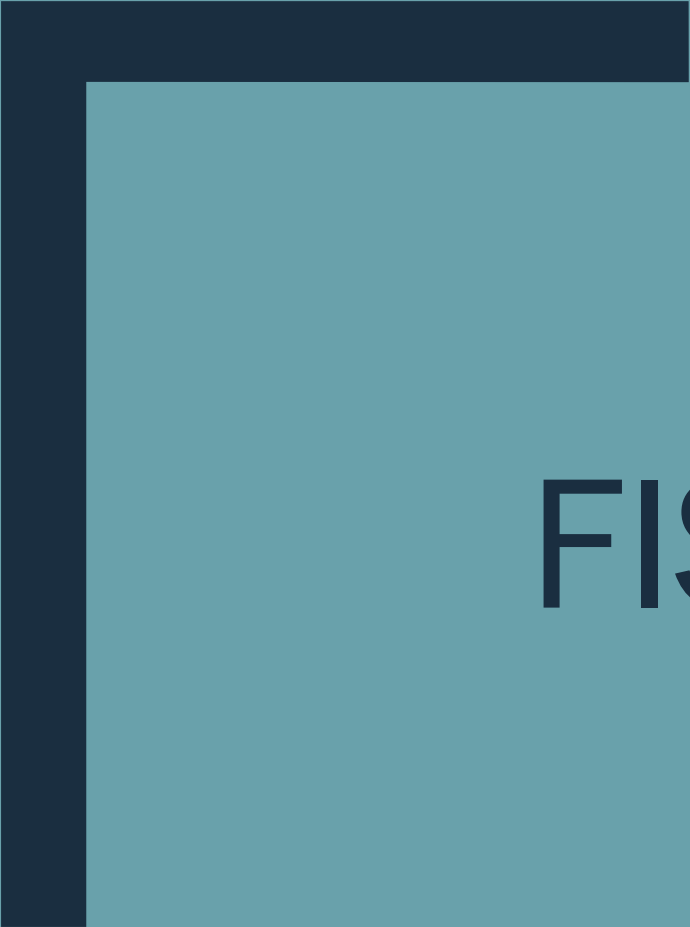




FISCAL POLICY



- Most mixed economies go through upheavals caused by ups and downs of the business cycle.
- John Maynard Keynes believed that the business cycle should be managed and advocated government intervention.
- Governments intervene in the economy through the use of Stabilization policies.
 - *Use of Fiscal and Monetary policies*

Keynes

- Able to explain the Great Depression in a way that classical economists could not.
 - *A collapse of investment spending brought consumer spending down with it.*
 - *With low levels of consumer spending, it was unlikely that investment spending would soon recover.*
- If government policy could affect the sizes of leakages ($T + S + M$) and the injections ($G + I + X$), aggregate demand could be managed.

- Aggregate demand could be purposely increased in a recession or a depression.
- Aggregate demand could be purposely reduced when leading to inflation.
- Government policies used to manage Aggregate Demand fall into 3 areas:
 - *Fiscal Policy*
 - *Monetary Policy*
 - *Trade Policy*

Fiscal Policy

- Use by a government of its powers of expenditure, taxation and borrowing to alter the size of the circular flow of income in the economy.
- Goals of the policies:
 - *Bring about greater consumer demand*
 - *More employment*
 - *Inflationary restraint*

- If personal spending is too low, the government can increase AD by increasing its own spending or by encouraging private spending.
- If personal spending is too large and the economy is threatened by excessive inflation, the government can decrease AD by restricting its own spending or by discouraging private spending.
- Governments use **Discretionary Fiscal Policies**
 - *Government is taking deliberate actions through legislation to alter spending or taxation policies in order to influence the level of spending and employment.*

Expansionary Fiscal Policy

- When the economy is in a recessionary gap, the government may implement:

1. Tax cut

- *This will increase the disposable incomes of consumers which will lead to increased spending (if they don't save it.)*
- *Increased spending will allow the Consumer Spending component of the GDP formula to grow, thus causing the aggregate demand curve to move to the full employment position.*

2. Increase in government spending

- *The increase in government spending could create new jobs.*
- *Jean Chrétien's government created many jobs in the health care field in the 1990`s which affected the government spending section of the GDP formula.*

