Deficit and Debt

Discretionary v. Automatic

Rules governing taxes and some transfers act as **automatic stabilizers,** reducing the size of the multiplier and automatically reducing the size of fluctuations in the business cycle.

In contrast, **discretionary fiscal policy** arises from deliberate actions by policy makers rather than from the business cycle.

Discretionary Fiscal Policy

- **Making the Automatic Stabilizers More Effective**
  - **Public Works**
    - **The main fiscal policy to end the Depression was public works**
  - **Transfer Payments**
    - **The government could extend the benefit period for unemployment compensation and increase welfare payments, Social Security, and veteran's pensions**

Discretionary Fiscal Policy

- Making the Automatic Stabilizers More Effective
  - Changes in Tax Rates
    - To fight inflation, the government can raise taxes
    - To fight recession, the government can cut taxes
    - Corporate incomes taxes can be raised during periods of inflation and lowered when recessions occur
  - Using tax rate changes as a counter cyclical policy tool provides a quick fix, however, temporary tax cuts carried out during recessions should not become permanent

 12-31

Discretionary Fiscal Policy

- Making the Automatic Stabilizers More Effective
  - Changes in Government Spending
    - The government increases spending and cuts taxes to fight recessions
    - The government decreases spending and raises taxes to fight inflation
    - In brief, we fight recessions with budget deficits and inflation with budget surpluses

 12-32

Who Makes Fiscal Policy?

- The President and Congress make fiscal policy
  - This is complicated and can be time consuming, especially when one political party controls Congress while the president belongs to the other party
  - No one seems to be in charge of *making* fiscal policy

 12-33

The Deficit Dilemma**

- **Deficits, Surpluses, and the Balanced Budget**
  - **When government spending is greater than tax revenue, we have a federal budget deficit**
    - **The government borrows to make up the difference**
    - **Deficits are prescribed to fight recession**

The Deficit Dilemma

- **Deficits, Surpluses, and the Balanced Budget**
  - **When the budget is in a surplus position, tax revenue is greater than government spending**
    - **Budget surpluses are prescribed to fight inflation**

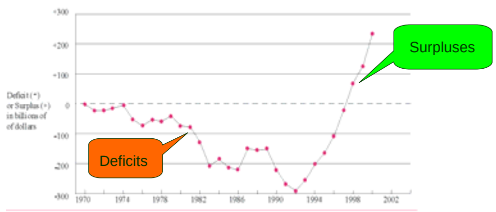
The Deficit Dilemma

- **Deficits, Surpluses, and the Balanced Budget**
  - **We have a balanced budget when government expenditures are equal to tax revenue**
    - **We've never had an exactly balanced budget**

The Deficit Dilemma

Deficits and Surpluses: The Record

The Federal Budget Deficit, Fiscal Years 1970-2001



Source: Economic Report of the President, 2001; Economic Indicators, March 2001

Why Are Large Deficits So Bad?

- Large deficits raise interest rates, which, in turn, discourages investment
  - Our real interest rate (the nominal interest rate less the rate of inflation) during the latter half of the 1980s and all of the 1990s was three times a high as the real interest rate in Japan' and it was much higher than those in most Western European countries as well

Why Are Large Deficits So Bad?

- The federal government has become increasingly dependent on foreign savers to finance the deficit
  - In the early – and mid – 1990s foreigners financed more than half the deficit

Why Are Large Deficits So Bad?

- Until the mid-1990s the deficit sopped up more than half the personal savings in this country, making that much less savings available to large corporate borrowers seeking funds for new plant and equipment

Why Are Large Deficits So Good?

- On the positive side, budget deficits stimulate the economy
  - The only problem is that we should not have needed this stimulus during the "prosperous" mid-to late 1980s when we were running huge deficits
  - We would do well to remember that John Maynard Keynes would have advocated running surpluses and paying off the debt during periods of prosperity

Will We Be Able to Balance Future Budgets?

