

Chapter 11

Fiscal Policy and the AD-AS Model

Built-In Stability

Evaluating Fiscal Policy

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Fiscal Policy, Deficits, and Debt

Key Terms



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Chapter Objectives

- **Purposes, Tools, and Limitations of Fiscal Policy**
- **Role of Built-In Stabilizers in Moderating Business Cycles**
- **How the Standardized Budget Reveals the Status of U.S. Fiscal Policy**
- **The Size, Composition, and Consequences of the U.S. Public Debt**

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Fiscal Policy and the AD-AS Model

- Fiscal Policy - taxing and spending decisions made by the president and congress.
 - Discretionary Fiscal Policy – at the choice or option of gov.
 - Nondiscretionary Fiscal Policy – “Passive” or “Automatic” spending
- Council of Economic Advisers (CEA) – 3 expert economists appointed by the president to advise on economic policy

Key Terms



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Fiscal Policy and the AD-AS Model

- Expansionary Fiscal Policy – used to fight a recession by increasing AD.
 - Increased Government Spending (AD↑)
 - Use Gov Spending multiplier $\frac{1}{1 - MPC}$
 - Tax Reductions (AD↑) $\frac{-MPC}{1 - MPC}$
 - Use Tax multiplier (neg., smaller)
 - Some Combination of the Two (AD↑)
- Budget Deficit – gov spending in excess of tax revenue (often results from expansionary fiscal policies)
 - Historical example = New Deal programs under FDR

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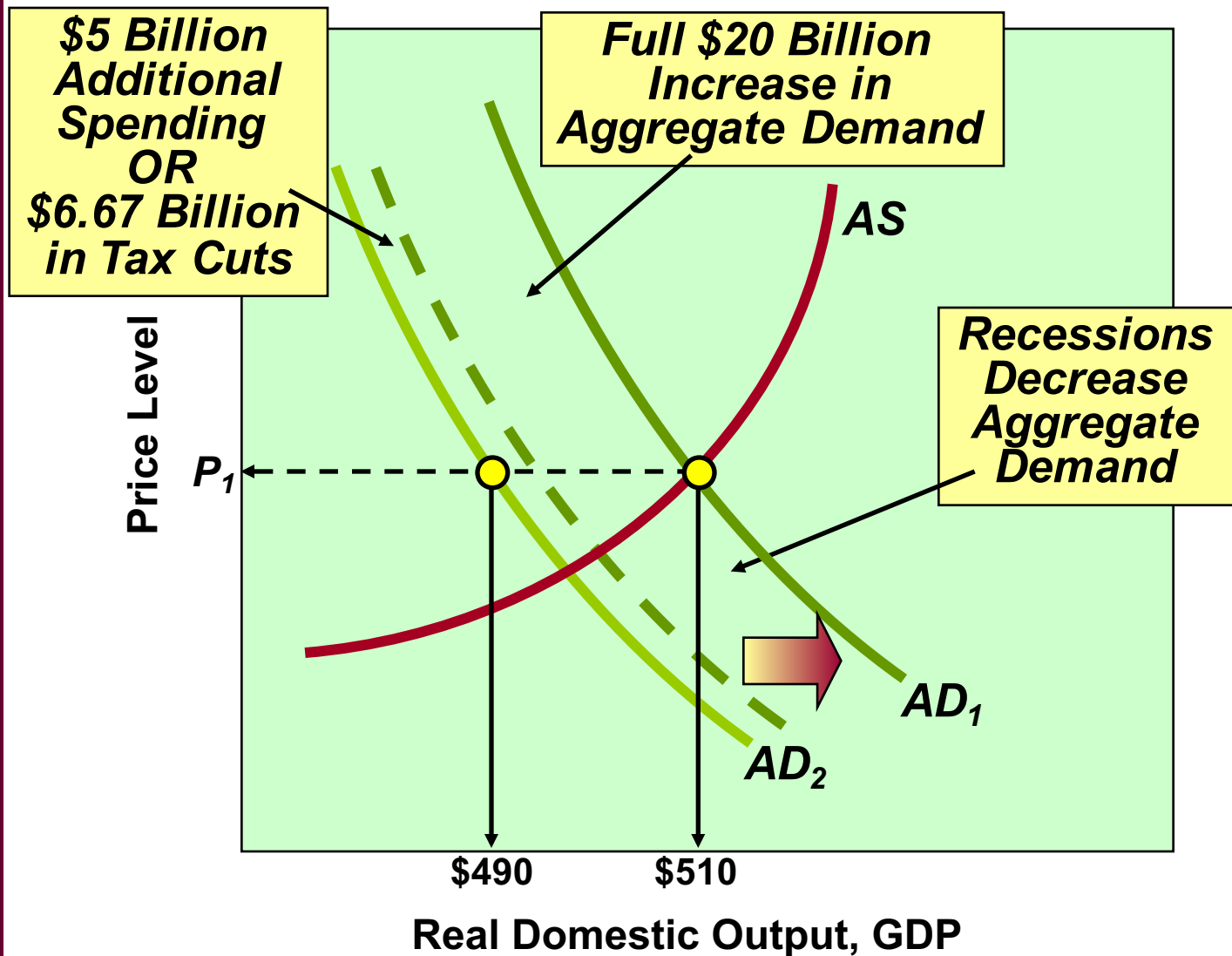
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Expansionary Fiscal Policy



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- Contractionary Fiscal Policy – used to reduce inflation associated with increasing real GDP.
 - Decreased Government Spending ($AD\downarrow$)
 - Increased Taxes ($AD\downarrow$)
 - Some Combination of the Two ($AD\downarrow$)
- Budget Surplus – tax revenues in excess of government spending
- Policy Options: G or T? – *depends on your view of gov!*



