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Six Debates over Macroeconomic Policy

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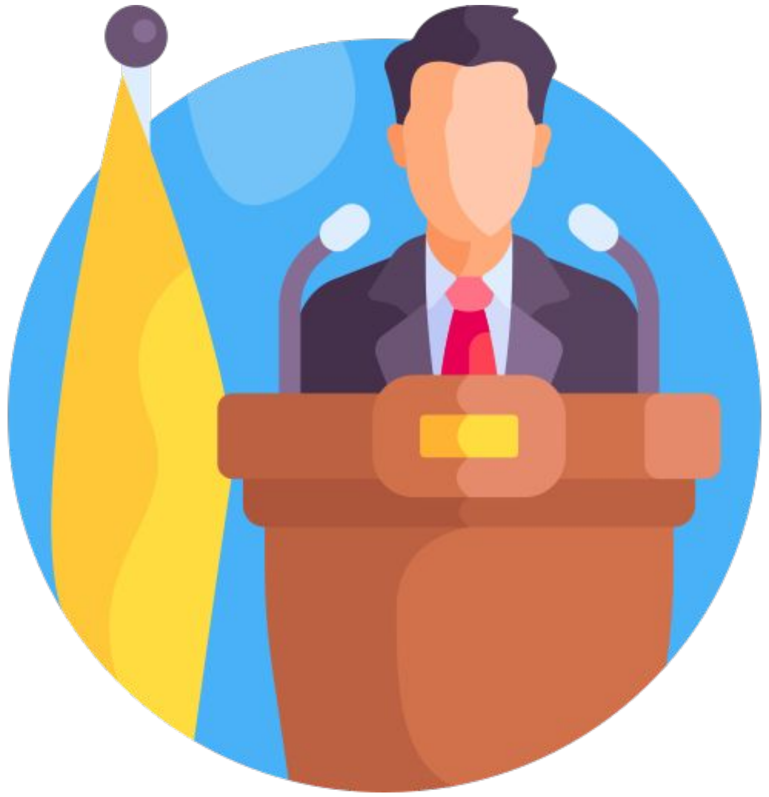
Objectives:

By the end of this chapter, you should be able to:

- Explain the benefits and challenges of using monetary policy to address economic imbalances.
- Debate the use of discretionary policy to stabilize the economy.
- Compare the effects of making monetary policy by rule rather than by discretion.
- Explain the short-run cost of the economy of reducing inflation.
- Discuss the benefits and costs of reducing the budget deficit.

Source: Principles of Economics 10th Edition, Mankiw (2024)



1.
How Actively Should Policymakers Try to Stabilize the Economy?

The Case for Robust Stabilization Policy (1 of 2)

Advocates of active monetary and fiscal policy

- ➢ The economy is inherently unstable
- ➢ Policymakers can use monetary and fiscal policy to stabilize aggregate demand, production, and employment
- ➢ A more stable economy benefits everyone

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Robust Stabilization Policy (2 of 2)

When aggregate demand is inadequate

- ➢ Boost government spending
- ➢ Cut taxes
- ➢ Expand the money supply
- ➢ Reduce interest rates

When aggregate demand is excessive

- ➢ Cut government spending
- ➢ Raise taxes
- ➢ Reduce the money supply
- ➢ Increase interest rates

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Modest Stabilization Policy (1 of 2)

Critics of active monetary and fiscal policy

- ➢ Policy affects the economy with a lag
- ➢ Ability to forecast future economic conditions is poor
- ➢ Attempts to stabilize the economy can end up being destabilizing

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Modest Stabilization Policy (2 of 2)

Policy must act in advance of economic changes

- ➢ Monetary policy lag: About 6 months
- ➢ Fiscal policy lag: Long political process (years)

Conditions can change from the time a policy action begins to the time it takes effect

Intervene when an economic downturn is deep or protracted

Source: Principles of Economics 10th Edition, Mankiw (2024)

Active Learning 1:
Active Stabilization Policy

Would you be more likely to support robust stabilization policy if wages, prices, and expectations adjust quickly in response to economic changes, or if they adjust slowly?

