



Everyone's Smart
University

Introduction to economics

Chapter 10

THEORY AND REALITY

Macroeconomics: Policy Tools



Policy tools for macroeconomics:

- Fiscal Policy
- Monetary Policy
- Supply-side Policy

Table 10.1



Type of Policy	Policy Tools
Fiscal	Tax cuts and increases Changes in government spending
Monetary	Open-market operations Reserve requirements Discount rates
Supply-side	Tax incentives for investment and saving Deregulation Education and training Immigration Trade policy

Fiscal Policy

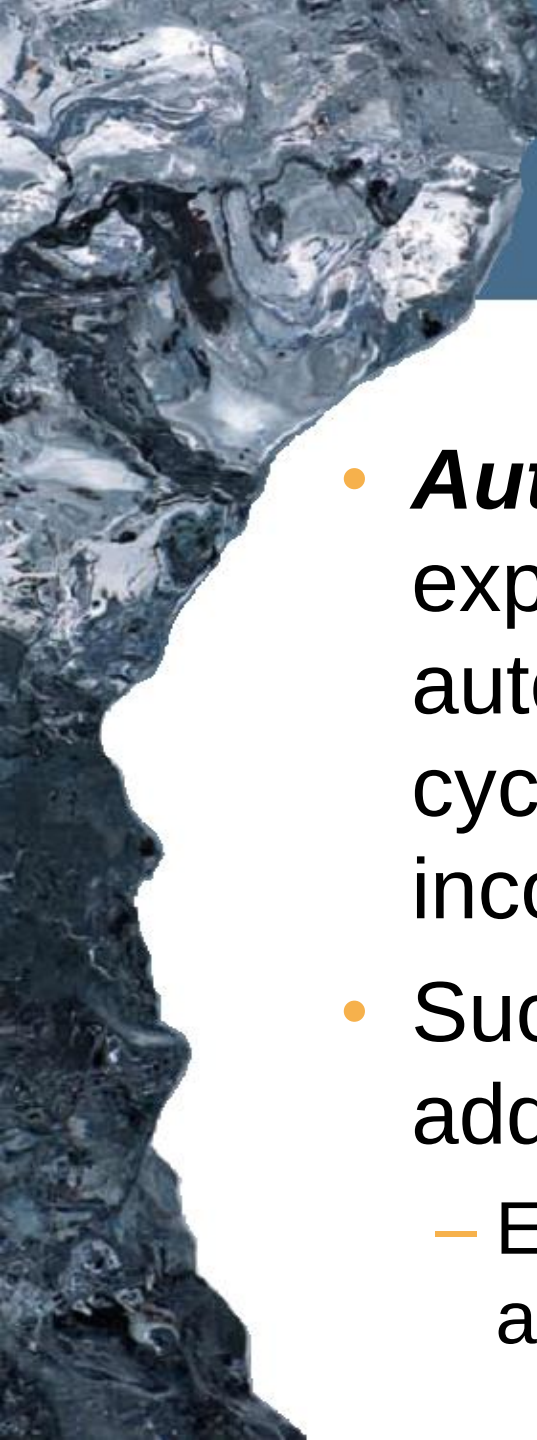


- ***Fiscal policy*** is the use of government taxes and spending to alter macroeconomic outcomes.

