ECON 202 - MACROECONOMIC PRINCIPLES

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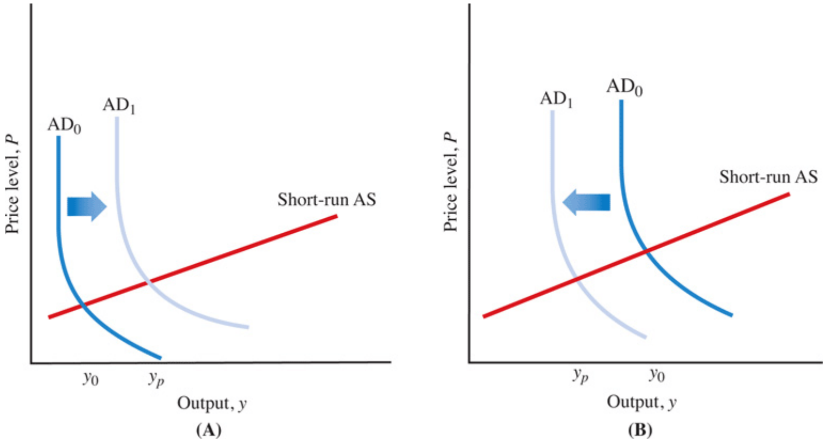
Chapter 10 - Fiscal Policy

Fiscal Policy - Topics

1. Explain how fiscal policy works using aggregate demand and aggregate supply
2. Identify the main elements of spending and revenue for the U.S. federal government
3. Discuss the key episodes of active fiscal policy in the U.S. since World War II

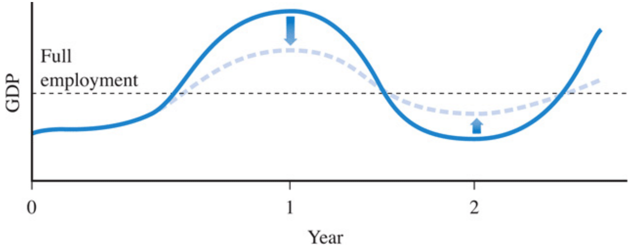
Fiscal Policy



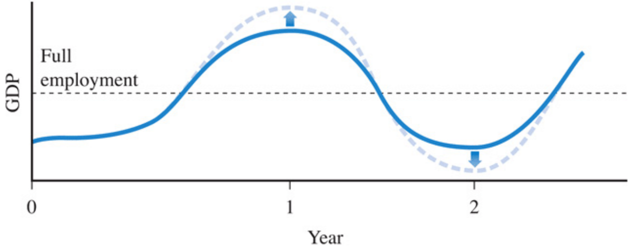
Fiscal Policy

- Expansionary policies
  - Government policy actions that lead to increases in aggregate demand
- Contractionary policies
  - Government policy actions that lead to decreases in aggregate demand

Limits to Stabilization



(A) Successful stabilization policy can dampen fluctuations.



(B) Ill-timed policies can magnify fluctuations.