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Key Terms



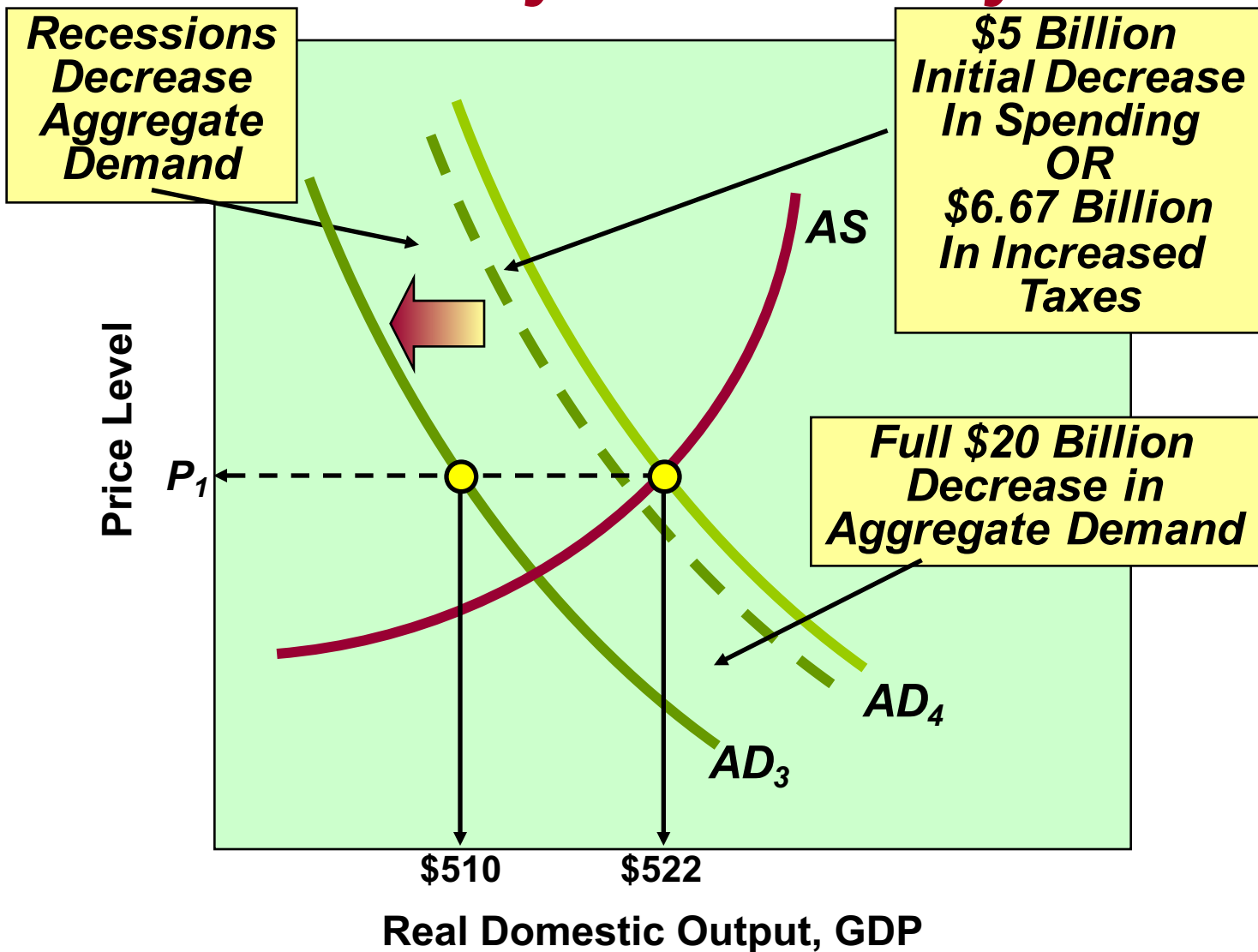
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Contractionary Fiscal Policy



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Built-In Stability

- Automatic or Built-In Stabilizers – anything that counter-acts the business cycle without gov action.
- Economic Importance – taxes (T) vary directly with GDP, government spending (G) is independent of GDP
 - GDP ↓, deficits ↑, helps end recession
 - GDP ↑, surplus ↑, helps end inflation
- Tax Progressivity
 - Progressive Tax System – average tax rate ↑ with GDP ↑
 - Proportional Tax System - average tax rate = with GDP ↑
 - Regressive Tax System - average tax rate ↓ with GDP ↑

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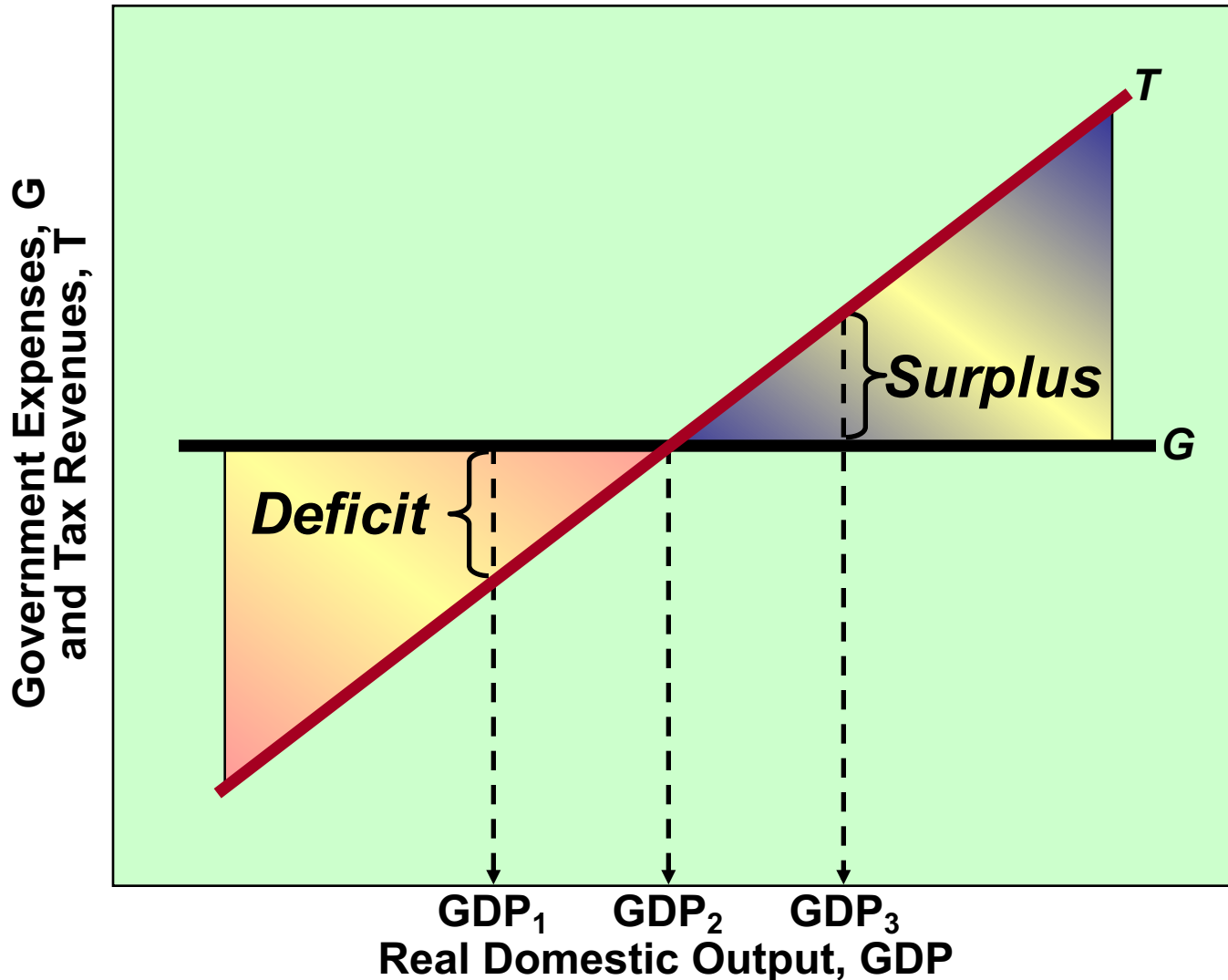
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- Standardized Budget (Full-Employment Budget) – eliminates the automatic stabilizers and assumes full-employment in order to examine discretionary fiscal policy
- Cyclical Deficit – budget deficit that results from decreased real GDP (recession). *NOT expansionary fiscal policy*

