Chapter 11
Fiscal Policy, Deficits, and Debt

Chapter Overview
This chapter explores the tools of government stabilization policy in terms of the aggregate demand-aggregate (AD-AS) model. Next, fiscal policy measures that automatically adjust government expenditures and tax revenues when the economy moves through the business cycle phases are examined. The recent use and resurgence of fiscal policy as a tool are discussed, as are problems, criticism, and complications of fiscal policy.

The material on the public debt is designed to explode two popular misconceptions as to the character and problems associated with a large public debt: (1) the debt will force the U.S. into bankruptcy; and (2) the debt imposes a burden on future generations. The debt discussion, however, also entails a look at substantive economic issues. Potential problems of a large public debt include greater income inequality, reduced economic incentives, and crowding out of private investment.

The chapter concludes with a Last Word on the leading economic indicators, identifying the specific components of the index and explaining how they combine to help forecast the future direction of the economy.

Instructional Objectives
After completing this chapter, students should be able to:

1. Define and explain the role of the CEA.
2. Distinguish between discretionary and nondiscretionary fiscal policy.
3. Differentiate between expansionary and contractionary fiscal policy.
4. Recognize the conditions for recommending an expansionary or contractionary fiscal policy.
5. Explain expansionary fiscal policy and its effects on the economy and Federal budget.
7. Give two examples of how built-in stabilizers help eliminate recession or inflation.
8. Explain the differential impacts of progressive, proportional, and regressive taxes in terms of stabilization policy.
9. Explain the significance of the “standardized budget” concept.
10. Describe recent U.S. fiscal policy actions and the motivation behind them.
11. List three timing problems encountered with fiscal policy.
12. State political problems that limit effective fiscal policy.
13. Identify actions by households, and by state and local governments that can frustrate fiscal policy.
14. Differentiate between deficit and debt.
15. State the relative size of the debt as a percentage of GDP and describe how that has changed in recent years.
16. Describe the annual interest charges on the debt, who holds the debt, and the impact of inflation on the debt.
17. Explain why the debt can also be considered public credit.
18. Identify and discuss two widely held myths about the public debt.
19. Explain the real or potential effect of the debt on income distribution, economic incentives, fiscal policy, and private investment.
20. Explain and recognize graphically how crowding out is a concern caused by a large public debt.
21. Explain the purpose and structure of the Leading Economic Indicators (Last Word).
22. Define and identify terms and concepts at the end of the chapter.

Lecture Notes

I. Introduction

A. Learning objectives – In this chapter students will learn:
   1. The purposes, tools, and limitations of fiscal policy.
   2. The role of built-in stabilizers in moderating business cycles.
   3. How the standardized budget reveals the status of U.S. fiscal policy.
   4. About the size, composition, and consequences of the U.S. public debt.

B. One major function of the government is to stabilize the economy (prevent unemployment or inflation).

C. Stabilization can be achieved in part by manipulating the public budget—government spending and tax collections—to increase output and employment or to reduce inflation.

D. This chapter will examine a number of topics.
   1. It explores the tools of government fiscal stabilization policy using AD-AS model.
   2. Both discretionary and automatic fiscal adjustments are examined.
   3. The problems, criticisms, and complications of fiscal policy are addressed.
   4. The size of and concerns about the public debt are identified and explored.

II. Fiscal Policy and the AD/AS Model

A. Discretionary fiscal policy refers to the deliberate manipulation of taxes and government spending by Congress to alter real domestic output and employment, control inflation, and stimulate economic growth. “Discretionary” means the changes are at the option of the Federal government.

B. Discretionary fiscal policy changes are often initiated by the President, on the advice of the Council of Economic Advisers (CEA).

C. Changes not directly resulting from congressional action are referred to as nondiscretionary (or “passive”) fiscal policy.

D. Fiscal policy choices: Expansionary fiscal policy is used to combat a recession (see examples illustrated in Figure 11.1).
   1. Expansionary Policy needed: In Figure 11.1, a decline in investment has decreased AD from AD$_1$ to AD$_2$ so real GDP has fallen and also employment declined. Possible fiscal policy solutions follow:
a. An increase in government spending (shifts AD to right by more than change in G due to multiplier),

b. A decrease in taxes (raises income, and consumption rises by MPC ∞ change in income; AD shifts to right by a multiple of the change in consumption).

c. A combination of increased spending and reduced taxes.

d. If the budget was initially balanced, expansionary fiscal policy creates a budget deficit.

