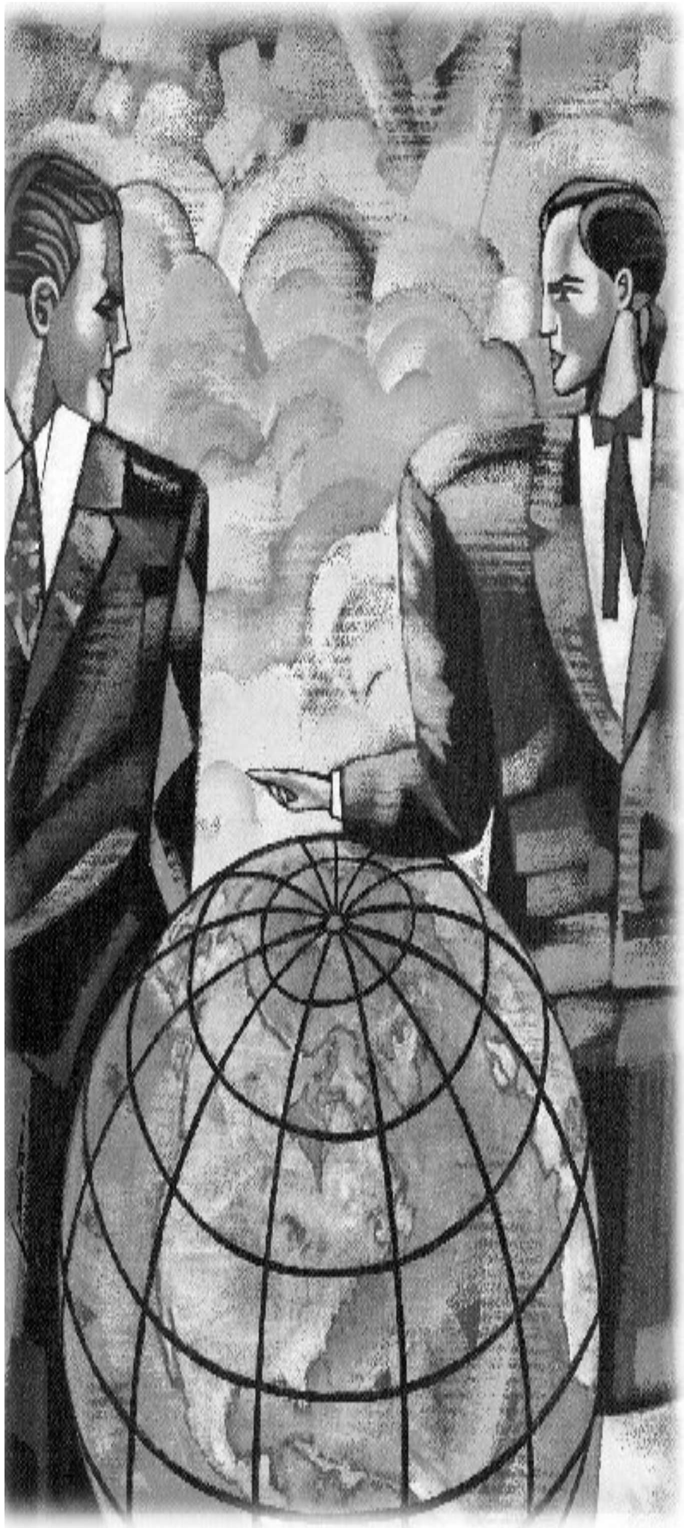

Five Debates over Macroeconomic Policy

Chapter 34

Five Debates over Macroeconomic Policy

1. Should monetary and fiscal policymakers try to stabilize the economy?
2. Should monetary policy be made by rule rather than by discretion?
3. Should the central bank aim for zero inflation?

Five Debates over Macroeconomic Policy

4. **Should the government balance its budget?**
5. **Should the tax laws be reformed to encourage saving?**

1. Should Monetary and Fiscal Policymakers Try to Stabilize the Economy?

Pro: Policymakers should try to stabilize the economy

- **The economy is inherently unstable, and left on its own will fluctuate.**
- **Policy can manage aggregate demand in order to offset this inherent instability and reduce the severity of economic fluctuations.**

Pro: Policymakers should try to stabilize the economy

- There is no reason for society to suffer through the booms and busts of the business cycle.
- Monetary and fiscal policy can stabilize aggregate demand and, thereby, production and employment.

Con: Policymakers should not try to stabilize the economy

- Monetary policy affects the economy with long and unpredictable lags between the need to act and the time that it takes for these policies to work.
- Many studies indicate that changes in monetary policy have little effect on aggregate demand until about six months after the change is made.

Con: Policymakers should not try to stabilize the economy

- Fiscal policy works with a lag because of the long political process that governs changes in spending and taxes.
- It can take years to propose, pass, and implement a major change in fiscal policy.

