
 **W12: 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 pg. 322-340
HW7: due 04/05
HW8: due 04/15

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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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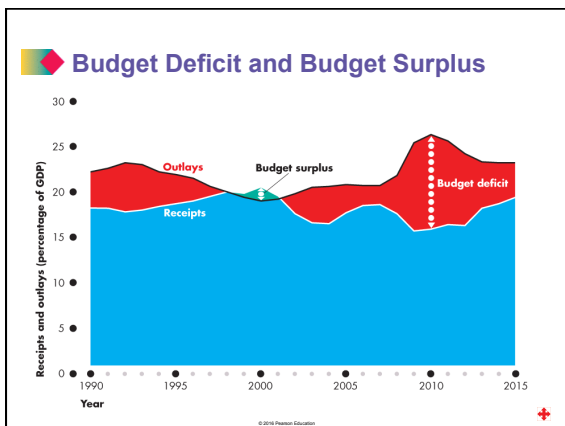
 **The Federal Budget**

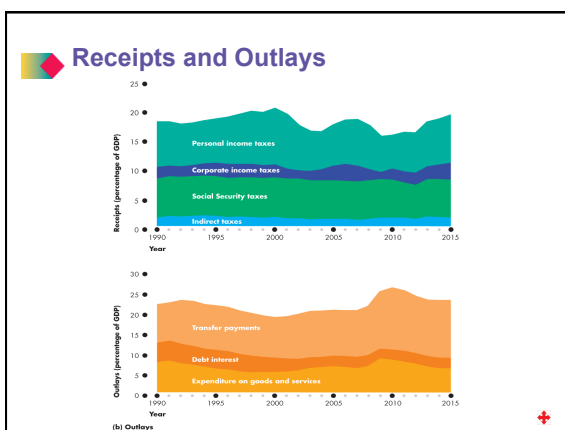
TABLE 13.1 Federal Budget in Fiscal 2015

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.

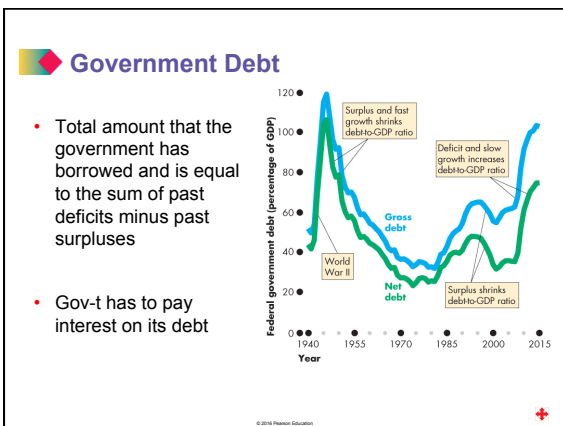
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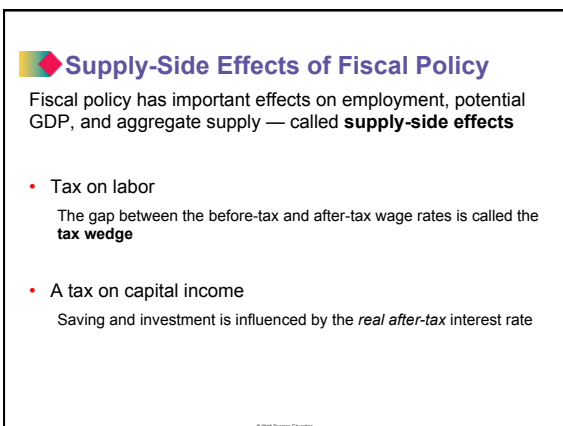


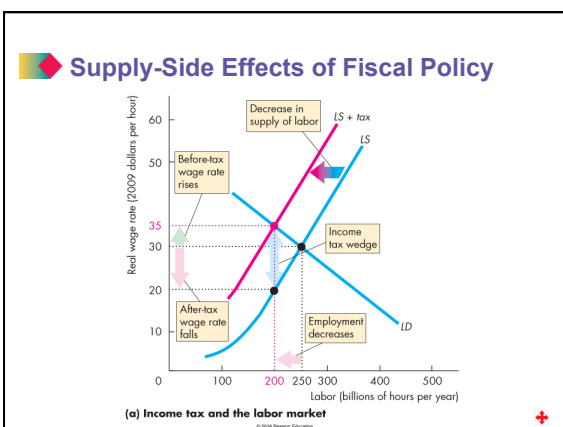


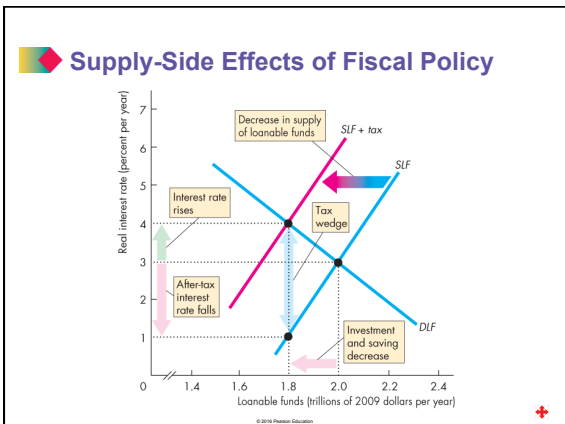
How Do Governments Finance Deficit?

