

Fiscal policy, crowding out, supply- side, economics

[Economics](#)



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What is the essence of the accounting identity (the so called saving investment identity) that the two distinguished professors refer to? Fiscal Policy, Crowding out, Supply-side, Economics By melted that the amount saved (S) in an economy is equal to the amount invested (I). It is an equilibrium expressed in terms of supply (S), and demand (I), for lending (loan-able funds). S_p (Private Saving) + S_g or (T-G) (Government Saving or Budget Balance) = I.

The authors are assuming full employment, where $S = I$. The saving "identity" where holds true by definition but it's complexity is that this does not mean that an increase in savings will automatically increase investment. The relationship is more complex. As discussed in class, to bring S and I in line, the composition of other elements of the economy change when S or I change. (b) Define the concept of "crowding out". How does the identity in part (a), as claimed by the authors, explain the concept of crowding out and hence in their opinion vitiate fiscal policy?

Basically the "crowding out effect" is when government spending increases, increasing aggregate demand, but supply doesn't change, government saving decreases, they finance by borrowing, issuing bonds, the government borrows more and the private sector borrows less, ultimately leading to less investment and a rising interest rate. The saving curve shifts to the left because of the rising interest rate. The authors are assuming full employment, as this is the only case where $S = I$.

They are basically saying that the effect of expansionary fiscal policy is that it creates a deficit, and government spending increases ultimately make

investments decrease by an equal amount essentially doing nothing, (because @ full employment you can't change the supply side). Also money available for borrowing is finite, the government stepping in leaves less for everyone else, the cost of borrowing for the private sector increases, interest rate rises, and all of it leads to less investment in the economy. This they argue impairs the validity of fiscal policy. C) Drawing a diagram, as presented in basic Economics textbook in terms of the elements of the above identity, show that an increase in G (government spending) does not reduce (I) one for one. (See diagram below) In FEE, government increase by 1 = Investment decrease by 1. An increase in government spending pushes S up significantly, interest rate will rise, Investment will decrease (). This is the 100% crowding out effect. Increase () This is generally not the case in the majority of economies. As mentioned, the degree to which the crowding out effect occurs depends on the economy's closeness to full employment.

If at full employment and the government changes fiscal policy to increase government spending, (100% crowding out effect) it creates competition for resources, which increases interest rates, which leads to investment reduction. BUT the 2008 financial crisis the economy has been BELOW full employment. We are not @ full employment. Increase in government spending actually makes GAP increase. As seen in the equation: $Y = C + I + G$. This will increase savings, because as GAP increases, disposable income increases, $Hyde = C + Sp$, savings increases.

Government increase by 1 = Investment decrease by less than 1. This is < 100% crowding out effect. The saving curve shifts left because Private Saving and overall saving increase (), and then it shifts right () (but not all

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the way) because GDP increases and then Investment increases. It shifts twice! (As seen by the arrows in the diagram) Therefore S decreases, but not all the way. Interest rate rises but not as high as FE, and investment declines but not as low as FE. Therefore " An increase in G doesn't reduce I one for one, it increases GDP, which leads to higher S and T. (d) What is the fallacy of arguing- as the professors do- that the savings-investment identity proves anything about the effectiveness of fiscal policy? Again, they are assuming the economy is at full employment or full potential when in fact, we are below full employment. Therefore the savings investment identity does not prove anything about the effectiveness of fiscal policy. Fiscal policy is a employment. Fiscal policy can raise GDP, create Jobs, increase income, etc... which is very beneficial. How can these professors be so ignorant of the full picture? They are not taking all the proper details into account it's very surprising.

Again, we are in a recession, this allows GAP to rise. An increase in G, increases GAP, which increases S. Therefore the actual degree at which interest rates rise and investments fall is not in line with what the professors think. They're off. They have not accounted for the rise in GAP and have mistakenly assumed full employment and 100% crowding out effect when this is clearly not the case in a recession. An example from the text that illustrates the flaw in their argument: " In the case of [government] infrastructure spending, Make rises, so investment increases.

