4.2 Fiscal Policy

How do we achieve our three economic objectives?

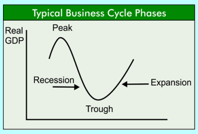
-Economic Growth

-Full Employment

-Steady inflation

With Monetary and Fiscal Policy!

Review of the **Business Cycle**



A cycle goes through a phase of expansion, reaches an upper turning point, the peak, and then enters a period of recession. Cycles differ from one another in the severity of their peaks and troughs and in the speed with which one phase follows another.

The Trough

- Heavy unemployment of labor
- A level of consumer demand that is low in relation to the economy's potential
- Few prices are rising
- Business profits are low
- Confidence in the future may be lacking; business people may be unwilling to take risks in making new investments
- Banks and other financial institutions will have a surplus of cash

Expansion or Recovery

- Worn out machinery will be replaced
- Employment, income and consumer spending will begin to rise
- As a result, increases in production, sales and profits, expectations become favorable – increases in investment
- As demand expands, production will expand with relative ease merely by reemploying the existing unused capacity and unemployed labor.
- Prices will stop falling and will generally tend to stay constant or else rise slowly.

Peak

- Existing capacity become fully utilized
- Labor shortages can occur
- Output can only be increased by means of investment
- Increase in demand are met by increases in prices rather than by increases in production
- As shortages develop, a situation of general excess demand for factors of production occur
- Costs rise, prices rise, businesses remain very profitable. (When price increases become quite general, inflation exists)
- Future expectations are favorable

Recession

- Consumption demand falls off
- Investment suddenly appears unprofitable
- Business failures are now becoming more common

Production and employment fall; income and expenditures fall; fall in demand; more firms experience difficulty

Fiscal Policy

Government spending and taxing decisions have an effect on the level of employment, income and output. These spending and taxing decisions are fiscal policy. Sometimes it is necessary for the government to use fiscal policy to:

- Stimulate the economy during a contraction (recession) to deal with unemployment (**Expansionary Fiscal Policy)**

- Slow the economy down during an expansion in order to bring inflation under control (**Contractionary Fiscal Policy)**

Automatic stabilizers refer to changes in taxation and expenditures that occur automatically with changes in the levels of employment, income and output. These changes have the effect of stabilizing the economy.

Discretionary fiscal policy occurs when government acts to change its taxation and expenditure policies deliberately to influence levels of income, output and employment.

Automatic Stabilizers

Automatic stabilizers are always at work in the economy. As output declines, stabilizers such as income tax and unemployment compensation act to slow down the decline in income, output and employment. Similarly, stabilizers are also at work as the economy expands. They work to slow the economy down when inflation becomes a problem. No specific action is necessary on the part of the government. Once stabilizers have been put in place, they work automatically.

When the economy is slowing down (leakages are greater than injections), output is declining and unemployment increases. As unemployment increases, the number of people collecting employment insurance increases as well. These people now have money to continue on with their daily lives. Government expenditures on unemployment compensation increase automatically; injecting money into the economy.

When the economy is expanding (injections are greater than leakages), output is increasing and unemployment is decreasing. As the level of unemployment decreases, government expenditures on unemployment insurance decrease. The number of people collecting unemployment insurance declines, decreasing the amount of money being injected into the economy thus helping to reduce the rate of inflation.

The Canadian income tax structure also acts as an automatic stabilizer. Because our income tax is progressive, as personal income declines in a recession, smaller proportions are taken in taxes. The tax leakage declines leaving more money in the economy.

In a recovery, as the output increases, incomes rise. With the rise in incomes, the amount collected in income tax increases and the tax leakage in our economy also increases, leaving less money in the economy. Income tax thus acts automatically to help stabilize the economy.

Automatic Stabilizers Review from Yesterday

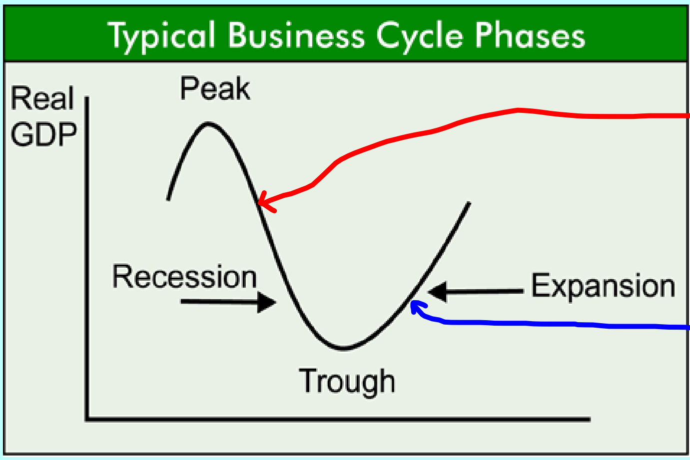
-Automatic stabilizers were put in place by the government to automatically stabilize the economy in periods of recession and expansion without them having to intervene

-Leakages = Economy is booming, need to decrease money supply. More income tax being paid (because of higher incomes). More EI premiums paid than collected.