Source: Principles of Economics 10th Edition, Mankiw (2024)

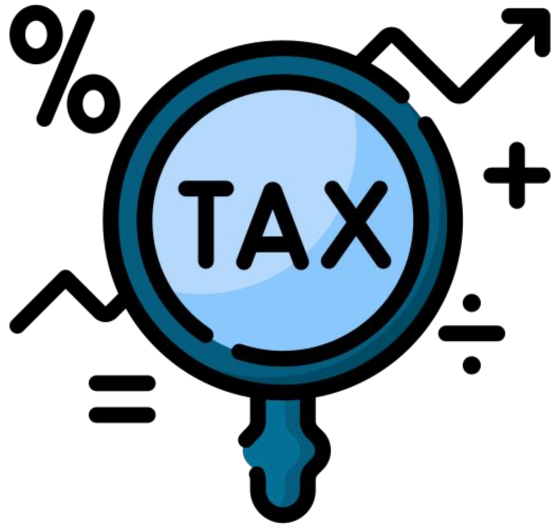
Active Learning 1: Answers

- **If wages, prices, and expectations adjust slowly, it will take longer for the economy to return to its natural rates of output and employment**
- **In that case, there's a better chance that expansionary policy will act in time to alleviate the recession, rather than push the economy into an inflationary boom**

Source: Principles of Economics 10th Edition, Mankiw (2024)

2.
Should the Government Fight Recessions with Spending Hikes or Tax Cuts?

The Case for Fighting Recessions with Spending Hikes (1 of 3)



Monetary policy

- ➢ Increasing the money supply
  - ▪ Reduces interest rates
  - ▪ Reduces the cost of borrowing
  - ▪ Increased spending on investment
- ➢ Increased aggregate demand

Fiscal policy

- ➢ Cutting taxes
  - ▪ Increases household disposable income
  - ▪ Increases spending on consumption
  - ▪ Increased government spending
- ➢ Adds directly to aggregate demand

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Fighting Recessions with Spending Hikes (2 of 3)

Fiscal policy has multiplier effects

- ➢ Higher aggregate demand leads to higher incomes
- ➢ Higher incomes lead to additional consumer spending
- ➢ Additional consumer spending leads to further increases in aggregate demand

Fiscal policy is useful when tools of monetary policy lose effectiveness

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Fighting Recessions with Spending Hikes (3 of 3)

Advocates of increased government spending to fight recessions

- ➢ Extra income from tax cuts may be saved rather than spent
- ➢ Direct government spending provides a greater boost to aggregate demand
  - ▪ Key to promoting production and employment

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Fighting Recessions with Tax Cuts

Critics of spending hikes

- ➢ Tax cuts can expand both aggregate demand and aggregate supply
- ➢ Hasty increases in government spending may lead to wasteful public projects

Tax cuts

- ➢ Increase households' disposable income and therefore increase consumption spending
- ➢ Increase aggregate demand with incentives—like the investment tax credit
- ➢ Increase aggregate supply by increasing the incentive to work and produce goods and services

Source: Principles of Economics 10th Edition, Mankiw (2024)

3.
Should Monetary Policy Be Made by Rule or Discretion?

The Case for Rule-Based Monetary Policy

Advocates of rules for monetary policy

- ➢ Discretionary policy can suffer from
  - ▪ Incompetence and abuse of power
  - ▪ Time inconsistency of policy

Solution: Commit the central bank to a policy rule

- ➢ For example, a law requiring the Fed to increase monetary growth by 1% for every 1% that unemployment rises above its natural rate

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Discretionary Monetary Policy

Critics of rules for monetary policy

- Discretionary policy is more flexible in responding to changing economic circumstances
- Political business cycles and time-inconsistency are theoretical possibilities but not that important in practice
- It is difficult to specify rules precisely and to determine what the best rule would be

Source: Principles of Economics 10th Edition, Mankiw (2024)

4.
Should the Central Bank Aim for an Inflation Rate Near Zero?

The Case for Near-Zero Inflation (1 of 2)

Costs of inflation

- ➢ Shoeleather costs associated with reduced money holdings
- ➢ Menu costs associated with more frequent adjustment of prices
- ➢ Increased variability of relative prices
- ➢ Unintended changes in tax liabilities due to non-indexation of the tax code
- ➢ Confusion and inconvenience resulting from a changing unit of account
- ➢ Arbitrary redistributions of wealth associated with dollar-denominated debts

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Near-Zero Inflation (2 of 2)

Advocates of a zero-inflation target

- ➢ Inflation has many costs and few benefits
- ➢ Reducing inflation would have temporary costs (higher unemployment) but permanent benefits
- ➢ Cost can be reduced if central bank credibly commits to reduce inflation (directly lowers inflation expectations)

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for Living with Moderate Inflation

Critics of a zero-inflation target

- ➢ Moderate inflation imposes only small costs on society
- ➢ Recession necessary to reduce inflation to zero is quite costly

Benefits of moderate inflation

- ➢ Facilitates real-wage adjustment
- ➢ Allows real interest rates to be negative when necessary

Source: Principles of Economics 10th Edition, Mankiw (2024)

Active Learning 2:
The Zero-Inflation Debate

Suppose a structural change reduces the demand for university administrators, lowering their equilibrium real wage by 3%.