3. Both

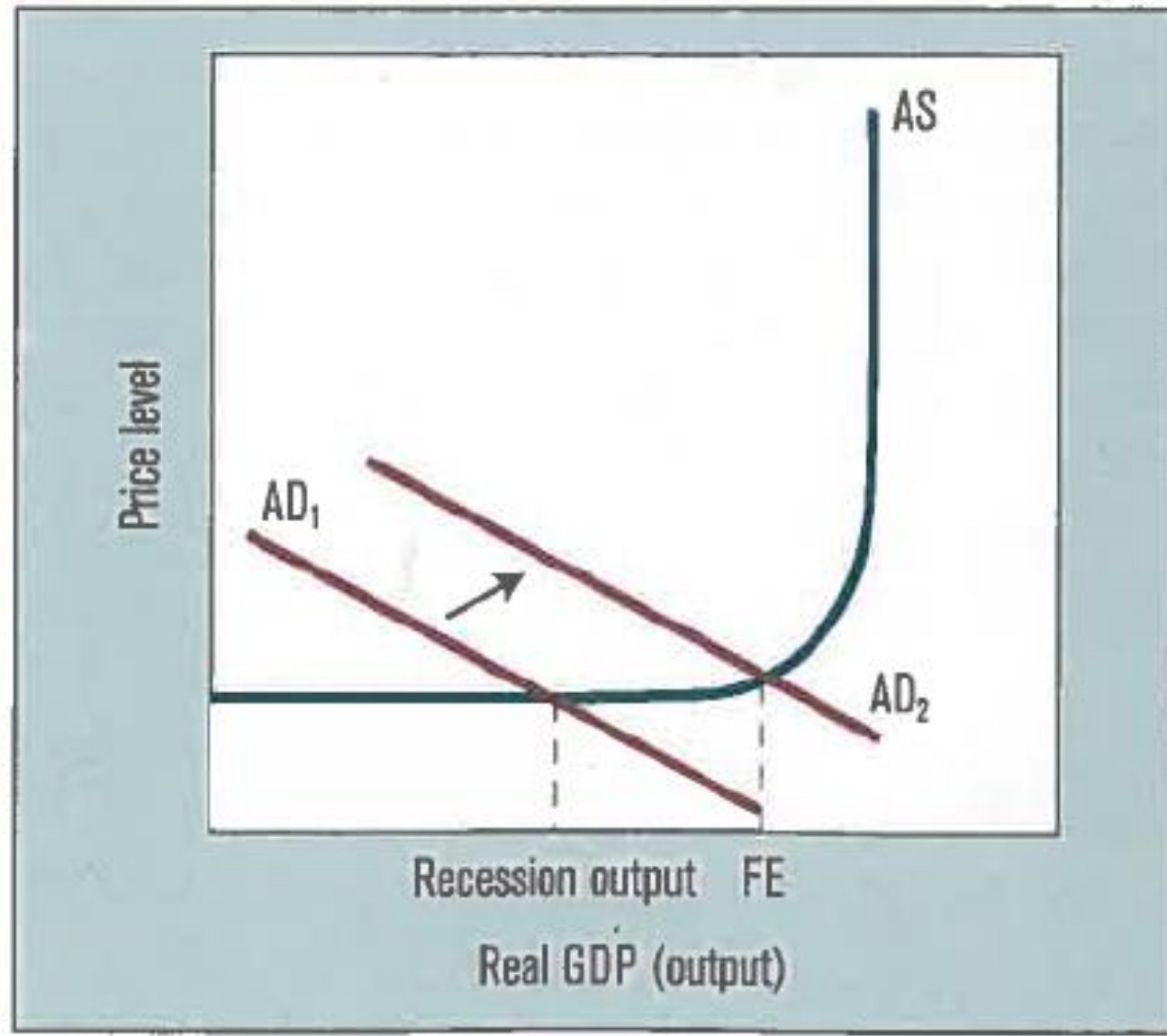


Figure 10.13 The effect of an expansionary fiscal policy.

