Fiscal Policy and Stimulus: Crash Course Economics #8

Crash Course: Economics
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(Deep Voice) Today, we peer into a world where shadowy government stooges manipulate the government's fiscal policy deep in their evil lairs. They pick economic winners, and losers, and control the business cycle, creating recessions and controlling inflation to serve their nefarious purposes.

Adrienne: (Evil laughter) Nah, fiscal policy is a completely legitimate tool used by non-shadowy government officials to correct fluctuations in the economy.

(Intro Music)

OK, in previous videos, we've discussed the business cycle and how the economy goes up and down and up and down and up and down over time. This line represents the economy's potential GDP, the maximum sustainable amount that the economy will produce in the long run. But the business cycle shows that the economy isn't always at its potential, and when actual output is below potential, that's what economists call a recessionary gap. Workers are unemployed and factories are sitting unused.

Sometimes, actual output can briefly rise above potential. Economists call this an inflationary gap. Unemployment is super low and factories are working overtime, but it's not sustainable. Eventually producers will bid up the price of scarce resources, and higher costs will lead to more inflation rather than more output. Obviously real-life fluctuations aren't as predictable as the business cycle might suggest, but every modern industrialized economy has seen times of boom and bust. You know, you get your Empire Strikes Back and you get your Phantom Menace.

So let's look at the real GDP growth rate in the United States since 1920. See, up and down over time, and in the mid-1980's, things flattened out, and we had a thing called the Great Moderation. It seemed like the days of deep recessions and high inflation were over. Then came the Great Recession as a result of the 2008 financial crisis. Back to the same old window: ups and downs of the business cycle.

Both recessionary and inflationary gaps caused serious problems. High unemployment when the economy is bad; that's bad, like really bad, and not just for the economy, for people. High unemployment rates have been linked to higher suicide rates, more domestic violence, and social upheaval. High inflation can be just as bad. Rising costs wiped out savings and have been the root of protests and riots throughout the world.

Well, this seems like a fun episode, Stan, what's with all the doom and gloom? Isn't there some way to smooth out these fluctuations?

I'm going to answer my own question. There might be. Many economists argue that policymakers should intervene in the macro-economy in order to promote full employment and to reduce inflation. Today we're going to look at one of the ways to do this: Fiscal Policy.

Mr. Clifford: The idea of Fiscal Policy is really simple. When the economy is going too slow or too fast, then the government can step on the gas or the brake, by changing government spending or taxes. In the United States, that's the job of Congress and the President.

When the economy falls into a deep recessionary gap, the government can increase government spending, cut taxes, or do part of both. That idea is called expansionary fiscal policy. The idea is that government spending creates jobs and increases income for construction workers, teachers, and other laborers. In turn, these workers spend more of their additional income, increasing consumer spending, and boosting the economy.

Cutting taxes follows a similar logic. A tax cut will increase disposable income for consumers, that will increase consumer spending, and boost the entire economy.

Adrienne: This is exactly what the US did in 2009 during the depths of the Great Recession. The American Recovery and Reinvestment Act was a stimulus bill that added more than 800 billion dollars to the economy. That stimulus was split 60/40 between new government spending and tax cuts. And the expansionary fiscal policy funded new roads and bridges and upgrades to the electric grid. And those projects created jobs.

Mr. Clifford: But in a inflationary gap, the government can cut spending and raise taxes or do some combination of the two. That's called contractionary fiscal policy, and that's not half as fun. The idea is that higher taxes will leave consumers less money to spend, and lower government spending will mean fewer public jobs. All that should reduce consumer spending, cooling off the economy and reducing inflation.

Adrienne: We don't see contractionary fiscal policy very often in practice, because politicians rarely want to hit their voters with a slower economy. It's a hard sell and it could cost policymakers their jobs. US President George H. W. Bush famously stated, "Read my lips, no new taxes." while campaigning in 1988. A few years later, he agreed to raise taxes to reduce the debt and lost the election in 1992.

So the big question here is: does fiscal policy actually work? Does stimulating the economy with spending and tax cuts actually, you know, make the economy grow? That is the most heated debate in modern economics, and it's been raging for decades. It's been known to drive mild-mannered economists to use their loud voices on cable news shows. Let's learn about it in Thought Bubble.

(Adrienne reads text on screen)

These theories dominated policy decisions during the early years of the Great Depression, which saw little stimulus. Economists argued that unemployed workers would eventually accept lower wages since some pay is better than no pay, and resource prices would eventually fall since fewer people were using resources. Lower costs would lead to more production, more jobs, and poof! The economy is back on track!

At the time, many policymakers thought about a sick economy the way doctors a thousand years ago thought about a sick patient. The thinking was the problems resulted from accumulated imbalances, which can be cured by aggressive purging. In the case of doctors, that meant bleeding their patients. In the case of a recession, that meant standing back and letting the economy bleed jobs and output until balance was restored.

