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Fiscal Policy

Fiscal policy is the use of the taxing and spending powers of government to regulate aggregate expenditure, and thereby to stabilize the economy

The economy *needs* to be stabilized.
The economy *can* be stabilized.
The economy *should* be stabilized.
This is the Keynesian view

Employment Act of 1946

This legislation established a responsibility for the federal government to promote "maximum employment, production, and purchasing power."

Fiscal Policy

- Deliberate changes in:
  - Government spending
  - Taxes
- Designed to:
  - Achieve full employment
  - Control inflation
  - Encourage economic growth

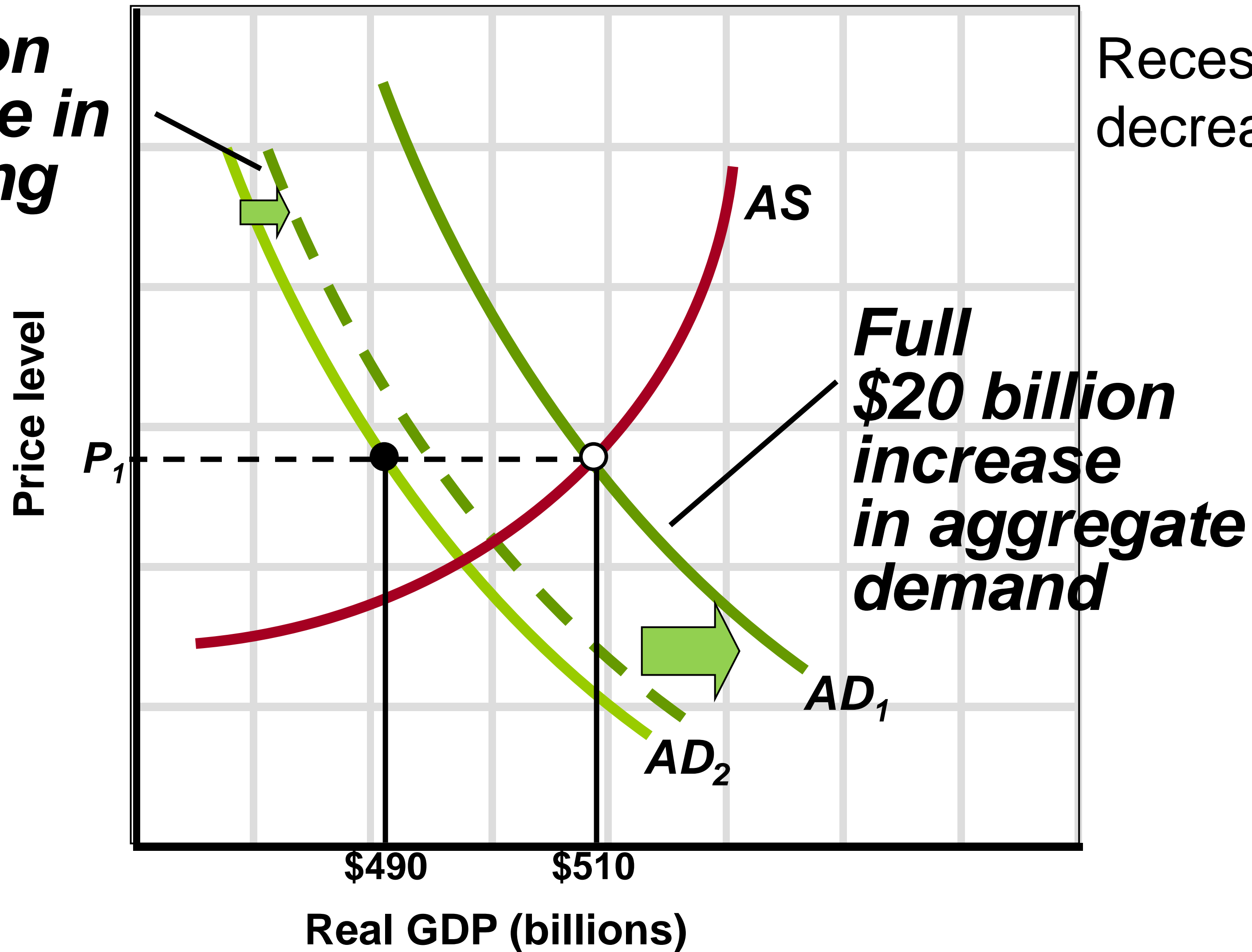
Expansionary Fiscal Policy

- Use during a recession
  - Increase government spending
  - Decrease taxes
  - Combination of both
  - Create a deficit

Policy Options: G or T?

