

**ECO 407**

**Competing Views in  
Macroeconomic Theory and Policy**

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**Lecture 4**

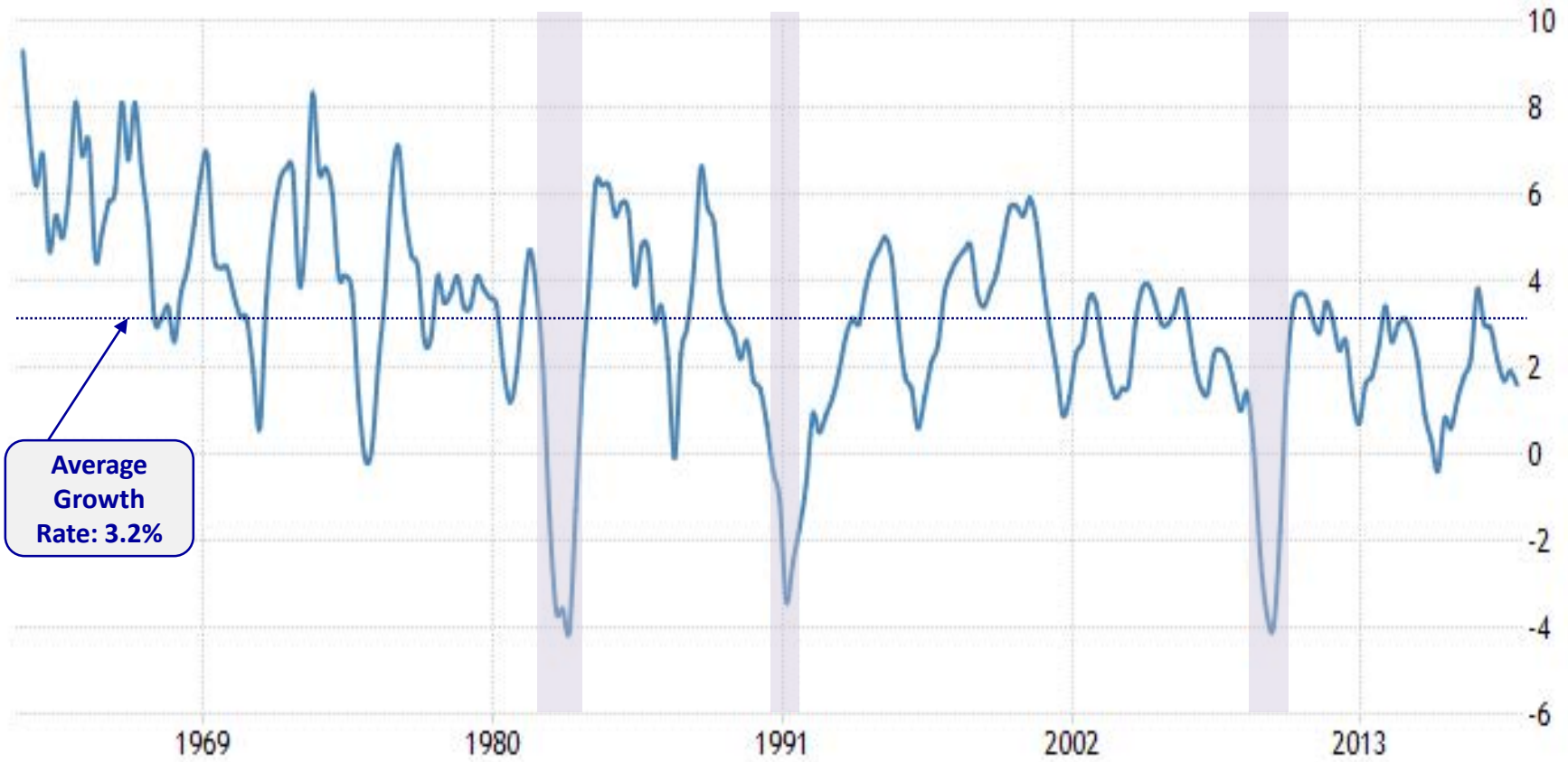
**Is Government Spending a  
Source of Stability or Instability?**

# Booms and Recessions

- Capitalist economies are characterized by having periods of expansion (***booms***) and contraction (***recessions***)
  - Periods of economic ***expansion*** occur when aggregate demand exceeds aggregate supply – **AD > AS**
  - Periods of economic ***contraction*** occur when aggregate supply exceeds aggregate demand – **AS > AD**
- A ***typical*** recession usually arises as a result of:
  - The central bank implementing contractionary monetary policy to reduce inflationary pressure in the economy
  - Overinvestment (and thus overproduction) by the business sector due to overoptimistic expectations
- A less typical recession may arise as a result of a sudden drop in asset-values – ***balance-sheet-recession***