- The federal government finally managed to run a budget surplus in 1998
  - This was the first time since 1969
- The congressional Budget Office forecasts a string of surpluses well into the new millennium
  - Congressional Republicans and Democrats quickly proposed dueling plans to dispose of those surpluses with various combinations of tax cuts and spending increases
  - No elected official proposed slowing down the projected increases in Social Security spending

Will We Be Able to Balance Future Budgets?

- A recession, a decline in stock prices, a tax cut, or an increase in government spending programs can easily eliminate any surpluses and replace them with deficits

- After the year 2015, as the baby boom generation attains senior citizenship, the Social Security Trust Fund will be quickly depleted
  - Unless the government has already raised Social Security taxes or cut benefits, the federal budget surplus will quickly become a large and growing deficit

The Proposed Balanced Budget Amendment and the Line Item Veto

- Must we balance the budget each year?
  - The government really tried to balance the budget each year into the early 1930s
  - The economic wisdom today tells us that we should have deficits in lean years and surpluses in fat years
    - From 1961 through 1997 the government managed only one surplus
    - The national debt rose every year as we ran budget deficits in fat years

The Proposed Balanced Budget Amendment and the Line Item Veto

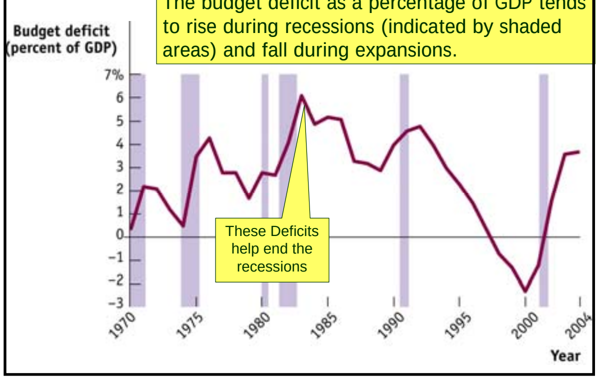
- The first step in passing a Constitutional amendment to balance the budget is a two-thirds vote in both houses of Congress
  - Despite some very close votes in 1994, 1995, 1996, and 1997, the balanced budget amendment failed in one or the other houses of Congress
  - Most economists oppose such an amendment because it would put us in an economic straitjacket

Should the Budget be Balanced?

- Most economists don't believe the government should be forced to run a balanced budget *every year* because this would undermine the role of taxes and transfers as automatic stabilizers.
- Yet policy makers concerned about excessive deficits sometimes feel that rigid rules prohibiting—or at least setting an upper limit on—deficits are necessary.

The Federal Budget Deficit & The Business Cycle

The budget deficit as a percentage of GDP tends to rise during recessions (indicated by shaded areas) and fall during expansions.



Defining Surpluses and Debt

- A ***surplus*** is an excess of revenues over payments.
- A ***deficit*** is a shortfall of revenues over payments.

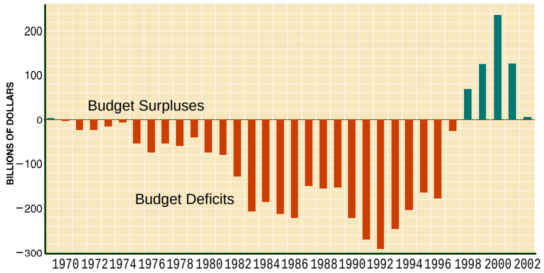
The Definition of Debt and Assets

- ***Debt*** is accumulated deficits minus accumulated surpluses.
- Deficits and surpluses are flow concepts.
- Debt is a stock concept.