Then entered British economist John Maynard Keynes, one of the most influential and controversial economist of the 20th century. Keynes basically invented modern economics, and developed theories and models about spending and production. He is the one that suggested using expansionary fiscal policy to speed up the economy. Keynes argued that government spending can make up for a decrease in consumer spending, so even if the economy does self-correct in the long run, there's no reason to wait it out. His justification? "In the long run, we are all dead." Well Keynes died in 1946, but his theories live on, and so does the debate.

Mr. Clifford: Thanks, Thought Bubble. So at first glance Keynesian policy seems like the perfect solution to fixing a sluggish economy if consumer spending falls, the government can spend its debt, what's the harm in that?

Well, the government has to pay for a that spending, they can't just raise taxes to cover, because that would decrease consumer spending and defeat the purpose. So to stimulate the economy, the government needs to deficit spend. They need to spend more money than they collect in tax revenue. Now to achieve this, the government needs to borrow money, which result in debt.

Now, we're going to make a video on the national debt and different schools of economic thought. But for now, it's fair enough to say that the people who don't like Keynesian policy don't like it because it causes debt. The more technical argument against deficit spending is it leads to something called crowding out. If the government borrows a lot of money, that increases interest rates, making it harder to borrow money and buy things like factories and tools. This weakens the economy while increasing government debt.

(Mr. Clifford reads text on screen)

In that case, since total output can't really rise more, government spending will result in less private spending. However, they argue, the situation is a lot different when the economy is below capacity with lots of unemployed workers and vacant factories. Now, in that case, more government spending can raise overall output by putting idle resources back to work. In fact, Keynesians would argue that government stimulus when the economy is below capacity could actually raise private spending. All those newly hired workers will start spending money.

Adrienne: So how can we figure out who's right? We can start by comparing the actual performance of economies that received stimulus to those that didn't. As we mentioned, in 2009, the US government launched a huge stimulus program in response to the financial crisis. Despite that, employment and GDP both fell. That sounds like a failure, but the majority of economists think the situation would have been far, far worse without that stimulus, and while the US was implementing stimulus, most European countries were doing the opposite. They were pursuing a policy called austerity: raising taxes and cutting government spending to reduce debt.

Since 2011, when the US and European policies really started to diverge, the US economy has grown at an average rate of 2.5% while the Euro-zone GDP actually shrank by 1%. US unemployment fell to 5.5%, while Euro-zone unemployment rose to 12%.

Mr. Clifford: Another thing to keep in mind is the stimulus is complicated, and hard to do well. One reason is because of this thing called the Multiplier Effect. The idea here is that the government spends $100 and the construction worker who got the money will save $50 and then spend $50 on a concert or something. The musician who got that money will save $25 and spend the other $25 and so on.

(Mr. Clifford reads text on screen)

Economists would call this a multiplier of 1.75, but the question is, what's the real multiplier of the United States economy? Economists have come up with a wide range of estimates for that multiplier. It turns out it depends on different situations. When the economy is already booming, the multiplier seems to be close to one. If everyone's already working, and the government wants to build a road, then they're going to have to hire workers away from the private sector.

Sure, public sector output increases, but private sector output falls, and GDP is unchanged. It's a wash. But when the economy is in recession with lots of unemployed workers in lots of unused capital, the multipliers around 2. Due that ripple effect an increase of $100 or government spending will lead to about $200 of total spending, which puts some people back to work. Moreover, different policies have different multipliers, spending on welfare and unemployment is the biggest bang for our buck since people with low incomes are likely to spend their additional income.

(Mr. Clifford reads text on screen)

More targeted tax cuts and tax credits have lower multipliers since they tend to benefit those with higher incomes, who often save rather than spend additional income. But we want is something that will affect the economy rapidly, but also have a high multiplier. So tax cuts put money in people's hands quickly, but that money might get saved rather than spent.

On the other hand, infrastructure projects like making roads and bridges have strong multipliers, but might take months or even years to complete. So fiscal stimulus may be an important tool, at least when it comes to a recession, but it doesn't mean that it's easy to do or that all stimulus is created equal.

Adrienne: So fiscal policy has its advantages and drawbacks, but in the end, maybe it's all about that thing you didn't have in 6th grade: confidence. When people are miserable and unemployed, they want to feel like help is on the way. Doing nothing doesn't create the kind of confidence that we'll get consumers and businesses spending again, and it doesn't get politicians re-elected. So it looks like Keynesian policies are here to stay unless...

(Evil Laugh)

Stan: (echoey announcer voice) CrashCourse economics is made with the help of all of these nice people. You could help make CrashCourse free for everyone forever through your support on Patreon. Patreon is a voluntary subscription service that allows you to support the content you love and earn great rewards. Check it out at patreon.com/crashcourse. Thanks for watching and DFTBA.

Adrienne: (laughs) Did I look evil?

(endscreen)