# Canada: Real GDP Growth Rate

## January 1960 to May 2019



**Source:** Trading Economics / Statistics Canada.

# Are Stabilization Policies Necessary?

- ***Orthodox economists*** believe that recessions are usually short-lived
  - Therefore, expansionary fiscal policy should not be used
  - If any, expansionary monetary policy should be used
  - And recessions play a very important positive role in the economy: They help to eliminate inefficient firms
- ***Heterodox (Keynesian) economists*** believe that governments should play an active role in balancing economic booms and busts
  - Recessions are too costly and recursive to be dismissed as accidental and just transitory
  - Governments should use expansionary fiscal policy

# Orthodox View: Why Not to Use Expansionary Fiscal Policy

- The government will have to borrow from the public or the central bank to finance the deficit
- If the government borrows from the *central bank*, the money supply will increase and inflation will rise
  - The value of money will fall
  - It will increase uncertainty and affect investment
  - Higher inflation will reduce the country's competitiveness and cause trade deficits

- But studies have shown no obvious link between *budget deficits* and *inflation* (e.g., Canada and the U.S.) or between *budget deficit* and *trade deficits* (e.g., Japan)

# Orthodox View: Why Not to Use Expansionary Fiscal Policy (cont'd)

- If the government borrows from the **public**, it will compete with other borrowers for investors' savings
  - The rate of interest will rise and private borrowers will be crowded out
  - Higher rates of interest will reduce investment
  - Individuals buying bonds will have less money to spend
- The conventional view is that financing economic activity (private or public) is necessarily constrained by the existence of **previously accumulated** savings
  - But money is created by banks in the form of credit
  - And this credit received is then transferred to workers and suppliers

# Orthodox View: Why Not to Use Expansionary Fiscal Policy (cont'd)

- Attempts to impact the economy through greater government spending will be ineffective
  - It will cause a reallocation of resources within the economy, but aggregate level of activity will not change
  - The increase in government spending will be offset by a reduction in consumption, investment, and net exports
- But this might be a possible outcome **only** if the economy is operating at **full capacity** and resources are **fixed**
- A temporary tax relief will be ineffective since households will save most of the increase in their disposable income

# Orthodox View: Why Not to Use Expansionary Fiscal Policy (cont'd)

- In addition, deficit will increase the public debt, thus imposing a burden on future generations
- But we should make a distinction between ***government investment*** and ***government consumption expenditure***
- Both in the private and public sectors, investment expenditure is not usually financed out of current income
  - It is usually financed through debt (e.g., the purchase of a house)
- And public investment will increase the productive capacity of the economy for the benefit of both ***present*** and ***future*** generations



# Heterodox View: Why Expansionary Fiscal Policy Should Be Used

- Recessions occur because **AD < AS**
  - Firms experience *involuntary* increases in inventory
  - This gives the signal to firms to adjust production downwards
  - Thus unemployment *rises* and income *falls* towards a lower equilibrium level (where **AD = AS**)
- Since the recession is due to insufficient **AD**, it makes sense for the government to implement policies to increase **AD**
  - Increasing government spending or decreasing taxes
- Expansionary fiscal policy should be enough to kick start the economy, i.e., to stop the decline and restore the *confidence* of consumers and businesses

# Is There an Optimum Size for the Government?

- The *orthodox* view is that government activity should be limited to ensure an environment suitable for markets to function efficiently
    - For instance, to provide police, courts, and infrastructure
  - Government should not go beyond that level of activity because it would negatively affect economic activity
    - The government would be providing services less efficiently than the private sector
    - Higher taxes need to be levied, thus reducing incentives for economic activity
- Does the CEO of a corporation or a professional hockey player reduce his work time/effort due to higher taxes?