2. Contractionary fiscal policy needed: When demand-pull inflation occurs as illustrated by a shift from AD₃ to AD₄ up the short-run aggregate supply curve in Figure 11.2. Then contractionary policy is the remedy:

a. A decrease government spending shifts AD₄ back to AD₃ once the multiplier process is complete. Here price level returns to its preinflationary level P₃ but GDP returns to its noninflationary full-employment level of output ($510 billion).

b. An increase in taxes will reduce income and then consumption at first by MPC fall in income, and then multiplier process leads AD to shift leftward still further. In Figure 11.2 a tax increase of $6.67 billion decreases consumption by 5 and multiplier causes eventual shift to AD₃.

c. A combined spending decrease and tax increase could have the same effect with the right combination ($2 billion decline in G and $4 billion rise in T will have this effect).

E. Policy options: G or T?

1. Economists tend to favor higher G during recessions and higher taxes during inflationary times if they are concerned about unmet social needs or infrastructure.

2. Others tend to favor lower T for recessions and lower G during inflationary periods when they think government is too large and inefficient.

III. Built-In Stability

A. Built-in stability arises because net taxes (taxes minus transfers and subsidies) change with GDP (recall that taxes reduce incomes and therefore, spending). It is desirable for spending to rise when the economy is slumping and vice versa when the economy is becoming inflationary. Figure 11.3 illustrates how the built-in stability system behaves.

1. Taxes automatically rise with GDP because incomes rise and tax revenues fall when GDP falls.

2. Transfers and subsidies rise when GDP falls; when these government payments (welfare, unemployment, etc.) rise, net tax revenues fall along with GDP.

B. The size of automatic stability depends on responsiveness of changes in taxes to changes in GDP: The more progressive the tax system, the greater the economy’s built-in stability. In Figure 11.3 line T is steepest with a progressive tax system.

1. The U.S. tax system reduces business fluctuations by as much as 8 to 10 percent of the change in GDP that would otherwise occur.

2. Automatic stability reduces instability, but does not eliminate economic instability.

IV. Evaluating Fiscal Policy
A. A standardized budget in Year 1 is illustrated in Figure 11.4(a) because budget revenues equal expenditures when full employment exists at GDP_1.

B. At GDP_2 there is unemployment and assume no discretionary government action, so lines G and T remain as shown.

1. Because of built-in stability, the actual budget deficit will rise with decline of GDP; therefore, actual budget varies with GDP.
2. The government is not engaging in expansionary policy since budget is balanced at full-employment output.
3. The standardized budget measures what the Federal budget deficit or surplus would be with existing taxes and government spending if the economy is at full employment.
4. Actual budget deficit or surplus may differ greatly from standardized budget deficit or surplus estimates.

C. In Figure 11.4b, the government reduced tax rates from T_1 to T_2, now there is a standardized deficit.

1. Structural deficits occur when there is a deficit in the standardized budget as well as the actual budget.
2. This is expansionary policy because true expansionary policy occurs when the standardized budget has a deficit.

D. If the standardized deficit of zero was followed by a standardized budget surplus, fiscal policy is contractionary.

E. Recent U.S. fiscal policy is summarized in Table 11.1.

1. Observe that standardized deficits are less than actual deficits.
3. The 2003 Bush tax cut increased the standardized budget deficit as a percentage of potential GDP (to -2.7 percent in 2003).
4. Federal budget deficits are expected to persist at least until 2012. The absolute size of the deficit is shown in Figure 11.5.
5. Surpluses and deficits shown in Figure 11.5 include payroll tax revenues obligated for future Social Security payments. Some economists believe that because these revenues are committed to future Social Security payments, they should not be included in calculating current deficits or surpluses.

F. Global Perspectives 11.1 gives a fiscal policy snapshot for selected countries.

V. Problems, Criticisms and Complications

A. Problems of timing

1. Recognition lag is the elapsed time between the beginning of recession or inflation and awareness of this occurrence.
2. Administrative lag is the difficulty in changing policy once the problem has been recognized.
3. Operational lag is the time elapsed between change in policy and its impact on the economy.
B. Political considerations: Government has other goals besides economic stability, and these may conflict with stabilization policy.

1. A political business cycle may destabilize the economy: Election years have been characterized by more expansionary policies regardless of economic conditions.

2. State and local finance policies may offset federal stabilization policies. They are often procyclical, because balanced-budget requirements cause states and local governments to raise taxes in a recession or cut spending making the recession possibly worse. In an inflationary period, they may increase spending or cut taxes as their budgets head for surplus.

3. The crowding-out effect may be caused by fiscal policy.
   a. “Crowding-out” may occur with government deficit spending. It may increase the interest rate and reduce private spending which weakens or cancels the stimulus of fiscal policy.
   b. Some economists argue that little crowding out will occur during a recession.
   c. Economists agree that government deficits should not occur at F.E., it is also argued that monetary authorities could counteract the crowding-out by increasing the money supply to accommodate the expansionary fiscal policy.

