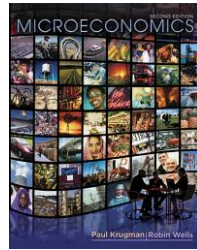


Economics 202 Principles Of Macroeconomics

Professor Yamin Ahmad

Supplemental Notes to Fiscal Policy

- Supplemental Notes on Fiscal Policy
- Structural/Cyclical Deficits/Surpluses
- Supply Side Effects of Fiscal Policy



The Federal Budget

- The **federal budget** is the annual statement of the federal government's expenditures and tax revenues.
- **Fiscal policy** is the use of the federal budget to achieve macroeconomic objectives, such as full employment, sustained long-term economic growth, and price level stability.

Note: These lecture notes are incomplete without having attended lectures

The Federal Budget

- The Institutions and Laws
 - Fiscal policy is made by the president and Congress.
 - Figure 1 illustrates the timeline.



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The Federal Budget

- Fiscal policy operates within the framework of the **Employment Act of 1946**, which committed the government to work toward “maximum employment, production, and purchasing power.”
- The President’s Council of Economic Advisers monitors the economy and advises the President on economic policy.

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Highlights of the 2003 Budget

- The projected fiscal 2003 Federal Budget has tax revenues of \$2,080 billion, expenditures of \$2,158 billion, and a projected deficit of \$78 billion.
- Tax revenues come from personal income taxes, social insurance taxes, corporate income taxes, and indirect taxes.
- Personal income taxes followed by social insurance taxes are the two largest revenue sources.

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The Federal Budget

- Expenditures are classified as transfer payments, purchases of goods and services, and debt interest.
- Transfer payments are by far the largest expenditure, and are sources of persistent growth in expenditures.

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The Federal Budget

- The federal government's budget balance equals tax revenue minus expenditure.
 - If tax revenues exceed expenditures, the government has a **budget surplus**.
 - If expenditures exceed tax revenues, the government has a **budget deficit**.
 - If tax revenues equal expenditures, the government has a **balanced budget**.

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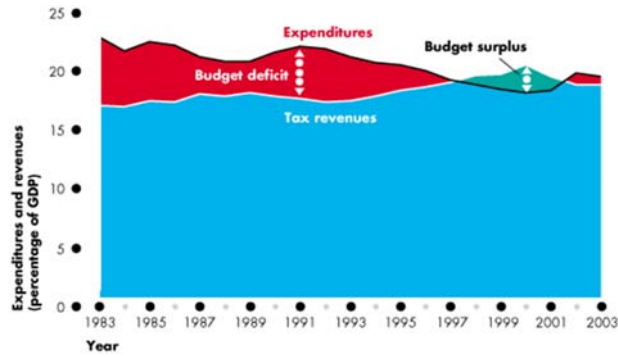
The Budget in Historical Perspective

- Figure 2 on the next slide shows the government's tax revenues, expenditures, and budget surplus or deficit as a percentage of GDP for the period 1983–2003.
- The government had a deficit of 5.2 percent in 1983.
- The deficit declined and in 1998 to 2001, the government had a surplus.
- A deficit arose again in 2002 and 2003.

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The Federal Budget



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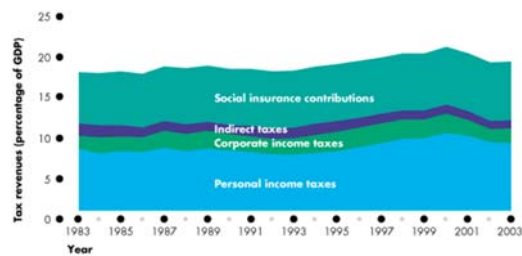
The Federal Budget

- Figure 3 on the next slide shows the evolution of the components of tax revenues and expenditures as a percentage of GDP over the period 1983–2003.
- Tax revenues increased and expenditures decreased.

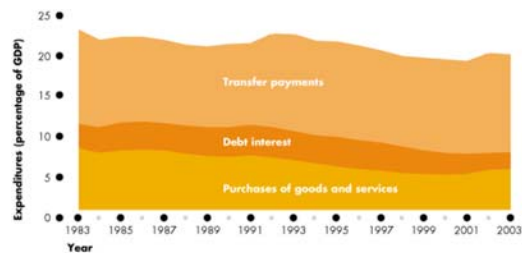
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The Federal Budget



(a) Tax revenues



(b) Expenditures

Note: These lecture



The Federal Budget

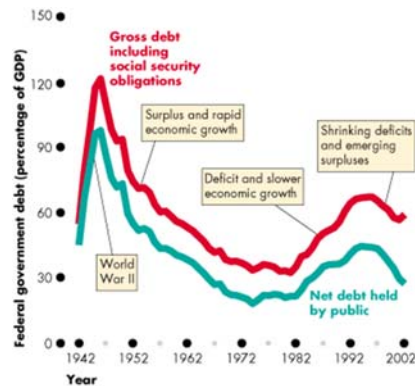
- **Government debt** is the total amount that the government has borrowed—that the government owes. It is the accumulation of all past deficits.