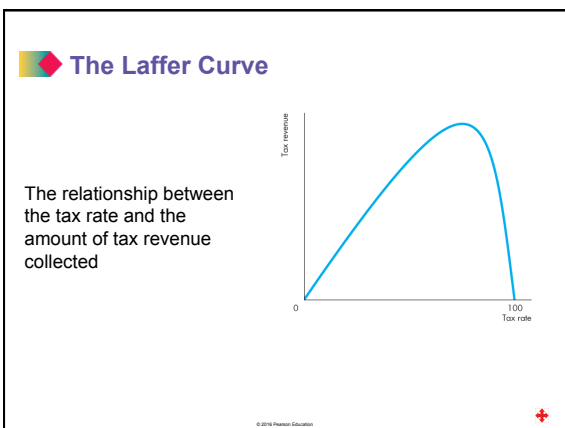
- Governments usually borrow by selling securities called government bonds
- When you buy a gov-t bond, you lend money to the gov-t
- Terms of this loan can be different: maturity, interest rate
- Anybody can buy a gov-t bond: a person, a firm, a country, a city, etc.
- Example of a government bond <http://ep.yimg.com/ty/cdn/scriphily/treasurybond2002bdls.jpg>











- ### Generational Effects of Fiscal Policy
- 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?

 **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

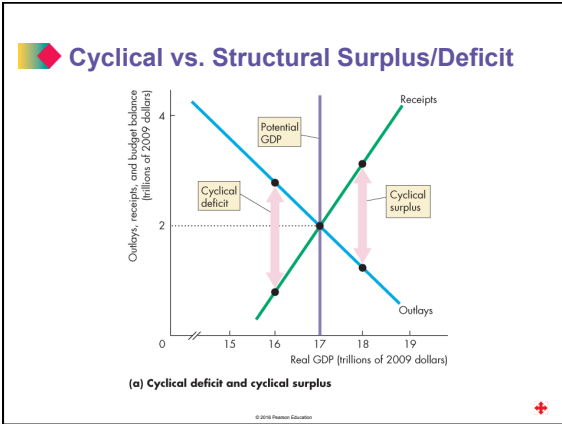
- In a recession, receipts decrease and outlays increase
- So the budget provides an automatic stimulus that helps shrink the recessionary gap
- In a boom, receipts increase and outlays decrease
- So the budget provides automatic restraint that helps shrink the inflationary gap

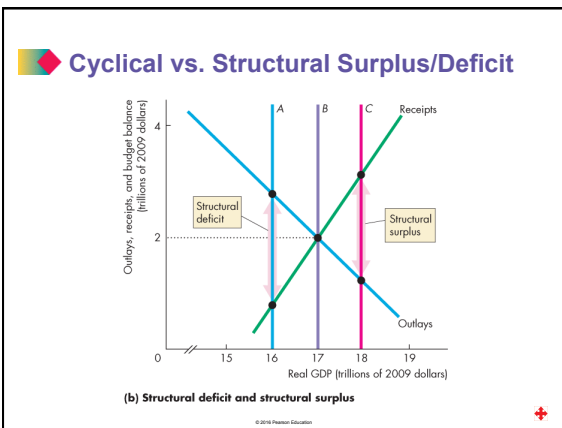
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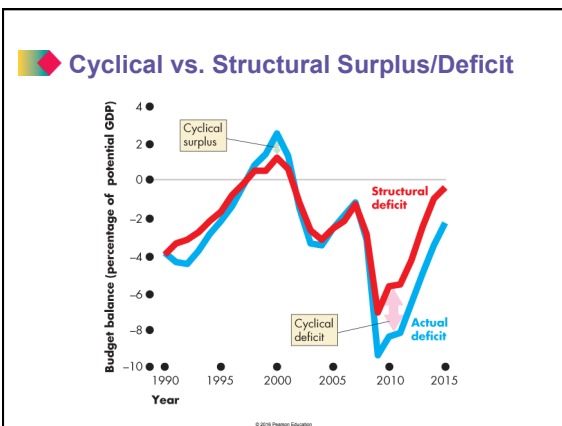
Cyclical vs. Structural Surplus/Deficit

- 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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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

