

Lecture Notes for Chapter 10 of
Macroeconomics: An Introduction

*Fiscal Policy:
Government
Spending & Taxation*

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02/28/08

In this chapter we will
discuss -

- ⌘ What is *Fiscal Policy*?
- ⌘ Federal Government spending & taxation.
- ⌘ Why was there a federal budget deficit?
- ⌘ How did it disappear?
- ⌘ How big is the federal debt?
- ⌘ In what areas is government growing?
- ⌘ In what areas is it shrinking?
- ⌘ Long term consequences of large deficits.

What is Fiscal Policy?

- ⌘ Taxation: Who? How much?
- ⌘ Spending: On what? How much?
- ⌘ How to finance the deficit?
- ⌘ Usually mean **federal** government,
though state and local are as big!
- ⌘ The President proposes federal budget.
- ⌘ Congress enacts tax and spending laws.

Some fiscal facts:

- ⌘ Expenditures or "outlays" = \$3 trillion, over \$10,000 per American!
- ⌘ Big swings in budget deficit.
- ⌘ Big deficits of 1980s gone by 1997!
- ⌘ Surplus in 2000, deficit now \$250b!
- ⌘ Strong economy boosts tax revenue, weak economy reduces revenue.
- ⌘ Outlook is for deficit to grow.

Expenditures -

- ⌘ Purchases of goods and services, and
- ⌘ Transfer payments or entitlements:
 - Social Security
 - Medicare, Medicaid,
 - "Welfare"
(Aid to Families with Dependent Children),
 - Unemployment benefits,
 - Agricultural price supports,
 - Export-Import Bank.
(“corporate welfare”)

Major expenditures 2008:

⌘ Defense	\$600b
⌘ Social security	\$614b
⌘ Medicare	\$397b
⌘ Health	\$287b
⌘ Income security	\$382b
⌘ Interest on federal debt	\$256b

Major tax sources 2008:

⌘ Individual income tax	\$1,226b
⌘ Corporation income tax	\$343b
⌘ Social Insurance	\$918b

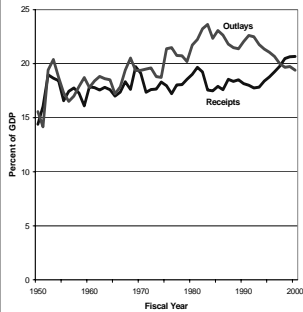
Why don't Congress & Pres
end the deficit?

- ⌘ Whose taxes will go up?
- ⌘ Whose benefits will be cut?
- ⌘ Not mine!

Balanced budget amendment
to the Constitution

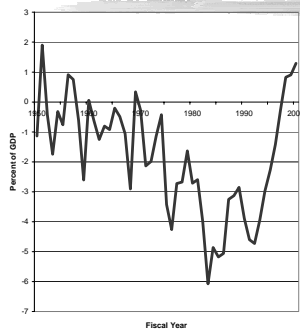
- ⌘ Will it be enacted?
- ⌘ Should it be enacted?
- ⌘ Controversy involves issues in Chap 11.
- ⌘ Not likely while surpluses persist.

Federal Outlays and Receipts as a % of GDP



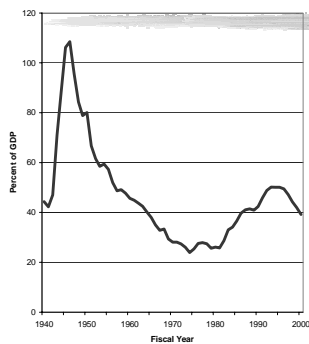
- ⌘ Tax receipts are:
 - trendless, 18% of GDP
 - but recently up sharply
 - pro-cyclical.
- ⌘ Outlays trends: 17% of GDP in 1960, 24% in 1983, now under 20%.
- ⌘ Outlays are counter-cyclical. Why?

Federal budget balance % of GDP



- ⌘ Worse during recession,
- ⌘ Rises during recovery.
- ⌘ Balance (surplus) is pro-cyclical.
- ⌘ But worsened after the 1981-82 recession.
- ⌘ 1990s improvement dramatic!

Federal debt as % of GDP.



- ⌘ 100% of GDP after World War II.
- ⌘ Big decline to 1980.
- ⌘ Recent rise now reversed again.
- ⌘ Many countries have higher debt, some over 100% of GDP!
- ⌘ Can we pay it?
- ⌘ Will we pay it?
- ⌘ Must we pay it?