C. Current thinking on fiscal policy

1. Some economists oppose the use of fiscal policy, believing that monetary policy is more effective or that the economy is sufficiently self-correcting.

2. Most economists support the use of fiscal policy to help “push the economy” in a desired direction, and using monetary policy more for “fine tuning.”

3. Economists agree that the potential impacts (positive and negative) of fiscal policy on long-term productivity growth should be evaluated and considered in the decision-making process, along with the short-run cyclical effects.

VI. The Public Debt

A. The national or public debt is the total accumulation of the Federal government’s total deficits and surpluses that have occurred through time.

B. Deficits (and by extension the debt) are the result of war financing, recessions, and lack of political will to reduce or avoid them.

C. The public debt was $7.96 trillion in 2005.

D. Ownership of the public debt (Figure 11.6)
   1. $3.9 trillion (49 percent) held by the public and $4.06 trillion (51 percent) by Federal government agencies, including the Federal Reserve.
   2. Foreigners held about 25 percent of the public debt in 2005.
   3. The Federal debt held by the public was 31.4 percent of GDP in 2005, higher than in 2001 (27.7%) but less than in the 1990s. (Figure 11.7)

E. Public debt as a percentage of GDP in 2005 for a number of countries can be seen in Global Perspective 11.2. Although the U.S. has the highest public debt in absolute terms, a number of countries owe more relative to their ability to support it (through income, or GDP).

F. Interest charges are the main burden imposed by the debt.
1. Interest on the debt was $184 billion in 2005, and is the fourth largest item in the Federal budget.

2. Interest payments were 1.5 percent of GDP in 2005. The percentage is important because it represents the average tax rate necessary just to cover annual interest on the debt. Low interest rates brought the percentage down from the 1990s.

VII. False Concerns

False concerns about the federal debt include several popular misconceptions:

A. Can the federal government go bankrupt? There are reasons why it cannot.
   1. The government does not need to raise taxes to pay back the debt, and it can borrow more (i.e. sell new bonds) to refinance bonds when they mature. Corporations use similar methods—they almost always have outstanding debt.
   2. The government has the power to tax, which businesses and individuals do not have when they are in debt.

B. Does the debt impose a burden on future generations? In 2005 the per capita federal debt in U.S. was $26,834. But the public debt is a public credit—your grandmother may own the bonds on which taxpayers are paying interest. Some day you may inherit those bonds that are assets to those who have them. The true burden is borne by those who pay taxes or loan government money today to finance government spending. If the spending is for productive purposes, it will enhance future earning power and the size of the debt relative to future GDP and population could actually decline. Borrowing allows growth to occur when it is invested in productive capital.

VIII. Substantive Issues

A. Repayment of the debt affects income distribution. If working taxpayers will be paying interest to the mainly wealthier groups who hold the bonds, this probably increases income inequality.

B. Since interest must be paid out of government revenues, a large debt and high interest can increase tax burden and may decrease incentives to work, save, and invest for taxpayers.

C. A higher proportion of the debt is owed to foreigners (about 18 percent) than in the past, and this can increase the burden since payments leave the country. But Americans also own foreign bonds and this offsets the concern.

D. Some economists believe that public borrowing crowds out private investment, but the extent of this effect is not clear (see Figure 11.8).

E. There are some positive aspects of borrowing even with crowding out.
   1. If borrowing is for public investment that causes the economy to grow more in the future, the burden on future generations will be less than if the government had not borrowed for this purpose.
   2. Public investment makes private investment more attractive. For example, new federal buildings generate private business; good highways help private shipping, etc.

IX. LAST WORD: The Leading Indicators
A. This index comprises 10 variables that have indicated forthcoming changes in real GDP in the past.

B. The variables are the foundation of this index consisting of a weighted average of ten economic measurements. A rise in the index predicts a rise in the GDP; a fall predicts declining GDP.

C. Ten components comprise the index:
   1. Average workweek: A decrease signals future GDP decline.
   2. Initial claims for unemployment insurance: An increase signals future GDP decline.
   4. Vendor performance: Better performance by suppliers in meeting business demand indicates decline in GDP.
   5. New orders for capital goods: A decrease signals GDP decline.
   7. Stock market prices: Declines signal GDP decline.
   8. Money supply: A decrease is associated with falling GDP.
   9. Interest-rate spread: when short-term rates rise, there is a smaller spread between short-term and long-term rates which are usually higher. This indicates restrictive monetary policy.
   10. Index of consumer expectations: Declines in consumer confidence foreshadow declining GDP.

D. None of these factors alone is sufficient to predict changes in GDP, but the composite index has correctly predicted business fluctuations many times (although not perfectly). The index is a useful signal, but not totally reliable.