Published on *Adam Smith Institute* (http://www.adamsmith.org)

Which fiscal policy? [1]

Written by **Tim Worstall** [2] | Monday 22 December 2008

Allow me to start by selling the pass. OK, so we need to have some form of a fiscal boost. Government has got to spend more than it taxes and thus boost aggregate demand and fund the gap by borrowing. Leave aside whether this is true or not and concentrate instead on the next step. We can increase the deficit either by spending more and keeping taxes where they are or by keeping spending where it is and reducing taxes.

Varied Guardianistas and the like think we should increase spending, usually because they think that increased governmental spending is the cure for all ills. I would prefer the lower taxation route for I of course know that reduced taxation is indeed the cure for all evils. But within the bounds of the current debate, which of us is right depends upon the various multipliers. How much extra GDP do we get in the short term for extra spending against how much extra GDP do we get from a cut in taxation? The usual assumption is that the boost is greater from spending but this probably (OK, it isn't) true. Firstly, government isn't very good at spending money quickly [3].

> To make a long story short, you cannot juice up a government agency's budget by tens of billions (or in the case of the stimulus package, hundreds of billions) and expect them to be able to process the paperwork to contract it out, much less oversee the projects or even choose them with any kind of hope for success. It's like trying to feed a Pomeranian a 25 lb turkey. It's madness.

That pretty much rules out any infrastructure or other directed spending on projects. They just take too long to get going.

It also seems that the multiplier of spending is, umm, not very impressive. Like, umm, one and a bit. For each pound of spending we get a one pound rise in GDP[4].

> Valerie Ramey has written a paper [5] with the results of her recent work on the question and with a full bibliography of earlier work. Her answer is that consumption and other categories stay about the same when the government spends more. In other words, the increase in GDP is about equal to the increase in govenment spending (*for technical reasons, a mulitplier of 1.4 or so-Tim*).

However, the tax multiplier is much higher [6]:

> By contrast, recent research by Christina Romer and David Romer [7] looks at tax changes and concludes that the tax multiplier is about three: A dollar of tax cuts raises GDP by about three dollars.

(Worth noting that Christina Romer is such an aggressive tax cutting right winger that she's just been made

Obama's head of the Council of Economic Advisors.)

So we should be cutting taxes rather than increasing spending to provide that fiscal boost then. And this holds even more strongly for us in the UK [8].

> Any large-scale fiscal policy impulse must therefore, to be effective quickly, work through transfers to the private sector, either via lower taxes or via higher transfer to households. The key problem here is that under the present circumstances of extreme uncertainty households might just save any increase in their disposable income. How likely is this to happen? A key factor will be the financial position of households themselves.
>
> Households that depend on credit to finance their consumption will be most affected by the credit crunch and are thus most likely to react to a tax cut by maintaining their consumption. For this type of household, a tax cut (or an increase in expenditure) will be an effective tool to prevent an even sharper drop in consumption.
>
> However, for households that do not depend on credit, the situation is quite different. Households that are saving anyway will probably at present just increase their savings in response to an increase in their disposable income that they know to be temporary.
>
> This implies that the effectiveness of fiscal policy will vary greatly across the EU. Table 1 shows that households are on average net borrowers in only two of the larger member countries ? Spain and the UK, unsurprisingly. In these two countries (with the largest housing bubbles) fiscal policy should thus be effective.

OK, OK, I agree, tax cuts aren't really the cure for all evils, they won't eradicate herpes, Simon Cowell or improve the form of the England rugby team. But it does seem to be true that if we do indeed need a fiscal boost we would be best advised to provide such by cutting taxes upon households rather than allowing politicians to splurge our money, ineffectively, upon their pet projects.

Source URL: http://www.adamsmith.org/blog/tax-and-economy/which-fiscal-policy

Links:
[1] http://www.adamsmith.org/blog/tax-and-economy/which-fiscal-policy
[2] http://www.adamsmith.org/taxonomy/term/5778
[3] http://gregmankiw.blogspot.com/2008/12/another-spending-stimulus-skeptic.html
[4] http://woodwardhall.wordpress.com/2008/12/11/measuring-the-effect-of-infrastructure-spending-on-gdp/
[5] http://econ.ucsd.edu/%7Evramey/research/IdentifyingGovt.pdf
[6] http://gregmankiw.blogspot.com/2008/12/spending-and-tax-multipliers.html
[7] http://www.econ.berkeley.edu/%7Ecromer/RomerDraft307.pdf
[8] http://www.voxeu.org/index.php?q=node/2721
[9] http://disqus.com/?ref_noscript
[10] http://disqus.com