Contractionary Policy

- When the economy is in an inflationary gap, the government will implement policy that will allow for the following:

1. Tax Increase

- *A tax increase will remove money from consumer's pockets.*
- *By doing so, the Consumer Spending component of the GDP will reduce, causing the aggregate demand to move back towards full employment.*

2. Decrease in Government Spending

- *The decrease in government spending would see fewer roads built, closure of hospitals etc.*

3. Both

- Contractionary policy is often considered controversial in our democratic society because any government who raises taxes or cuts jobs will be unpopular and thus reduce the chances of being re-elected.

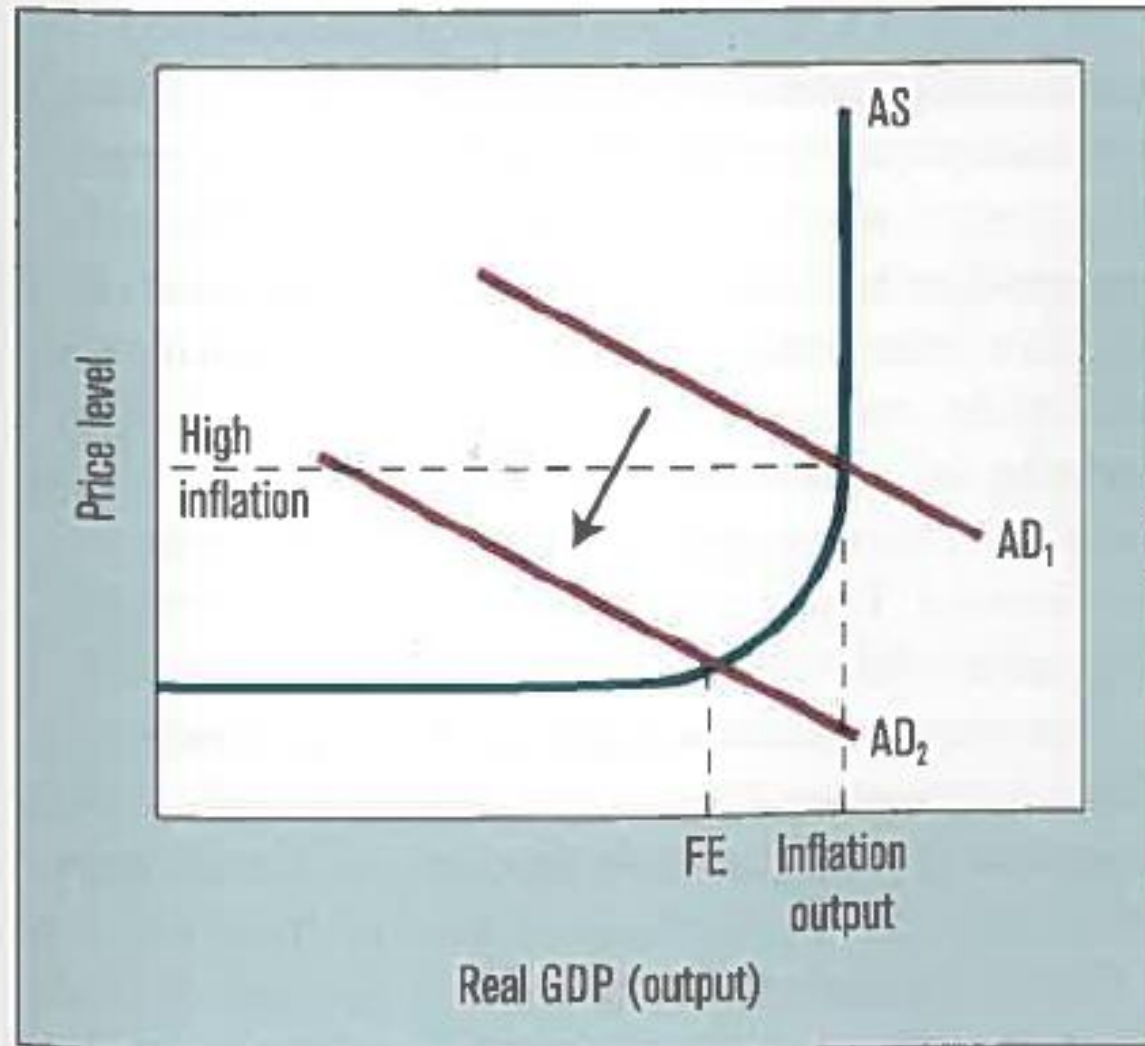


Figure 10.14 Effect of a contractionary fiscal policy.

