

Fiscal Policy

A. The Federal Budget

1. Federal budget – the federal government’s plan for the use of government revenues during a fiscal year
 - a. The federal budget is developed by the President, who consults the Office of Management & Budget (OMB), the Council of Economic Advisers, the Department of the Treasury, & other presidential advisers
 - (1)
 - (2)
 - b. The budget approved by Congress will often have many changes from the budget submitted by the President
 - (1)
 - (2)
 - c. The bulk of federal government spending goes toward payments to Social Security, the national defense, medical expenses (like Medicare & Medicaid), & interest payments on the national debt; The bulk of state & local government spending goes toward education, public welfare, road work, & public safety
2. The government budget is balanced when its revenues equal its expenditures, but more commonly the federal government will have either a ***budget surplus*** or a ***budget deficit*** at the end of the fiscal year
 - a. Budget surplus
 - b. Budget deficit – when government expenditures exceed government revenues
 - (1)
 - (2)
 - c. National debt – the total amount of money that the government owes, which is the accumulated annual budget deficits minus the annual budget surpluses

3. Deficit spending – the government policy of spending more money for its programs than it is able to cover with its tax revenues
 - a. Deficit spending has been relied upon for several reasons
 - (1)
 - (2)
 - (3)
 - (4)
 - b. The major problem with deficit spending is that in recent years the national debt has been growing at a very steep rate
 - (1)
 - (2)
4. There are things that can be done to limit deficit spending
 - a. There are two ways to balance the annual budgets, but these options tend to not be very popular options among most Americans
 - (1)
 - (2)
 - b. Occasionally there are calls for a balanced budget amendment to the Constitution that would force Congress to balance the budget each year
 - (1)
 - (2)

B. Fiscal Policy Strategies

1. Fiscal policy – involves the use of national government spending & taxation programs to affect the level of economic activity in such a way to promote price stability, maximum employment, & reasonable economic growth
 - a. Fiscal policies effectiveness is dependent on several factors
 - (1)
 - (2)
 - (3)
 - (4)

- b. Effective fiscal policies can have a very powerful impact on aggregate demand & national income when they successfully influence consumption, investment, government spending, & net exports (C+I+G+(X-M))
 - 2. Fiscal policies can be either restrictive or expansionary
 - a. Restrictive fiscal policy
 - b. Expansionary fiscal policy
- 3. There are two schools of economic thought when it comes what is expected to happen due to a particular fiscal policy
 - a. Demand-side economics – focuses on achieving economic stability & growth through the government’s influence on aggregate demand
 - (1)
 - (2)
 - (3)
 - b. Supply-side economics – focuses on achieving economic stability & growth by increasing the economy’s aggregate supply (real GDP)
 - (1)
 - (2)
 - (3)
 - c. Critics of supply-side economics question two major assumptions of supply-side theory
 - (1)
 - (2)

C. Tools of Fiscal Policy

- 1. Marginal tax rates – the raising or lowering of taxes
 - a. An expansionary fiscal policy will lower marginal tax rates
 - (1)

- (2)
 - b. A restrictive fiscal policy will raise marginal tax rates
 - (1)
 - (2)
- 2. Tax incentives – a special tax break that the government gives to businesses to encourage investment in new capital
 - a. Investment tax credit – permits firms to deduct from its corporate income taxes a percentage of the money spent on new capital
 - (1)
 - (2)
 - b. Raising or lowering the investment tax credit will have an effect on unemployment & inflation
 - (1)
 - (2)
- 3. Changes in government spending can influence AD
 - a.
 - b.
- 4. Public transfer payments – tax dollars that are redistributed to nonproductive actors in the economy
 - a.
 - b. Changing public transfer payments can be illustrated well through looking at unemployment benefits
 - (1)
 - (2)
 - c. Most federal public transfer payments tend to keep AD steady or rising
- 5. Progressive income taxes prove to be a tool of fiscal policy by a built in mechanism that will keep AD relatively steady
 - a. During periods of prosperity, incomes tend to rise
 - (1)

(2)

b. During periods of economic decline, incomes tend to fall

(1)

(2)

D. Limitations of Fiscal Policies

1. Rather than being based on economic factors, fiscal policies are often the result of political factors

a. Expansionary fiscal policies are often always popular, since peoples' disposable incomes are increased

(1)

(2)

b. Elected officials are often reluctant or unwilling to favor unpopular fiscal policies out of fear of being voted out of office

2. Fiscal policy requires time to affect the economy

a.

b.

3. Large federal deficits of recent years also make it increasingly difficult to coordinate monetary & fiscal policy for the purpose of stabilizing the economy

a.

b.