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## Fiscal policy

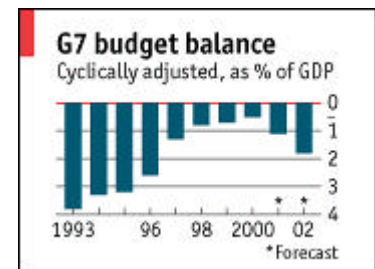
**A stimulating debate**

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**How should fiscal policy be used to support a slumping economy?**

AFTER a decade of budgetary prudence, Keynes is back in fashion. America looks set for a fiscal stimulus of at least 1.5% of GDP to help revive its economy. France announced a modest stimulus last week and now five economic institutes have urged the German government to bring forward planned tax cuts to revive growth. Singapore plans a fiscal boost worth a massive 7% of GDP. However, focusing on the size of such packages ignores two important questions. What is the appropriate balance between fiscal and monetary policy? What shape should tax cuts or spending increases take?



The extent to which governments can or should pursue fiscal easing varies. The “stability pact” (which limits budget deficits to a maximum of 3% of GDP) rules out a big stimulus in most of the euro-area. Yet governments still have room to allow automatic stabilisers to operate. It is essential that they do not tighten policy to offset the automatic loss of tax revenues and the rise in jobless benefits as economies sink. In America, balanced-budget rules are already forcing states to tighten policy, partly offsetting the federal stimulus ([see article](#)).

There are, however, two reasons why the euro area should not use fiscal policy as aggressively as America has done. Monetary policy is more suited to support demand because it is easier to reverse if the economy recovers unexpectedly fast. But in America excess debt and overcapacity may have blunted the economic impact of lower interest rates. In contrast, the euro area has avoided such excesses and so monetary policy remains effective. A second difference is that America starts with a budget surplus and so can afford a stimulus. Many of the euro-area economies are already in deficit and so a fiscal easing is more likely to push up bond yields as markets fret that public borrowing is on an unsustainable path.

Where a budget surplus exists, how might a government best use it? The economic impact of a stimulus depends upon the mix of tax cuts and spending increases. Even the best designed policy cannot prevent a recession, but it can ensure the biggest boost to demand at the least cost. A first rule is that government spending gives a bigger boost to the economy than income-tax cuts, part of which will be saved. The Federal Reserve estimates that a \$1 increase in government spending on goods and services boosts GDP after one year by three times as much as a \$1 income-tax cut. The difficulty is finding enough sensible public projects on which to spend money quickly.

A second rule is that tax cuts aimed at low-earners are more likely to be spent than handouts to the rich, who tend to save more. Income-tax cuts are also more likely to be spent if they are

permanent; temporary cuts tend to be saved. One of Japan's many mistakes in the 1990s was that tax cuts were only temporary. Here lies a dilemma: income-tax cuts need to be permanent if they are to boost spending, but permanent cuts—and larger future government borrowing—are more likely to push up bond yields, crowding out private investment.

The rule for corporate taxes is the opposite. Permanent tax cuts are unlikely to boost investment, which is influenced more by profits, excess capacity and confidence. On the other hand, a temporary tax break for investment could well work, encouraging firms to bring forward capital spending.

How do the ideas being considered by America's Congress score on these criteria? They focus too much on corporate taxes, and the incentives for business investment are permanent—exactly the opposite of what should be done. The permanent part of the income-tax cuts, bringing forward planned cuts, will mainly benefit richer Americans who are more likely to save it. The tax rebate for the low paid is only temporary.

The risk is a package shaped too much by ideology rather than economics. Lower tax rates for firms and workers are worthy long-term objectives, but today's problem of insufficient demand cannot be solved with measures designed largely to boost supply. Keynes's solution to the Great Depression was that governments should even be willing to pay people to dig holes and fill them in again. America should avoid such a deep slump, but its policy makers are in danger of digging their own economic—and perhaps political—grave.

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