Tools of Fiscal Policy

1. Changes in Spending

■ Stimulate the economy

- *Increase general spending in all areas (health & welfare, culture, education, etc.)*
- *Infrastructure Programs*

- Economic foundation of goods and services that allows a society to operate (roads, schools, hospitals, communication systems)

- Spending in these areas adds to capital goods and promotes an outward shift in the PPC.

2. Changes in Taxation

■ Options that are open to the Government:

- *Raise or Lower personal and corporate income taxes and/or sales and excise tax (an indirect tax charged on the sale of a particular good).*
- *Alter tax exemptions and credits (tuition, contributions to RRSP's)*
- *Provide tax incentives for investment (larger capital cost allowances on new buildings and equipment).*

3. Automatic Stabilizers

- Already exist and are acting on aggregate demand before a recession or inflationary trend takes hold.
- Built into the economy to increase/decrease AD as needed
- Require no additional direction or legislation by policy makers.
- Examples:
 - *Employment Insurance and Welfare*
 - *Progressive Tax*

A. Employment Insurance and Welfare

- In downturn, EI payments increase as more people become unemployed.
- Helps to maintain income and consumption in GDP.
- If the recessionary period is prolonged, the number of people on the welfare roll increases.
 - *Purpose is to ensure people a level of income so that they can survive.*

B. Progressive Tax

- Tax rates that vary with levels of income
- Rises in income acts as a leakage.
- Slows down increase in consumption and stops AD from shifting too quickly.

Drawback and Limitations of Fiscal Policy

1. Time Lag

- Recognition Lag – time government takes to see a problem.
- Decision Lag – time required to determine appropriate policy.
- Implementation Lag – decisions need to be figured out by several levels of government.
- Impact Lag – time required for effects to be felt.
- Total time may be years
- Problems could have corrected themselves before policy takes hold.
- Stabilizers help minimize impact of lag.

2. Governments have difficulty changing policy

- Raising taxes is unpopular.
- Cutting spending may be impossible if there are signed contracts.
- Timing of elections.

3. Conflicts between levels of government

- If the federal government is reducing spending and increasing taxes but a powerful province is doing the opposite, the two policies will offset one another.

4. Regional Variations

- One province may be suffering while another is doing well.

5. Size of debt can limit effectiveness of fiscal policy

- Current political pressure in Canada is to not increase the debt further.

6. Deficits redistribute income from all taxpayers to bondholders

- The debt is owed to ourselves.
- Government sells bonds and T-bills to finance debt.
- In 2012, 70% of debt was in Canadian hands, 30% foreign investors.
- Selling bonds redistributes income from the poor through taxes to the rich (bondholders)

7. Deficits impose net burden on future generations

- If the money is spent on infrastructure, future generations will benefit.
- If money is used to pay current expenditures (salaries of EI) then future generations will not benefit.

Government Budgets

- Governments have three options available when establishing budgets:
 - *Deficit Budget*
 - *A Surplus Budget*
 - *A Balanced Budget*

Deficit Budget

- This occurs when the government spends more than it collects in tax revenue and from earnings of Crown Corporations.
- It must borrow the money to cover the shortfall.
- It may borrow from internal sources by issuing Treasury Bills or Canada Savings Bonds that are available only for Canadian citizens and permanent residents.
- In addition governments may borrow from external sources such a multi-national bank.
- Note that this debt will have to be repaid (+interest).

Surplus Budget

- This occurs when the government collects more in tax revenues than it spends.
- It has money left over for that fiscal period.
- How this surplus is spent is often debated.
- A surplus may be used to:
 - *Pay off existing debt*
 - *Fund more social services?*
 - *Cut taxes?*
 - *Which income group should benefit most?*

A Balanced Budget

- When the government collects the same amount as it spends.
- Ahhhh... glorious balance

Changing Opinions About Government Budgets

- Until the 1930's the primary aim of fiscal policy in Canada was to ensure a Balanced Budget.
- During the Great Depression, it was obvious that this would increase an existing problem in the economy.
- Today, governments will run the type of budget that they feel will best fit the economic periods.