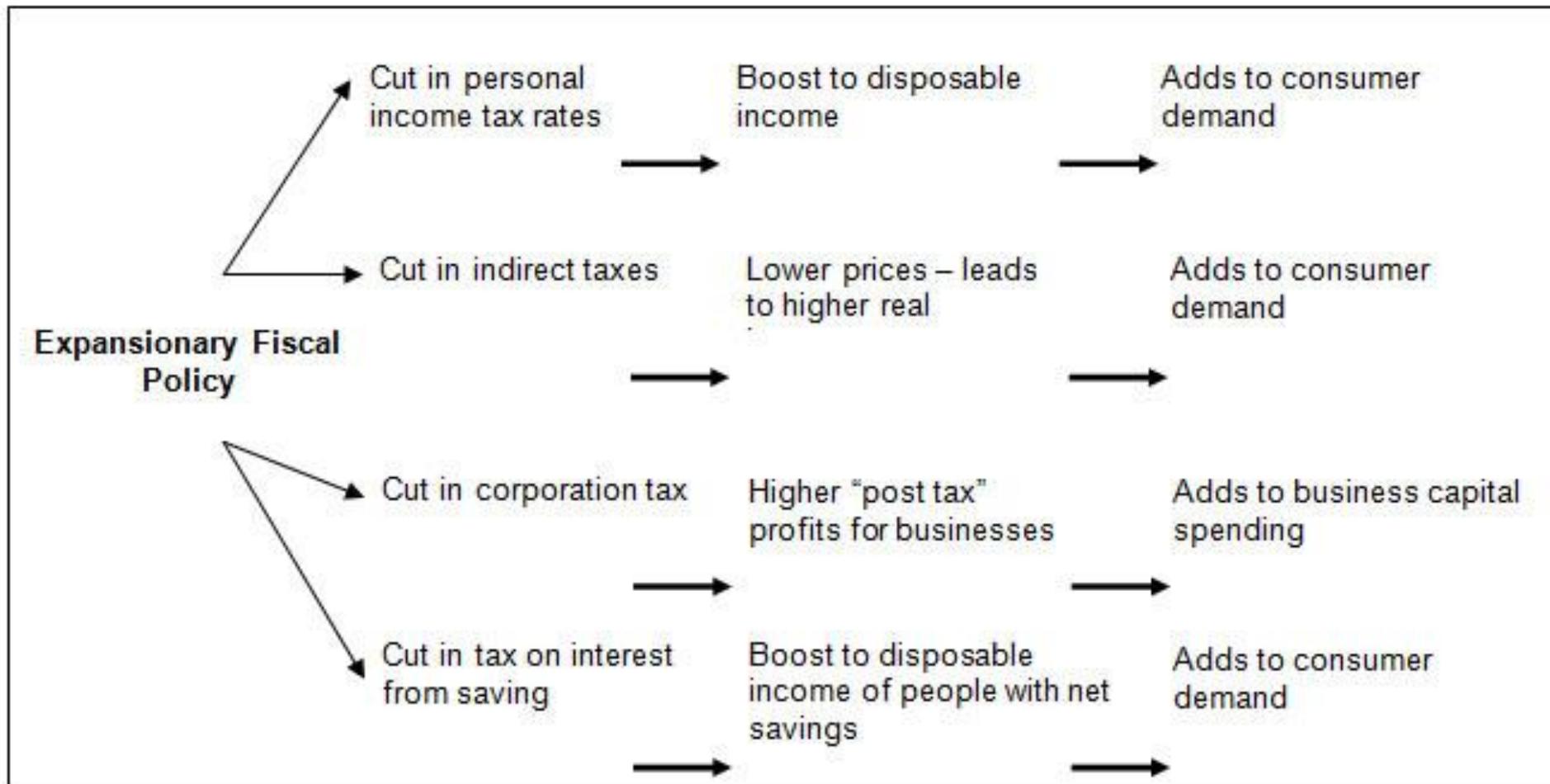


Fiscal Policy



What Is Fiscal Policy?

Fiscal policy is the federal government's use of taxing and spending to keep the economy stable.