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***Standardized budget compares actual Gov expenditures with full employment Tax revenues

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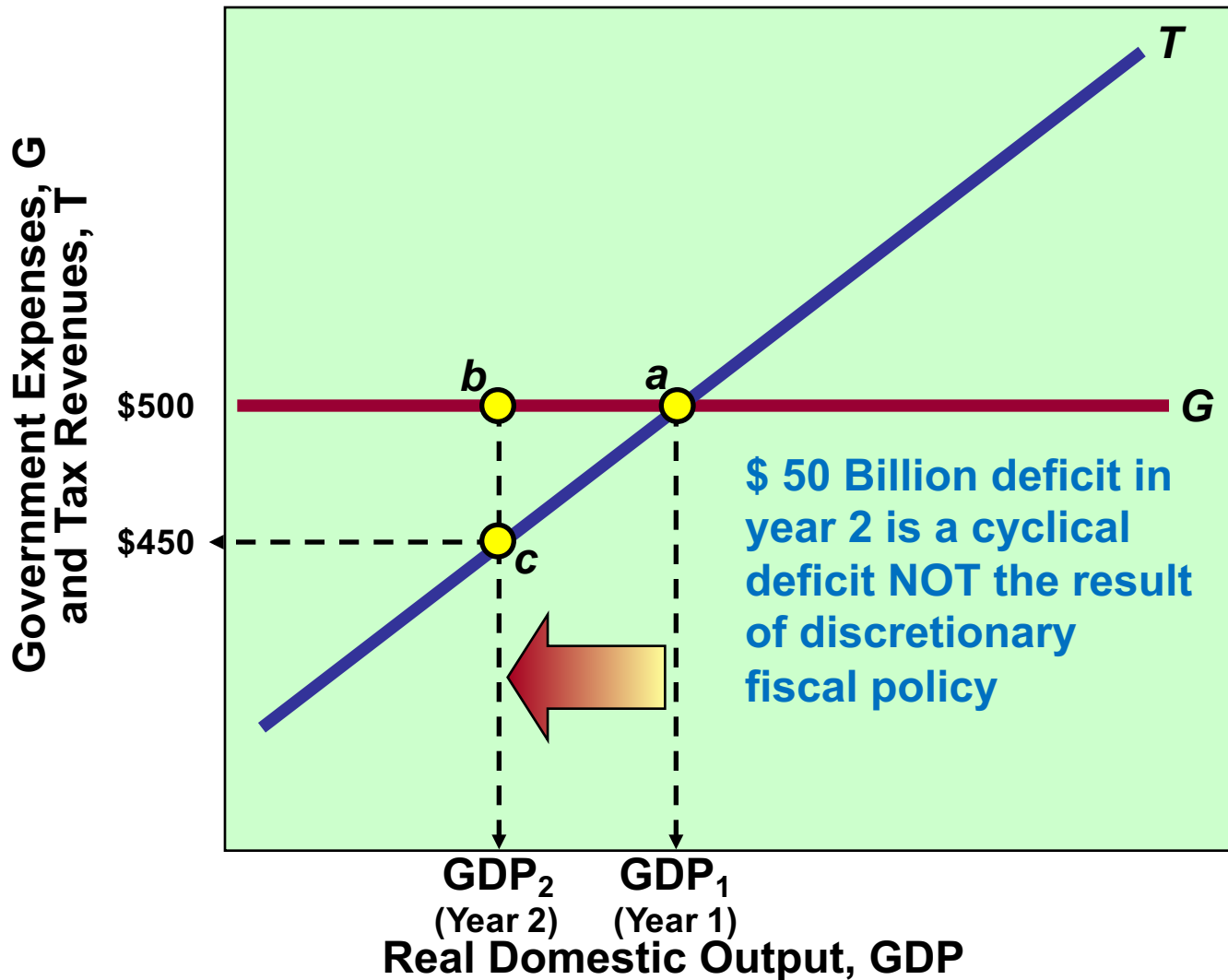
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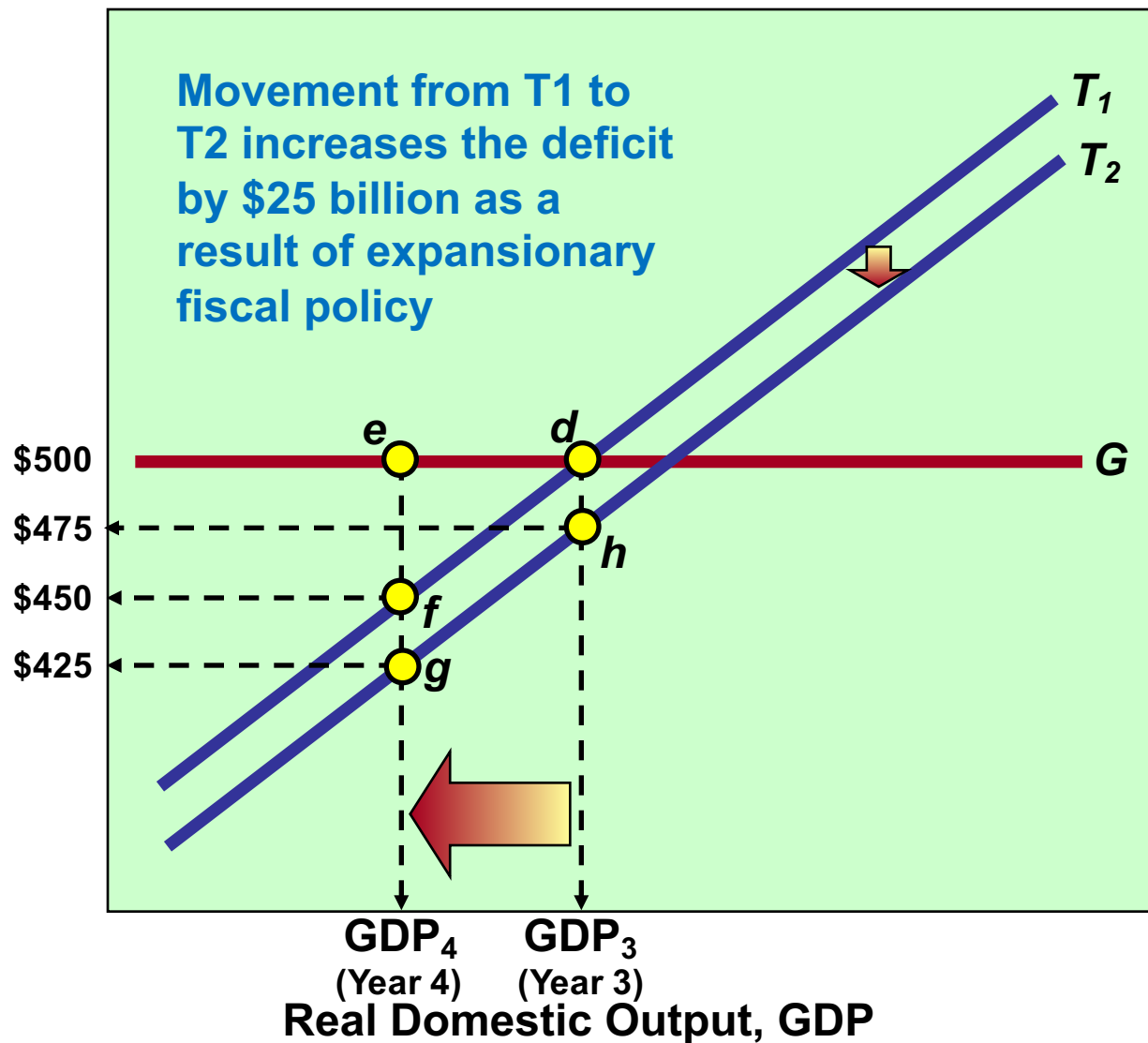
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Government Expenses, G
and Tax Revenues, T



