Chapter 13

Fiscal Policy

THE BUDGET BALANCE

- People usually think of budget surpluses as good:
  - When the federal government ran a record surplus in 2000, many people regarded it as a cause for celebration.
- People usually think of budget deficits as bad:
  - When the U.S. federal government ran record deficits from 2009 to 2011, many people regarded it as a cause for concern.
- How do surpluses and deficits fit into the analysis of fiscal policy? Are deficits ever a good thing and surpluses a bad thing?
- Visit this site for current debt and deficit figures:

  https://www.cbo.gov/topics/budget

THE BUDGET BALANCE AS A MEASURE OF FISCAL POLICY (1 of 2)

- The budget balance is the difference between tax revenue and government spending, both on goods and services and on government transfers:

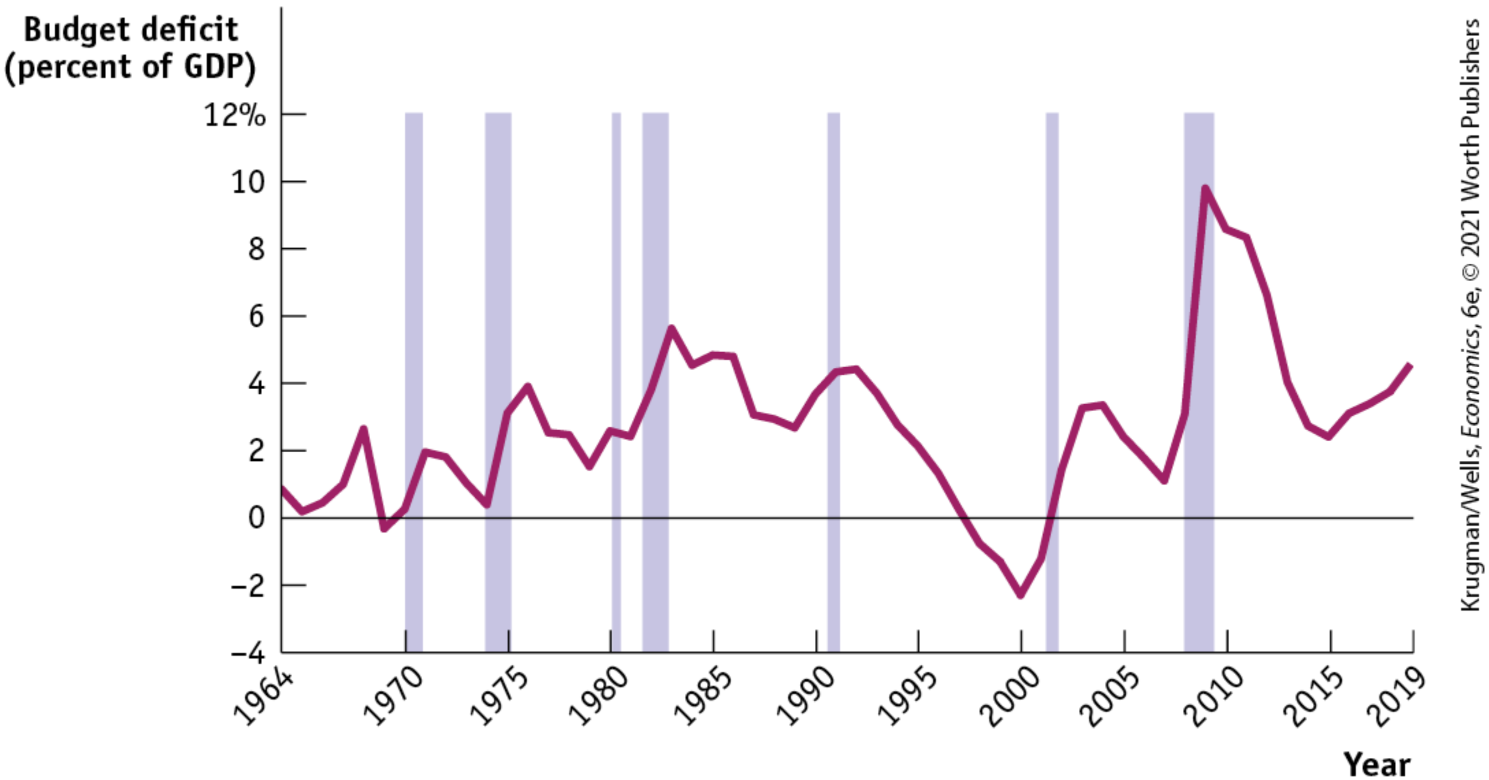
$$S_{Government} = T - G - TR$$

- **Budget balance (government savings) = tax revenues (*T*) – government purchases (*G*) and transfers (*TR*)**
- A budget surplus is a positive budget balance, and a budget deficit is a negative budget balance.
  - Other things equal, discretionary expansionary fiscal policies reduce the budget balance for that year.
  - Other things equal, discretionary contractionary fiscal policies increase the budget balance for that year.

THE BUDGET BALANCE AND THE BUSINESS CYCLE

The budget tends to move into deficit when the economy is in a recession (look at the shaded areas), but deficits tend to get smaller or even turn into surpluses when the economy is expanding.

