Fiscal Policy

Fiscal policy is most commonly viewed by economists as one-half of macroeconomic policy, the other half being monetary policy. In its most basic form fiscal policy describes how government funds its activities and what these activities are. The putting together of a government budget, for example, is fiscal policy. Fiscal policy is seen as sustainable or rational when the public and those buying government debt instruments perceive that a government's fiscal policy is predictable and that the government will continue to make payments on its debt. The most obvious example of a rational fiscal policy is that a government's revenues sources (taxes, tariffs, user fees) roughly equal its expenditures on government programs. A rational fiscal policy might also be defined by a government making public its budgets and the process by which these budgets are formulated. In addition, it is common practice and rational fiscal policy for governments to prepare financial statements and to have these statements audited. Fiscal policy goes hand-in-hand with monetary policy because a country's currency will lose its value if its fiscal policy is not seen as sustainable.

Some economists, known as Keynesian economists, believe that fiscal policy can help governments manage the economy to ensure full employment. Keynesians believe that when private economic activity is not creating enough demand in the economy to create full employment that fiscal policy can be used to increase demand and therefore stimulate enough economic activity to create more jobs. This idea of active government management of the economy through fiscal policy is derived from John Maynard Keynes, whose book *The General Theory of Employment, Interest and Money* was published in 1936 during the Great Depression.

As is well known the Great Depression was a time when unemployment was prolonged at very high levels compared to preceding historical periods. This motivated Keynes to recommend that government should take action to increase employment. *The General Theory* is oftentimes seen as the first time that a respected economist proposed that government and not the private sector can create employment. *The General Theory* is also seen as the beginning of macroeconomics as a subfield of economics.

An active fiscal policy then is the use of government taxing and spending policy to stimulate demand in an economy. In political debates, the use of government fiscal policy to increase demand is now known as a "fiscal stimulus". If the private sector is not investing enough in productive assets and not spending to increase output, including the hiring of employees, then Keynesians believe that a fiscal stimulus

created by government will start an upward cycle of economic activity. As government spending increases through a fiscal stimulus, the stimulus will provide more income to private individuals who will therefore spend more through consumption. This increased spending, this increased demand, will encourage private companies to begin spending more for output to meet the higher demand. This increase in output in turn will mean the hiring of more people. These newly hired employees will then spend more themselves, more demand is created and more output is produced to meet this demand, and an upward cycle of economic activity ensues. This idea of an active fiscal policy is also known as "demand management".

Keynesian economists believe that a fiscal stimulus is created when a government spends more than it receives in taxes and other revenue sources; this is called "deficit spending". There are several ways that a government can use deficit spending to create a fiscal stimulus and the differences in these ways to create a stimulus are often the subject of political debates in the formation of government fiscal policy. Economists who believe that government programs help people recommend that government should spend more on government programs. This increased government spending then increase demand. Other economists recommend that a fiscal stimulus be created through a reduction in taxes because taxes are seen as a drain on private on economic activity. Deficit spending can therefore can be created through; 1) more government spending while keeping taxes the same, 2) a reduction in taxes while keeping spending the same, or, 3) a reduction in taxes and an increase in government spending combined.

The use of deficit spending is also called "priming the pump" of economic activity. It is this pump-priming, where the economy is seen as a system analogous to water flowing through a closed system, which starts the upward cycle of economic activity. The first overt use of active fiscal policy in the United States, which might be seen as when Keynesian economics became institutionalized in American politics, was the Pump Priming Act of 1938, which increased the federal government budget by 5% over 1937 levels. In hindsight today this spending increase does not seem that much greater than the general increase in government spending from year-to-year whether or not the economy is facing above-average levels of unemployment.

Fiscal policy as a tool for managing the economy has been criticized for many reasons. Perhaps the most cogent argument against Keynesian economics is that political reality does not allow it to work in practice as it is proposed in theory. The purpose of a fiscal stimulus, of government running a deficit in the short term to boost economic activity in the short term, is to create a temporary demand

increase to begin the upward cycle in private sector demand. However it has been shown over time that once increased government spending has been put in place more often than not the government deficit spending does not decrease once there is full employment. For example, the “public choice” school of economics explains why it is very difficult to reduce spending on a government program once a program is put into place due to the special interest groups created by the government program.

Many economists agree that the private sector, and not government, can best create long term productivity increases (which is what supports higher standards of living) through the profit incentive in the market. Therefore it is argued that when governments continue to run budget deficits, increasing government debt levels each year, society’s resources are diverted from private sector activity to paying the debt on the government borrowing necessary for the government to spend more than it receives in taxes. For example, except during periods of war, prior to the common use of Keynesian economics government debt in the United States averaged less than 10% of national income. After the 1930s, again excepting periods of war, debt as a percentage of national income has averaged more than 35%.

A second critique against fiscal policy as demand management is what is known as the “lag time” involved in implementing public policy. In order for a fiscal stimulus to be effective the deficit spending must take place when the economy is performing poorly. There have consistently been business cycles throughout economic history. Periods of increasing economic growth and employment are followed by periods of decreasing growth and increasing unemployment. It is difficult if not impossible to time a fiscal stimulus to take place during the exact moment of the downturn of the economic cycle. In the first place it takes time for the government to gather the economic data required to determine when unemployment is increasing. Then it takes time for the government to put together a budget proposal recommending the stimulus. Then it takes time for the legislative body to approve the budget, and further time for the government to then spend the approved budget and for the deficit spending to take effect in creating increased demand.

Therefore these lag times in public policy make it very difficult for government to manage the economy through fiscal policy. For example it is possible for the fiscal stimulus spending on a government program to flow through the economy at the same time that the private sector is already increasing its economic activity. If this is the case then both the government and the private sector are competing for the scarce economic resources of a society at the same time. This would mean that the

government spending is counter-productive and in fact may worsen the social costs of the already existing boom and bust cycles common to all economies because productivity gains in the up-cycle are not as great as they could be due to government using scarce economic resources at the wrong time. In economic thinking this is what is known as a negative "unintended consequence" of public policy.

Every government by definition uses fiscal policy (the management of government revenues and expenditures) as part of its budget cycles. However it is the use of fiscal policy as demand management which is still under debate in economics, even after being common political practice for more than 70 years.

See Also: Economic Stimulus Plan, Fiscal Balance, Monetary Stability, Recessions, Treasury Bills, United States

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