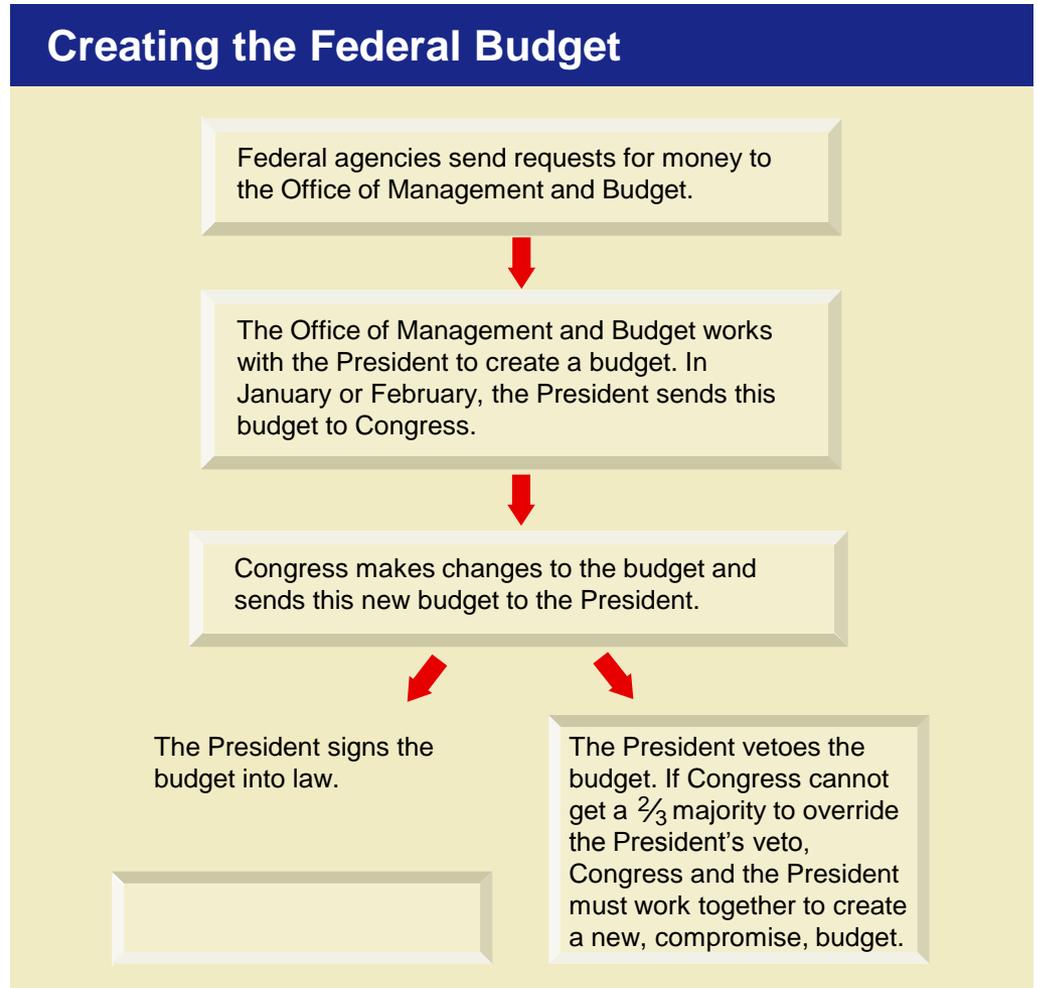
- The tremendous flow of cash into and out of the economy due to government spending and taxing has a large impact on the economy.
- Fiscal policy decisions, such as how much to spend and how much to tax, are among the most important decisions the federal government makes.

Fiscal Policy and the Federal Budget

- The **federal budget** is a written document indicating the amount of money the government expects to receive for a certain year and authorizing the amount the government can spend that year.
- The federal government prepares a new budget for each fiscal year. A **fiscal year** is a twelve-month period that is not necessarily the same as the January – December calendar year.

The Budget Process

Congress and the White House work together to develop a federal budget.



Fiscal Policy and the Economy

The total level of government spending can be changed to help increase or decrease the output of the economy.

Expansionary Policies

- Fiscal policies that try to increase output are known as expansionary policies.

Contractionary Policies

- Fiscal policies intended to decrease output are called contractionary policies.