Table 10.2



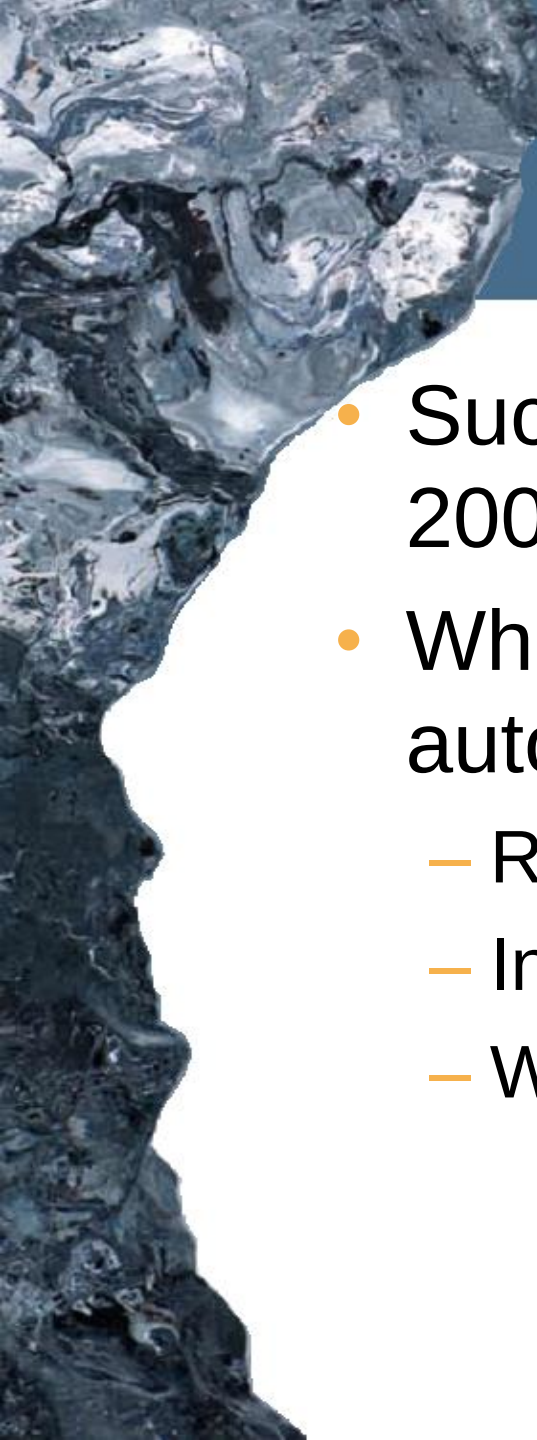
1981	Economic Recovery Tax Act	Three-year consumer tax cut of \$213 billion plus \$59 billion of business tax cuts
1982	Tax Equity and Fiscal Responsibility Act	Raised business, excise, and income taxes by \$100 billion over three years
1983	Social Security Act Amendments	Increased payroll taxes and cut future retirement benefits
1984	Deficit Reduction Act	Increased income, business, and excise taxes by \$50 billion over three years
1985	Gramm-Rudman-Hollings Act	Required a balanced budget by 1991 and authorized automatic spending cuts
1986	Tax Reform Act	Major reduction in tax rates coupled with broader tax base
1990	Budget Enforcement Act	Eliminated deficit ceilings; imposed limit on discretionary spending
1993	Clinton's "New Direction"	Tax increases and spending cuts to reduce deficit, 1994–97
1997	Balanced Budget Act Taxpayer Relief Act	Package of tax cuts and spending cuts to balance budget by 2002
2001	Economic Growth and Tax Relief Reconciliation Act	\$1.35 trillion in personal tax cuts spread over 10 years
2003	Jobs and Growth Tax Relief Act	\$350 billion tax cut, including reduced dividend and capital gains taxes
2008	Tax rebates	\$160 billion in \$600 rebates and business tax cuts
2009	American Recovery and Reinvestment Act	\$787 billion package of increased spending and tax cuts



Automatic Stabilizers



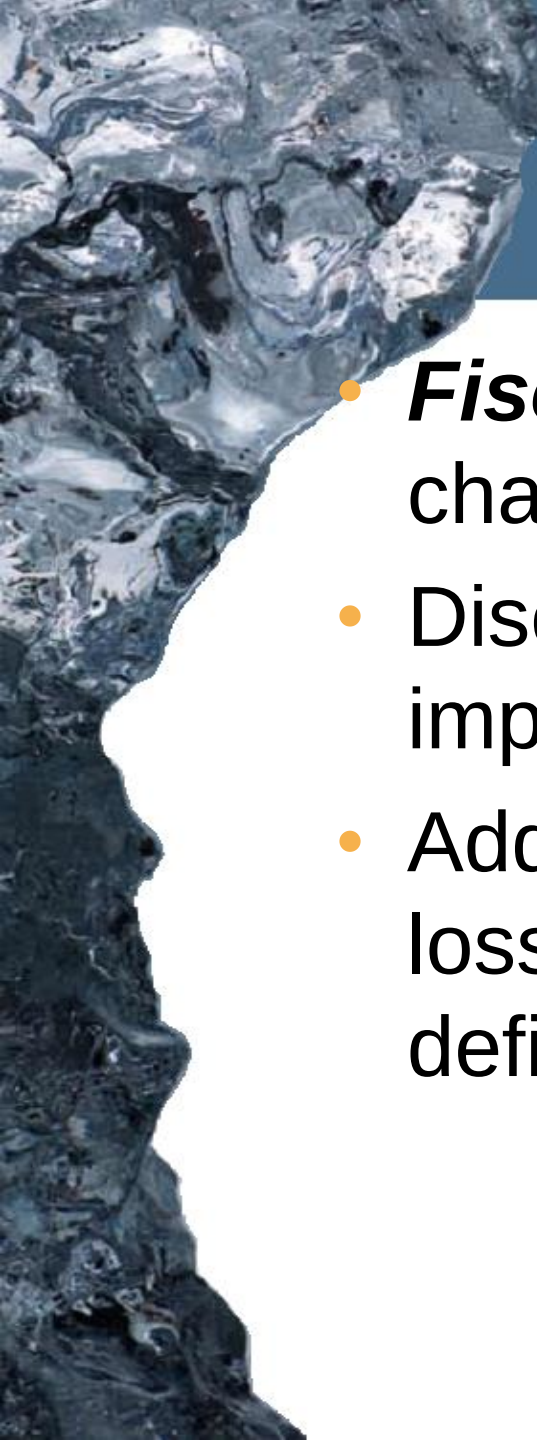
- ***Automatic stabilizers*** are federal expenditure or revenue items that automatically respond counter-cyclically to changes in national income.
- Such stabilizers don't require an additional act of Congress.
 - Examples include unemployment benefits and income taxes