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The Federal Budget

- Figure 4 shows the evolution of the debt as a percentage of GDP since 1942.

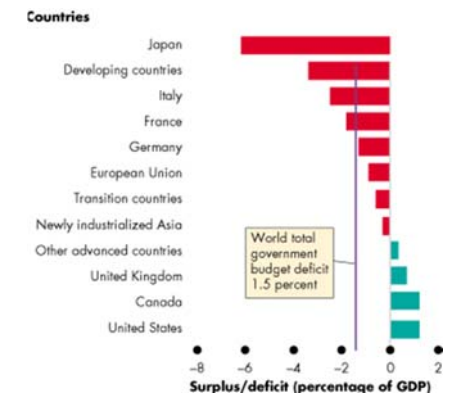


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The U.S. Government Budget in Global Perspective

- Figure 5 compares government budget deficits around the world in 2001.
- The world as a whole that year had a government budget deficit of about 1.5 percent of world GDP.



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State and Local Budgets

- In 2001, when the federal government spent \$1,900 billion, state and local governments spent about \$1,300 billion, mostly on education, protective services, and roads.
- State and local budgets are not used for stabilization purposes, and occasionally are destabilizing in recessions.

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Automatic Stabilizers

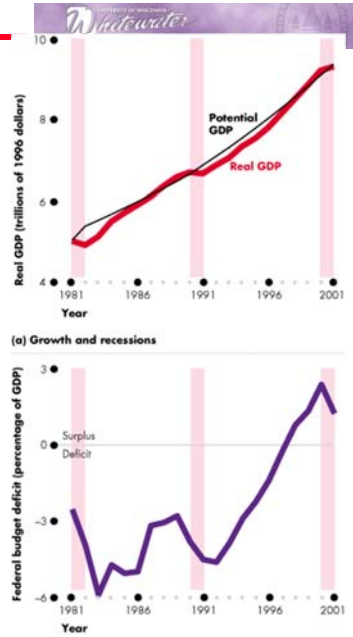
- Automatic stabilizers** are mechanisms that stabilize real GDP without explicit action by the government.
- Income taxes and transfer payments are automatic stabilizers.
- Because income taxes and transfer payments change with the business cycle, the government's budget deficit also varies with this cycle.
- In a recession, taxes fall, transfer payments rise, and the deficit grows; in an expansion, taxes rise, transfers fall, and deficit shrinks.

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Fiscal Policy Multipliers

- Figure 6 shows the budget deficit over the business cycle for 1981–2001.
- Recessions are highlighted.



Note: These lecture notes are incomplete without having attended lectures. (b) Federal budget deficit



Fiscal Policy Multipliers

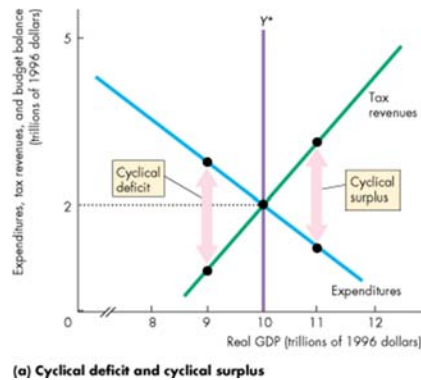
- The **structural surplus or deficit** is the surplus or deficit that would occur if the economy were at full employment and real GDP were equal to potential GDP.
- The **cyclical surplus or deficit** is the actual surplus or deficit minus the structural surplus or deficit; that is, it is the surplus or deficit that occurs purely because real GDP does not equal potential GDP.

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Fiscal Policy Multipliers

- Figure 7 illustrates the distinction between a structural and cyclical surplus and deficit.
- In part (a), as real GDP fluctuates around potential GDP, a cyclical deficit or surplus arises.



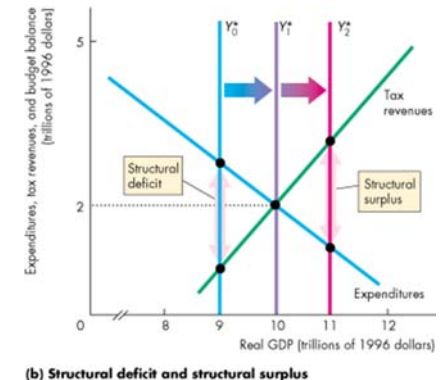
(a) Cyclical deficit and cyclical surplus

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Fiscal Policy Multipliers

- In part (b), as potential GDP grows, a structural deficit becomes a structural surplus.



