

## FISCAL POLICY, DEFICITS AND DEBT

- I. FISCAL POLICY AND THE AD-AS MODEL
  - a. FISCAL POLICY – Deliberate changes in government spending and tax collection designed to achieve full employment, moderate inflation, and economic growth.
    - i. This is DISCRETIONARY (or active) spending. It is often initiated by the Council of Economic Advisers (CEA), a group of 3 economist appointed by the President to provide expertise.
    - ii. Automatic changes in government spending and taxing within the economy is NONDISCRETIONARY (or passive) spending.
  - b. EXPANSIONARY FISCAL POLICY
    - i. When a recession occurs, an EXPANSIONARY FISCAL POLICY may be in order.
      1. Review figure 15.1 on page 359.
    - ii. How does the Federal Government adopt policy to combat recession? See the next sections....
    - iii. Government intervention via fiscal policy can create BUDGET DEFICITS – government spending in excess of tax revenues.
    - iv. GOVERNMENT SPENDING INCREASES – to increase aggregate demand, the government can increase its spending.
      1. Examples are highways, education and health care.

2. Ceteris parabis, an sufficient increase in government spending will shift the aggregate demand curve to the right – see figure 15.1 for AD2 to AD1
- v. TAX REDUCTIONS- government could reduce taxes to shift the aggregate demand curve rightward.
1. Example is to cut personal income taxes which increases disposable income.
  2. A tax cut MUST BE LARGER than an increase in government spending to achieve the SAME rightward shift in the AD curve. This is because a reduction in taxes will be mostly consumption but partly savings.
- vi. COMBINED GOVERNMENT SPENDING INCREASES AND TAX REDUCTIONS
1. Government may combine spending increases and tax cuts to produce the desired initial increase in spending and the eventual increase in AD and real GDP.
- c. CONTRACTIONARY FISCAL POLICY
- i. When DEMAND-PULL INFLATION occurs, a restrictive or CONTRACTIONARY FISCAL POLICY may help control it.
    1. Review figure 15.2 on page 361
    2. Demand-pull inflation is reflected by the rise in price level from P1 to

P2 and a positive GDP gap of  
\$12BB (\$522BB-\$510BB)

- ii. Options to control inflation are opposite of expansionary fiscal policy:
  - 1. Decrease government spending.
  - 2. Increase taxes
  - 3. Use a combination of those two policies.
- iii. GOVERNMENT SPENDING DECREASES – Reduced government spending shifts the AD curve leftward to control demand-pull inflation.
  - 1. Review figure 15.2; if prices were downwardly flexible, the price level would return to P1; deflation would occur
  - 2. Real world, increase in AD tend to move price level up, but declines in AD do not move price level down
- iv. TAX INCREASES – Uses tax increases to reduce consumption spending
  - 1. A tax increase must exceed a decrease in government spending to cause the SAME shift leftward on the AD curve because only part of the tax increase affects consumption spending.
- v. COMBINED GOVERNMENT SPENDING DECREASES AND TAX INCREASES.
  - 1. Government may choose to do a combination in order to decrease AD and check inflation.

## II. BUILT-IN STABILITY

- a. To a degree, government tax revenues change automatically over the course of a business cycle and in ways to stabilize the economy.
  - i. This constitutes the NONDISCRETIONARY budgetary policy and results from the progressive nature of the tax system.
  - ii. Any tax revenue will yield ADDITIONAL TAX REVENUE AS GDP RISES.
    - 1. As GDP rises, more goods and services are purchased; therefore corporate, sales and excise taxes also increase
  - iii. The negative side of GDP acts in the same way as the positive side.
- b. AUTOMATIC OR BUILT-IN STABILIZERS
  - i. A BUILT-IN STABILIZER is anything that INCREASES the government's budget deficit (or reduces its budget surplus) during a recession and increases its budget surplus (or reduces its budget deficit) during inflation without requiring explicit intervention by policy makers.
    - 1. Review figure 15.3; this is how the U.S. tax system works.
- c. ECONOMIC IMPORTANCE- The economic importance of the direct relationship between tax receipts and GDP becomes apparent when we consider that:
  - i. Taxes reduce spending and AD
  - ii. Reductions in spending are desirable when the economy is moving toward inflation; whereas increases in spending

are desirable as the economy is moving towards recession.