Automatic Stabilizers



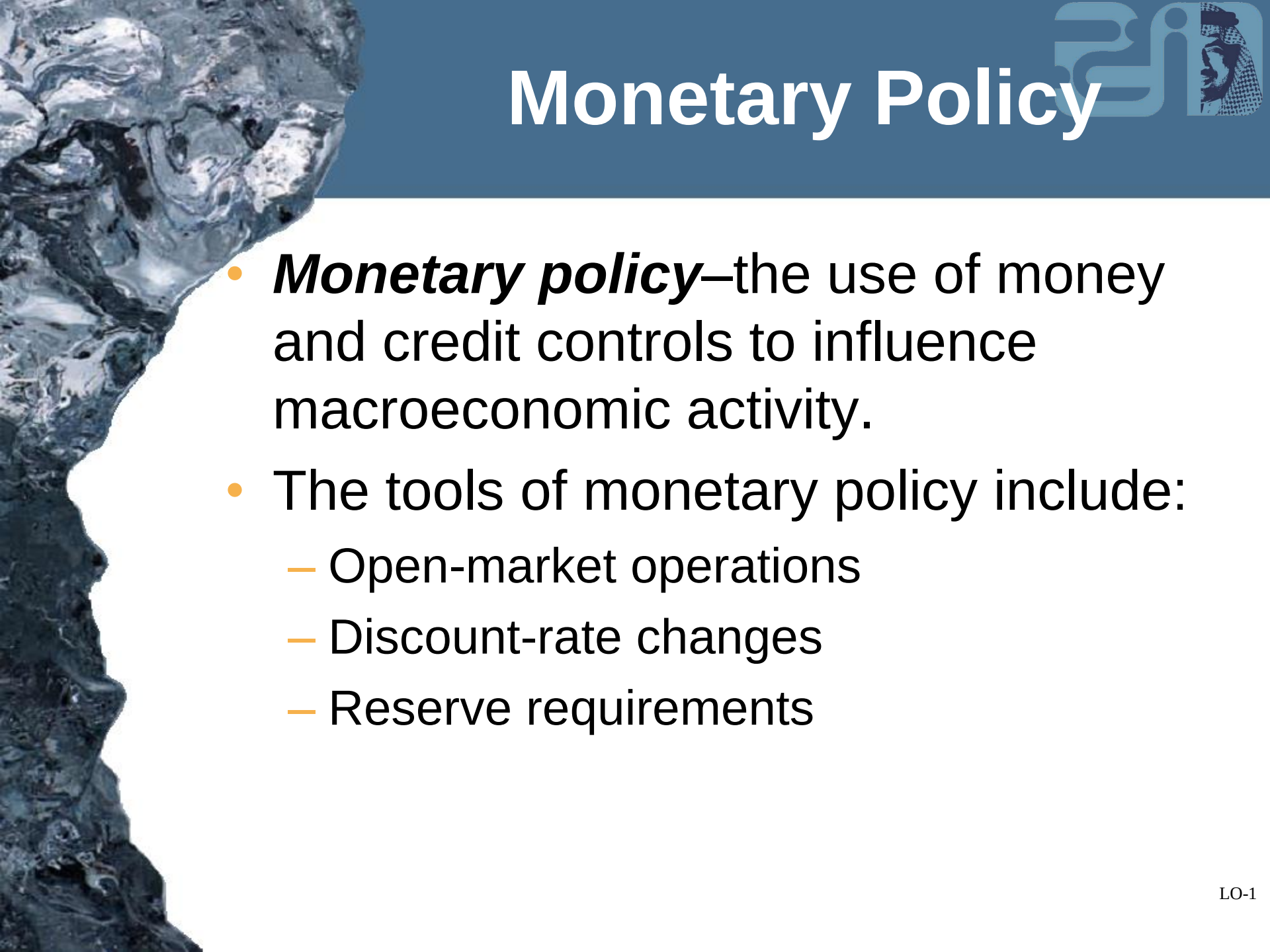
- Such actions “kicked in” during the 2008-09 recession.
- When the economy slows, recessions automatically:
 - Reduce tax revenues
 - Increase government outlays
 - Widen budget deficits



Discretionary Policy



- ***Fiscal policy*** refers to *deliberate* changes in tax or spending legislation.
- Discretionary policy often has limited impacts on the economy.
- Additional spending and tax revenue losses created a \$1.4 trillion federal deficit in 2009.



Monetary Policy

- ***Monetary policy***—the use of money and credit controls to influence macroeconomic activity.
- The tools of monetary policy include:
 - Open-market operations
 - Discount-rate changes
 - Reserve requirements

Monetary Policy



- If the *AS* curve is horizontal, changes in the money supply affect *output* only.
- If the *AS* curve is vertical, changes in the money supply affect *prices* only.
- If the *AS* curve is upward-sloping, changes in the money supply affect *both* prices and output.