Expansionary Fiscal Policies

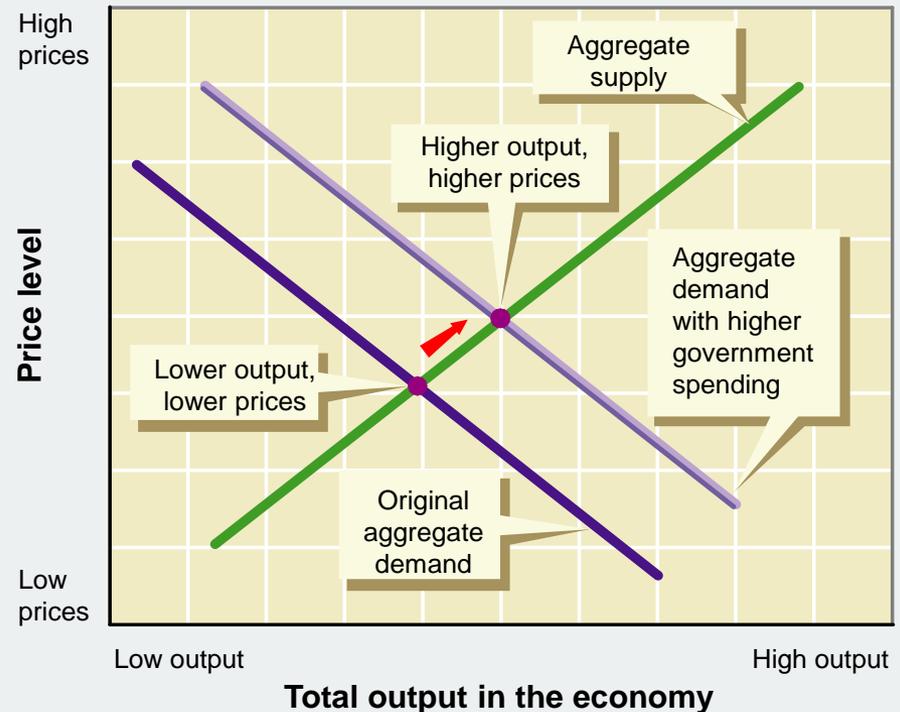
Increasing Government Spending

- If the federal government increases its spending or buys more goods and services, it triggers a chain of events that raise output and creates jobs.

Cutting Taxes

- When the government cuts taxes, consumers and businesses have more money to spend or invest. This increases demand and output.

Effects of Expansionary Fiscal Policy



Contractionary Fiscal Policies

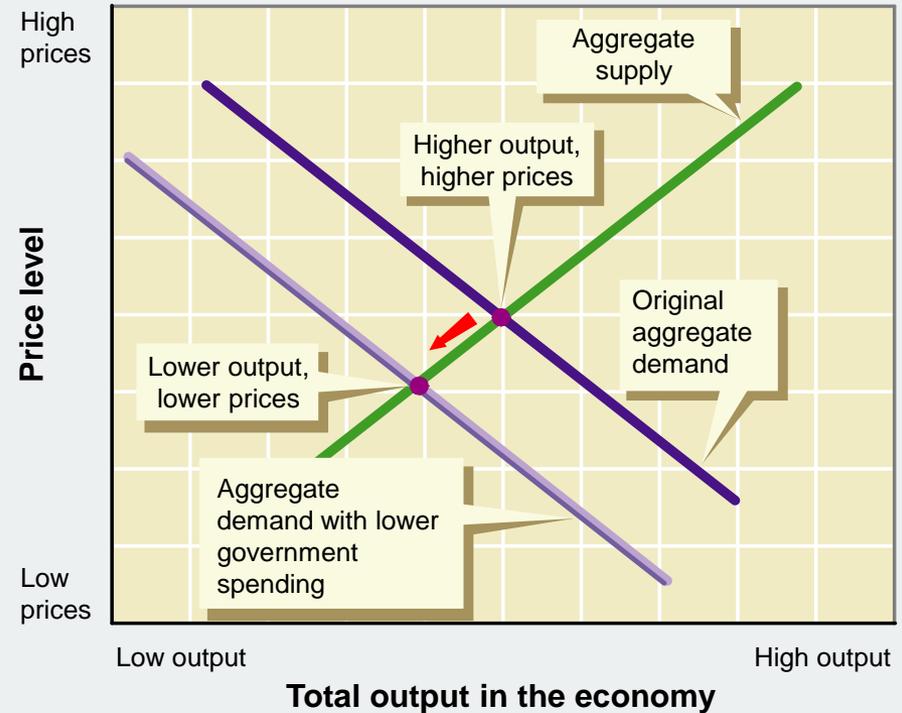
Decreasing Government Spending

- If the federal government spends less, or buys fewer goods and services, it triggers a chain of events that may lead to slower GDP growth.

Raising Taxes

- If the federal government increases taxes, consumers and businesses have fewer dollars to spend or save. This also slows growth of GDP.

Effects of Contractionary Fiscal Policy



Limits of Fiscal Policy

Difficulty of Changing Spending Levels

- In general, significant changes in federal spending must come from the small part of the federal budget that includes discretionary spending.

Predicting the Future

- Understanding the current state of the economy and predicting future economic performance is very difficult, and economists often disagree. This lack of agreement makes it difficult for lawmakers to know when or if to enact changes in fiscal policy.

Delayed Results

- Even when fiscal policy changes are enacted, it takes time for the changes to take effect.

