LABOR CENTER REPORTER

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Number 182
May 1986

FISCAL POLICY

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~~The~~ government's policy concerning the amount of taxes it collects and the amount of money it spends is called fiscal policy. It is a powerful tool often credited with ending the Great Depression. Like monetary policy (see LCR 177), fiscal policy can help us fight inflation or recession.

Here is how fiscal policy works. Suppose the government decides to spend $1 million more than it had planned to in order to build a bridge (forget for a moment where the money comes from). How would this affect the economy? The answer depends on the state of the economy. If everyone is employed and all factories are running at full capacity, the government will have to offer higher wages than people are already getting in order to convince some people to quit their jobs and take bridge building jobs, and the existing employers will have to raise their wages somewhat so that some people will be willing to stay at their old jobs. Extra competition by government contractors may also drive up the prices of bridge building materials. One million dollars won't buy as much bridge as the government had anticipated, the things that would have been built by the bridge builders if they hadn't built the bridge won't get built, and workers' higher wages will be "chasing fewer goods" and won't buy as much as the old lower wages used to. In other words, inflation will result.

In the other extreme case, suppose there are a lot of people out of work, and a lot of factories running below capacity. If the government spends $1 million on bridge builders and bridge building materials, a lot of formerly idle hands will now have work. But the story doesn't stop there. The bridge builders and bridge building materials makers will now have income that they didn't have before, and will spend part of this income on groceries, haircuts, furniture, etc. perhaps creating even more jobs. Then the grocers, barbers and furniture makers will go out and spend some of their extra income. And so on. In the absence of full employment, a $1 million increase in government spending increases the value of total production (GNP) by much more than $1 million.

It is obvious that in this simple example the government should spend more money when there is a recession and spend less money when there is inflation. In the real world, it is never so clear what sort of fiscal policy is best for the economy. When there is both unemployment and inflation, there are difficult choices to make. It is impossible to predict exactly how much growth and inflation will result from an expansionary policy, or how much increase in unemployment and decrease in inflation will result from a contractionary policy.

Now to return to the nagging question of where the $1 million came from. The obvious answer is that it came from a $1 million increase in taxes. This is a possibility, but raising taxes is itself a contractionary fiscal policy, and tends to counteract the expansionary effect of an increase in government spending. Just think of our two examples. In the full employment example, an increase in taxes could have partially offset the effect of the increased wages by decreasing the amount of money in circulation, decreasing the resultant inflation. In the low employment example, an increase in taxes would have counteracted the income and job creation cycle that was started by the spending increase. Bridge builders and their grocers, barbers, etc. would have more income, but everyone else would have less after tax income than if the increase in spending and taxes hadn't occured. So the result of increasing both taxes and spending is uncertain.

To amend the previous statement, a government should spend more money or collect less taxes when there is a recession. This is called expansionary fiscal policiy. When there is inflation, the government should use contractionary fiscal policy, spending less money or collecting more taxes. To some extent our economy does this automatically. Income tax revenues increase as more people become employed and as inflation increases their incomes, and total government spending on unemployment and welfare benefits increases as more people become unemployed.

Since an increase in taxes would tend to counteract the effect of an increase in spending (and a decrease in spending would tend to counteract a decrease in taxes), and simply printing more money is a sure way to fuel inflation, U.S. federal and local governments often rely on borrowing money from the private sector when the country is in a recession. The amount by which government spending exceeds tax revenues is the budget deficit (see LCR 178).

Fiscal policy as a stabilization tool should not be confused with the other functions of government spending and taxation in our economy. Tax money is used to pay for many things that couldn't easily be purchased by individuals, for example, public libraries and national defense. Tax money is redistributed from rich to poor, and acts as insurance against natural and man-made disasters. Taxes, subsidies and tax credits provide incentives and disincentives that encourage "socially desirable behavior" (such an investment in factories that pollute less). The fiscal policy effects of changes in government spending and taxation depend mainly on the amount by which these variables are changed, and not significantly on which government programs experience changes in funding or which tax rates are changed.

However some kinds of spending are politically easier to increase than others. Historically in our country most fiscal expansions have taken the form of increased military expenditures. The experimental "pump priming" of the Great Deparession was nothing compared to the massive World War II expenditures that finally ended the Depression. And during the Viet Name War, the onset of inflation did nothing to dampen U.S. expenditures on the War.

The current U.S. budget includes over $1000 per person per year for the Department of Defense. Decreasing this significantly would probably have adverse effects on the economy in terms of lost jobs unless cuts in military spending were coupled with increases in other spending. For example, if the military budget were cut back to the level of 1980, it would be possible to send $2000 per school aged child per year to all schools in the U.S. without changing the net budget. Of course there would be employment consequences. Jobs and wages would fall for engineers and rise for schoolteachers. But GNP wouldn't be affected much.

Fiscal policy gives our government the ability to increase employment by increasing spending or decreasing taxes, and the ability to slow inflation by decreasing spending or increasing taxes. But the health and nature of our future economy will depend, in part, on where government spending is going, and where taxes are coming from.

-- *Catherine Weinberger*