Table 10.3



October 1979	Fed adopts monetarist approach, tightening money supply; interest rates soar
July 1982	Deep into recession, Fed votes to ease monetary restraint
October 1982	Fed abandons pure monetarist approach and expands money supply rapidly
1986	Money supply increases by 15 percent
May 1987	Fed abandons money-supply targets as policy guides
June 1987	Alan Greenspan appointed chairman; money-supply growth decreases; discount rate increased
1989	Greenspan announces goal of zero inflation, slows money-supply growth
1991	In midst of recession Fed reverses monetary policy; interest rates fall to their lowest level in decades
1994	As growth accelerates and unemployment dips, Fed raises interest rates substantially
1995	Fed reduces interest rates slightly when economy stalls in first quarter
1997	When unemployment rate drops below 5 percent, Fed nudges interest rates higher
1998	Fed cuts interest rates to offset shock of Asian crisis
1999–2000	Fed increases interest rates six times in one year
2001–2003	Fed reverses policy, cuts interest rates; continues cutting interest rates repeatedly until mid-2003
2004–2006	Fearing inflationary pressures, the Fed raises interest rates 17 times
2006	Alan Greenspan retires; Ben Bernanke becomes Fed chairman
2008–2009	Battling recession, Fed cuts interest rates sharply and repeatedly

Supply-Side Policy



- The shape of the aggregate supply curve limits the effectiveness of fiscal and monetary policies.
- ***Supply-Side Policy***—the use of tax rates, (de)regulation, and other mechanisms to increase the ability and willingness to produce goods and services.

Supply-Side Policy



- The goal of a supply-side policy is to shift the aggregate supply curve to the *right*.
- The supply-side toolbox is filled with a variety of tools.
- These include tax cuts designed to stimulate work effort, saving, and investment.

Supply-Side Policy

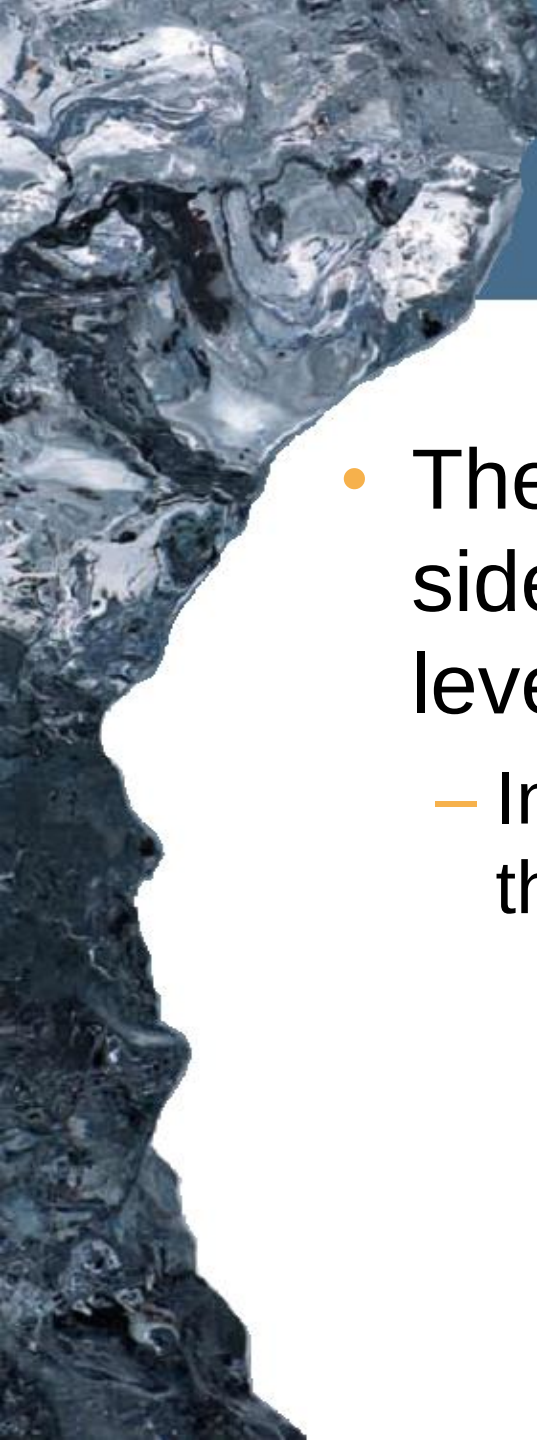


- Deregulation may also reduce production costs and stimulate investment.
- Expenditures on education, training, and research expand our capacity to produce.