- To expand the size of government
  - If recession, then increase government spending
  - If inflation, then increase taxes
- To reduce the size of government
  - If recession, then decrease taxes
  - If inflation, then decrease government spending

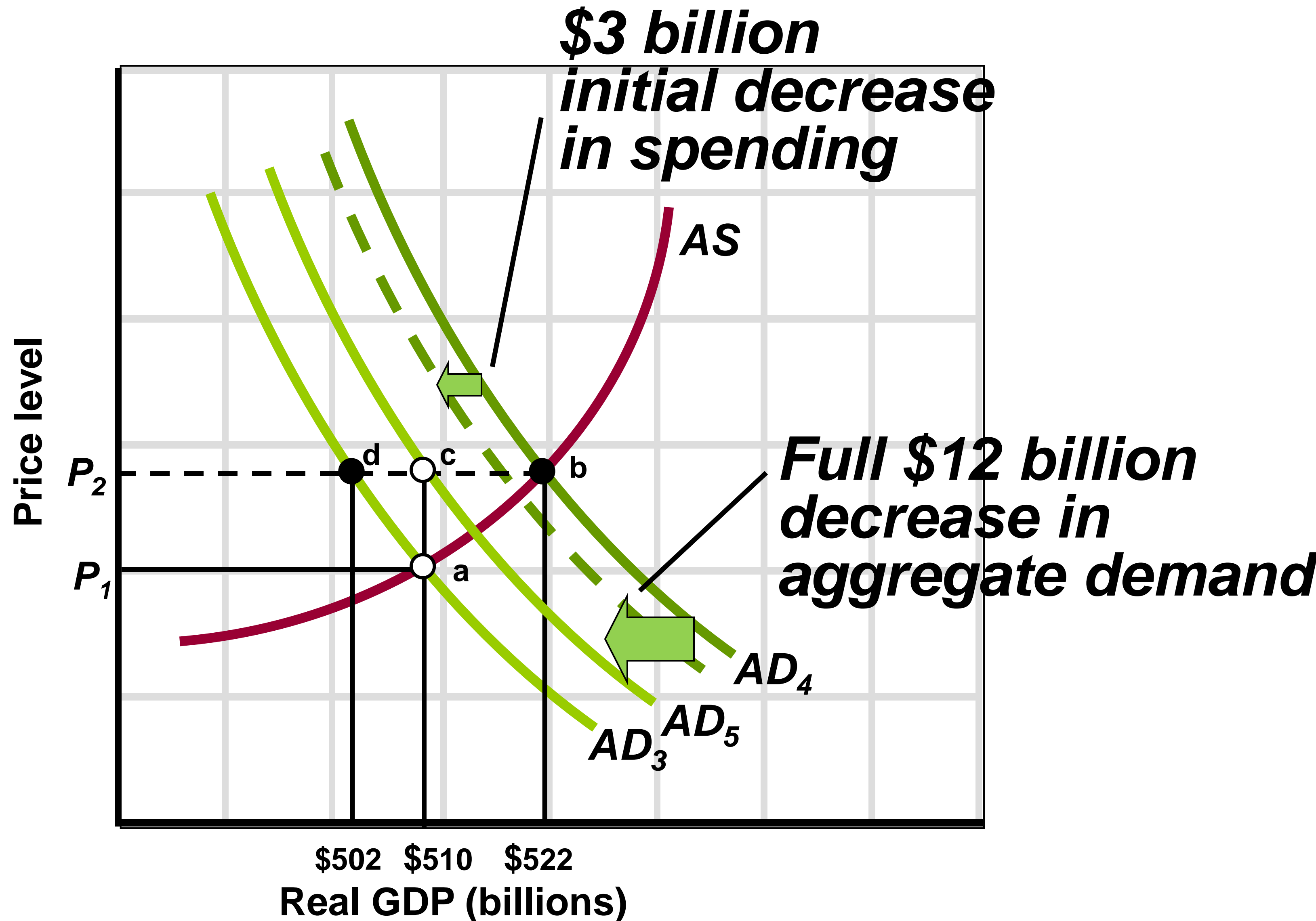
Expansionary Fiscal Policy



Contractionary Fiscal Policy

- Use during demand-pull inflation
  - Decrease government spending
  - Increase taxes
  - Combination of both
  - Create a surplus

Contractionary Fiscal Policy



Discretionary vs. non-discretionary spending

Discretionary fiscal policy is the deliberate manipulation of government purchases, taxation, and transfer payments to pursue macroeconomic goals such as full employment and price stability.

