balance remained close to balance
- The French stimulus spilled over to other countries (imports were higher)
- The French stimulus increased German export => German GDP



Fiscal policy in 1960s in the USA

- 1958 – recession

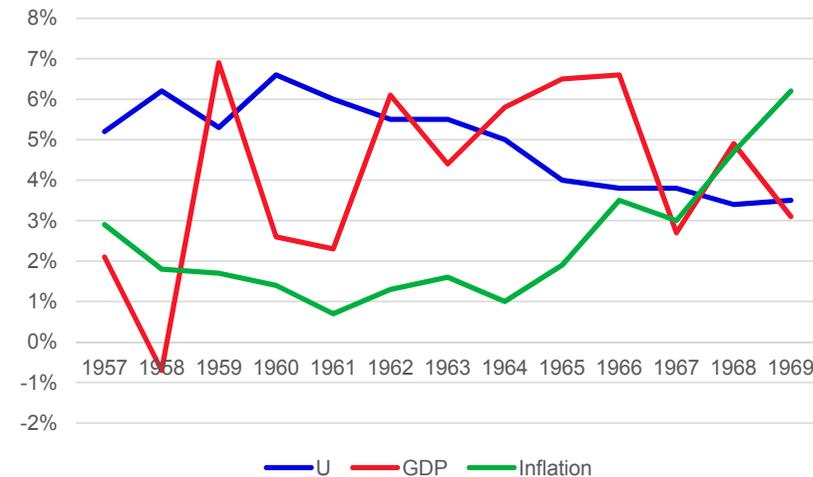
- GDP -0,7 %
- U 6,8 %

- 1960 – slowdown

- GDP 2,6 %
- U 6,6 %

- New Economics

- Kennedy, L. Johnson => decrease in taxes (20% reduction in personal tax; 10% reduction in corporate tax)
- GDP, employment growth; U decline
- taxes remained reduced, increase in G => inflation



Reference textbook

- Benassy-Quéré, A. et al. *Economic Policy: Theory and practise*.
Oxford University Press, 2010. **Chap. 3 – 3.2.1**

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