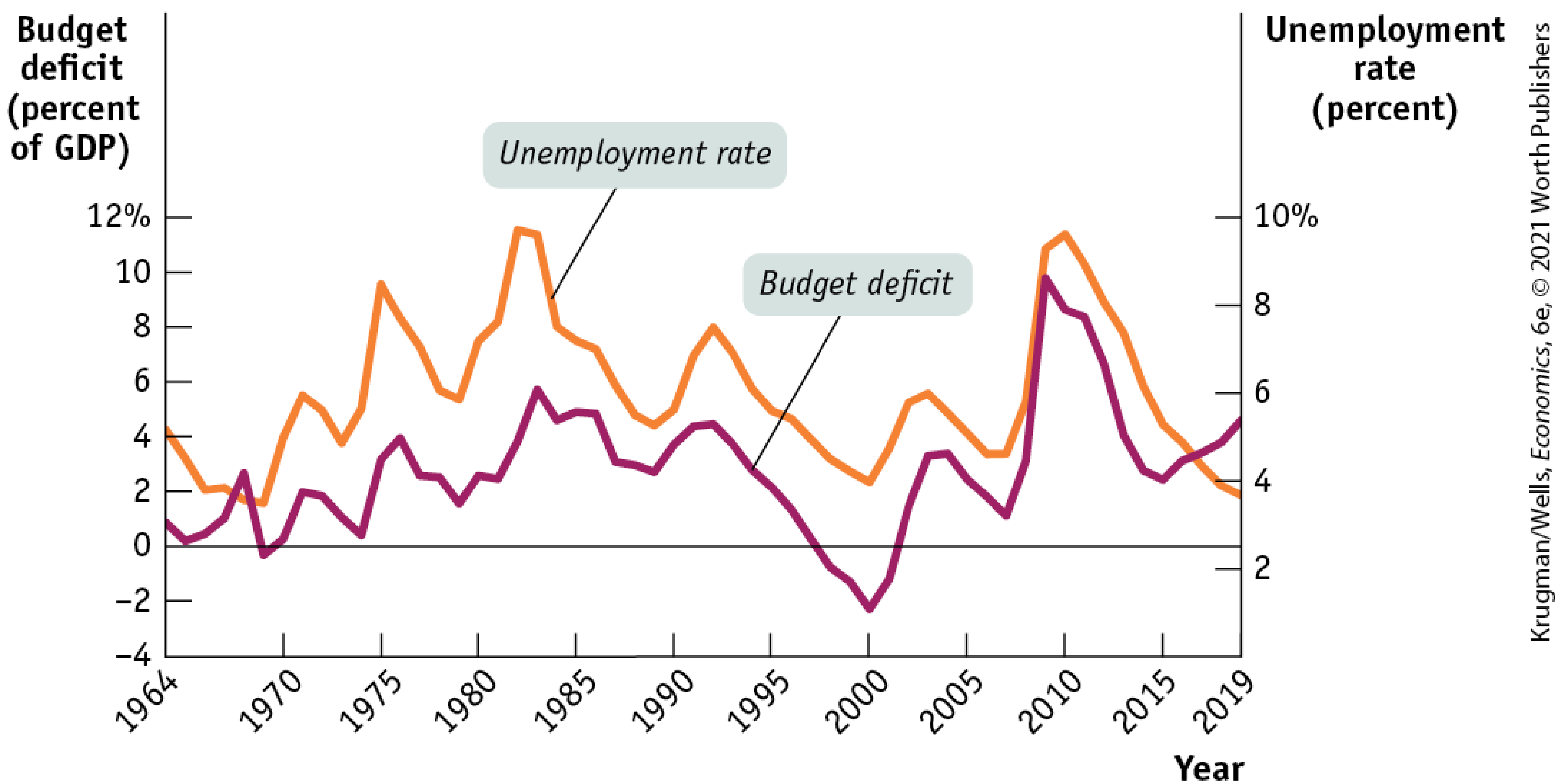
Figure 13-8



THE BUDGET BALANCE AND UNEMPLOYMENT

The budget deficit rises when the unemployment rate rises and falls when the unemployment rate falls.

Figure 13-9



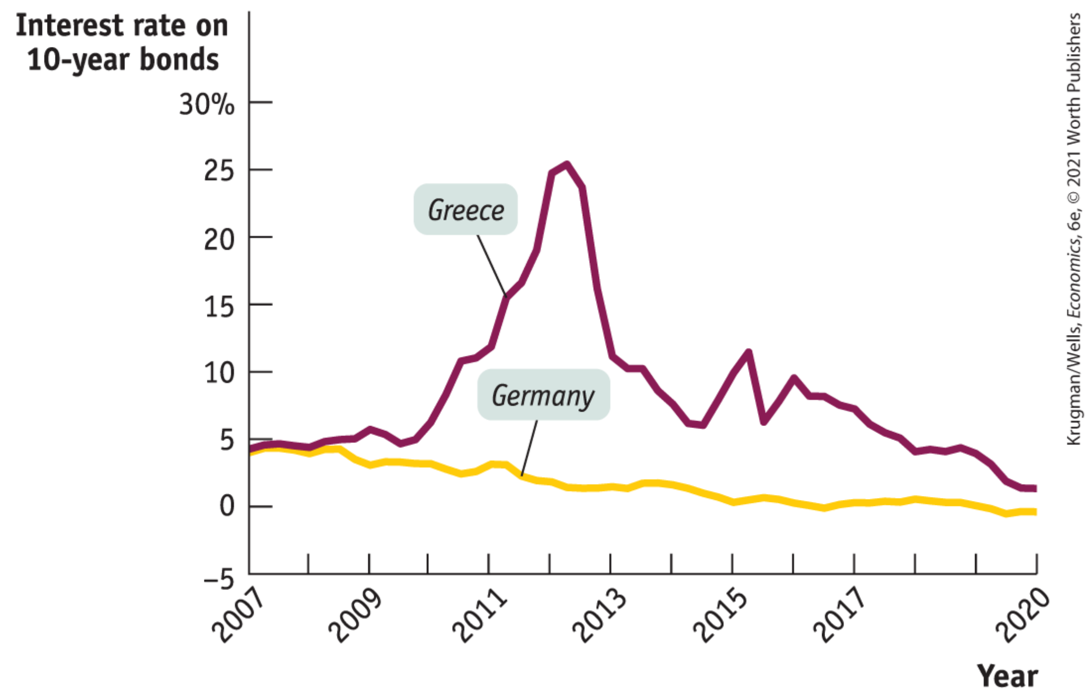
SHOULD THE BUDGET BE BALANCED?

- Most economists don’t think so.
- They believe that the government should only balance its budget on average—that it is okay to run deficits in bad years, offset by surpluses in good years.
- The government should be forced to run a balanced budget every year because this would undermine the role of taxes and transfers as automatic stabilizers.