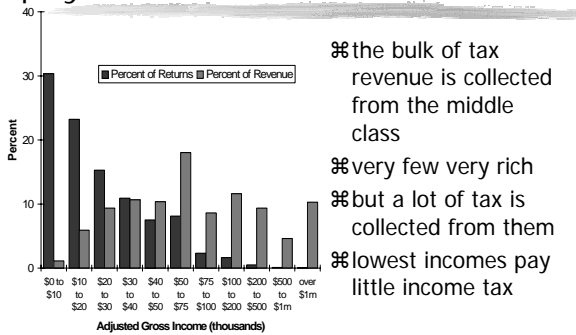
State and Local Governments:

- ⌘ Spend about \$1 trillion, 2/3 size of federal
- ⌘ Increasingly burdened by entitlements: medicaid.
- ⌘ Receive about \$300b in grants-in-aid from federal gov't.
- ⌘ Rarely have a deficit because most state constitutions require budget balance!
- ⌘ What are trends in WA state government?

Growth of government in the 20th century.

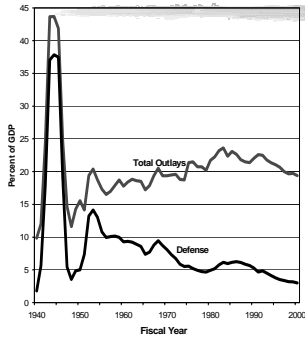
- ⌘ In 1900 the role of government was small
 - ☒ Entitlements did not exist
 - ☒ Income tax was declared unconstitutional
 - ☒ The Federal Reserve did not exist yet.
- ⌘ World War I greatly expanded its size.

The Income Tax - who pays?



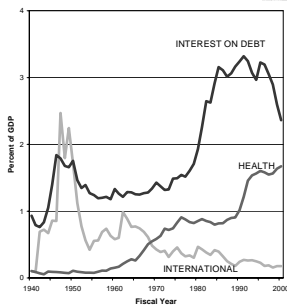
- ⌘ the bulk of tax revenue is collected from the middle class
- ⌘ very few very rich
- ⌘ but a lot of tax is collected from them
- ⌘ lowest incomes pay little income tax

How large is defense?



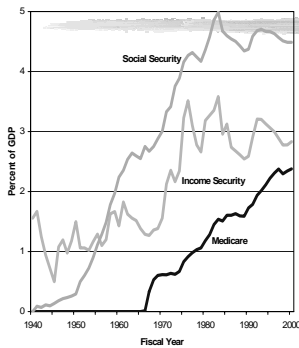
- ⌘ WWII was 35% of GDP!
- ⌘ Up from 2% in 1940.
- ⌘ Post WWII peaks are Korean War, Vietnam, Reagan build-up.
- ⌘ Trend is down.
- ⌘ Now at pre-WWII level!

Other Major Federal Outlays -



- ⌘ Health spending, apart from Medicare, is major.
- ⌘ Interest on debt is down sharply. Why?
- ⌘ International "foreign aid" is tiny.

Entitlements are new.



- ⌘ Social Security from Roosevelt's "New Deal."
- ⌘ Medicare from Johnson's "Great Society."
- ⌘ Future will reflect aging of population.
- ⌘ Aging will be big issue of 21st century.

Role of federal government has changed.

- ⌘ Traditional functions are less important.
- ⌘ Increasingly, it transfers income from one citizen to another.
- ⌘ The guarantor of income and medical care for the elderly, the poor.

Is the Social Security System sustainable?

- ⌘ Skeptics charge it is a Ponzi scheme, doomed to collapse eventually. Why?
- ⌘ SS is a pay-as-you-go system, not a pension fund.
- ⌘ The "trust fund" is small relative to future payments.
- ⌘ After Baby Boomers comes the Birth Death generation.

What is a Ponzi scheme?

- ⌘ Charles Ponzi promised investors unrealistically high returns.
- ⌘ More than he could actually earn.
- ⌘ Early "investors" were paid with money collected from later ones.
- ⌘ Scheme collapses when cash flow stops.
- ⌘ Also "pyramid" or "chain letter."

Is the Social Security System a Ponzi scheme?

- ⌘ First SS pensioner paid in \$20, collected \$20,000.
- ⌘ Baby Boomers will live longer.
- ⌘ Can Birth Dearth Generation afford it?
- ⌘ "Intergenerational accounting" suggests tax rates of 65% to 93% for future generations.

Can Medicare costs be contained?

- ⌘ One third of all medical costs in US are for care of elderly in last year of life.
- ⌘ Ethical dilemmas!
- ⌘ Technology keeps people alive indefinitely
- ⌘ at great cost (economic and emotional!)

Long Term Consequences of Deficits

- ⌘ What will we do when bankruptcy looms?
- ⌘ Boost tax rates to 65% or more??
- ⌘ Cancel programs? Cut benefits?
- ⌘ "Monetize" the debt?

Is a "Soft Landing"
Possible?

⌘ Can Social Security be privatized?

⌘ Does that solve the problem?

⌘ How has the System transferred wealth in society?

The End!
