In this chapter you will learn about the importance of fiscal policy - the spending, borrowing, and taxation decisions taken by governments. In the United States, Congress handles fiscal policy. Fiscal policy is used to stabilize an economy and to lessen the negative or excessively positive economic fluctuations that can weaken an economy, like employment, inflation, or real GDP that is too high or too low. Fiscal policy is referred to as supply-side policy because it focuses on increasing long-term economic growth of aggregate supply (AS)/potential GDP. The primary tools that Congress use to influence aggregate supply/potential GDP (AS/GDP) are 1) government spending/expenditures and 2) taxes.
Fiscal Policy: Supply-Side Policy

When the U.S. economy is in a recession/in contraction, Congress can use **expansionary fiscal policy** to increase real GDP/economic output by increasing government (G) spending/expenditures and/or lowering taxes to increase the money supply and build up the economy. When the U.S. economy is in expansion/with inflation, Congress can use **contractionary fiscal policy** to decrease real GDP/economic output by decreasing government (G) spending/expenditures and/or increasing taxes to decrease the money supply and slow down the economy. **Expansionary** and **contractionary** fiscal policy are **countercyclical fiscal policies** because they help the economy meet its potential output and minimize economic fluctuations. The **cyclical movements in the economy** are being "countered," or offset, by changes in government spending/expenditures or taxes.
Fiscal Policy: Supply-Side Policy (cont.)

Actions by Congress that reduce unemployment and increase GDP (close a recessionary gap)
- Increase government spending
- Decrease taxes (increasing disposable income)
- Combinations of the two

Actions by Congress that reduce inflation and decrease GDP (close an inflationary gap)
- Decrease government spending
- Increase taxes (decreasing disposable income)
- Combinations of the two
Fiscal Policy: Supply-Side Policy - Questions

1. Which of the following combinations of economic policies would be most effective to correct a severe recession?

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<thead>
<tr>
<th>Taxes</th>
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<tbody>
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<td>(A) Increase</td>
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<td>(C) Increase</td>
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58. Expansionary fiscal policy will most likely result in

(A) a decrease in the money supply
(B) an increase in the marginal propensity to consume
(C) an increase in nominal interest rates
(D) a decrease in the level of output
(E) a decrease in the price level
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by decreasing taxes more money is left in the pockets of consumers and businesses and an increased money supply allows for additional spending.

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good answer, but...

C encompasses B; for C to happen B already happened.
Fiscal Policy: Supply-Side Policy (cont.)

The first lesson about fiscal policy is "do no harm," but fiscal policy can go terribly wrong. Poorly determined increases or decreases in government purchases ($G$) or taxes can negatively impact potential GDP. Crowding out of the private sector ($C$, $I$, and $X$) can also occur. A decline in $C$, $I$, & $X$ spending/investment due to an increase in government purchases/expenditures is called crowding out because $C$, $I$, & $X$ spending/investment is “crowded out” by government purchases/expenditures. Because the government is borrowing money, it leaves less money for $C$, $I$, & $X$ thus raising interest rates.
The Government's Budget

The federal budget is the major summary document describing fiscal (Congressional) policy in the United States. The budget includes estimates of a surplus or deficit. A government's tax revenues include personal income taxes paid by individuals on their total income, corporate income taxes paid by businesses on their profits, sales taxes paid on items such as gasoline and beer, and payroll taxes, a percentage of wages paid by workers and their employers that supports government programs such as Social Security. On the expenditure/spending side of the budget, one must distinguish between purchases of goods and services (such as defense), transfer payments (such as Social Security and Medicare), and interest payments. Interest payments are not only what investors receive when they put their money into a bank. It is also what the federal government pays every year on its debt. The government pays interest on its borrowings, just like anyone else.
The fiscal year is a period of time that a company or government uses for accounting purposes and preparing financial statements. In the U.S., it is from October 1 to September 30. The President and Congress, specifically the Congressional Budget Office (CBO), make their own economic forecasts. In putting together the federal budget, the President proposes many specific spending programs. However, most of the spending in the budget is determined by ongoing programs, which the President usually can do little to change, like Social Security.
A Balanced Budget vs. a Deficit or Surplus