- iii. Built-in stability reduces the fluctuations in the U.S. business cycle, possibly as much as 8-10%

- 1. Can only diminish, not eliminate, swings in real GDP.

### III. EVALUATING FISCAL POLICY

- a. Changes in discretionary fiscal policy depends on the change relative to the size of the economy, not on its absolute value.

- b. Economists use the **STANDARDIZED BUDGET** (or full-employment budget) to adjust actual Federal budget deficits and surpluses to account for the changes in tax revenues that happen automatically whenever GDP changes

- i. The idea is to compare **ACTUAL** government expenditures with the tax revenues that **WOULD HAVE OCCURRED IF THE ECONOMY HAD ACHIEVED FULL EMPLOYMENT**.
  - ii. Review figure 15.4 on page 364; review the explanation; this is an example of **CYCLICAL DEFICIT** – a Federal budget deficit that is caused by a recession and the consequent decline in tax revenues
  - iii. If we observed a **STANDARDIZED DEFICIT** of 0 in a specific year, followed by a **STANDARDIZED BUDGET DEFICIT** in the next, we could conclude that fiscal policy is **EXPANSIONARY** (in figure 15.4, shifting either the line G upward or the line T downward would

explain expansionary policy). The reverse would be contractionary

c. RECENT U.S. FISCAL POLICY

- i. Standardized deficits are generally smaller than actual deficits because the actual deficits include cyclical deficits, whereas standardized deficits do not.
- ii. Review figure 15.5 to determine the projected deficits and surpluses moving into the future.

IV. PROBLEMS, CRITICISMS, AND COMPLICATIONS

a. PROBLEMS OF TIMING

- i. RECOGNITION LAG – it takes time to RECOGNIZE that a recessionary phase or inflationary phase of the business cycle is occurring.
  1. Even in good times, there are months of weak economic data. It takes a pattern before people recognize a change in the phase of the business cycle.
- ii. ADMINISTRATIVE LAG – the wheels of politics move slowly. They need to enact legislation for discretionary policy.
- iii. OPERATIONAL LAG – there is a time period from the passing of legislation until the action affects price level or GDP. Usually 6-12 months at least.

b. POLITICAL CONSIDERATIONS

- i. Fiscal policy is in a POLITICAL arena.
- ii. Politicians want to get re-elected
  1. Expansionary policy before elections and contractionary policy

right after election; **POLITICAL BUSINESS CYCLES**

2. Pork products expand spending during both inflationary and recessionary times.

c. **FUTURE POLICY REVERSALS**

- i. Fiscal policy may fail to achieve its intended objectives if households expect future reversals of policy.

1. If households believe a tax cut will be reversed, less consumption and more saving. **CONSUMPTION SMOOTHING.**

d. **OFFSETTING STATE AND LOCAL FINANCE**

- i. State and local governments are **PRO-CYCLICAL** – they worsen rather than correcting inflationary or recessionary periods- due to constitutional or other legal requirements; balanced budget amendments at the state level.

e. **CROWDING-OUT EFFECT:** an expansionary fiscal policy (deficit spending) may increase the **INTEREST RATE** and **REDUCE INVESTMENT SPENDING**, thereby weakening or canceling the stimulus of expansionary policy.

- i. The rising interest rate may potentially **CROWD OUT** interest sensitive consumption spending (such as auto loans)
- ii. If government borrows money (it must in deficit spending) and the money supply is constant, the interest rate **MUST** rise.

Some investment spending will be  
CHOKED OFF or CROWDED OUT

iii. If the economy is operating at or near full capacity, investment demand will be high and crowding out effect will be much greater.

f. CURRENT THINKING ON FISCAL POLICY

i. Mainstream economists believe that monetary policy (the FED) is the best month-to-month stabilization tool for the U.S. economy – can move quicker.

ii. The government should hold discretionary fiscal policy for more severe inflationary or recessionary situations.

iii. Fiscal policy should be evaluated for its potential positive and negative impacts on LONG-RUN PRODUCTIVITY GROWTH.