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Recent U.S. Fiscal Policy

Federal Deficits and Surpluses – 1990 - 2005 as a Percentage of Potential GDP

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(1) Year	(2) Actual Deficit (-) or Surplus (+)	(3) Standardized Deficit (-) or Surplus (+)
1990	-3.9%	-2.2%
1991	-4.4%	-2.5%
1992	-4.5%	-2.9%
1993	-3.8%	-2.9%
1994	-2.9%	-2.1%
1995	-2.2%	-2.0%
1996	-1.4%	-1.2%
1997	-0.3%	-1.0%
1998	+0.8%	-0.4%
1999	+1.4%	+0.1%
2000	+2.5%	+1.1%
2001	+1.3%	+1.1%
2002	-1.5%	-1.1%
2003	-3.4%	-2.7%
2004	-3.5%	-2.4%
2005	-2.6%	-1.8%

Source: Congressional Budget Office

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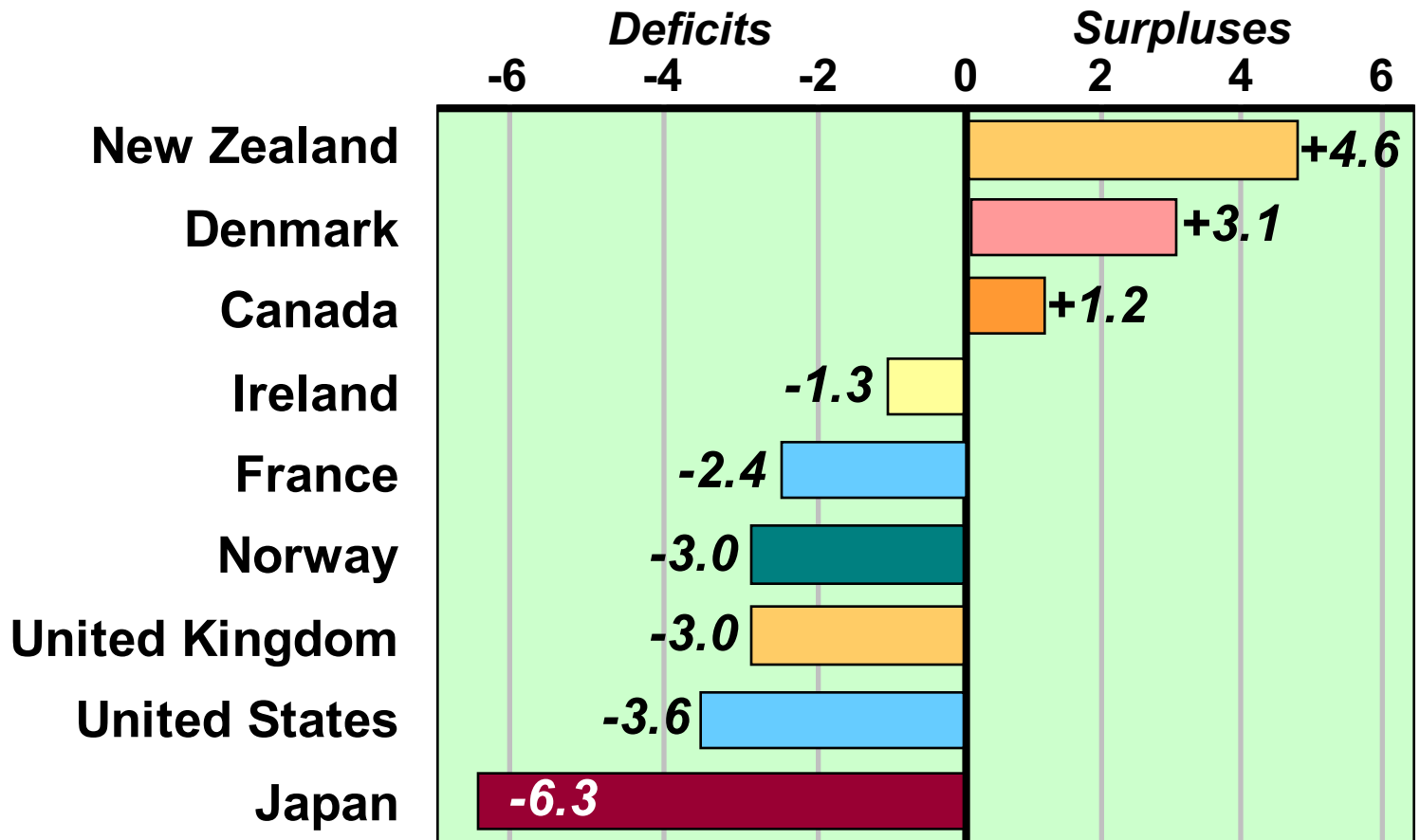
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Recent U.S. Fiscal Policy



