W14: Fiscal Policy

- Gov-t budget, receipts and outlays
- Supply-side effects of fiscal policy
- Generational Effects of Fiscal Policy
- Automatic and discretionary fiscal stimulus

Reading: CH13 pages 322-340

HW8

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What Is Fiscal Policy?

Fiscal policy is the use of the federal budget to achieve macroeconomic objectives

- The **federal budget** is the annual statement of the federal government's outlays and tax revenues
- The President and Congress make fiscal policy
- The **Council of Economic Advisers** monitors the economy and keeps the President and the public informed about the current state of the economy and provides forecasts of where it is heading

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The Federal Budget

TABLE 13.1 Federal Budget in Fiscal 2015

Item	Projections (billions of dollars)	
Receipts	**3,514**	
Personal income taxes		1,505
Social Security taxes		1,176
Corporate income taxes		537
Indirect taxes and other receipts		296
Outlays	**4,158**	
Transfer payments		2,649
Expenditure on goods and services		1,030
Debt interest		479
Deficit	**644**	

Source of data: Budget of the United States Government, Fiscal Year 2015, Table 14.1.

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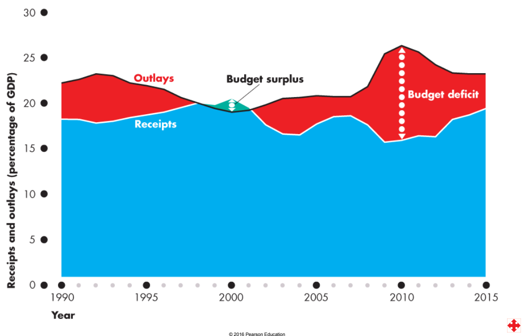
Budget Deficit and Budget Surplus



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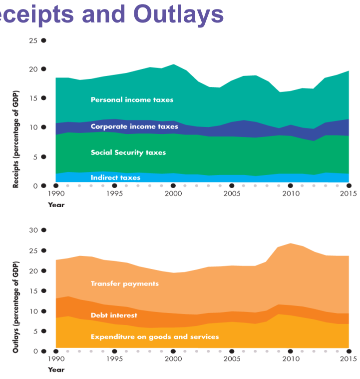
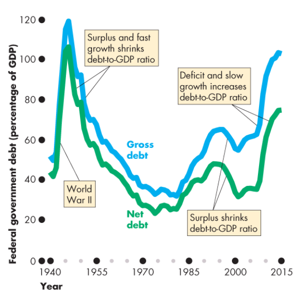
Receipts and Outlays



Government Debt

Total amount that the government has borrowed and is equal to the sum of past deficits minus past surpluses



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Supply-Side Effects of Fiscal Policy

Fiscal policy has important effects on employment, potential GDP, and aggregate supply — called **supply-side effects**

- Tax on labor

  The gap between the before-tax and after-tax wage rates is called the **tax wedge**

- A tax on capital income

  Saving and investment is influenced by the *real after-tax* interest rate

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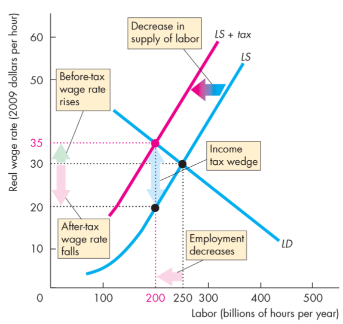
Supply-Side Effects of Fiscal Policy



(a) Income tax and the labor market

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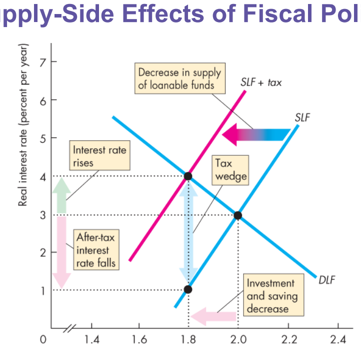
Supply-Side Effects of Fiscal Policy



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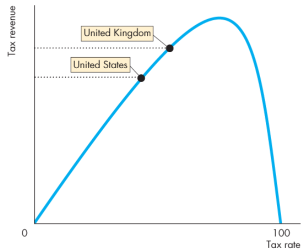
The Laffer Curve

The relationship between the tax rate and the amount of tax revenue collected



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Generational Effects of Fiscal Policy

Generational accounting measures the lifetime tax burden and benefits of each generation

- Is the budget deficit a burden on future generations?
- What about the deficit in the Social Security fund?
- Does it matter who owns the bonds that the government sells to finance its deficit?