LONG-RUN IMPLICATIONS OF FISCAL POLICY

- Persistent budget deficits have long-run consequences because they increase **public debt** (government debt held by individuals and institutions outside the government).
- In 2008, the government of Greece could borrow at interest rates barely higher than those of Germany (widely considered a very safe borrower). Things changed in 2009…

Figure 13-12

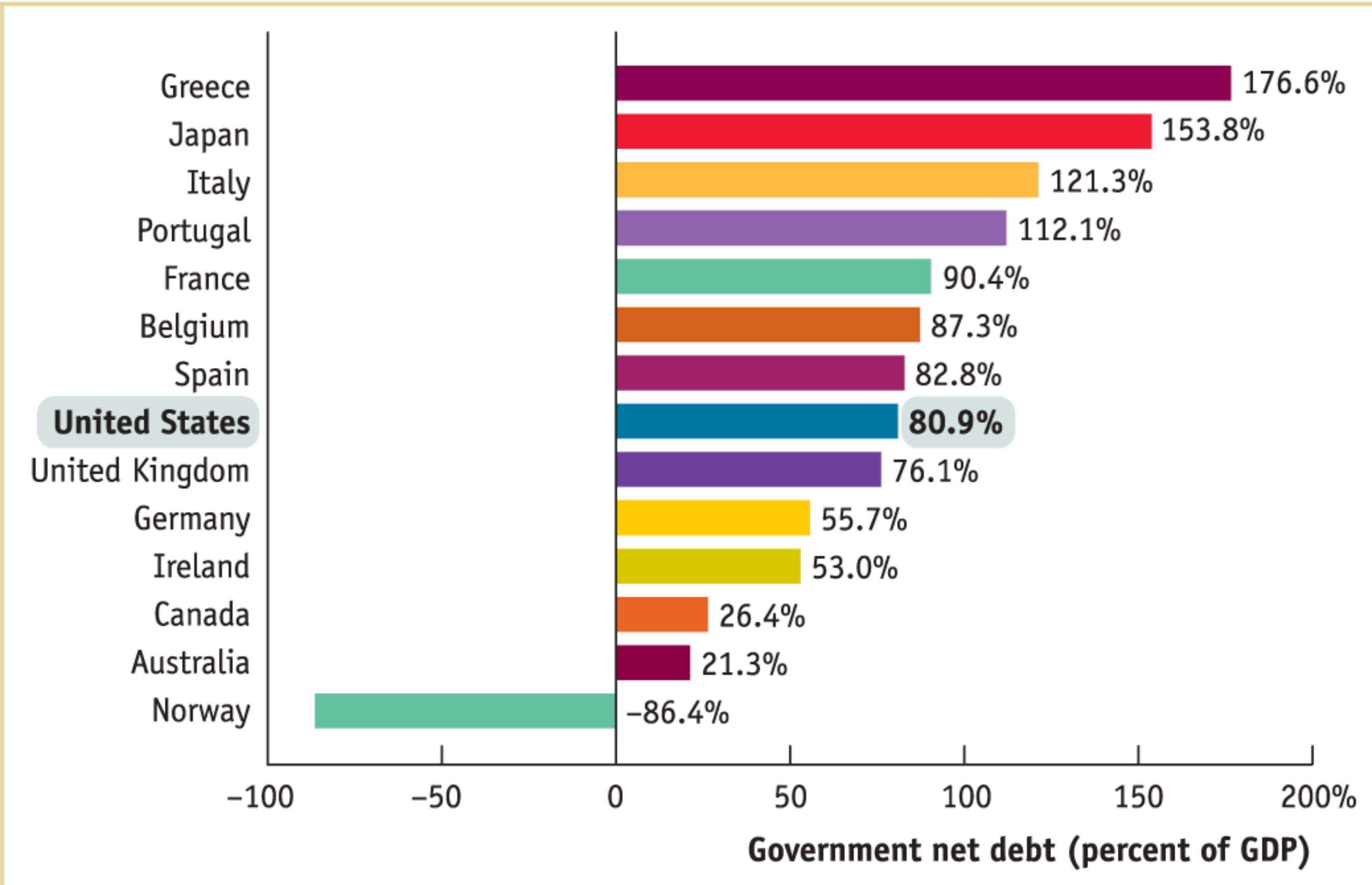


DEFICITS VS. DEBT

- A **deficit** is the difference between the amount of money a government spends and the amount it receives in taxes **over a given period.**
- A **debt** is the sum of money a government owes **at a particular time.**
- **Deficits and debt are linked,** because government debt grows when governments run deficits. But they aren't the same thing, and they can tell different stories.

