Fiscal Policy Definitions

- Fiscal policy is the use of taxes, government transfers, or government purchases of goods and services to shift the aggregate demand curve.
- Discretionary Fiscal Policy: government takes deliberate actions through legislation to alter spending or taxation policies

Expansionary Fiscal Policy

- When the economy is in recession, government wants to increase AD
- Tax cut: increases consumers disposable income
    - Increases AD as long as consumers don't increase savings or spending on imports
- Increase in government spending: directly shifts the AD curve

Contractionary Fiscal Policy

- When economy is suffering from inflation, government wants to decrease AD
- Tax increase: decreases disposable income of consumers
    - AD curve shifts left, both inflation and GDP decrease
- Decrease in government spending: directly shifts the AD curve left

Tools of Fiscal Policy

Changes in government spending

- Can increase spending in normal budgetary programs (health, education, welfare, etc.)
- Can increase spending on infrastructure (underlying economic foundation of goods and services that allows a society to function e.g. build roads, schools, communication systems)
    - Added advantage of increasing capital goods in economy which can shift AS in the future

Changes in taxation

- Raise or lower personal and corporate income taxes and/or sales and excise taxes
- Alter tax exemptions or tax credits
- Provide special tax incentives for investment (Capital Cost Allowance)

Automatic Stabilizers

- Exist and act on AD before a recession or inflationary trend takes hold
- Employment insurance and welfare: increased payments during times of economic downturns
    - Help to maintain incomes during recessions (maintain spending)
    - Either slows the leftward shift of AD or shifts curve right
- Progressive tax: as incomes rise, taxes rise
    - Slows down increases in consumption
    - Stops AD curve from shifting too quickly to the right

Fiscal Policy and the Multiplier

- Fiscal policy has a ***multiplier effect*** on the economy.
- Expansionary fiscal policy leads to an increase in real GDP larger than the initial rise in aggregate spending caused by the policy. The government spends an additional $4 Billion through discretionary fiscal policy. The total effect on GDP will be larger than $4 Billion.
- The multiplier effect refers to the additional shifts in aggregate demand that result when expansionary fiscal policy increases income and thereby increases consumer spending.
- Conversely, contractionary fiscal policy leads to a fall in real GDP larger than the initial reduction in aggregate spending caused by the policy.

The Budget Balance

- Other things equal, discretionary expansionary fiscal policies—increased government purchases of goods and services, higher government transfers, or lower taxes—reduce the budget balance for that year.
- That is, ***expansionary fiscal policies*** make a budget surplus smaller or a budget deficit bigger.
- Conversely, ***contractionary fiscal policies***—smaller government purchases of goods and services, smaller government transfers, or higher taxes—increase the budget balance for that year, making a budget surplus bigger or a budget deficit smaller.
- Some of the fluctuations in the budget balance are due to the effects of the business cycle.
- In order to separate the effects of the business cycle from the effects of discretionary fiscal policy, governments estimate the **cyclically adjusted budget balance,** an estimate of the budget balance if the economy were at potential output.

Government Budgets

- Deficit budget: government spends more than it receives in tax revenue (must borrow money to cover shortfall)
- Surplus budget: government collects more in taxes than it spends
- Balanced budget: government spends amount equal to collected tax revenue
- Debt: total amount owed by the government
- Deficits Versus Debt
  - A *deficit* is the difference between the amount of money a government spends and the amount it receives in taxes over a given period.
  - A *debt* is the sum of money a government owes at a particular point in time.
  - Deficits and debt are linked, because government debt grows when governments run deficits. But they aren't the same thing, and they can even tell different stories.

Types of Deficits

- Cyclical deficit: part of deficit incurred in trying to pull an economy out of recession (spending on infrastructure, jobs retraining, etc.)
- Structural deficit: part of deficit that exists even when economy is operating at full employment
- Full employment budget: intervene only when economy falls below its full-employment targets – no structural deficits

Should the Budget Be Balanced?

- Most economists don't believe the government should be forced to run a balanced budget *every year* because this would undermine the role of taxes and transfers as automatic stabilizers.
- Yet policy makers concerned about excessive deficits sometimes feel that rigid rules prohibiting—or at least setting an upper limit on—deficits are necessary.

Problems Posed by Rising Government Debt

- Public debt may **crowd out** investment spending, which reduces long-run economic growth.
- And in extreme cases, rising debt may lead to government **default**, resulting in economic and financial turmoil.
- Can't a government that has trouble borrowing just print money to pay its bills?
- Yes, it can, but this leads to another problem: inflation.