GLOBAL PERSPECTIVE

Full-Employment Budget Deficits or Surpluses as a Percentage of Potential GDP, 2005



Source: Organization for Economic Cooperation and Development

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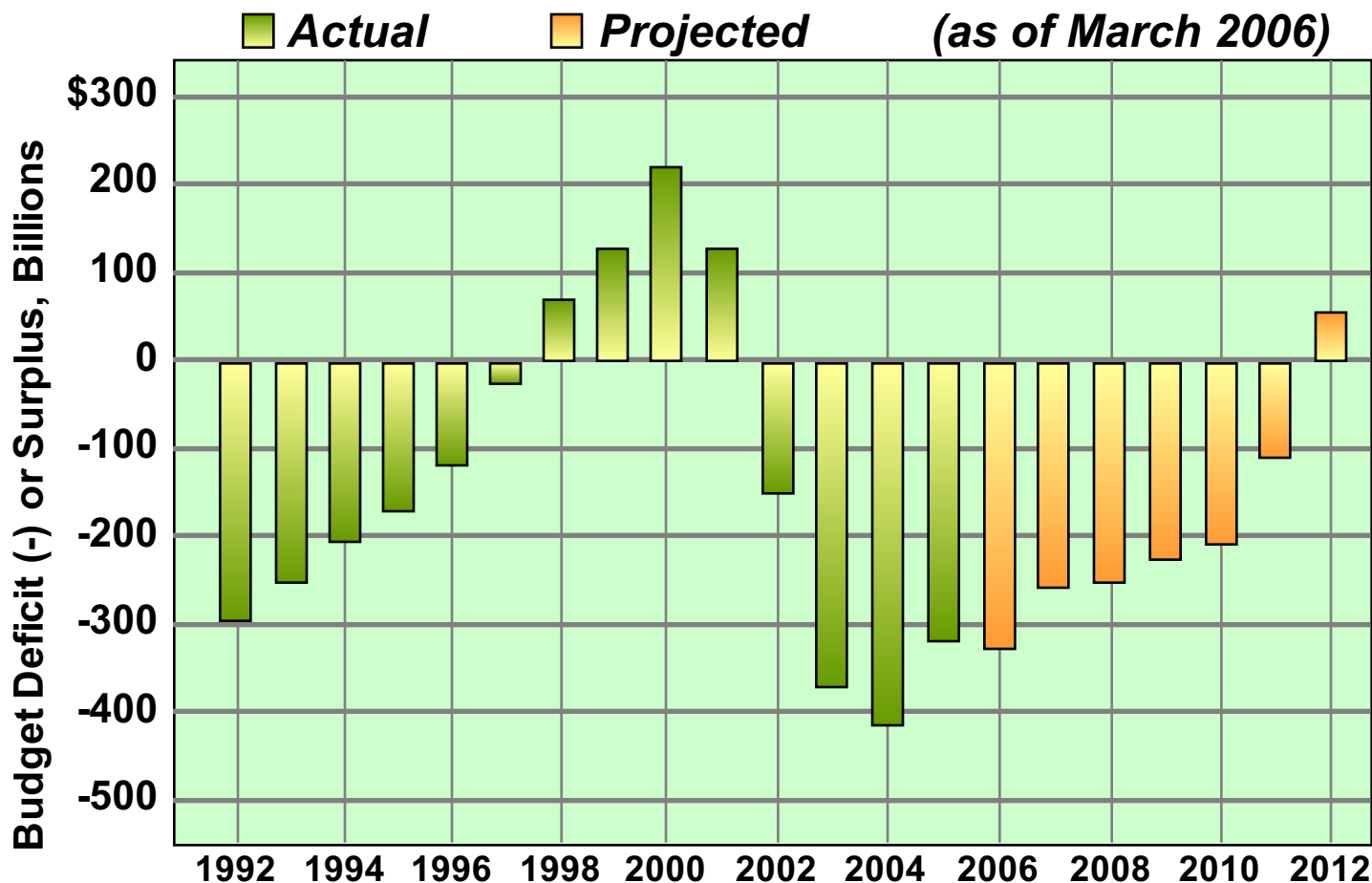
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Recent U.S. Fiscal Policy

Federal Budget Deficits and Surpluses Actual and Projected, Fiscal 1992-2012



Source: Congressional Budget Office

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Recent U.S. Fiscal Policy

Problems, Criticisms, and Complications

- Problems of Timing
 - Recognition Lag – it takes time (3-6 months) to gather and analyze the data that signals recession or inflation.
 - Administrative Lag – fiscal policy relies on the congress and President cooperating...need I say more?
 - Operational Lag – once action is taken, it takes time for the impact to be seen



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- Political Considerations
- Political Business Cycle – politicians are tempted to do what is best for re-election rather than best for the economy in the long-run!
- Future Policy Reversals – some people will predict short-term policies and act contrary to the goals of current fiscal policy
- Offsetting State and Local Finance – many states have balanced budget requirements which requires them to cut spending in recessions which counter-acts federal fiscal policy.

