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 Dearth 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!