Federal Budget

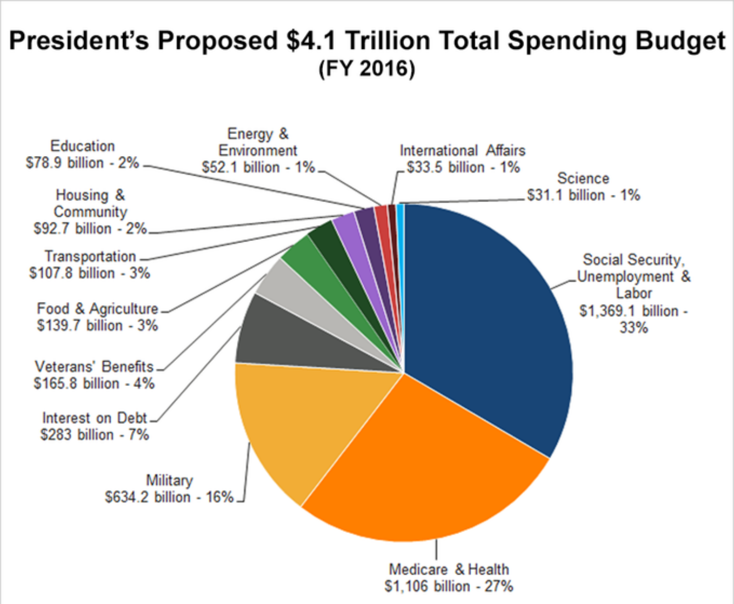
Federal Budgets

TABLE 10.1 Federal Spending for Fiscal Year 2011

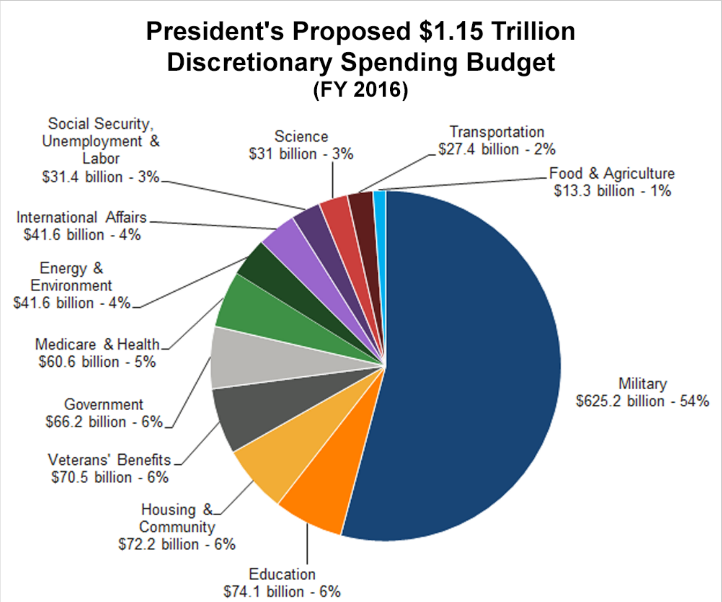
Category	Outlays (billions)	Percent of GDP
Total outlays	\$3,598	24.1%
Discretionary spending	1346	9.0
Defense	700	4.7
Nondefense	646	4.3
Entitlements and mandatory spending	2,025	13.5
Social Security	725	4.8
Medicare and Medicaid	835	5.5
Other programs and offsetting receipts	466	3.1
Net interest	227	1.5

SOURCE: Congressional Budget Office, January 2012.

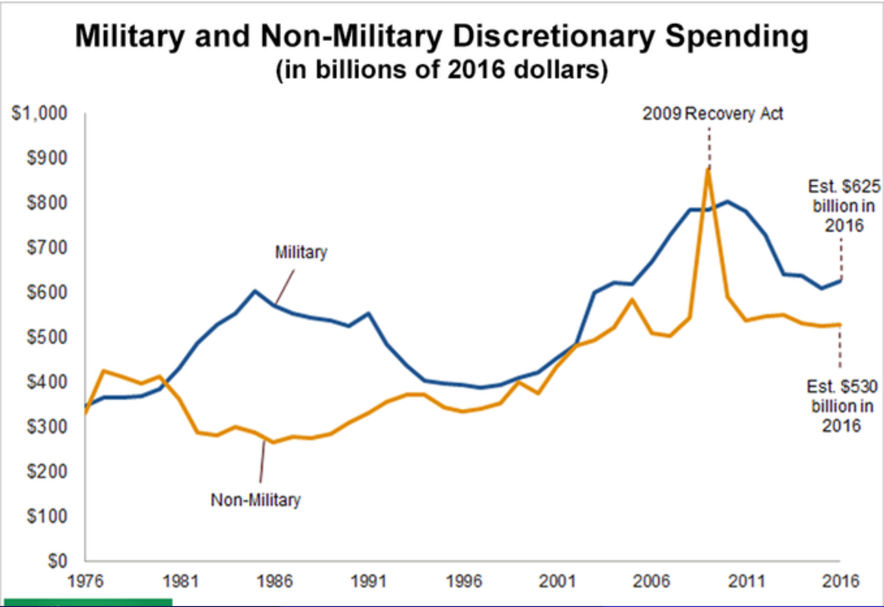
Total Federal Spending 2016 (Proposed)