Con: Policymakers should not try to stabilize the economy

- **All too often policymakers can inadvertently exacerbate rather than mitigate the magnitude of economic fluctuations.**
- **It might be desirable if policy makers could eliminate all economic fluctuations, but this is not a realistic goal.**

2. Should Monetary Policy Be Made by Rule Rather Than by Discretion?

Pro: Monetary policy should be made by rule

- **Discretionary monetary policy can suffer from incompetence and abuse of power.**
- **To the extent that central bankers ally themselves with politicians, discretionary policy can lead to economic fluctuations that reflect the electoral calendar – the political business cycle.**

Pro: Monetary policy should be made by rule

- There may be a discrepancy between what policymakers say they will do and what they actually do – called time inconsistency of policy.
- Because policymakers are so often time inconsistent, people are skeptical when central bankers announce their intentions to reduce the rate of inflation.

Pro: Monetary policy should be made by rule

- Committing the Fed to a moderate and steady growth of the money supply would limit incompetence, abuse of power, and time inconsistency.

Con: Monetary policy should not be made by rule

- **An important advantage of discretionary monetary policy is its flexibility.**
- **Inflexible policies will limit the ability of policymakers to respond to changing economic circumstances.**

Con: Monetary policy should not be made by rule

- The alleged problems with discretion and abuse of power are largely hypothetical.
- Also, the importance of the political business cycle is far from clear.

3. Should The Central Bank Aim for Zero Inflation?

Pro: The central bank should aim for zero inflation

- **Inflation confers no benefit to society, but it imposes several real costs.**
  - **Shoeleather costs**
  - **Menu costs**
  - **Increased variability of relative prices**
  - **Unintended changes in tax liabilities**
  - **Confusion and inconvenience**
  - **Arbitrary redistribution of wealth**

Pro: The central bank should aim for zero inflation

- **Reducing inflation is a policy with temporary costs and permanent benefits.**
- **Once the disinflationary recession is over, the benefits of zero inflation would persist.**

Con: The central bank should not aim for zero inflation

- **Zero inflation is probably unattainable, and to get there involves output, unemployment, and social costs that are too high.**
- **Policymakers can reduce many of the costs of inflation without actually reducing inflation.**

4. Should Fiscal Policymakers reduce the Government Debt?

Pro: The government should balance its budget

- **Budget deficits impose an unjustifiable burden on future generations by raising their taxes and lowering their incomes.**
- **When the debts and accumulated interest come due, future taxpayers will face a difficult choice:**
  - **They can pay higher taxes, enjoy less government spending, or both.**

Pro: The government should balance its budget

- **By shifting the cost of current government benefits to future generations, there is a bias against future taxpayers.**
- **Deficits reduce national saving, leading to a smaller stock of capital, which reduces productivity and growth.**

Con: The government should not balance its budget

- The problem with the deficit is often exaggerated.
- The transfer of debt to the future may be justified because some government purchases produce benefits well into the future.

Con: The government should not balance its budget

- **The government debt can continue to rise because population growth and technological progress increase the nation's ability to pay the interest on the debt.**

5. Should The Tax Laws Be Reformed to Encourage Saving?

Pro: Tax laws should be reformed to encourage saving

- A nation’s saving rate is a key determinant of its long-run economic prosperity.
- A nation’s productive capability is determined largely by how much it saves and invests for the future.
- When the saving rate is higher, more resources are available for investment in new plant and equipment.

Pro: Tax laws should be reformed to encourage saving

- **The U.S. tax system discourages saving in many ways, such as by heavily taxing the income from capital and by reducing benefits for those who have accumulated wealth.**

Pro: Tax laws should be reformed to encourage saving

- **The consequences of high capital income tax policies are reduced saving, reduced capital accumulation, lower labor productivity, and reduced economic growth.**

Pro: Tax laws should be reformed to encourage saving

- An alternative to current tax policies advocated by many economists is a consumption tax.
- With a consumption tax, a household pays taxes based on what it spends not on what it earns.
  - Income that is saved is exempt from taxation until the saving is later withdrawn and spent on consumption goods.

Con: Tax laws should not be reformed to encourage saving

- Many of the changes in tax laws to stimulate saving would primarily benefit the wealthy.
  - High-income households save a higher fraction of their income than low-income households.
  - Any tax change that favors people who save will also tend to favor people with high incomes.

Con: Tax laws should not be reformed to encourage saving

- **Reducing the tax burden on the wealthy would lead to a less egalitarian society.**
- **This would also force the government to raise the tax burden on the poor.**

Con: Tax laws should not be reformed to encourage saving

- **Raising public saving by eliminating the government's budget deficit would provide a more direct and equitable way to increase national saving.**