The Bush tax stimulus package of 2008 and the Obama stimulus package of 2009 are examples of discretionary fiscal policy

Automatic stabilizers

Non-discretionary or "built-in" features of government spending and taxation that reduce fluctuations in disposable income, and thus consumption, over the business cycle.

- Tax rates for various types of income are set by elected officials. Tax collections depend on the employment levels/incomes, profits, capital gains, retails sales . . .
- Elected officials establish eligibility requirements and support levels for needs-tested transfer payments — e.g., food stamps, and unemployment compensation. Actual government outlays for needs-tested transfer payments depend on (1) number of persons eligible; and (2) number of those eligible that actually file claims.

As the economy enters a recession, federal revenues tend to decline while at the same time transfer payments rise. Thus recession brings about an *automatic* decline of net taxes (NT)

Remember that disposable income equals GDP - Taxes:
$DI = Y - NT$

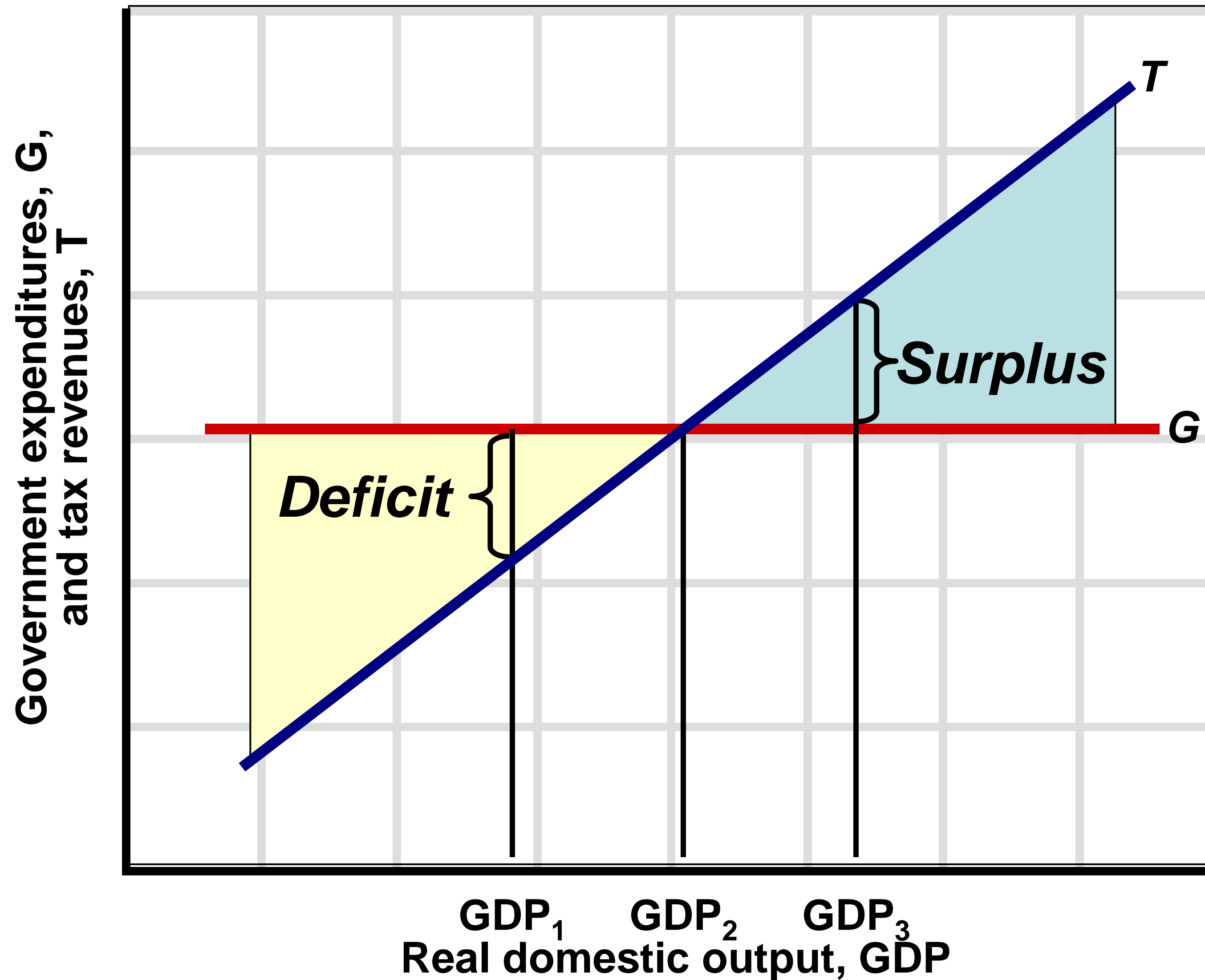
$$\downarrow Y \rightarrow \downarrow NT \rightarrow \uparrow DI$$

$$\uparrow Y \rightarrow \uparrow NT \rightarrow \downarrow DI$$

Built-In Stability

- Automatic stabilizers
  - Taxes vary directly with GDP
  - Transfers vary inversely with GDP
- Reduces severity of fluctuations
- Tax progressivity
  - Progressive tax system
    (avg tax rate rises with GDP)
  - Proportional tax system
    (avg tax rate remains same as GDP rises)
  - Regressive tax system
    (avg tax rate falls as GDP rises)