Discretionary Federal Spending 2016 (Proposed)



Discretionary Federal Spending

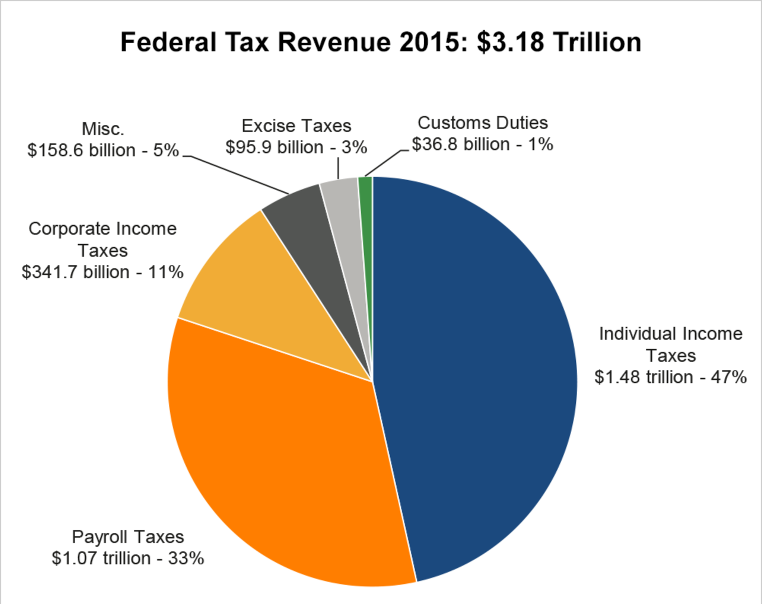


Federal Revenues

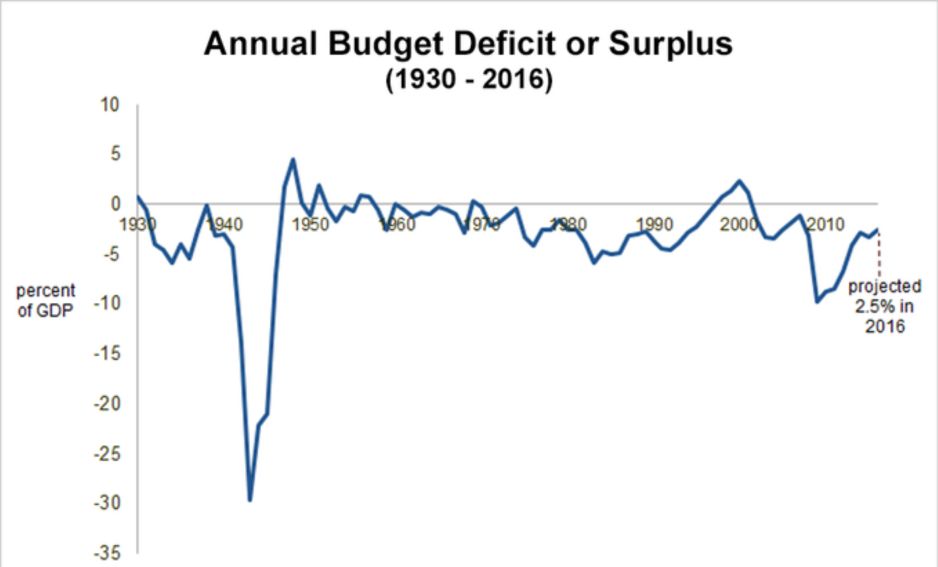
TABLE 10.2 Sources of Federal Government Revenue, Fiscal Year 2011		
Category	**Receipts (billions)**	**Percent of GDP**
Total revenue	$2,302	15.4%
Individual income taxes	1091	7.3
Social insurance taxes	819	5.5
Corporate taxes	181	1.2
Estate, excise, and others	211	1.4

SOURCE: Congressional Budget Office, January 2012.