Political Pressures

- Pressures from the voters can hinder fiscal policy decisions, such as decisions to cut spending or raising taxes.

Coordinating Fiscal Policy

- For fiscal policies to be effective, various branches and levels of government must plan and work together, which is sometimes difficult.
- Federal policies need to take into account regional and state economic differences.
- Federal fiscal policy also needs to be coordinated with the monetary policies of the Federal Reserve.

Section 1 Review

1. Fiscal policy is

- (a) the federal government's use of taxing and spending to keep the economy stable.
- (b) the federal government's use of taxing and spending to make the economy unstable.
- (c) a plan by the government to spend its revenues.
- (d) a check by Congress over the President.

2. Two types of expansionary policies are

- (a) raising taxes and increasing government spending.
- (b) raising taxes and decreasing government spending.
- (c) cutting taxes and decreasing government spending.
- (d) cutting taxes and increasing government spending.

SECTION 2

Fiscal Policy Options

- What are classical, Keynesian, and supply-side economics?
- What is the multiplier effect?
- What role do automatic stabilizers play?
- What role has fiscal policy played in American history?

Classical Economics

- The idea that markets regulate themselves is at the heart of a school of thought known as **classical economics**.
- Adam Smith, David Ricardo, and Thomas Malthus are all considered classical economists.
- The Great Depression that began in 1929 challenged the ideas of classical economics.

Keynesian Economics

- **Keynesian economics** is the idea that the economy is composed of three sectors – individuals, businesses, and government – and that government actions can make up for changes in the other two.
- Keynesian economists argue that fiscal policy can be used to fight both recession or depression and inflation.
- Keynes believed that the government could increase spending during a recession to counteract the decrease in consumer spending.

The Multiplier Effect

The multiplier effect in fiscal policy is the idea that every dollar change in fiscal policy creates a greater than one dollar change in economic activity.

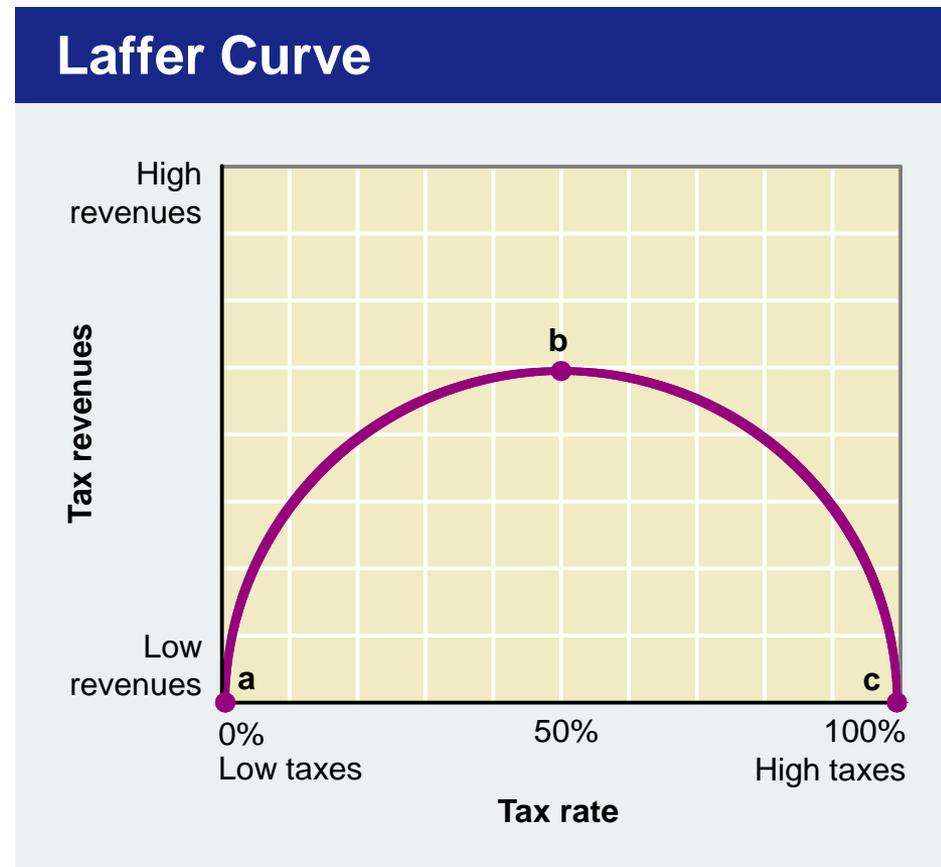
- For example, if the federal government increases spending by \$10 billion, there will be an initial increase in GDP of \$10 billion. The businesses that sold the \$10 billion in goods and services to the government will spend part of their earnings, and so on.
- When all of the rounds of spending are added up, the government spending leads to an increase of \$50 billion in GDP.