Table 10.4



1978	Airline Deregulation Act	Phased out federal regulations of airline routes, fares, and entry
1980	Motor Carrier Act	Eliminated federal restrictions on entry, routes, and fares in the trucking industry
1981	Economic Recovery Tax Act	Decreased marginal tax rates by 30 percent
1986	Tax Reform Act	Eliminated most tax preferences for investment and saving but sharply reduced marginal tax rates
1990	Social Security Act amendments	Increased payroll tax to 7.65 percent
1990	Americans with Disabilities Act	Required employers to provide more handicap access
1990	Immigration Act	Increased immigration quotas, new preference for skilled workers
1990	Clean Air Act	Toughened pollution standards
1991	Surface Transportation Act	Accelerated highway and rail improvements
1993	Family Leave Act	Required employers to offer unpaid leave
1994	NAFTA	Lowered North American trade barriers
1998	Workforce Investment Act	Provided funds for skill-training programs
2001	Economic Growth and Tax Relief Reconciliation Act	Reduced marginal tax rates over 10 years
2002	Job Creation and Worker Assistance Act	Provided business tax cuts and incentives
2003	Jobs and Growth Tax Relief Act	Reduced taxes on dividends and capital gains
2007–09	Minimum wage	Increased minimum wage from \$5.15 to \$7.25 per hour
2010	American Recovery and Reinvestment Act	Sharply increased infrastructure and energy development



Idealized Uses

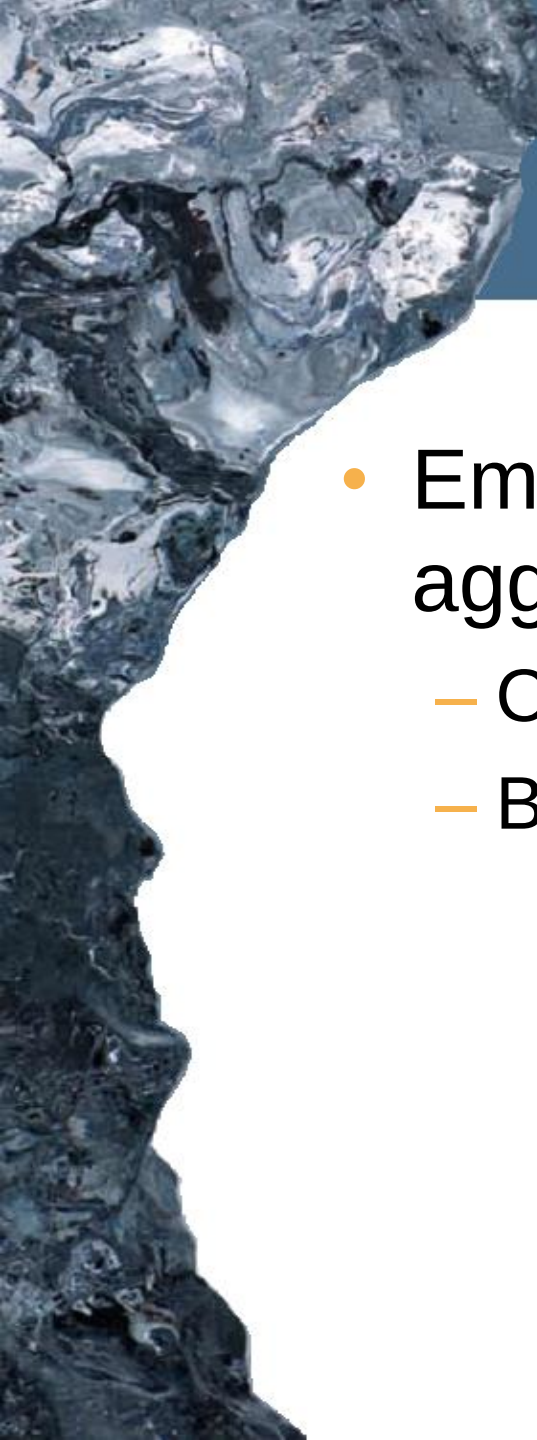


- These fiscal, monetary, and supply-side tools are potentially powerful levers for controlling the economy.
 - In principle, they can cure the excesses of the business cycle.

Case 1: Recession



- Need to put people to work.
- The GDP gap must be closed:
 - The ***GDP gap*** is the difference between full-employment output and the amount of output demanded at current price levels.



Case 1: Recession: Keynesians



- Emphasize the need to stimulate aggregate demand with fiscal policy by:
 - Cutting taxes
 - Boosting government spending

Case 1: Recession: Keynesians

- Modern Keynesians acknowledge that monetary policy might also help if it gives investment spending a further boost.
- The resulting stimulus will set off a multiplier reaction:

— .

Case 1: Recession: Monetarists



- See no point in discretionary policies.
 - The aggregate supply curve is vertical at the natural rate of unemployment
 - Changes in fiscal or monetary policy are ineffective because increases in *AD* only cause *inflation*
- The appropriate response to a recession is patience.



