# Background

## What characteristics make fiscal stimulus most effective?



**Q. What characteristics make fiscal stimulus most effective?**

**A. Fiscal stimulus can raise output and incomes in the short run. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted.**

Fiscal stimulus, such as tax cuts or spending increases, can raise output and incomes in the short run by increasing overall demand. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted. *Timely*, so that its effects are felt while economic activity is still below potential; when the economy has recovered, stimulus becomes counterproductive. *Temporary*, to avoid raising inflation and to minimize the adverse long-term effects of a larger budget deficit. And well *targeted*, to provide resources to the people who most need them and will spend them: for fiscal stimulus to work, it is essential that the funds be spent, not saved.

### TIMELY

Making fiscal stimulus timely is especially challenging because it involves not just enacting tax cuts or spending but also implementing them. For example, even once enacted, increased government appropriations may not translate into actual spending for quite some time. Poorly timed fiscal policy can destabilize the economy, intensifying rather than damping the business cycle: If fiscal stimulus is enacted too slowly, it might fail to prevent a drop in output and incomes or arrive after recovery has begun, leading to overexpansion and higher inflation.

### TEMPORARY

Fiscal stimulus should be temporary because, in the long run, the Federal Reserve generally keeps the economy operating close to full employment and full capacity through monetary policy. This means that, in the long run, fiscal stimulus would not increase output, but instead simply crowd out other economic activity or induce the Federal Reserve to tighten monetary policy to keep inflation down.

Over the long run, permanent tax cuts or increases in government spending that are not matched by changes on the other side of the ledger reduce national saving. The result is less investment or more foreign borrowing. This, in turn, diminishes economic growth and future national income. Also, larger expected budget deficits tend to push up long-run interest rates, which restrain investment and weaken net exports by pushing up the value of the dollar—effects that will undo part or all of the direct stimulative effects of lower taxes or higher government spending. Therefore, a temporary stimulus is likely to be more effective than a permanent policy change, and at a much lower long-run cost.

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### TARGETED

Fiscal stimulus should be well targeted in two ways. First, it should go to households or businesses most likely to raise spending in response to the stimulus and thus increase gross domestic product in the short run. Second, it should provide the greatest benefit to the people most adversely affected by the slowdown. These two aspects of targeting are complementary. Higher-income households can generally smooth their consumption over the business cycle by drawing down their savings or borrowing. Therefore directing resources to them will likely have little effect on consumer spending. In contrast, lower-income families are more likely to cut back their consumption in hard times. These families are likely to spend any additional money they receive from tax cuts or transfer payments, which helps protect them from the downturn while also boosting the economy.

### Further Reading

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