Automatic Stabilizers

- A stable economy is one in which there are no rapid changes in economic factors. Certain fiscal policy tools can be used to help ensure a stable economy.
- An **automatic stabilizer** is a government tax or spending category that changes automatically in response to changes in GDP or income.

Supply-Side Economics

- **Supply-side economics** stresses the influence of taxation on the economy. Supply-siders believe that taxes have a strong, negative influence on output.
- The Laffer curve shows how both high and low tax revenues can produce the same tax revenues.



Fiscal Policy in American History

The Great Depression

- Franklin D. Roosevelt increased government spending on a number of programs with the goal of ending the Depression.

World War II

- Government spending increased dramatically as the country geared up for war. This spending helped lift the country out of the Depression.

The 1960s

- John F. Kennedy's administration proposed cuts to the personal and business income taxes in an effort to stimulate demand and bring the economy closer to full productive capacity. Government spending also increased because of the Vietnam war.

Supply-Side Policies in the 1980s

- In 1981, Ronald Reagan's administration helped pass a bill to reduce taxes by 25 percent over three years.

Section 2 Review

1. What are the two main economic problems that Keynesian economics seeks to address?
 - (a) business and personal taxes
 - (b) military and other defense spending
 - (c) periods of recession or depression and inflation
 - (d) foreign aid and domestic spending

2. Government taxes or spending categories that change in response to changes in GDP or income are called
 - (a) fiscal policy.
 - (b) automatic stabilizers.
 - (c) income equalizers.
 - (d) expansionary aids.

SECTION 3

Budget Deficits and the National Debt

- What are budget surpluses and budget deficits?
- How does the government respond to budget deficits?
- What are the effects of the national debt?
- How can government reduce budget deficits and the national debt?

Balancing the Budget

A **balanced budget** is a budget in which revenues are equal to spending.

Budget Surpluses

- A **budget surplus** occurs when revenues exceed expenditures.

Budget Deficits

- A **budget deficit** occurs when expenditures exceed revenue.

Responding to Budget Deficits

Creating Money

- The government can pay for budget deficits by creating money. Creating money, however, increases demand for goods and services and can lead to inflation.

Borrowing Money

- The government can also pay for budget deficits by borrowing money.
- The government borrows money by selling bonds, such as **United States Savings Bonds, Treasury bonds, Treasury bills, or Treasury notes**. The government then pays the bondholders back at a later date.

The National Debt

The **national debt** is the total amount of money the federal government owes. The national debt is owed to anyone who holds U.S. Savings Bonds or Treasury bills, bonds, or notes.

The Difference Between Deficit and Debt

- The deficit is amount the government owes for one fiscal year. The national debt is the total amount that the government owes.

Measuring the National Debt

- In dollar terms, the debt is extremely large: \$5 trillion at the end of the twentieth century. Economists often measure the debt as a percent of GDP.

Is the Debt a Problem?

Problems of a National Debt

- To cover deficit spending the government sells bonds. Every dollar spent on a government bond is one fewer dollar that is available for businesses to borrow and invest. This encroachment on investment in the private sector is known as the **crowding-out effect**.
- The larger the national debt, the more interest the government owes to bondholders. Dollars spent paying interest on the debt cannot be spent on anything else, such as defense, education, or health care.

Other Views of a National Debt

- Keynesian economists argue that if government borrowing and spending help the economy achieve its full productive capacity, then the national debt outweighs the costs.

Deficit and Debt Reduction

Legislative Solutions

- In reaction to large budget deficits during the 1980s, Congress passed the Gramm-Rudman laws which would have automatically cut spending across-the-board if spending increased too much.
- The Gramm-Rudman laws were declared unconstitutional in the early 1990s.

Constitutional Solutions

- In 1995 Congress came close to passing a Constitutional amendment requiring balanced budgets.
- Proponents of such a measure argue that a balanced budget is necessary to make the government more disciplined about spending.
- Opponents of the measure argue that it is not flexible enough to deal with rapid changes in the economy.

Section 3 Review

1. A balanced budget is
 - (a) a budget in which expenditures equal revenues.
 - (b) a budget in which expenditures do not equal revenues.
 - (c) a budget in which the government spends money.
 - (d) a budget in which revenues equal taxes.

2. Which of the following are problems associated with a national debt?
 - (a) increased spending on defense and education
 - (b) the crowding-out effect and interest payments on the debt
 - (c) interest payments on the debt and too much individual investment
 - (d) increased individual investment and decreased government spending