- ➢ If the actual real wage paid to university administrators remains constant, what would be the consequences?
- ➢ Would it be easier to achieve the 3% real wage reduction if the inflation rate is 0% or if it is 4%? Why?

Source: Principles of Economics 10th Edition, Mankiw (2024)

Active Learning 2: Answers

Whenever the actual real wage exceeds the equilibrium real wage, there is a surplus of labor, which represents wasted resources. A fall in the wage would alleviate the surplus.

- ➢ It would encourage some administrators to switch to university teaching or private sector employment
- ➢ It would increase the quantity of administrators demanded

To restore labor market equilibrium under 0% inflation, administrators would have to accept a 3% nominal wage cut.

- ➢ Under 4% inflation, they would have to accept a 1% nominal wage increase
- ➢ The second scenario is more likely, as many people suffer from "money illusion" and focus on nominal variables rather than real ones

Source: Principles of Economics 10th Edition, Mankiw (2024)

5.
Should the Government Balance Its Budget?

The Case for a Balanced Budget (1 of 2)

Advocates of a balanced government budget

- ➢ Budget deficits impose an unjustifiable burden on future generations by raising their taxes and lowering their incomes

A balanced budget means

- ➢ Greater national saving
- ➢ Increased capital accumulation
- ➢ Faster economic growth

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case for a Balanced Budget (2 of 2)

While deficits may be justified during recessions or wars, surging peacetime debt of recent decades is unsustainable and detrimental

- ➢ Federal debt 2021: $22.4 trillion
- ➢ Congressional Budget Office (CBO) forecast
    - ▪ U.S. government debt as a percentage of GDP would increase to 195% in 2040
- ➢ Presidents and Congresses committed the federal government to a variety of spending programs without passing the taxes necessary to fund them

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case against a Balanced Budget

Critics of a balanced government budget

- ➢ Deficit is only one small piece of fiscal policy
- ➢ Single-minded concern about the budget deficit can obscure the many ways in which spending programs affects different generations

Government debt can continue to rise forever

- ➢ The problem of government debt is often exaggerated; small % of a person's lifetime income
  - ▪ Debt/income ratio more relevant than debt itself
- ➢ Cutting the deficit could do more harm than good
  - ▪ Cutting education would reduce human capital accumulation and future living standards
  - ▪ Raising taxes reduces incentives to work and save

Source: Principles of Economics 10th Edition, Mankiw (2024)

6.
Should the Tax Laws Be Reformed to Encourage Saving?

The Case for Promoting Saving through Tax Reform

Advocates of tax incentives for saving

- ➢ Society discourages saving in many ways, such as by heavily taxing capital income and reducing benefits for those who have accumulated wealth
- ➢ Endorse reforming the tax laws to encourage saving, perhaps by switching from an income tax to a consumption tax

Higher saving provides more funds for capital accumulation, which increases productivity and living standards

Source: Principles of Economics 10th Edition, Mankiw (2024)

The Case against Promoting Saving through Tax Reform

Critics of tax incentives for saving

- Many proposed changes to stimulate saving would primarily benefit the wealthy, who do not need a tax break
- Estimates of the interest-rate elasticity of saving are low, so tax incentives might have only a small effect on private saving
- Reducing taxes on capital income may increase the government's budget deficit, negating the benefits of higher private saving
- Better: Increase national saving directly by reducing the budget deficit

Source: Principles of Economics 10th Edition, Mankiw (2024)

Active Learning 3: Consumption Tax

Suppose the income tax were replaced with a consumption tax, and the tax rate was chosen carefully to ensure the average person’s tax burden remains unchanged.

A. Who would benefit?

B. Who would be worse off?

Source: Principles of Economics 10th Edition, Mankiw (2024)

