UNIVERSITY OF THE PEOPLE

BUS 1104-01 Macroeconomics- AY2024-T1

Written Assignment Unit 7

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"Gross Domestic Product is a measure of the value of all of the goods and services produced in the economy in a given period." (Wessel et al., 2021) If an economy enters a recession with equilibrium GDP falling below its potential output, the government budget will be impacted in several ways. "Potential GDP is a theoretical construct, an estimate of the value of the output that the economy would have produced if labor and capital had been employed at their maximum sustainable rates—that is, rates that are consistent with steady growth and stable inflation." (Wessel et al., 2021) Transfer payments to individuals will increase as more people qualify and enroll in social safety net programs like unemployment insurance and food stamps. At the same time, government tax revenues will decrease across the board as personal and business incomes decline during the downturn. With spending rising and revenues falling, the budget deficit will widen automatically as a recession hits. This expanding budget deficit helps cushion the economy by maintaining incomes and consumption. However, the larger deficit is unsustainable long-term and will need to be brought back into balance once the economy recovers to potential output.

How Transfer Payments Would Change

"Equilibrium GDP occurs when the businesses within a nation produce exactly the amount of goods and services that people want to buy. In economic terms, equilibrium GDP can be defined as the level of GDP where aggregate demand and aggregate supply are equal." (B. Turner, 2023) If equilibrium GDP falls below potential GDP, it means the economy has entered a recession with higher unemployment. More people would lose their jobs or work reduced hours. This would increase eligibility and demand for government transfer payments like unemployment insurance, welfare, food stamps, and Medicaid.

During recessions, laws and regulations often expand eligibility for these programs to help more people. For example, unemployment insurance may pay benefits longer, cover more parttime workers, and reduce waiting periods. Welfare and food stamps would see increased enrollment as more households fall into poverty. Medicaid would cover more low-income unemployed people who lost work-related health insurance.

In summary, transfer payments would rise automatically as more people qualify and apply during a downturn. Additional policy expansions would further increase transfer spending to provide a social safety net.

How Tax Receipts Would Change

When GDP falls below potential, personal and business incomes decline. This reduces tax revenues across the board for the government.

Individual income taxes would decrease as unemployment rises and wages fall. Payroll tax receipts would also decline as fewer people work and earn less taxable pay. Corporate income taxes would shrink as business profits decline during recession.

Beyond direct income taxes, overall spending in the economy slows during a downturn. This reduces sales tax receipts for state governments. Declines in real estate transactions would also lower property transfer taxes.

In total, the major tax sources for government revenue would fall significantly as economic activity slows below potential. Tax receipts would decline just as transfer payments rise.

How the Budget Would Change

With transfer payments rising and tax revenues falling, the government budget deficit would widen automatically during a recession with GDP below potential. Some economists view this expanding budget deficit as a beneficial fiscal policy.

The rise in transfer payments helps stabilize household incomes and consumption. The fall in taxes leaves more money in people's pockets. Both help cushion the economy against an even deeper recession.

However, the widening budget deficit is unsustainable in the long run. Once the economy recovers back to potential output, transfer payments should fall back to normal levels. Tax policy may need to adjust higher rates or coverage to bring tax revenues back up. These steps would aim to bring the budget back into balance as a share of GDP.

In conclusion, the government budget deficit naturally increases during a recession to help stabilize the economy. But targeted policy changes may be needed after the recession to reduce this deficit once GDP returns to potential. The goal should be a budget that is balanced over long periods as a share of the economy's potential output.

Reference:

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