Total Federal Revenues 2015



Federal Budget Deficit



Automatic Stabilizers

Taxes and transfer payments

- During an economic boom, transfer payments fall and taxes increase
- During a recession, running a government budget deficit offsets part of the adverse effect of the recession and thus helps stabilize the economy

Fiscal Policy in U.S. History

- The Depression Era During the 1930s, politicians did not believe in modern fiscal policy, largely because they feared the consequences of government budget deficits
- Although government spending increased during the 1930s, taxes increased sufficiently during that same period, with the result that there was no net fiscal expansion
- The Kennedy Administration
  - It was not until the presidency of John F. Kennedy during the early 1960s that modern fiscal policy came to be accepted.
  - Walter Heller, the chairman of the president's Council of Economic Advisers, was a forceful advocate of active fiscal policy.
  - Kennedy put forth an economic program that was based largely on modern fiscal policy principles
  - Rapid growth during this period suggests that the tax cuts had the effect predicted by Heller's theory of stimulating economic growth

Fiscal Policy in U.S. History (cont.)

- The Vietnam War Era
  - As the Vietnam War began and military spending increased, unemployment fell to very low levels.
  - In 1968, a temporary tax surcharge of 10% was enacted to reduce total demand for goods and services
  - The surcharge did not decrease consumer spending as much as initially estimated because the tax increase was temporary
  - Consumers often base their spending on an estimate of their long-run average income or permanent income, not on their current income
  - The surtax reduced saving
- The Reagan Administration
  - The tax cuts enacted during 1981 were justified on the basis of improving economic incentives and increasing the supply of output
  - By the mid 1980s, large government budget deficits began to emerge and policymakers became concerned by them
- The Clinton and George W. Bush Administrations

Fiscal Policy in U.S. History (cont.)

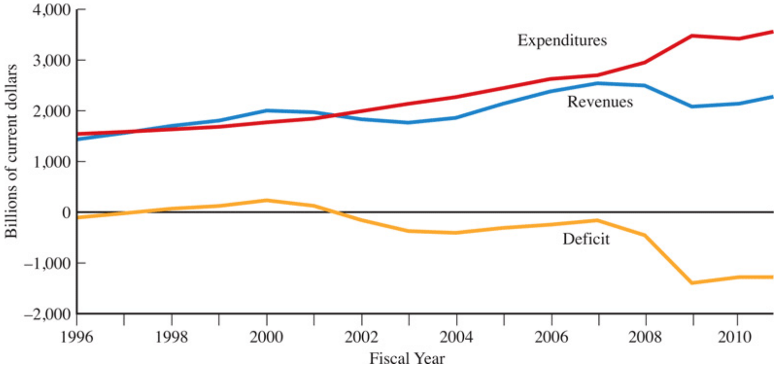
- Clinton successfully passed a major tax increase that brought the budget into balance
- During his first year in office, President George W. Bush passed a 10-year tax cut plan that decreased tax rates
- Economists estimate that consumers by and large saved, not spent, the tax rebates featured by the tax cut
- In May of 2003, President Bush signed another tax bill to stimulate the sluggish economy
- This bill had many distinct features including an increased child tax credit and lower taxes on dividends and capital gains
- The prospect of future deficits sharply limits the ability of the U.S. government to conduct expansionary fiscal policy in the near future

- The Obama Administration
  - In 2009, President Obama and Congress enacted the largest stimulus package in U.S. history. The stimulus was controversial in both size and composition

Fiscal Policy in U.S. History (cont.)

- In 2009, President Obama signed into law the American Recovery and Reinvestment Act, the largest fiscal stimulus in United States history. Although the recovery of the economy from the 2007 recession was still sluggish, many economists—including those at the Congressional Budget Office—believe that the stimulus did have a significant impact on the economy.
- But not all economists share this belief. John B. Taylor, at Stanford University,. Based on his analysis, first examined whether the temporary tax cuts stimulated consumption spending. Consistent with much prior research on this topic, he found little evidence that the temporary tax cuts stimulated consumption; they were essentially saved. Taylor believes the stimulus was ineffective.

History



4,000
3,000
2,000
1,000
0
−1,000
−2,000
Billions of current dollars
Expenditures
Revenues
Deficit
1996
1998
2000
2002
2004
2006
2008
2010
Fiscal Year