Active Learning 3: Answers

A. **People with higher incomes save a bigger percentage of their incomes, so would benefit most from this change**

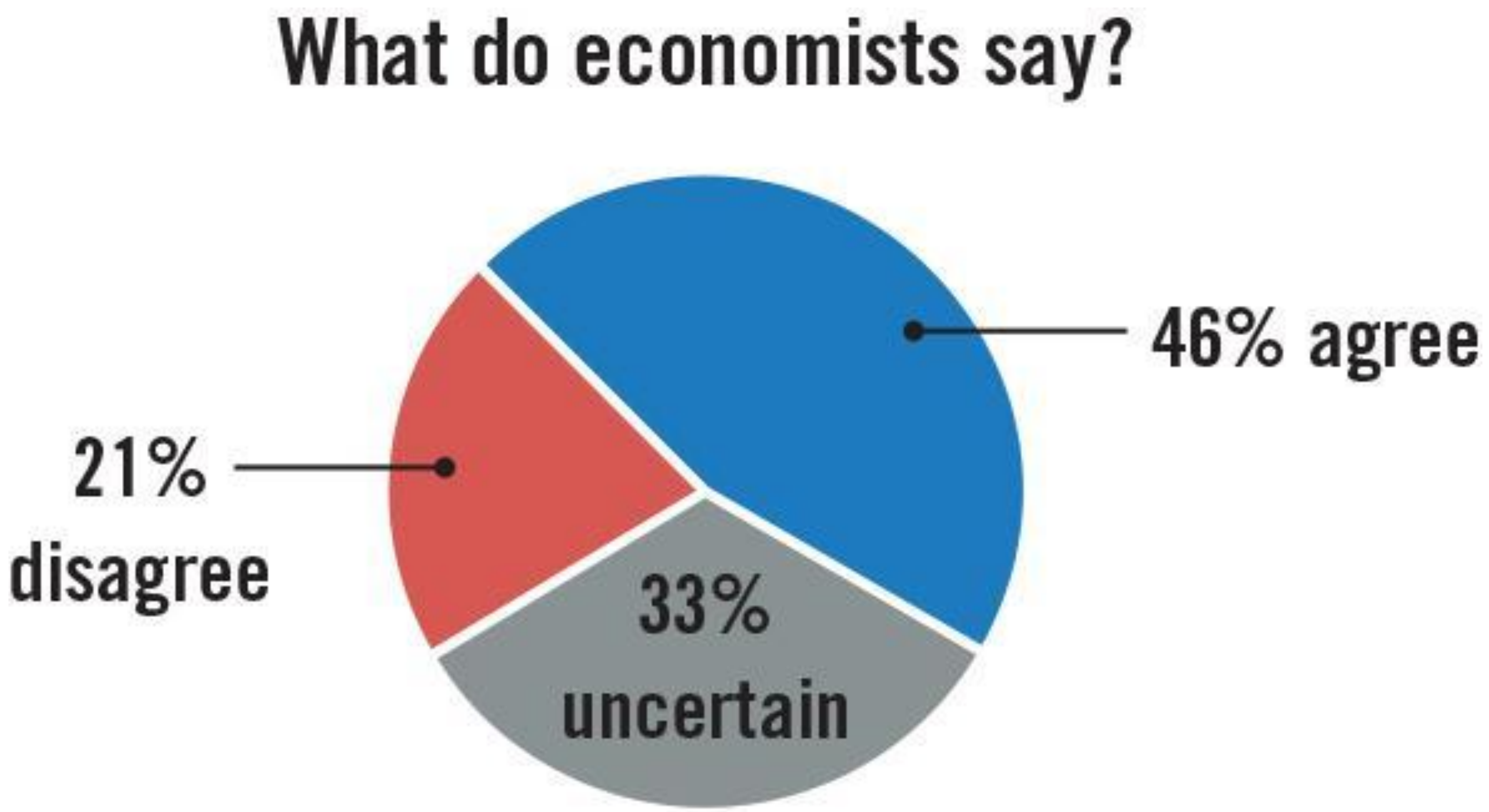
B. **People with low incomes use most or all of their incomes for consumption and would be worse off**

- This is why most consumption tax proposals include exemptions for necessities which comprise a larger share of the budgets of low-income persons

Source: Principles of Economics 10th Edition, Mankiw (2024)

Ask the Experts: Taxing Capital and Labor

"Despite relabeling concerns, taxing capital income at a permanently lower rate than labor income would result in higher average long-term prosperity, relative to an alternative that generated the same amount of tax revenue by permanently taxing capital and labor income at equal rates instead."



Source: IGM Economic Experts Panel, October 9, 2012.

Source: Principles of Economics 10th Edition, Mankiw (2024)

Conclusion: Economic Policy and Shades of Gray

Conclusion

The study of economics does not always make it easy to choose among alternative policies

- ➢ There are few easy answers and many unresolved questions
- ➢ Few policies come with benefits and no costs

Crafting the best policy

- ➢ Requires knowing the pros and cons of every alternative

Being an informed voter

- ➢ Requires the ability to evaluate the candidates’ policy proposals

Source: Principles of Economics 10th Edition, Mankiw (2024)

THANK YOU

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