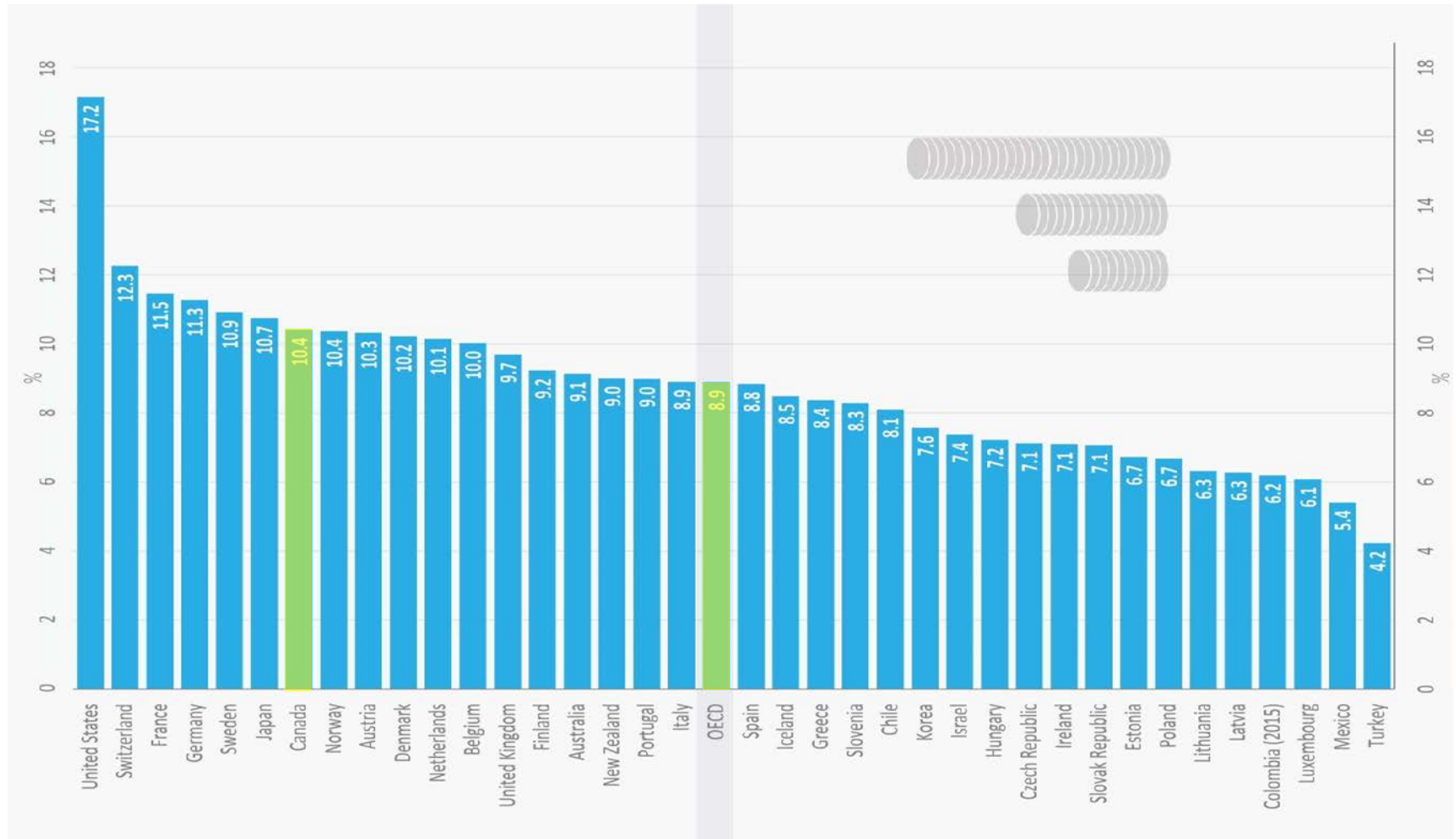
# Is There an Optimum Size for the Government? (cont'd)

- In their view, for Canada the optimum government size should be 30 percent of GDP
- According to Veldhuis, Canadian government spending represented about 40 percent of GDP in 2008
  - Therefore, it should be reduced to improve the Canadian economy
- But let's try to answer the following questions:
  - Should taxes be considered a burden?
  - Should indirect taxes be preferred to direct taxes?
  - Are Canadians over-taxed?
  - What's the relationship between government size and a country's competitiveness?