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- Crowding-Out Effect – when expansionary fiscal policy causes interest rates to increase which leads to less consumption and investment (usually occurs at full-employment)
- Current Thinking on Fiscal Policy – Fiscal Policy vs. Monetary policy?
 - Fiscal policy is slow and political...IF used correctly, better for long terms goals or major imbalances in the economy
 - Monetary policy is fast but has a limited impact, best for small, short run adjustments and “fine tuning”

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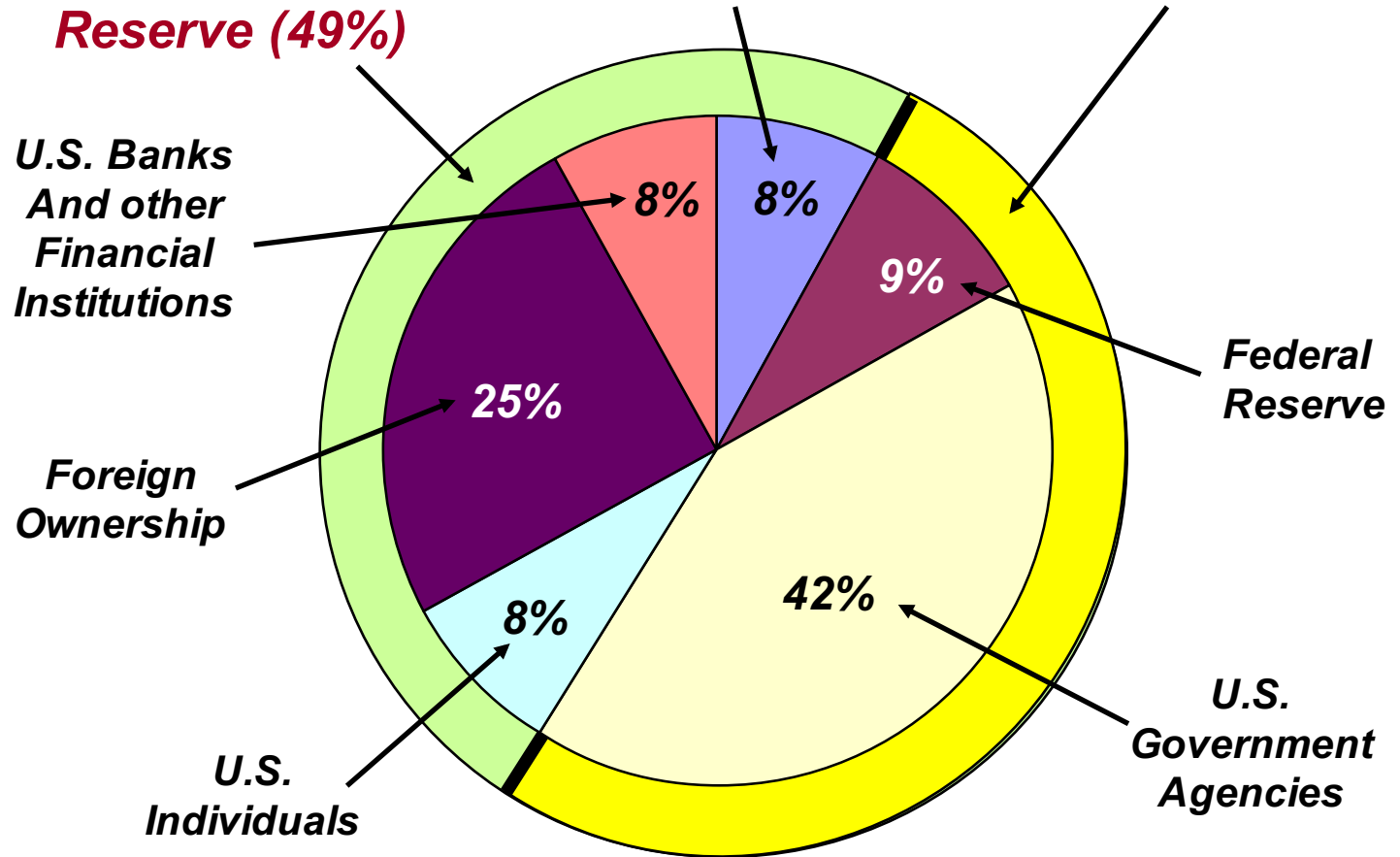
The Public Debt

Debt Held Outside The Federal Government and Federal Reserve (49%)

Total Debt \$7.96 Trillion

Debt Held by the Federal Government and Federal Reserve (51%)