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The Social Security Time Bomb

- In 2008, the first of the baby boomers started collecting Social Security pensions and in 2011, they became eligible for Medicare benefits
- By 2030, all the baby boomers will have reached retirement age and the population supported by Social Security will have doubled

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Fiscal Stimulus

A **fiscal stimulus** is the use of fiscal policy to increase production and employment

- Fiscal stimulus can be:
  - *Automatic* – policy action triggered by the state of the economy with no government action (tax revenues, needs-tested spending)
  - *Discretionary* – a policy action that is initiated by an act of Congress (tax cuts, gov-t expenditure)

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Automatic Changes in Tax Revenues

- Congress sets the tax *rates* that people must pay
- The tax dollars people pay depend on their incomes
- But incomes vary with real GDP, so tax revenues depend on real GDP
- In an expansion, tax revenues increase
- In a recession, tax revenues decrease

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Automatic Changes in Needs-Tested Spending

- The government creates programs that pay benefits to qualified people and businesses
- These transfer payments depend on the economic state of the economy
- In an expansion, unemployment falls, so needs-tested spending decreases
- In a recession, unemployment rises, so needs-tested spending increases

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Automatic Stimulus

- In a recession, receipts decrease and outlays increase
- So the budget provides an automatic stimulus that helps shrink the recessionary gap
- In a boom, receipts increase and outlays decrease
- So the budget provides automatic restraint that helps shrink the inflationary gap

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Cyclical vs. Structural Surplus/Deficit

- The **structural surplus or deficit** is the budget balance that would occur if the economy were at full employment and real GDP were equal to potential GDP
- The **cyclical surplus or deficit** is the actual surplus or deficit minus the structural surplus or deficit
- That is, a cyclical surplus or deficit is the surplus or deficit that occurs purely because real GDP does *not* equal potential GDP

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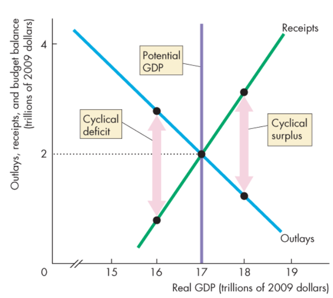
Cyclical vs. Structural Surplus/Deficit



(a) Cyclical deficit and cyclical surplus

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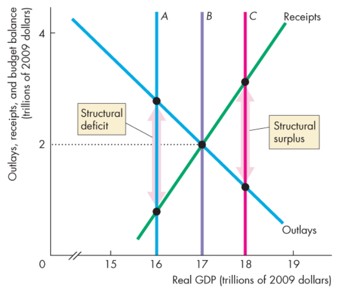
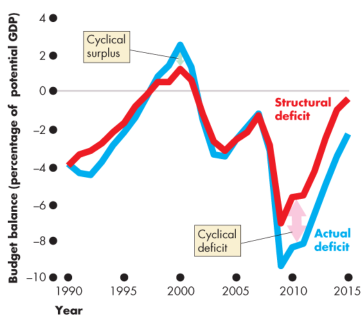
Cyclical vs. Structural Surplus/Deficit



(b) Structural deficit and structural surplus

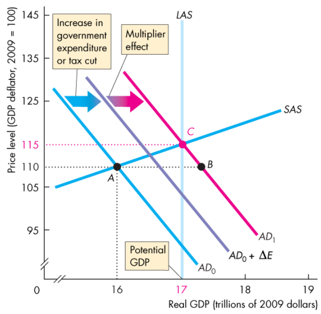
Cyclical vs. Structural Surplus/Deficit



Discretionary Fiscal Stimulus

- Most discretionary fiscal stimulus focuses on its effects on aggregate demand
- Changes in government expenditure and taxes change aggregate demand and have multiplier effects:
- An increase in government expenditure increases government borrowing and raises the real interest rate
- With the higher cost of borrowing, investment decreases, which partly offsets the increase in government expenditure

Discretionary Fiscal Stimulus



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