Notes: Fiscal Policy

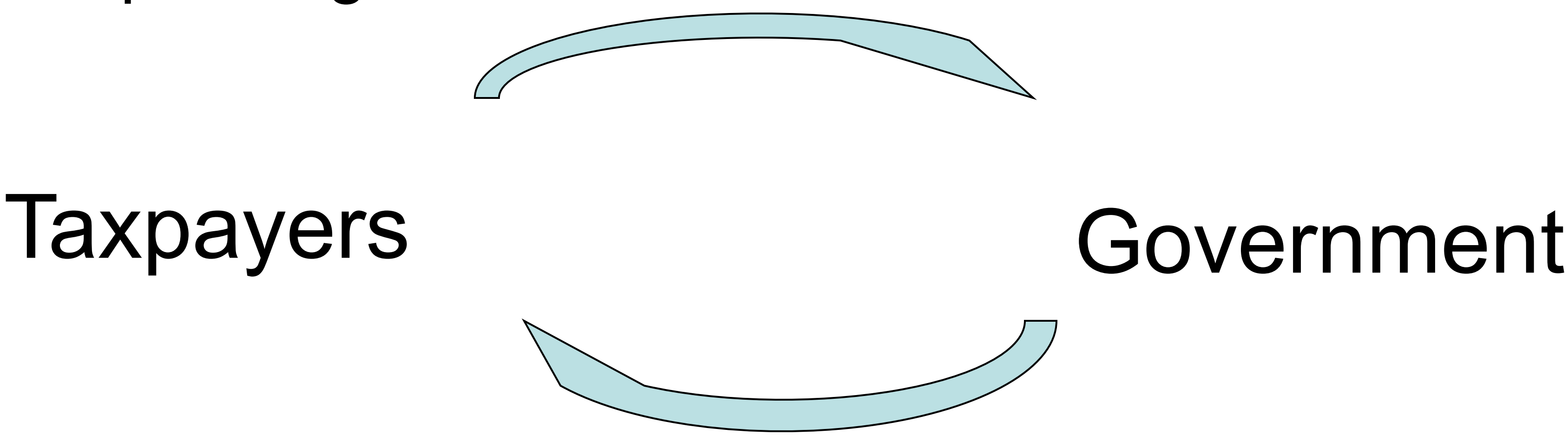
Economics

Setting an example?

- "Dear Congress, Last year I mismanaged my funds and this year my spouse and I cannot decide on a budget. Until we have come to a unified decision that fits all of our needs and interests, we will have to shut down our checkbook and will no longer be able to pay our taxes. I'm sure you'll understand. Thank you very much for setting an example we can all follow."

What is fiscal policy?

Fiscal policy is an attempt to control the economy through the use of taxes and government spending.



Who makes fiscal policy?

- Congress and the President work together to pass bills into law about how much money the national government collects in taxes and how much it spends.

What impacts can fiscal policy have?

- Fiscal policy tends to have large effects on the economy.
- Fiscal policy changes occur much slower than monetary policy changes

What does the U.S. Treasury do?

- The U.S. Treasury does **NOT** *make* fiscal policy.
- The Treasury **IS** responsible for *implementing* fiscal policy by
  - Collecting taxes
  - Borrowing money
  - Making payments authorized by Congress and the President

Taxes

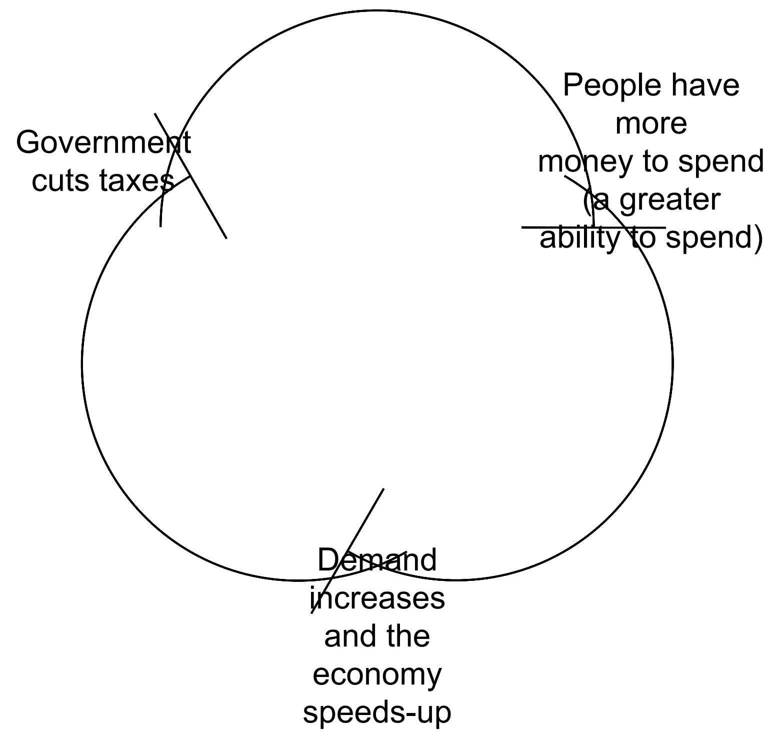
- Taxes are called **revenue**.
- The federal agency responsible for tax collection is the Internal Revenue Service (IRS).
  - Started in 1862 by Lincoln
- The IRS does not set tax policy, it just enforces it.
- Each state also collects taxes and sets it own tax policy.