Other – Including State and Local Governments



Source: U.S. Treasury

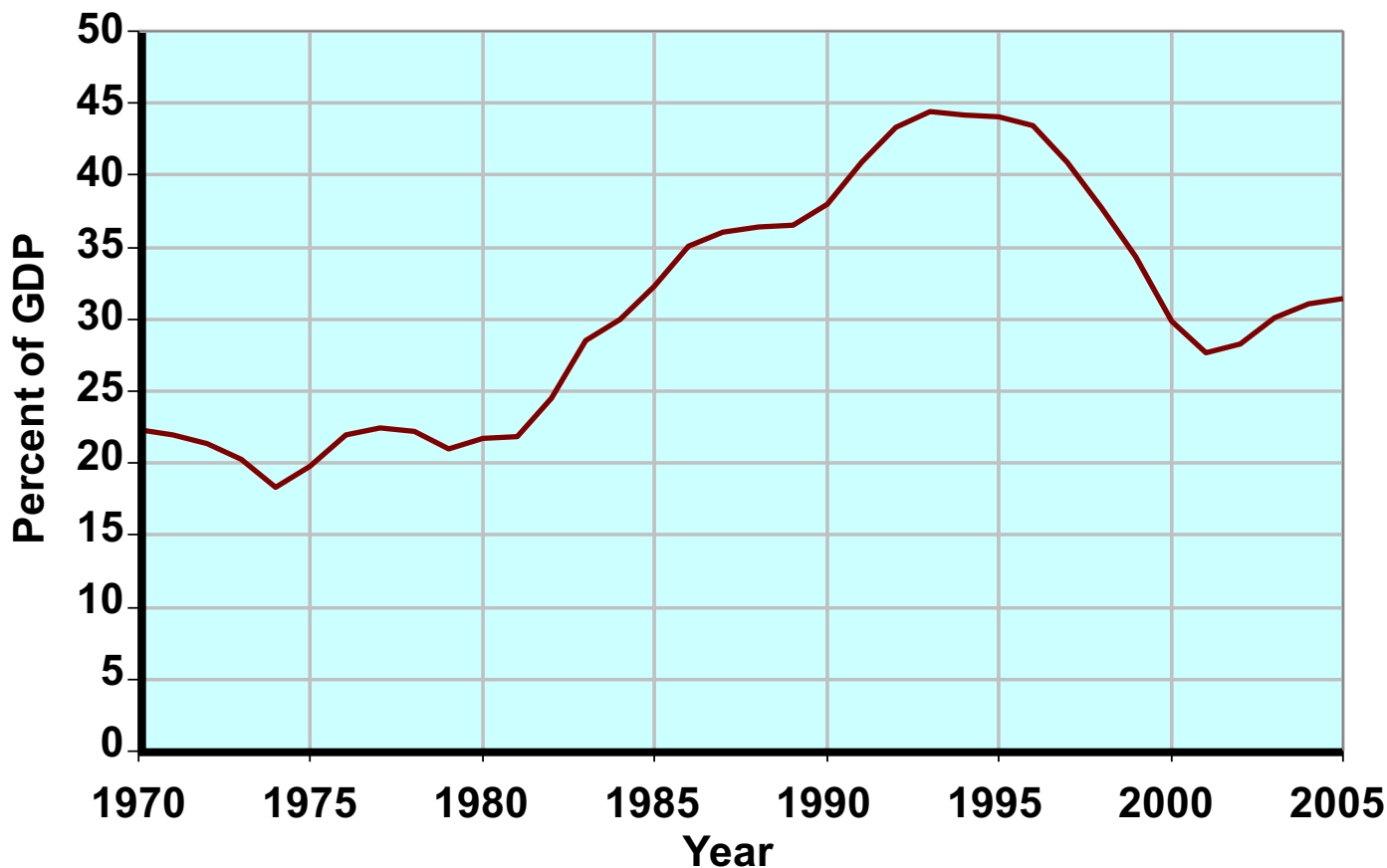
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Federal Debt Held by the Public as a Percentage of GDP, 1970 - 2005



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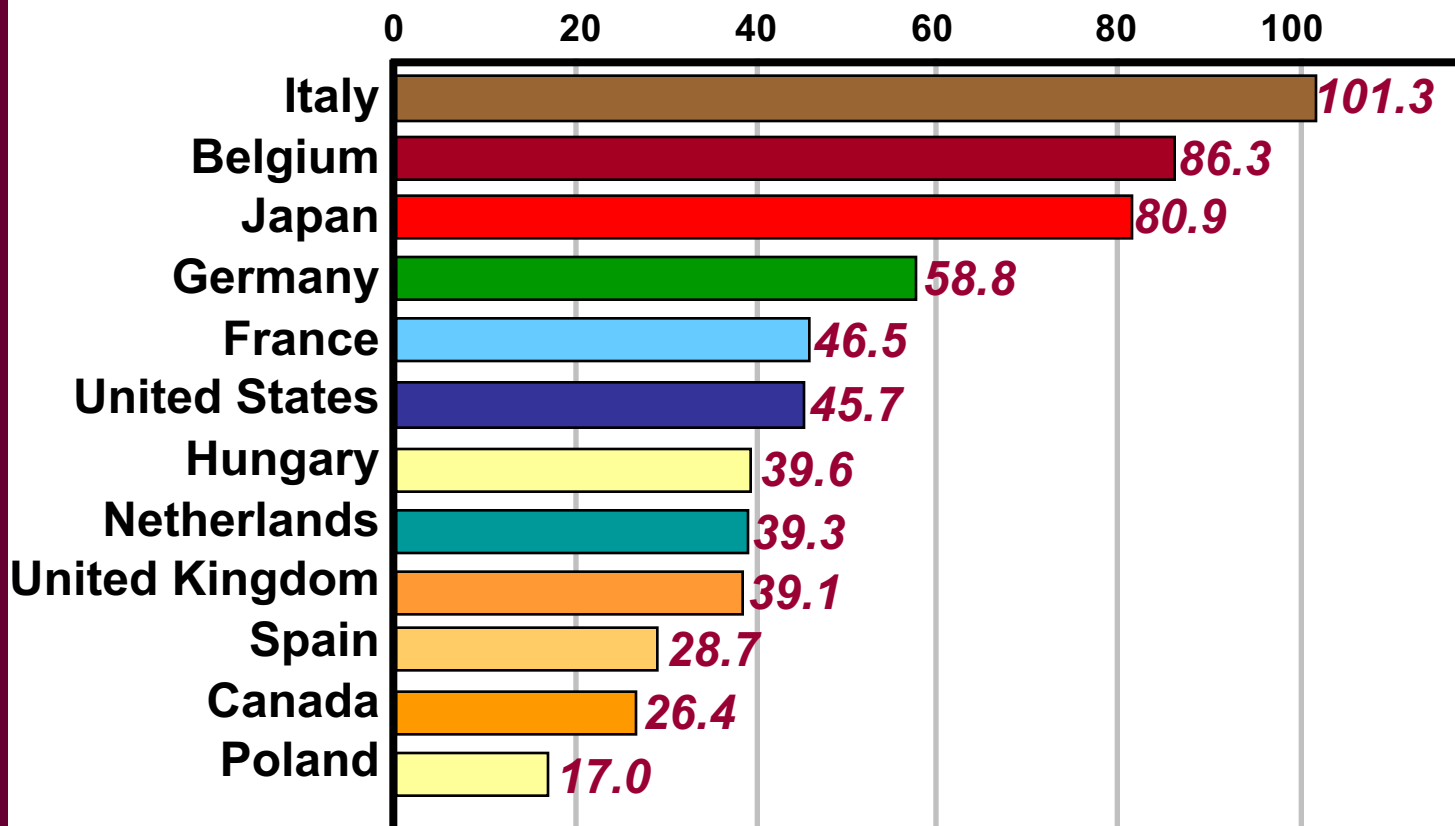
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GLOBAL PERSPECTIVE