V. THE PUBLIC DEBT

a. THE PUBLIC DEBT is an accumulation of the deficits minus the surpluses the Federal government has incurred over time.

b. OWNERSHIP – the total public debt represents the amount of money owed by the Federal government to the holders of U.S. securities: Treasury bills, Treasury notes and Treasury bonds

i. Review figure 15.6 on page 372; most of the debt is INTERNALLY HELD, not externally held.  $\frac{3}{4}$  to Americans

c. DEBT AND GDP- wealth and productive ability is vast in the U.S.

i. Review figure 15.7 on page 373.

- d. INTERNATIONAL COMPARISONS – other countries have public debt. See Global Snapshot on page 374
- e. INTEREST CHARGES- the primary burden of the debt is the interest payment to finance the debt. In '07 the interest was \$237BB; 1.7% of GDP.

## VI. FALSE CONCERNS

- a. BANKRUPTCY- two reasons to not worry:
  - i. EASY TO REFINANCE; sells new bonds to pay off previous holders of debt.
  - ii. TAXATION – government can levy and collect taxes to pay interest and principal on the debt.
- b. BURDENING FUTURE GENERATIONS- debt per capita in '07 was \$29,987. It is okay....why?
  - i. Most of the debt is held by Americans.
    - 1. Would require a transfer from Americans to Americans

## VII. SUBSTANTIVE ISSUES

- a. INCOME DISTRIBUTION – distribution of ownership of government securities is highly uneven. It is concentrated among wealthier groups who realize additional income from interest payments. The rich get richer.
- b. INCENTIVES- If debt is paid off by taxes, that reduces incentives to innovate, bear risk, etc.
- c. FOREIGN-OWNED PUBLIC DEBT – 25% of U.S. debt is owned by citizens and institutions of foreign countries – EXTERNAL PUBLIC DEBT. Enables foreigners to buy some of our output.
- d. CROWDING OUT REVISITED – the financing of the large public debt can transfer a

real economic burden to future generations by passing a smaller stock of capital goods to them.

- i. Because private investment demand tends to be LOW during recessions, any increase in interest rates caused by public borrowing (issuing debt) will at most cause a small reduction in investment spending. A large debt will mean higher interest payments and more issuing of debt during a recession
- ii. Review figure 15.8 on page 377
- iii. PUBLIC INVESTMENTS AND PUBLIC-PRIVATE COMPLEMENTARIES – even with crowding out, 2 factors can offset the net economic burden
  1. As private expenditures may involve either consumption or investment, same with public goods; PUBLIC INVESTMENTS increase the economy's future production capacity; example is highway construction or mass-transit systems)
  2. Some public investment financed through debt could spur some private sector investment by increasing its expected rate of return,  $r$ .
  3. Usually smaller than the crowding out, so some crowding out would occur.

## VIII. THE LONG-RUN FISCAL IMBALANCE: SOCIAL SECURITY

- a. Most critical long-run issue in U.S. economy is the imbalance of Social Security and Medicare
- b. THE FUTURE FUNDING SHORTFALL
  - i. Has grown from less than  $\frac{1}{2}$  of 1% in '50 to 4.2% of GDP today.
  - ii. The amount of money in the SOCIAL SECURITY FUND will be inadequate for paying retirement and other benefits in the future
  - iii. In 2017 there will be a net negative income and it will be exhausted in 2041
  - iv. Workers per beneficiaries
    - 1. 1960: 5 to 1
    - 2. Today: 3 to 1
    - 3. 2040: 2 to 1
    - 4. Baby boomers
  - v. Either benefits must be reduced or revenues (taxes) must be increased
- c. POLICY OPTIONS
  - i. Increase the retirement age, subject larger portion of income to tax, or reduce benefits of wealth retirees.
  - ii. Invest some of the trust fund into the market for stocks and bonds; higher return but higher risk.
  - iii. Increase payroll tax immediately; 1.5%
  - iv. Place  $\frac{1}{2}$  the payroll tax to individuals to invest.