Taxes to pay for spending programs are included in the budget. As part of the budget, the President may propose an increase or a decrease in taxes. **Tax revenues** are the total dollar amount the government receives from taxpayers each year. When tax revenues are exactly equal to government spending, there is a **balanced budget**. When tax revenues are greater than spending, there is a **budget surplus**. When spending is greater than tax revenues, there is a **budget deficit** and the government must borrow to pay the difference, which raises nominal interest rates. A budget deficit is the number one problem of fiscal policy. The **federal debt** is the total amount of outstanding loans that the federal government owes. If the government runs a surplus, the debt comes down by the amount of the surplus. If there is a deficit, like during **deficit spending**, governments spend while they are in debt, the debt goes up, the nominal interest rate increases, and net exports decrease. The **national debt**, on the other hand, is the cumulative amount of money that the federal government has borrowed to make up for all those deficits in previous years.
A Balanced Budget vs. a Deficit or Surplus- Questions

45. Assume a country has an open economy and a flexible exchange rate system. An increase in the country’s government budget deficit would most likely cause

(A) a decrease in real interest rate and a decrease in net exports
(B) a decrease in real interest rate and a decrease in domestic investment in plant and equipment
(C) no change in real interest rate and a decrease in net exports
(D) an increase in real interest rate and an increase in domestic investment in plant and equipment
(E) an increase in real interest rate and a decrease in net exports

42. An increase in government deficit spending can crowd out private investment by

(A) decreasing the supply of money
(B) increasing the supply of money
(C) decreasing the real interest rate
(D) increasing the real interest rate
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The Proposed Budget vs. the Actual Budget

The budget the President submits is only a proposal. After the fiscal year has begun (Oct. 1) and the budget has been enacted, various supplementals are proposed and passed. A supplemental is a change in a spending program or a change in the tax law that affects a country's budget in the current fiscal year. Recessions and booms always affect tax revenues and spending to some degree. Because the whole budget cycle from a budget's beginning to becoming a reality takes over two years to finish, at any one time discussions about three budgets are taking place.
Discretionary Fiscal Policy

Discretionary fiscal policy refers to specific changes in laws or administrative procedures, such as a change in an existing program to speed up spending, the creation of a program (such as a new welfare program), or a change in the tax system (such as lower tax rates). These changes in the law are discretionary changes because they require action on the part of the Congress or the President. Congress creates a new bill that is designed to change aggregate demand ($AD$) through government spending ($G$) or taxation. The problem is the time lag between bill creation and approval due to bureaucracy. It takes time for Congress to act.
Discretionary Fiscal Policy - Questions

10. A discretionary fiscal policy action to reduce inflation in the short run would be to

(A) increase transfer payments to those on fixed incomes
(B) increase taxes or decrease government spending
(C) decrease taxes or increase government spending
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Non-discretionary Fiscal Policy
Many of the very large changes in government taxes and spending are automatic. Unemployment compensation, Social Security payments, and welfare payments all rise in a recession. These automatic tax and spending changes are called **automatic stabilizers** or **non-discretionary fiscal policy** because they tend to stabilize the fluctuations of real GDP. For example, tax revenue decreasing when an economy is contracting and increasing when expanding.
Discretionary vs. Non-discretionary Fiscal Policy

For many years economists have debated the usefulness of discretionary and automatic fiscal policy. Proponents of discretionary fiscal policy argue that the automatic stabilizers would not be large enough or well-timed enough to bring the economy out of a recession quickly. Critics of discretionary policy, like Nobel prize winner Milton Friedman, emphasize that the effect of a policy is uncertain and that there are long lags in the impact of policy. By the time spending increases and taxes are cut, a recession could be over. Three types of lags are particularly problematic for discretionary fiscal policy: a recognition lag (the time between the need for the policy and the recognition of the need), an implementation lag (the time between the recognition of the need for the policy and its implementation), and an impact lag (the time between the implementation of the policy and its impact on real GDP).