THE AMERICAN WAY OF DEBT

How does the U.S. public debt stack up internationally? In dollar terms, we're number one—but this isn't informative, since the U.S. economy is much larger than those of other nations. A more informative comparison is the ratio of public debt to GDP.



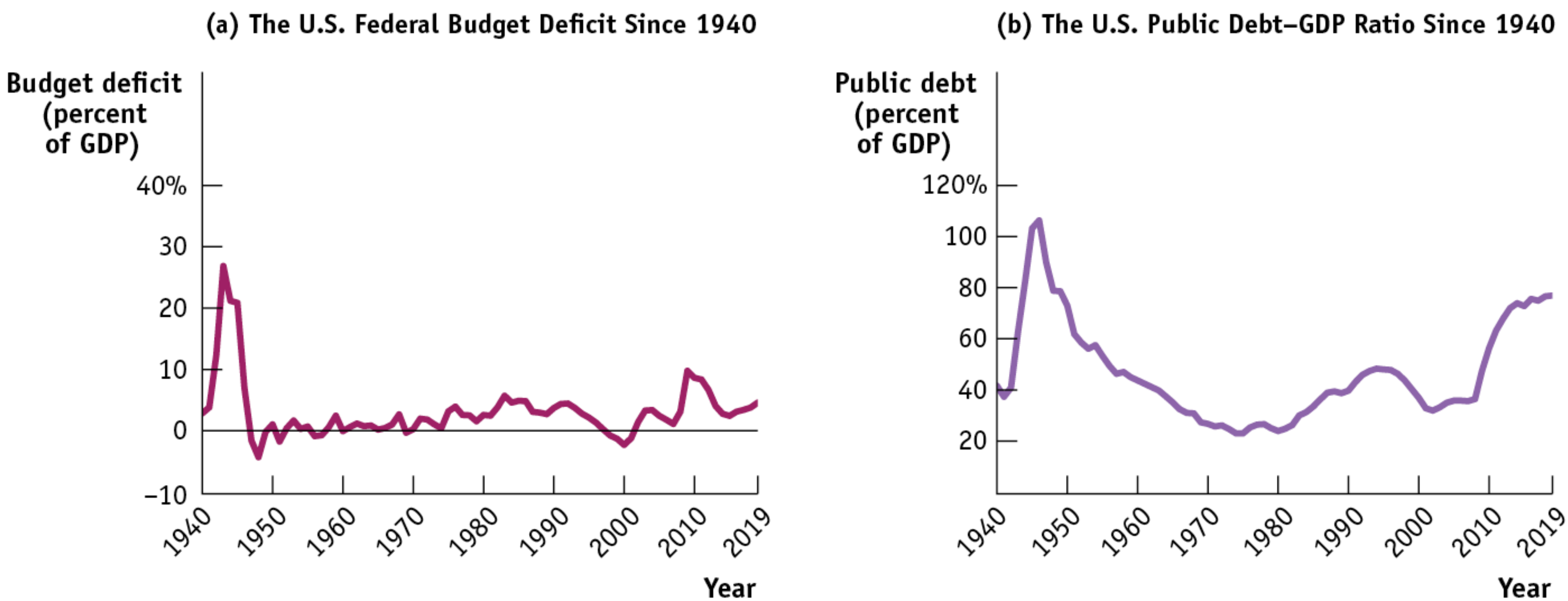
DANGERS POSED BY RISING GOVERNMENT DEBT

- **Crowding out**: the government's borrowing may crowd out private investments, raising interest rates and reducing the economy's long-run growth.
- **Financial pressure and default:**
  - Deficits place financial pressure on future budgets.
  - A government paying large sums in interest must raise taxes, cut spending—or it must borrow even more. If it borrows to pay the interest, it pushes itself even deeper into debt—the **debt spiral**. The debt spiral may end up in a default when the government stops paying what it owes, resulting in economic and financial turmoil.
- **Can't a government that has trouble borrowing just print money to pay its bills?**
- **Yes, it can, but this leads to another problem: inflation.**

