Fiscal Policy Agenda

- Fiscal Policy and Budget Balances.
- Measuring Budget Changes.
  - Automatic versus Discretionary Changes.
- Designing Effective Short-run Fiscal Policy.

Budget Balance

- Budget Arithmetic:
  - $G = G$
  - $T = tY$
  - $T - G = tY - G$, where
    - $G$ is the autonomous budget, and
    - $tY$ is the induced budget.

Budget Balance Line

- Ye is determined in the IS – LM model.
- $T - G$ is determined by the BB line.

Actual Budget Balance

- Automatic Fiscal Policy:
  - Automatic or induced changes in the budget balance.
    - Results from changes in induced taxes.
      - $\Delta T = t \cdot \Delta Y$
    - Represented by movement along a given BB line.
Budget Balance

• Discretionary Fiscal Policy:
  ➢ Deliberate changes in fiscal policy.
    • Changes in G.
    • Changes in t.
  ➢ Represented by a change in the BB line.
    • Changes in G generate a parallel shift.
    • Changes in t generate a rotation.

Increasing G

Decreasing t

Budget Balance

• How do we compare:
  ➢ A change in G (measured in dollars) with
  ➢ A change in t (measured in %)?

• Alternatively, how do we compare a
  ➢ Parallel shift in the BB line with
  ➢ A rotation of the BB line?
Budget Balance

- Distinguishing Automatic from Discretionary Changes:
  - Select a given $Y$.
    - Potential GDP, $Y_n$.
  - Budget balance at potential GDP is call the Structural Budget Balance, SBB.
    - Also, the standardized or natural employment budget.
    - If $T - G = tY - G$.
    - Then $SBB = tY_n - G$.

Budget Balance

- Changes in the structural budget balance will represent changes in discretionary fiscal policy.

Budget Balance

- Budget Concepts:
  - Actual budget balance (measured at $Y_e$).
  - Structural budget balance (measured at $Y_n$).
  - Cyclical budget balance:
    - Occurs when $Y_e$ not $= Y_n$.
    - $\Delta = actual - structural$.
      - If actual budget $< structural$, then cyclical budget $< 0$.
      - If actual budget $> structural$, then cyclical budget $> 0$. 

Structural Budget Balance

- $T - G$
- Surplus ($+$)
- Structural surplus
- If $Y_n$
- Structural deficit
- $- G$
- Deficit ($-$)
- If $Y_n$

Increasing $G$

- $T - G$
- Surplus ($+$)
- Change in the SBB
- $T - G$
- $Y_n$
- Deficit ($-$)
- $- G$
- $- G$

Decreasing $t$

- $T - G$
- Surplus ($+$)
- Change in the SBB
- $T - G$
- $Y_n$
- Deficit ($-$)
- $- G$
- $- G$
Fiscal Policy
• Designing Effective Short-run Fiscal Policy
  ➢ Size versus composition of fiscal package.
  ➢ Relative effectiveness:
    • $ of G > $ of T.
    – G multiplier is larger than T multiplier.
    – G has direct effect on spending, T has indirect effect.

Fiscal Policy
• Designing Effective Short-run Fiscal Policy
  ➢ Government spending considerations.
    • New spending or replacement outlays.
    • Prospective timing of outlays.
      ➢ How quickly can you spend the money once it is approved.
      ➢ Infrastructure projects.
    • Nature and location of the prospective outlays.
      ➢ How much “leaks” abroad.

Fiscal Policy
• Designing Effective Fiscal Policy
  ➢ Tax considerations:
    • Corporate Taxes.
      ➢ Permanent or temporary.
        » Temporary tax cuts can have greater stimulus effects.
        » But may only shift the timing of investment.
      ➢ Design of tax.
        » Changes in marginal or average taxes.