# Are Canadians Over-Taxed? (2017)

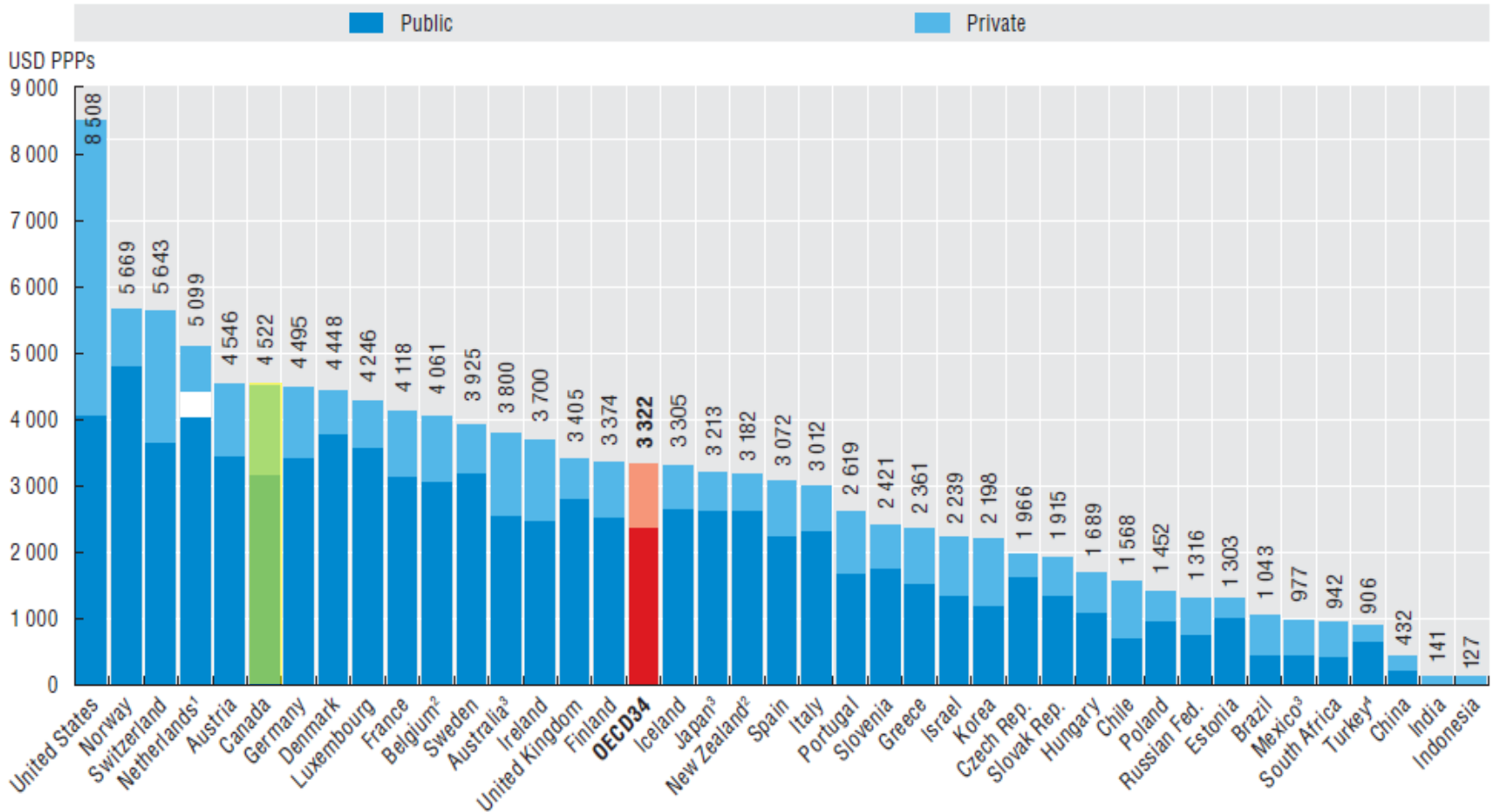
| Country                                    | Taxes as % of GDP | Country               | Taxes as % of GDP |
|--|-------------------|-----------------------|-------------------|
| Austria                                    | 41.8              | Japan                 | 30.6              |
| Belgium                                    | 44.6              | Korea                 | 26.9              |
| <b>Canada</b>                              | <b>32.2</b>       | Mexico                | 16.2              |
| Chile                                      | 20.2              | Netherlands           | 38.8              |
| Czech Republic                             | 28.5              | New Zealand           | 32.0              |
| <b>Denmark</b>                             | <b>46.0</b>       | <b>Norway</b>         | <b>38.2</b>       |
| <b>Finland</b>                             | <b>43.3</b>       | Poland                | 33.9              |
| France                                     | 46.2              | Portugal              | 34.7              |
| Germany                                    | 37.5              | Slovak Republic       | 32.9              |
| Greece                                     | 39.4              | Spain                 | 33.7              |
| Hungary                                    | 37.7              | <b>Sweden</b>         | <b>44.0</b>       |
| Iceland                                    | 37.7              | Turkey                | 24.9              |
| Ireland                                    | 22.8              | United Kingdom        | 33.3              |
| Israel                                     | 32.7              | <b>United States</b>  | <b>27.1</b>       |
| Italy                                      | 42.4              | <b>OECD - Average</b> | <b>34.2</b>       |
| Source: <i>OECD Tax Statistics</i> , 2018. |                   |                       |                   |