Publicly Held Debt: International Comparisons

As a Percentage of GDP - 2005



Source: Organization for Economic Cooperation and Development

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Debt and GDP

- False Concerns

- **Bankruptcy** – essentially impossible!
- **Refinancing** – as securities mature, the gov sells new ones! (Always in high demand due to zero risk)
- **Taxation** – if all else fails, the gov will simply raise taxes to pay off the debt or interest on the debt!
- **Burdening Future Generations** – even with increasing debt, US standard of living has increased over time...are we gaining more than we are losing?

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- Substantive Issues
 - Income Distribution – uneven! (99% vs. 1%) The wealthiest Americans own the majority of the bonds and earn the interest off the debt = increases income inequality
 - Incentives – large debt = higher taxes to pay interest = less investing/consumption
 - Foreign-Owned Public Debt (25%) – “Bad Debt”, other people/nations are profiting off of investing in the US, when we pay them, \$ “leaks” out!

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Graphically...

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Debt and GDP

The Investment Demand Curve and the Crowding-Out Effect

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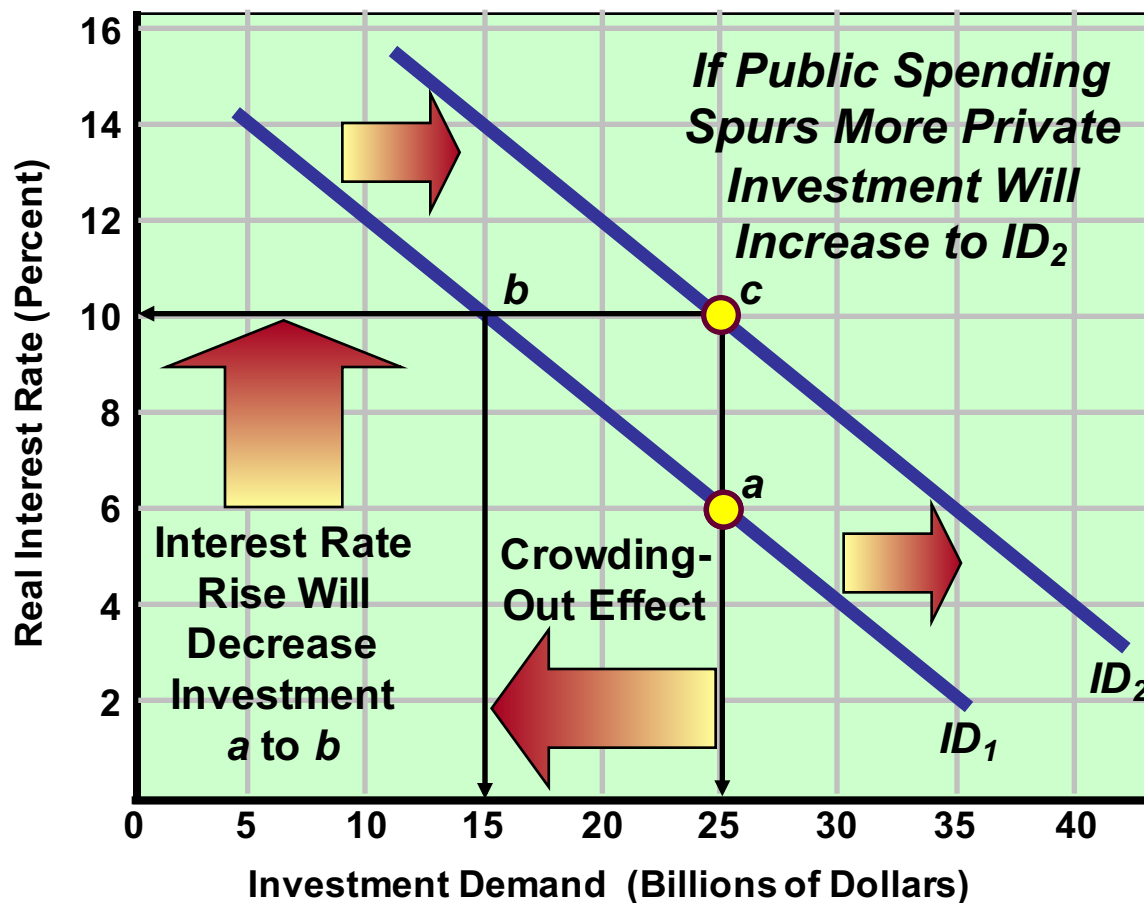
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A Large Public Debt to Finance Public Investment Will Cause...



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- **Public Investments and Public-Private Complementarities** (some gov spending will spur private investment)
- **Public Investments**
 - **Public Goods Spending** – (highways, power plants, mass transit, etc.)
 - **Human Capital Spending** – (education, grants, job training, health care)
 - **Reduction on Crowding-Out Effect** – as private investment increases (ID curve shifts R) the crowding out effect is eliminated or reduced

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The Leading Indicators

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1. Average Workweek
2. Initial Claims for Unemployment Insurance
3. New Orders for Consumer Goods
4. Vendor Performance
5. New Orders for Capital Goods
6. Building Permits for Houses
7. Stock Prices
8. Money Supply
9. Interest-Rate Spread
10. Consumer Expectations

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Key Terms

- fiscal policy
- Council of Economic Advisers (CEA)
- expansionary fiscal policy
- budget deficit
- contractionary fiscal policy
- budget surplus
- built-in stabilizer
- progressive tax system
- proportional tax system
- regressive tax system
- standardized budget
- cyclical deficit
- political business cycle
- crowding-out effect
- public debt
- U.S. Securities
- external public debt
- public investments

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Money and Banking

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