Long-Run Implications

- U.S. government budget accounting is calculated on the basis of **fiscal years.**
- Persistent budget deficits have long-run consequences because they lead to an increase in **public debt.**

A String of Deficits



The U.S. Government Has Always Been in Debt Except

- ***1835-36: Debt Free!*** – The U.S. was completely out of debt by 1835.
- The Mexican-American War (1846-48) caused a four-fold increase in the debt

The Public Debt

- **Differentiating between the Deficit and the Debt**
  - **The *deficit* occurs when federal government spending is greater than tax revenue**
  - **The *debt* is the cumulative total of all the federal budget deficits less any surpluses**
    - **Suppose that our deficit declined one year from $200 billion to $150 billion**
    - **The national debt would still go up by $150 billion**
    - **So every year that we have a deficit – even a declining one – the national debt will go up**

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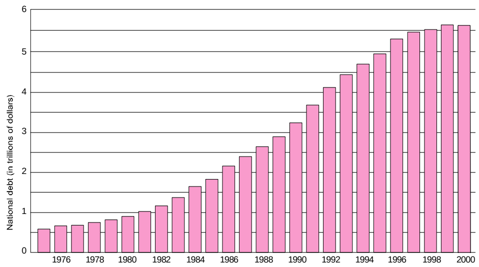
The Public Debt

National Debt, 1975-2000



Economic Report of the President, 2000

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The Public Debt

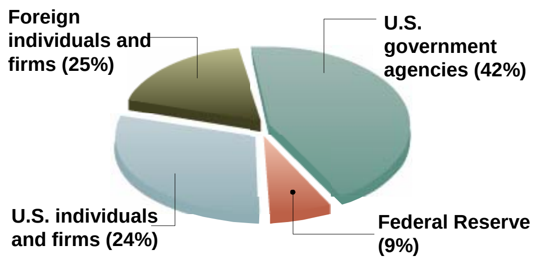
- **Who holds the national debt?**
  - **Private American citizens hold a little less than half**
  - **Foreigners hold almost one-third**
  - **The rest is held by banks, other business firms, and U.S. government agencies**

12-50

Who do we owe?

- **Public Debt** is government debt held by individual and institutions outside the government.
- Big part of the Government debt is owned by the Government!
  - It owes money to itself?

Debt



Debt Burden

- **Is the national debt a burden that will have to borne by future generations?**
  - **As long as we owe it to ourselves, the answer is no**
  - **If we did owe it mainly to foreigners, and if they wanted it paid off, it could be a great burden**

Difference Between Individual and Government Debt***

- Paying interest on the internal debt involves a redistribution among citizens of the country.
- It does **not** involves a net reduction in income of the average citizen.

Difference Between Individual and Government Debt**

- External debt is more like an individual's debt.
- ***External debt*** – government debt owed to individuals in foreign countries.

The Public Debt

- **When do we have to pay off the debt?**
  - **We don't. All we have to do is roll it over, or refinance it, as it falls due**
  - **Each year several hundred billion dollars worth of federal securities fall due**
    - **By selling new ones, the Treasury keeps us going**
  - **In the future, even if we never pay back one penny of the debt, our children and our grandchildren will have to pay hundreds of billions of dollars in interest**
    - **At least to that degree, the public debt will be a burden to future generations**

Debt and Our Children

- **In the future, even if we never pay back one penny of the debt, our children and our grandchildren will have to pay hundreds of billions of dollars in interest**
  - **At least to that degree, the public debt will be a burden to future generations**

Interest Rates and Debt Burden

- The interest rate determines annual debt service.
- The annual ***debt service*** is the interest rate on debt times the total debt.

Interest Rates and Debt Burden

- Interest payments on the debt is government revenue that ***cannot*** be spent on defense or welfare.
- That is what people mean when they say a deficit is burdening future generations.*

The Public Debt

- **Why not go ahead and just pay off the debt?**
  - **Economists predict that following this course would have catastrophic consequences**
  - **If we tried to pay off the debt too quickly, it might even send us into a deep depression**
  - **If we keep running large surpluses and pay down the national debt, this will cause a problem for both the Social Security Trust Fund and the Federal Reserve**
    - **As the national debt goes down, eventually there would be no securities for them to buy**
    - **Still, it is a whole lot better to have problems like these than those caused by running huge budget deficits every year**