Saving shifts and investment shifts. With upward shifts in both saving and investment, the new equilibrium is one with a higher real interest rate.

However, saving and investment at the new equilibrium may be higher or

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lower. The effect on consumption is unclear as well. The higher real interest rate reduces consumption, but future income is higher, which increases consumption. If investment actually rises, then the increase in government spending causes private investment to be "crowded in" rather than "crowded out." (Able, 2013.) This effect is also shown in the diagram on the previous page.

It completely exposes the flaws in the professors' argument. Question II. Supply-side Economics? The republican's argument of reducing taxes is deeply flawed and is not the ideal method to stimulate the economy. The nature and affect of fiscal multipliers illustrates this: Background from class: The government spending multiplier is the ratio of the MAC). MAC is the marginal propensity of consumption. The tax multiplier is the ratio of the change in GAP to the change of tax rates that triggered it. $\Delta Y/\Delta T = -MAC / (1 - MAC)$. Tax and GAP are negatively related.

Mathematically this negative relationship is key and intuitively proves the flaw in the republican tax cut method. It will always be less than government spending. Multipliers will affect GAP directly, and indirectly by increasing consumption. For example. As discussed in class, the government pen's and builds more infrastructure like a highway or roads, spends \$1 billion, the GAP increases by the same amount. They had to hire workers to accomplish this, the workers have more disposable income, and their consumption increases, which increases income for other workers, say a group of musicians who's performances the workers attend.

Assuming prices are constant, this is what is referred to as the fiscal policy's induced effect. Decreasing taxes has a similar affect. It fosters more incentive for the public to invest, BUT, not as much as government spending.

As seen in Elmsford " Estimated Impact Of the American Recovery and Reinvestment Act of 2009 on Output and the Budgetary Costs, 2009 to 2019" that we looked at in class, all the tax multipliers are significantly lower than the government spending multipliers. Therefore generally, government spending will have a greater impact on GAP than tax cuts. (Elmsford, 2009)

The Loafer curve gives this notion more weight: Fig. 1. 1 (Investigated, 2013)

The Loafer curve is a relationship between tax revenue and tax rate. As shown, when tax rate is 0% and 100%, tax revenue is zero. There is little incentive to work at the extremes. Government's want to be at T^* , where they collect Max tax revenue and people still work hard. (Investigated, 2013)

The problem with this model is that there is debate as to where the point of tax revenue minimization occurs.

It is intuitive that different countries economies will have different points due to inherent complexities. As discussed in class, some argue it's to the left of T^* and some argue it's to the right. A key issue is that it is difficult to tell which side of the curve the economy is on because of inherent complexities of economies, which can change all of a sudden. As economies gain more complexity, many economists believe the reliance on the Loafer Curve Theory to be obsolete, as it has failed in the past and therefore will not help in the future. (Loafer, 2004) If we are on the right side of T^* as the republicans believe, decreasing the tax rate would increase tax revenue.

However, if we were to the left of T^* it would have a negative affect on the

economy, decreasing taxes would decrease tax revenues. Historical empirical evidence indicates that the latter was the case. During the Reagan era, government revenues decreased very sharply from levels that could have been realized had there been no tax cuts. Same story when Bush was in office. Failure. Flawed policy justified by a Laffer Curve that's riddled with uncertainty and inaccuracy.

The hindsight and idiotic bias of the republicans is very apparent in the Forbes article that praises "Ergonomics," there is no mention of government administration was literally handed all the problems of the Bush era, which used Reagan's economic policies and the republicans are blaming Obama for republican caused problems. The republicans are arguing that by cutting taxes this will ultimately stimulate more investment. However, as we discussed in class, this fiscal policy fails to entertain what a perfectly normal person might do with a tax break.

They might simply save the extra funds as opposed to invest it. They don't automatically invest. The republican's supply side economics is assuming this risk and treating it with little weight when in fact it is very significant. Contrastingly, government spending CREATES JOBS. This increases income, inducing an increase in consumption, and GDP increases. Therefore government spending is a more effective way to stimulate the economy. Therefore as outlined above, reducing taxes is not the ideal method to stimulate the economy.