(b) Structural deficit and structural surplus

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Supply-Side Effects of Fiscal Policy

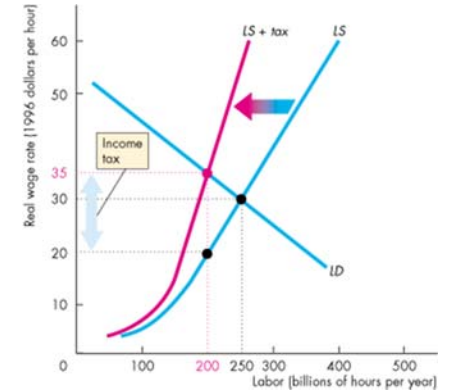
- Fiscal Policy and Potential GDP
 - Potential GDP depends on the full-employment quantity of labor, which in turn is influenced by the income tax.
 - Figure 12 on the next slide illustrates the effect of the income tax in the labor market.

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Supply-Side Effects of Fiscal Policy

- The income tax decreases the supply of labor because it decreases the after-tax wage rate.
- Because the income tax decreases the supply of labor, it raises the equilibrium wage rate, decreases employment, and decreases potential GDP.

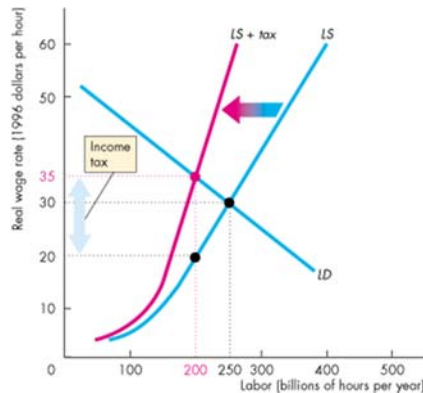


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Supply-Side Effects of Fiscal Policy

This supply-side effect of the income tax means that a cut in the income tax rate increases potential GDP and increases aggregate supply.



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Supply-Side Effects of Fiscal Policy

Effects of Tax Cut on AD/AS:

- A tax cut increases aggregate demand and the AD curve shifts rightwards
- Two Views on effects of Tax Cut on Real GDP and Price Level with regards to aggregate Supply

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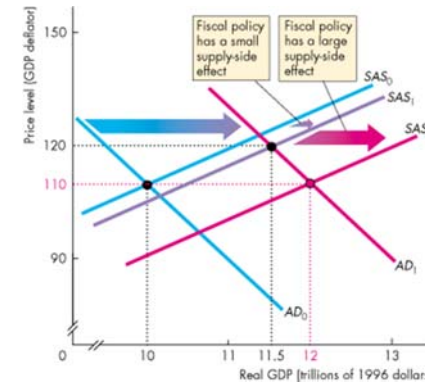
Supply-Side Effects of Fiscal Policy

- Most economists believe that a tax cut has a small effect on aggregate supply.
 - So GDP increases and the price level rises.
- Supply-side economists think that a tax cut increases aggregate supply by a large amount so that GDP increases and the price level does not change (or might even fall).

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Supply-Side Effects of Fiscal Policy



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Fiscal Policy and Economic Growth

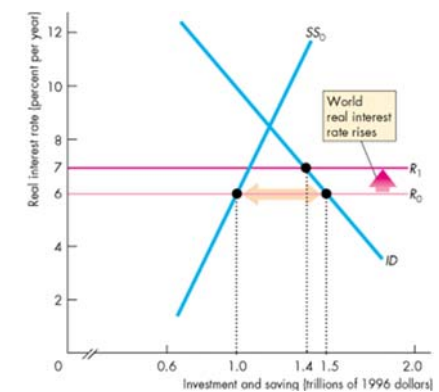
- Fiscal policy also influences economic growth by changing the incentives to save, invest, and innovate.
- These incentives work similarly to those in the labor market.
- Fiscal policy can also influence growth and the well-being of future generations by crowding out investment and increasing foreign debt.

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Supply-Side Effects of Fiscal Policy

- Figure 14 illustrates some of these effects.
- An increase in government purchases or a tax cut decreases world saving and increases the world equilibrium real interest rate.

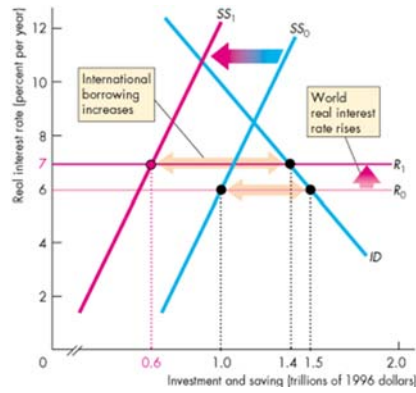


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Supply-Side Effects of Fiscal Policy

The increase in government purchases or a tax cut decreases domestic saving and increases international borrowing.



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