-Injections = Economy is slow, need to increase money supply. Less income tax being paid (because of lower incomes and less jobs). More EI collected than premiums being paid.

-During a recession, automatic stabilizers increase injections and decrease leakages

-During expansion, automatic stabilizers increase leakages and decrease injections.



injections > leakages

leakages > injections

Discretionary Fiscal Policy

We are now in a position to examine how governments can act to increase the level of employment or decrease the level of inflation.

First let's suppose we have an increasing rate of unemployment (Recession). This means that the total injections into the economy are less than the total leakages. To slow, stop, or reverse the increases in unemployment, the government can act in a number of ways. The Government can increase injections, decrease leakages, or do both. This is called expansionary fiscal policy.

Government Action to Cut Leakages (during recession)

1. Tax Leakages

The leakage most easily influenced by the government is taxation. A cut in personal income tax leaves consumers with more disposable income. Consequently, we can expect consumer spending to increase. Similarly, a cut in business taxes leaves businesses with more funds for investment and /or distribution to shareholders; thus, consumer and /or investment spending will increase. The actions lead to more money in the economy which will lead to more jobs and an expanding economy.

2. Import Leakages

Government can also move to diminish imports. The imposition of taxes and other restrictions on imports increases the price of imports and encourages Canadian consumers to consider buying a similar product made in Canada.

Government Action to Increase Spending

1. Government Spending Injection

The injection most easily influenced by government is its own spending. Governments can increase their own spending on goods and services, and increase the amount of transfer payments they make. The increase in government spending leads to more money in the economy which will lead to more jobs and an expanding economy.

2. Export Injection

Governments can also encourage exports in a variety of ways. For example, subsidies and low interest loans are likely to encourage exports.

Now let’s assume that the economy is in an **expansion and inflation is rising**. To lower or eliminate the rate of inflation, the government could increase leakages and/or decrease injections by fiscal policies.

Contractionary Fiscal Policy (during expansion phase)

In using its spending and taxing powers, the government could engage in a contractionary fiscal policy. By cutting its expenditures and/or increasing taxation, government can lower the amount of injections into the economy and increase leakages, thus lowering the rate of inflation.

In this case government revenues increase and expenditures decrease. The government will follow the same action as in a expansionary fiscal policy, except the opposite.

It is an appropriate policy for governments to aim for a budget surplus during an expansion and a budget deficit during a recession. Over the course of the business cycle, the budget would be balanced with deficits during depressions and surpluses during expansions.

Comprehension Questions

1. What is the difference between fiscal policy and monetary policy?

2. When will the government use expansionary fiscal policy? contractionary?

3. Does the government increase or decrease spending during a recession? Why?

4. Does the government increase or decrease taxes during during an expansion? Why?

Comprehension Questions

1. What is the difference between fiscal policy and monetary policy? Fiscal= government/ Monetary= BofC

2. When will the government use expansionary fiscal policy? contractionary? Exp= recession/ Cont= Expansion, approaching peak

3. Does the government increase or decrease spending during a recession? Why? Increase to inject $ into supply

4. Does the government increase or decrease taxes during during an expansion? Why? Increase to leak $ out of supply

Limitations of Fiscal Policy

It would appear that the government has a lot of power to resolve the problems associated with cyclical unemployment and inflation. While things may look relatively simple on paper, they are much more complicated in reality. One problem is evident from the start. Government has a number of choices. Should taxes be cut/increased? Should government expenditures be increased/decreased? Can the deficit and the debt be safely increased? Should exports be stimulated/slowed? Should imports be cut/stimulated?

Once a general decision has been made about taxes, expenditures and trade policy, government has to work out specifics.

Timing of Fiscal Policy

Decisions about the appropriate fiscal policy are complicated by the fact that the government cannot be certain which way the economy is headed. Is the economy headed towards increasing unemployment? If so, then expansionary fiscal policy may be appropriate. On the other hand the economy may be headed in the direction of full employment. An expansionary fiscal policy at this time could bring about inflation.

The problem of knowing what will be happening in the economy at some point in the future is heightened by three problems:

- Recognition Lag – a period of time between the onset of the problem and the recognition of the problem
- Decision Lag – in a democracy it takes a significant amount of time for decision to be made.
- Implementation Lag – there is a delay until fiscal policy changes start to take effect.

National and Regional Effects

The federal government must gauge the effects if policies in different parts of the country. If unemployment is high in Atlantic Canada and low in the rest of the country, should government do nothing on the grounds that in most of the country unemployment is low? Or should it cut taxes to help stimulate unemployment in Atlantic Canada and run the risk of inflation elsewhere?

Questions and Graphic
Organizer

Discretionary Fiscal Policy

Expansionary Fiscal Policy
(recession)

Injections > Leakages

Leakages
1. Taxes
2. Imports

Injections
1. Government Spending
2. Exports

Contractionary Fiscal Policy
(expansion)

Leakages > Injections

Leakages
1. Taxes
2. Imports

Injections
1. Government Spending
2. Exports

Formative Assignment