# Health Expenditure as % of GDP (2017)



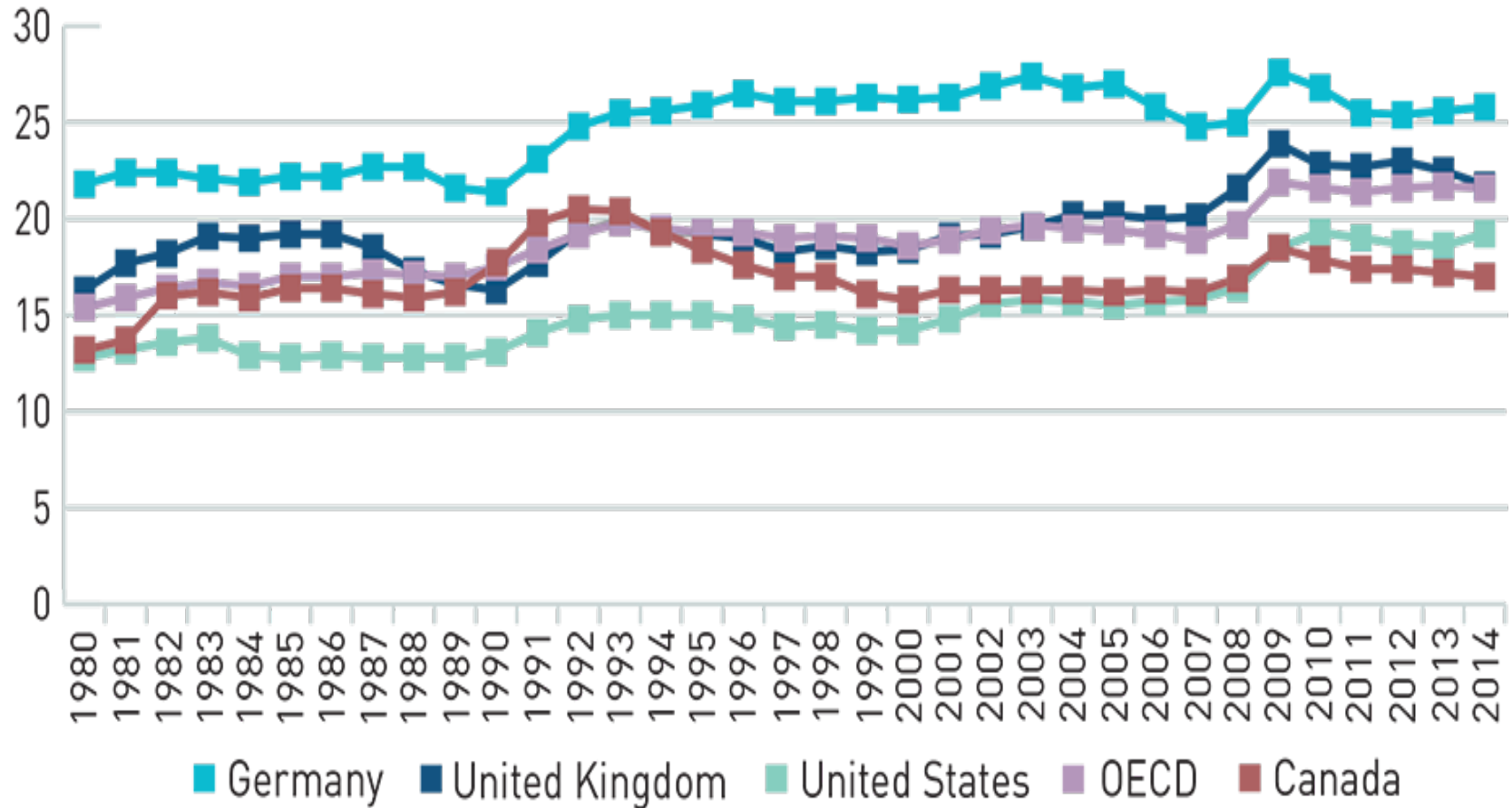
Source: OECD, *Health Statistics 2018*.

# Health Expenditure Per Capita (2011 or nearest year)



Source: OECD, *Health at Glance 2013 – OECD Indicators*, p. 155.