The Impact of Tax Policies

- Taxes affect how much money Americans have to spend which affects demand.
- Tax increases or tax cuts affect large numbers of Americans.

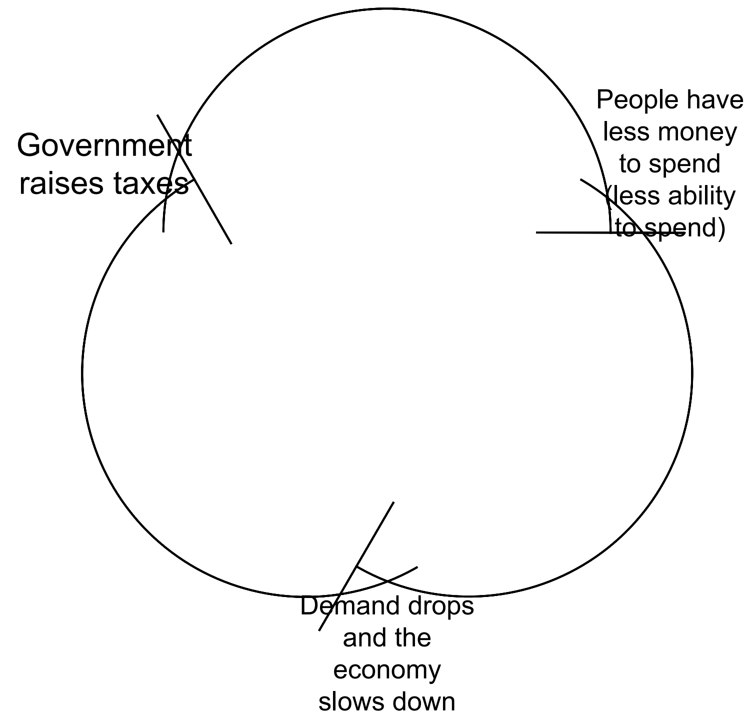
Tax Cuts

- Tax cuts allow the people or business whose taxes are cut to keep more of their income.
- If they invest that income, it can become private capital
- If they spend that income it can stimulate demand
- There are no guarantees how people will use the money they get from a tax cut



Tax Increases

- Tax increases mean that people or businesses pay more of their income to the government
- Tax increases can reduce spending and affect demand
- Tax increases can affect how people choose to invest and affect capital formation



Spending

- Expenditures are authorized by Congress and the President
- Most spending is categorized as
  - mandatory (must be paid) or
  - discretionary (government has a choice)

Mandatory Spending

- Entitlements – People who have paid in are entitled to receive a benefit – these are called transfer payments
  - Social Security
  - Medicare
  - Veterans benefits
- Interest on the debt

Discretionary Spending

- All of the other functions of the federal government
- This includes direct spending and grants (money) for states and Cities
  - Defense
  - Homeland Security
  - Transportation
  - Education
  - Welfare
  - Agriculture

Spending Policy

- Government spending stimulates the economy by creating a demand for specific goods and services.
- Government can buy product.
  - example: The Air Force buys planes from Boeing. Boeing hires workers to make the planes at good wages.
- Government can hire us.
  - Example: create jobs, wages

Who gets what? The Politics of Taxes and Spending

- Fiscal policy is often controversial because it creates unequal conditions
- Consider the following questions:
  - Who gets a tax cut/ increase (shareholders, low income Americans, people who own their houses, people with children) and why?
  - Where should the government spend money (border security, parks preservation, schools, aircraft carriers) and why?

Policy Choices

- Expansionary Fiscal Policy – to increase economic activity (lower unemployment) by any combination of
  - tax cuts
  - Expenditure (spending) increases
- Contractionary Fiscal Policy – to reduce inflationary pressures by any combination of
  - tax increase
  - Expenditure (spending) decreases

Surpluses, Deficits and Debts

Surplus – When the government collects more in revenue than it spends in one year.

Deficit - When the government spends more in one year than it collects in revenue. This is the amount owed in one year.

Debt – The sum of all past surpluses and deficits. This is the total amount owed.

How the Government borrows money

- When the government spends more than it collects in revenue (runs a deficit). It borrows the money.
- The U.S. Treasury sells bonds (T-bills) to investors and agrees to pay back the amount it borrows with interest.

Who buys the government bonds?

- Some bonds are held by the Social Security Administration to pay for future retirees.
- Many bonds are purchased by pension funds and insurance companies.
- Some bonds are purchase by private investors both inside and outside the United States.

Debt clock

- How large is the debt of the United States right this minute?
- Click on the Debt Clock

Is the debt a problem?

- Some economists believe that as long as the economy is growing, the % of the debt compared to the total economy stays the same. So it isn't a problem.
- Other economists see the debt as crowding out other investment choices for current investors (i.e. they buy government bonds instead or investing in U.S. stocks). This would make it a problem now.
- Some economists worry that the size of the debt will restrict the ability of the government to make fiscal policy changes in the future. This could make it a problem in the future
- What do you think?