The Federal Budget

Revenue Outlook (Including Budget 2010 measures)

	2008–2009	Projection 2009–2010	2010–2011	2011–2012	2012–2013	2013–2014	2014–2015
		(billions of dollars)					
Income taxes							
Personal income tax	116.0	108.2	117.0	124.5	133.3	141.9	150.6
Corporate income tax	29.5	22.3	25.5	28.9	29.5	31.6	33.2
Non-resident income tax	6.3	4.9	5.5	5.9	6.4	6.9	7.0
Total income tax	151.8	135.4	148.0	159.4	169.3	180.3	190.8
Excise taxes/duties							
Goods and Services Tax	25.7	25.8	27.3	28.8	30.5	32.1	33.7
Customs import duties	4.0	3.4	3.4	3.5	3.7	3.8	4.1
Other excise taxes/duties	10.0	10.1	10.3	10.3	10.3	10.3	10.4
Total excise taxes/duties	39.8	39.3	41.0	42.7	44.4	46.3	48.3
Total tax revenues	191.6	174.7	188.9	202.0	213.7	226.6	239.1
Employment Insurance premium revenues	16.9	16.6	17.6	20.0	22.6	25.2	26.6
Other revenues	24.6	22.6	24.8	27.0	30.3	30.8	30.8
Total budgetary revenues	233.1	213.9	231.3	249.0	266.5	282.7	296.5
Per cent of GDP							
Personal income tax	7.3	7.1	7.3	7.4	7.5	7.6	7.7
Corporate income tax	1.8	1.5	1.6	1.7	1.7	1.7	1.7
Goods and Services Tax	1.6	1.7	1.7	1.7	1.7	1.7	1.7
Total tax revenues	12.0	11.4	11.8	12.0	12.0	12.2	12.2
Employment Insurance premium revenues	1.1	1.1	1.1	1.2	1.3	1.4	1.4
Other revenues	1.5	1.5	1.5	1.6	1.7	1.7	1.6
Total	14.6	14.0	14.4	14.8	15.0	15.2	15.2

Note: Totals may not add due to rounding

Program Expense Outlook (Including Budget 2010 Measures)

	2008–2009	Projection 2009–2010	2010–2011	2011–2012	2012–2013	2013–2014	2014–2015
		(billions of dollars)					
Major transfers to persons							
Elderly benefits	33.4	35.0	36.7	38.6	40.7	42.9	45.2
Employment Insurance benefits[1]	16.3	22.4	22.6	19.6	18.8	18.4	18.4
Children's benefits	11.9	12.3	12.7	13.2	13.4	13.4	13.5
Total	61.6	69.7	72.0	71.4	72.9	74.8	77.1
Major transfers to other levels of government							
Federal transfers in support of health and social programs	33.3	35.7	37.1	38.7	40.7	42.7	44.7
Fiscal arrangements[2]	15.2	16.1	16.4	16.8	17.7	18.6	19.5
Alternative Payments for Standing Programs	-3.0	-2.7	-2.9	-3.1	-3.3	-3.5	-3.7
Canada's cities and communities	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Other[3]	0.0	0.3	4.3	1.9	0.0	0.0	0.0
Total	46.5	51.4	56.8	56.3	57.1	59.8	62.4
Direct program expenses							
Transfer payments	30.2	39.8	39.4	33.7	33.6	32.8	32.1
Capital amortization	4.1	4.4	4.6	4.9	5.1	5.3	5.4
Other operating expenses	20.6	20.8	21.5	22.9	24.2	25.2	25.8
Operating expenses subject to freeze	44.9	51.8	54.9	52.2	52.4	53.5	54.8
Total	99.8	116.8	120.4	113.7	115.2	116.7	118.2
Total program expenses	**207.9**	**237.8**	**249.2**	**241.4**	**245.2**	**251.4**	**257.7**

Table 4.2.3

Summary Statement of Transactions (Including Budget 2010 Measures)

	2008–2009	Projection 2009–2010	2010–2011	2011–2012	2012–2013	2013–2014	2014–2015
		(billions of dollars)					
Budgetary revenues	233.1	213.9	231.3	249.0	266.5	282.7	296.5
Program expenses	207.9	237.8	249.2	241.4	245.2	251.4	257.7
Public debt charges	31.0	29.9	31.3	35.3	38.9	39.8	40.6
Total expenses	238.8	267.7	280.5	276.7	284.0	291.2	298.3
Budgetary balance	-5.8	-53.8	-49.2	-27.6	-17.5	-8.5	-1.8
Federal debt	463.7	517.5	566.7	594.3	611.9	620.3	622.1
Per cent of GDP							
Budgetary revenues	14.6	14.0	14.4	14.8	15.0	15.2	15.2
Program expenses	13.0	15.6	15.6	14.3	13.8	13.5	13.2
Public debt charges	1.9	2.0	2.0	2.1	2.2	2.1	2.1
Budgetary balance	-0.4	-3.5	-3.1	-1.6	-1.0	-0.5	-0.1
Federal debt	29.0	33.9	35.4	35.2	34.4	33.3	31.9

Note: Totals may not add due to rounding.

Drawbacks and Limitations of Fiscal Policy

- Time lags are significant
  - Recognition lag: time it takes government to recognize there is a problem
  - Decision lag: time required for government to determine most appropriate policy
  - Implementation lag: time it takes to figure out how to implement new directives
  - Impact lag: time it takes to be felt through multiplier effect
- Difficulties in changing spending and taxation policies
  - It is far easier to increase spending and decrease taxes then to increase taxes and decrease spending
- Conflict between levels of government over appropriate policies
  - Federal, provincial and city governments may differ on what needs to be done.
- Regional variations
  - Some provinces can be in recession while others are still growing
- Size of debt can limit use of fiscal policy
- Crowding out of private investment
  - Increases interest rates
  - Reduces amount of funding for private investment
- Deficits redistribute income from all taxpayers to bondholders
  - Interest payments on debt made from tax revenue
- Deficits impose net burden on future generations
- Foreign-owned debt removes capital from economy