# Public Social Spending (% of GDP)



Source: Mowat Centre based on OECD Social Expenditure Database, 2015.

# Competitiveness Ranking (2017)

| Country              | Rank      | Score       | Country              | Rank      | Score       |
|----------------------|-----------|-------------|----------------------|-----------|-------------|
| Switzerland          | 1         | 5.86        | Norway               | 11        | 5.40        |
| <b>United States</b> | <b>2</b>  | <b>5.85</b> | Denmark              | 12        | 5.39        |
| Singapore            | 3         | 5.71        | New Zealand          | 13        | 5.37        |
| Netherlands          | 4         | 5.66        | <b>Canada</b>        | <b>14</b> | <b>5.35</b> |
| Germany              | 5         | 5.65        | Taiwan, China        | 15        | 5.33        |
| Hong Kong            | 6         | 5.53        | Israel               | 16        | 5.31        |
| <b>Sweden</b>        | <b>7</b>  | <b>5.52</b> | United Arab Emirates | 17        | 5.30        |
| United Kingdom       | 8         | 5.51        | Austria              | 18        | 5.25        |
| Japan                | 9         | 5.49        | Luxembourg           | 19        | 5.23        |
| <b>Finland</b>       | <b>10</b> | <b>5.49</b> | OECD - average       |           | n/a         |

Source: World Economic Forum, *The Global Competitiveness Report 2017 – 2018*.



# Corruption Perceptions Index (2018)

| Country        | Rank     | Score     | Country              | Rank      | Score     |
|----------------|----------|-----------|----------------------|-----------|-----------|
| <b>Denmark</b> | <b>1</b> | <b>88</b> | Australia            | 13        | 77        |
| New Zealand    | 2        | 87        | Austria              | 14        | 76        |
| <b>Finland</b> | <b>3</b> | <b>85</b> | Hong Kong            | 14        | 76        |
| Singapore      | 3        | 85        | Iceland              | 14        | 76        |
| <b>Sweden</b>  | <b>3</b> | <b>85</b> | Belgium              | 17        | 75        |
| Switzerland    | 3        | 85        | Estonia              | 18        | 73        |
| <b>Norway</b>  | <b>7</b> | <b>84</b> | Ireland              | 18        | 73        |
| Netherlands    | 8        | 82        | Japan                | 18        | 73        |
| <b>Canada</b>  | <b>9</b> | <b>81</b> | France               | 21        | 72        |
| Luxembourg     | 9        | 81        | <b>United States</b> | <b>22</b> | <b>71</b> |
| Germany        | 11       | 80        | United Arab Emirates | 23        | <b>70</b> |
| United Kingdom | 11       | 80        | Uruguay              | 23        | 70        |

Source: Transparency International.

# Happiness Ranking (2018)

| Country        | Rank     | Score        | Country              | Rank      | Score        |
|----------------|----------|--------------|----------------------|-----------|--------------|
| <b>Finland</b> | <b>1</b> | <b>7.632</b> | Israel               | 11        | 7.190        |
| <b>Norway</b>  | <b>2</b> | <b>7.594</b> | Austria              | 12        | 7.130        |
| <b>Denmark</b> | <b>3</b> | <b>7.555</b> | Costa Rica           | 13        | 7.072        |
| Iceland        | 4        | 7.495        | Ireland              | 14        | 6.977        |
| Switzerland    | 5        | 7.487        | Germany              | 15        | 6.965        |
| Netherlands    | 6        | 7.491        | Belgium              | 16        | 6.927        |
| <b>Canada</b>  | <b>7</b> | <b>7.328</b> | Luxembourg           | 17        | 6.910        |
| New Zealand    | 8        | 7.324        | <b>United States</b> | <b>18</b> | <b>8.886</b> |
| <b>Sweden</b>  | <b>9</b> | <b>7.314</b> | United Kingdom       | 19        | 6.814        |
| Australia      | 10       | 7.272        | United Arab Emirates | 20        | 6.774        |

Source: United Nations, *World Happiness Report*, 2019.

# Should Governments Implement Industrial Policy

- ***Orthodox view:***
  - Governments should not ***pick winners*** through industrial policy since they don't have the necessary information nor the expertise to make informed business decisions
- ***Heterodox view:***
  - Governments can pick winners, sometimes spectacularly well
  - Moreover, not only can they pick winners, they can also ***make winners***
- History shows that today's developed countries have all used industrial policies during their period of development
  - And they have continued using them afterwards