Case 1: Recession: Supply-Siders

- Believe that policy initiatives should focus on changing the shape and position of the aggregate supply curve.
 - Improve production incentives
 - Cut marginal tax rates on investment and labor
 - Reduce government regulation

Case 2: Inflation: Keynesians



- Need to restrain aggregate demand by:
 - Raising taxes
 - Cutting government spending
 - Relying on the multiplier to cool down the economy

Case 2: Inflation: Monetarists



- Believe that inflation reflects excessive money supply growth.
 - Cut the money supply
 - Convince market participants that cautious monetary policy will be continued

Case 2: Inflation: Supply-Siders



- Point out that inflation implies both too much money and not enough goods.
 - Expand productive capacity
 - Propose more incentives to save
 - Cut taxes and regulations, encourage more immigration, and lower import barriers

Case 3: Stagflation



- ***Stagflation*** is the simultaneous occurrence of substantial unemployment and inflation.
- There are no simple solutions for stagflation.
 - There is a need to balance the competing threats of inflation and unemployment

Case 3: Stagflation

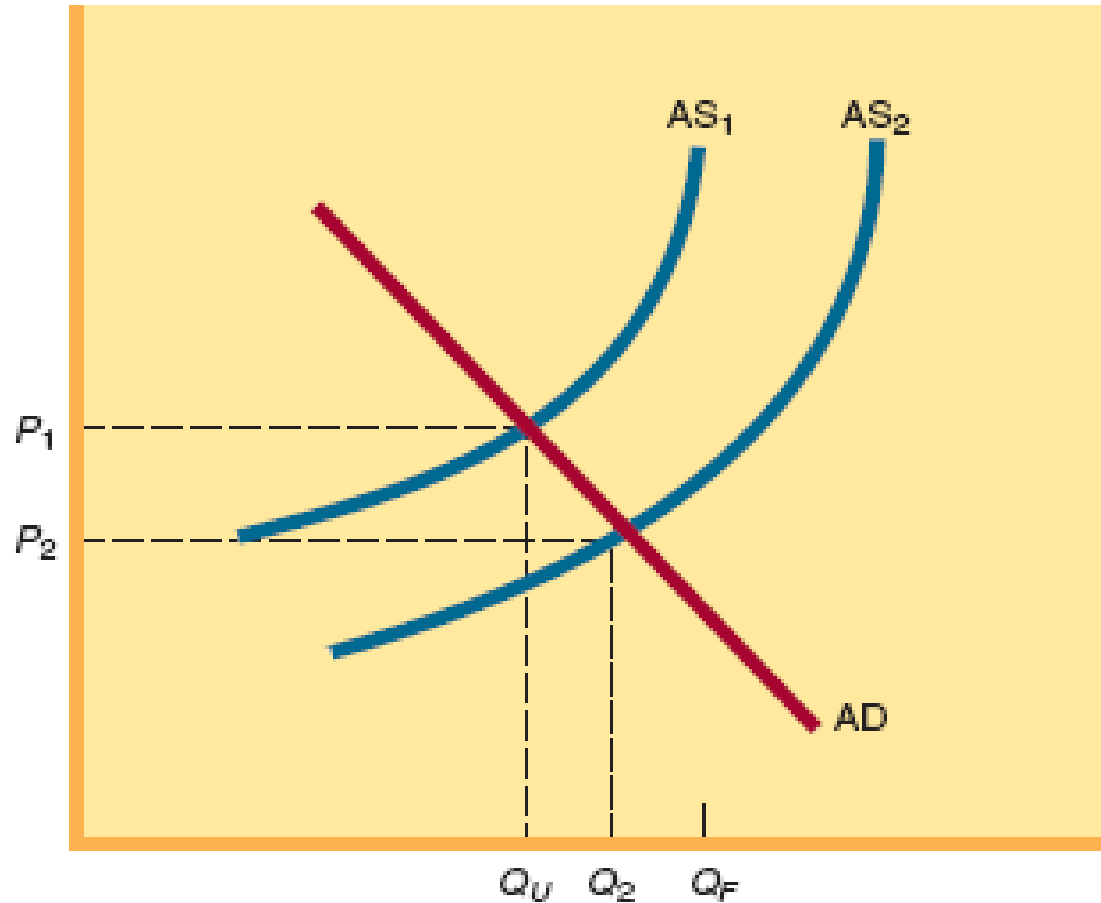


- There are several possible contributors to stagflation:
 - High tax rates or costly regulation.
 - An external shock (such as a natural disaster) or an abrupt change in world trade (such as higher oil prices).
- The result is a *leftward* shift of the aggregate supply curve.

Figure 16.1



PRICE LEVEL (average price per unit of output)



REAL OUTPUT (real GDP per time period)

