Expansionary fiscal policy exercise:

In principle government can increase aggregate demand in one of 4 ways. Some of these are discussed in the two articles below. For each one of the 4 ways:

(i) Draw an AD/AS diagram showing the probable short and long run effects on the policy objectives (Think about whether in the long run AS might be shifted rightwards as well)

(ii) Provide a list of evaluative points in two sub-categories (not all policies will have both sets of problems)

a. Why the policy might have limited effectiveness

b. Why there might be side effects

Look at the two articles for some help with evaluation if you're stuck, although there are many other points apart from the ones included there!

1) **Cut in direct taxes**

2) **Cut in indirect taxes**

3) **Increase in capital spending**

4) **Increase in current spending**

The key question: Can fiscal policy increase demand effectively?

The most direct way for governments to increase demand is to buy goods and services from the market. However, most European governments spend very little this way. Public sector investment represents only 2–2.5% of GDP and is difficult to increase quickly since the large projects, which make up the bulk of the expenditure, take often a decade or more to realize. Even if governments were able to increase public investment by 20% in one year, this would result in a fiscal impulse of only less than 0.5% of GDP. Even in the US, this instrument will only have limited importance, as public infrastructure spending is projected to increase from around 2.6% (in 2007) to 3.6% of GDP (in 2009), thus constituting only a small fraction of the overall deficit, which is now projected to climb to around 8%–9% of GDP.

Any large-scale fiscal policy impulse must therefore, to be effective quickly, work through transfers to the private sector, either via lower taxes or via higher transfer to households. The key problem here is that under the present circumstances of extreme uncertainty households might just save any increase in their disposable income. How likely is this to happen? A key factor will be the financial position of households themselves.

Households that depend on credit to finance their consumption will be most affected by the credit crunch and are thus most likely to react to a tax cut by maintaining their consumption. For this type of household, a tax cut (or an increase in expenditure) will be an effective tool to prevent an even sharper drop in consumption.

However, for households that do not depend on credit, the situation is quite different. Households that are saving anyway will probably at present just increase their savings in response to an increase in their disposable income that they know to be temporary.

Question: Do tax cuts create jobs?

Answer: Tax cuts create jobs in different ways, depending on the type of tax cut.

Income tax cuts stimulate demand by putting more money into consumers' pockets. That's important because consumer spending drives 70% of economic growth. This creates jobs when businesses ramp up production to meet higher demand. A study by the Congressional Budget Office(CBO) found that the Bush tax cuts would create 4.6 jobs for every $1 million, if extended into 2011-2012.

However, there is some debate over whether tax cuts to higher income families create as many jobs as tax cuts to low- and moderate-income families. The theory is that lower income families must spend the tax cuts, driving demand, while higher income families will save their tax cut. Furthermore, higher income family spending is less influenced by tax cuts because families can maintain their spending by cutting into their savings, or getting loans or credit. Their tax cuts are more likely to be used to pay back loans.

Payroll tax cuts are one of the most cost effective ways to increase jobs. According to the CBO, every $1 million in payroll tax cuts creates 13 new jobs. Payroll tax cuts create jobs in four ways. First, some companies use the savings to reduce prices, increasing demand, which would necessitate hiring more workers to meet the demand. Second, other companies increase wages to retain good workers, who would then spend more, increasing demand. Third, some firms keep the tax savings, allowing them to buy more and increase demand. Fourth, companies that already had products in demand would use the savings to hire more workers. This fourth method is the most cost effective way to create jobs. In fact, if the payroll tax cut is only given for new hires, then every $1 million in payroll tax cuts creates 18 new jobs.(Source: CBO, "The Economic Outlook and Fiscal Policy Choices," September 28, 2010)

By the way, the most cost effective way to increase jobs is not a tax cut at all. The CBO study found that unemployment benefits create jobs because the unemployed are most likely to spend these tax dollars. Every $1 million in unemployment benefits creates 19 new jobs.

However, fiscal policy through government spending is not a really good way to create jobs. Think about it. If $1 million creates 19 jobs, that's still over $50,000 of your tax dollars needed to create one job. The CBO didn't analyze what type of jobs, or the income from the jobs. The best way to create jobs is through monetary policy that expands the money supply, making more liquidity available to businesses to invest. Fiscal policy is only necessary when monetary policy is already as expansionary as possible. This happened in 2009 and 2010, after the Great Recession forced the Fed funds rate to zero.