

Economics 1936

Problem Set 6. Countercyclical Finance in Theory and Practice

Due Monday, November 8, 11.59 pm

Question 1. Theory (This question has 4 parts.)

In *The Economics of Control*, written in the early 1940s, Abba Lerner argued

As soon as it is recognized as a duty of the government—perhaps even the primary duty of the government—to ensure the maintenance of full employment, and that any so-called principle of “sound finance” that might interfere with this task can have no possible justification, the instruments by which full employment can be maintained stand out clear and unmistakable. For Lerner the “instruments by which full employment can be maintained” are instruments of *fiscal policy*—government spending, transfer payments, and taxes.

1. Explain how fiscal policy can in principle achieve full employment *without* the government ever incurring a deficit, that is, while obeying a “sound finance” constraint.
2. Despite the theoretical possibility of achieving full employment without a government deficit, policy makers might choose to run deficits in pursuing full employment. Why?
3. To a great extent these deficits take place “automatically,” without anyone making specific decisions or taking particular actions to bring them about. And as Figure 1 shows, the incidence of these deficits is largely independent of who occupies the White House or which party is in power. Explain how so-called automatic stabilization works.

Unemployment and the Federal Deficit, 1948-2020

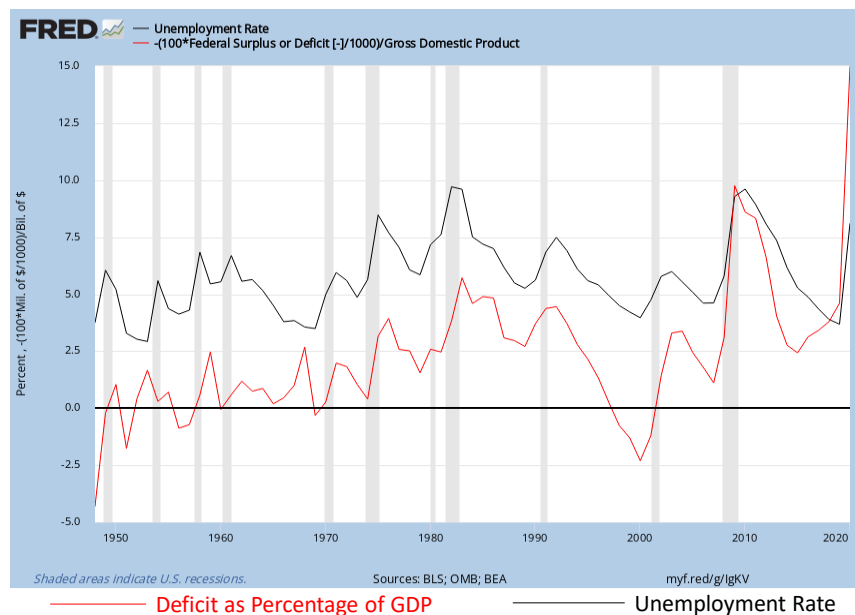


Figure 1

4. Explain why a policy of countercyclical stabilization need not lead to a rising government debt even if the Government runs deficits during slack times. How would the fiscal policy reflected in Figure 1 have to be modified in order to accomplish this?

Question 2. The Obama Stimulus (This question has 2 parts.)

And what we see with [President Obama's] plan is a lot of spending that I just don't think will work... We can't borrow and spend our way back to prosperity... Providing \$300 billion of this package to states—\$166 billion in direct aid to the states, another \$140 billion in education funding—this is not going to do anything, anything to stimulate our economy. House Minority Leader John Boehner on “Meet the Press,” January 25, 2009.

http://www.nbcnews.com/id/28841300/ns/meet_the_press/t/meet-press-transcript-jan/#.VrVB0vkrK00 (accessed February 5, 2016)

1. The most controversial part of the Obama Stimulus package (The American Recovery and Reinvestment Act) were grants to the states, roughly 1/3 of the \$750 billion total. The controversy hinged on whether the states would use the stimulus monies they received to shore up their balance sheets or would spend these funds. What are the arguments on the two sides?
2. What is your assessment of the arguments?