Fine-Tuning



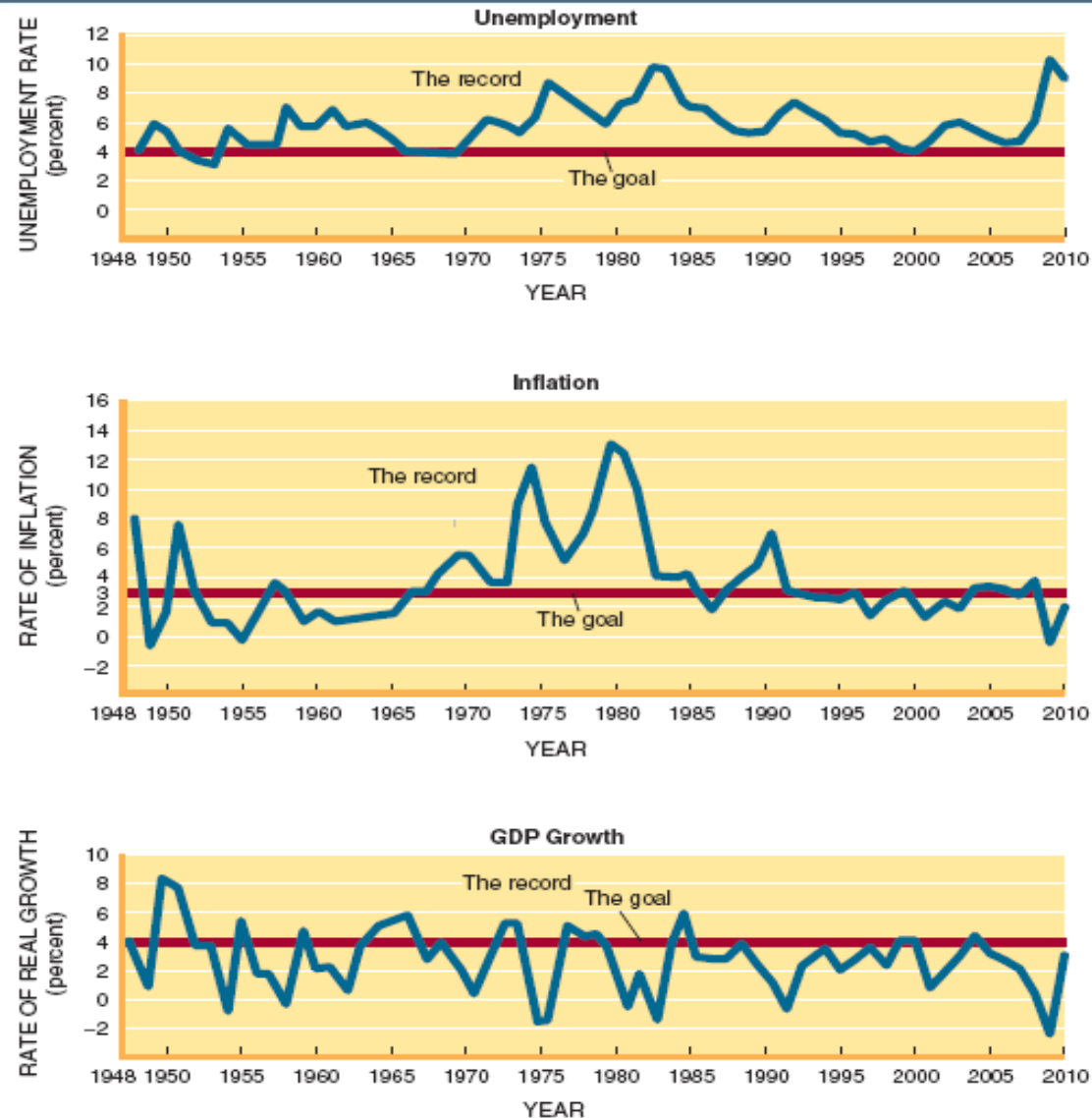
- Fine-tuning entails continual adjustments of policy levers.
- Choosing the right target for stimulus and restraint is the key to fulfilling goals.
- Some people believe it is possible to fine-tune the economy:
 - ***Fine-tuning***—adjustments in economic policy designed to counteract small changes in economic outcomes.



The Economic Record

- The economy's track record does not live up to these high expectations.
- The economy has had impressive long-run growth and improvement in the standard of living, but we must also recognize that our economic history has experienced periods of recession, high unemployment, and inflation.

Figure 10.2



Why Things Don't Always Work



- We can distinguish four obstacles to policy success:
 - Goal conflicts
 - Measurement problems
 - Design problems
 - Implementation problems

Goal Conflicts



- The Fed is traditionally viewed as the guardian of price stability and tends to favor policy *restraint*.
- The President and Congress favor policy *stimulus*.