DEFICITS AND DEBT IN PRACTICE

- To assess the government’s ability to pay its debt, we use the **debt–GDP ratio**.
- Panel (a): The U.S. government ran huge deficits during World War II and has run smaller deficits ever since.
- Panel (b): The debt–GDP ratio has declined despite government deficits.

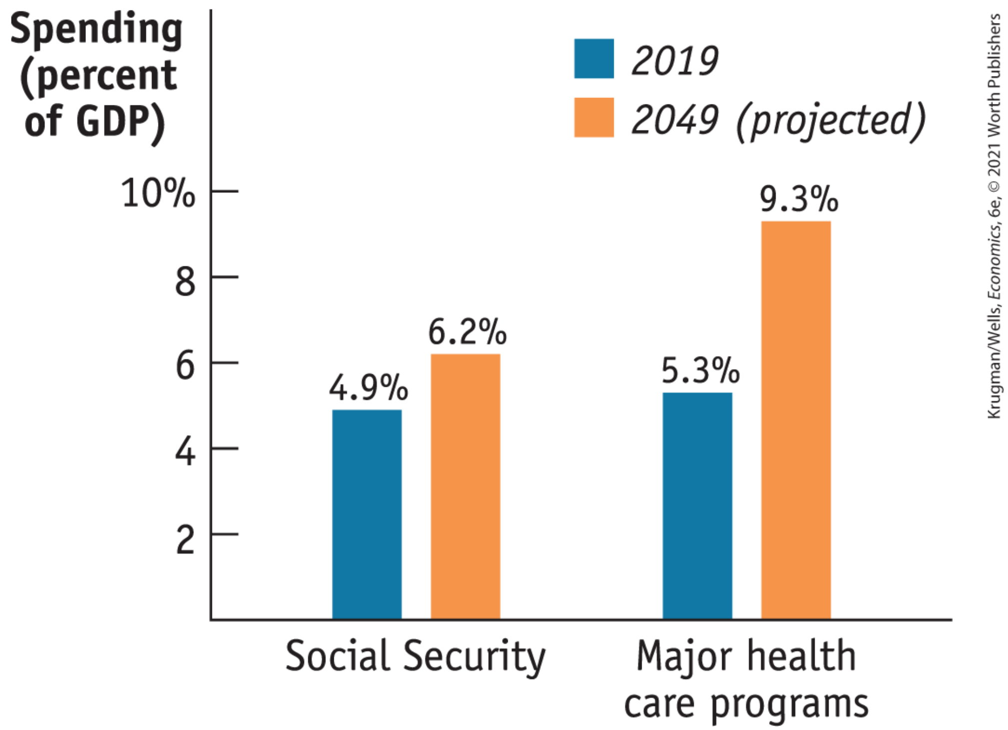
Figure 13-13



IMPLICIT LIABILITIES (1 of 2)

- Experts on long-run budget issues view the situation of the United States (and other countries such as Japan and Italy) with alarm.
- The reason is **implicit liabilities:** spending promises made by governments that are effectively a debt despite the fact that they are not included in the usual debt statistics. The aging population and rising health care costs will soon pose real problems for the federal budget.

Figure 13-14



IMPLICIT LIABILITIES (2 of 2)

- Social Security and part of Medicare are supported by **dedicated taxes** (special taxes on wages). At times, these dedicated taxes yield more revenue than is needed to pay current benefits.
- Since the mid-1980s the Social Security system has been taking in more revenue than it needs. This surplus has been used to accumulate a **Social Security trust fund**, which was $2.8 trillion at the end of fiscal 2019.