Goal Conflicts

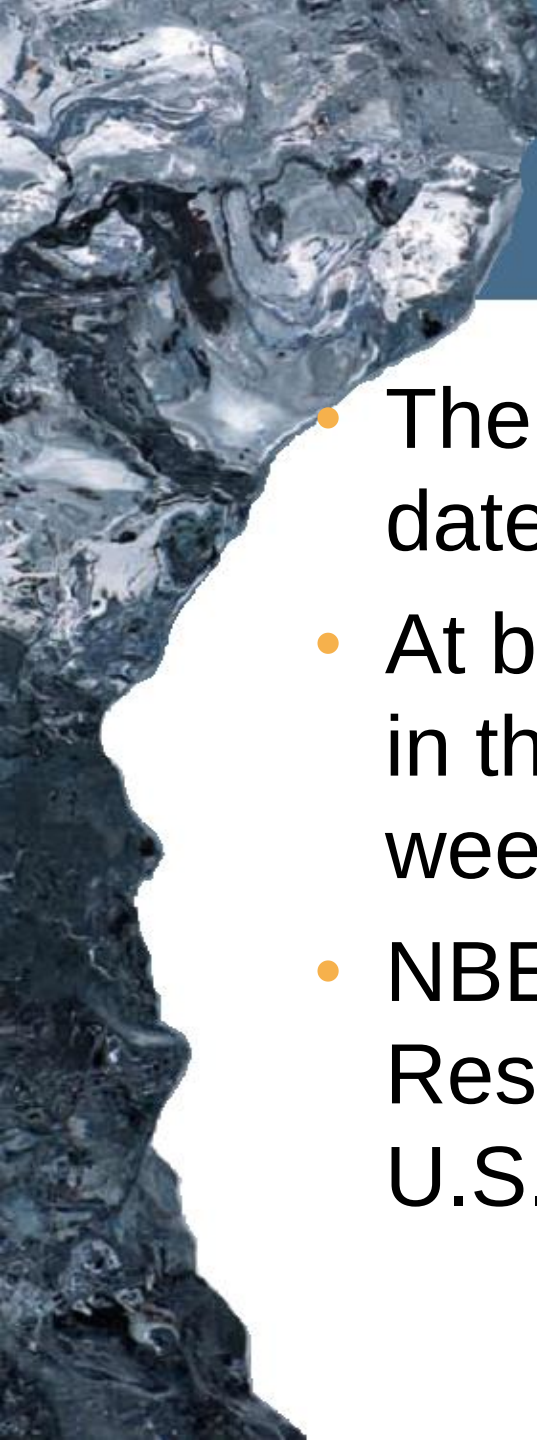


- Distributional goals may also conflict with macro objectives.
 - Anti-inflationary policies may require cutbacks in programs for the poor, the elderly, or needy students.

Goal Conflicts



- Tight-money policies may be viewed as too great a burden for small businesses.
- All policy decisions entail opportunity costs.
- This means that we will always be confronted with trade-offs.



Measurement Problems

- The available information is always dated and incomplete.
- At best, we know what was happening in the economy last month or last week.
- NBER (National Bureau of Economic Research) is the official designator of U.S. recessions (www.nber.org).

Forecasts



- In designing policy, policymakers must depend on economic forecasts, informed *guesses* about what the economy will look like in future periods.

Macro Models



- Those guesses are often based on complex computer models of how the economy works.
- Different models and data generate different policy recommendations.

Design Problems



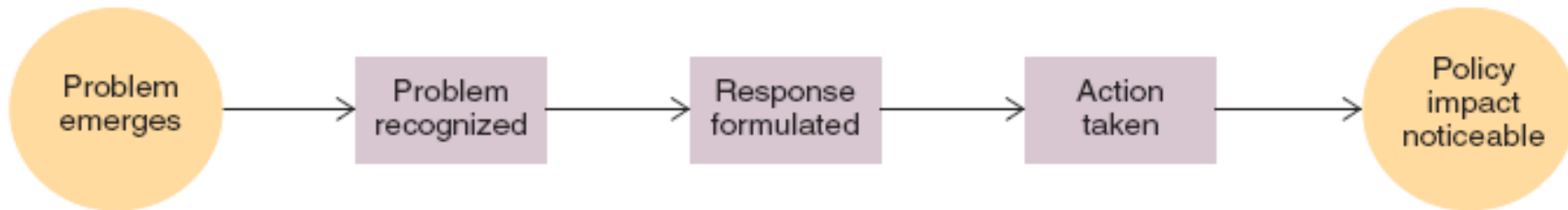
- We never know for sure how market participants are going to respond to any specific actions taken.

Implementation Problems



- To understand fully why things go wrong, we must also consider the difficulties of implementing a well-designed (and credible) policy initiative.

Figure 16.3



Congressional Deliberations



- The legislative process takes time.
- Even if the right policy is formulated to solve an emerging economic problem, there is no assurance that it will be implemented.
- And if it is implemented, there is no assurance that it will take effect at the right time.

Politics versus Economics



- Tax hikes and budget cuts *rarely* win votes.
- On the other hand, tax cuts and pork-barrel spending are always popular.

Politics versus Economics



- Savvy politicians tend to stimulate the economy before elections, then tighten the fiscal restraints afterward.
- This creates a *political business cycle*—a two-year pattern of short-run stops and starts.

Hands Off or Hands On?



- Consistent fine-tuning of the economy is not compatible with either our design capabilities or our decision-making procedures.
- We have not been able to make adjustments to completely fulfill our economic goals.

Hands-Off Policy



- Those who argue to leave the economy alone say to abandon discretionary policies altogether because fine-tuning isn't really possible.
- Milton Friedman advocated fixed-policy rules instead of discretionary policies.



Hands-On Policy



- Those who support continued fine-tuning emphasize that the historical record of prices, employment, and growth has improved since active fiscal and monetary policies were adopted.
- With fixed rules it is impossible to maintain a steady rate of money supply growth.



Modest Expectations

- Discretionary policies will continue to be used and will continue to fall short of complete success.

- End chapter 10