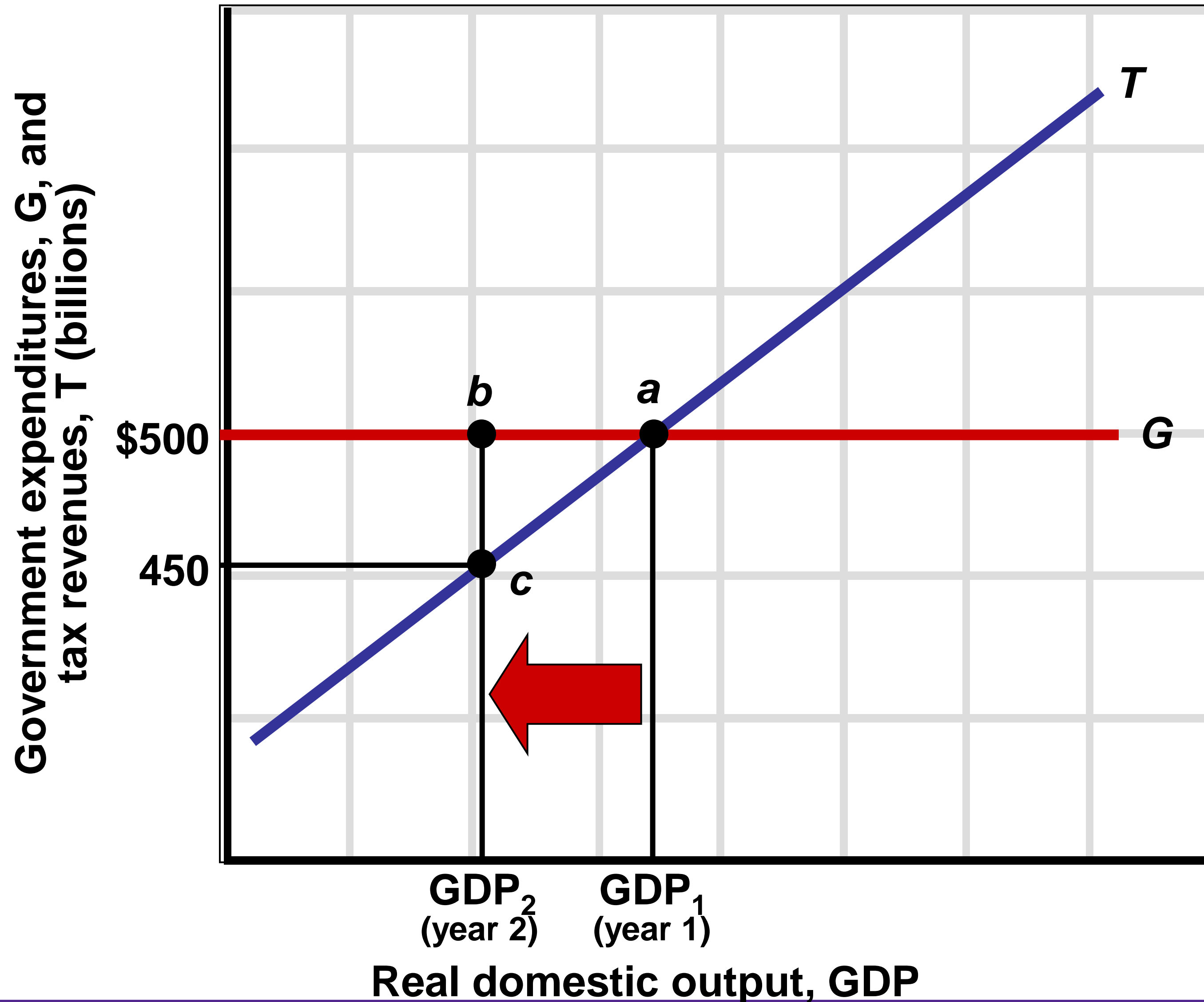
Built-In Stability



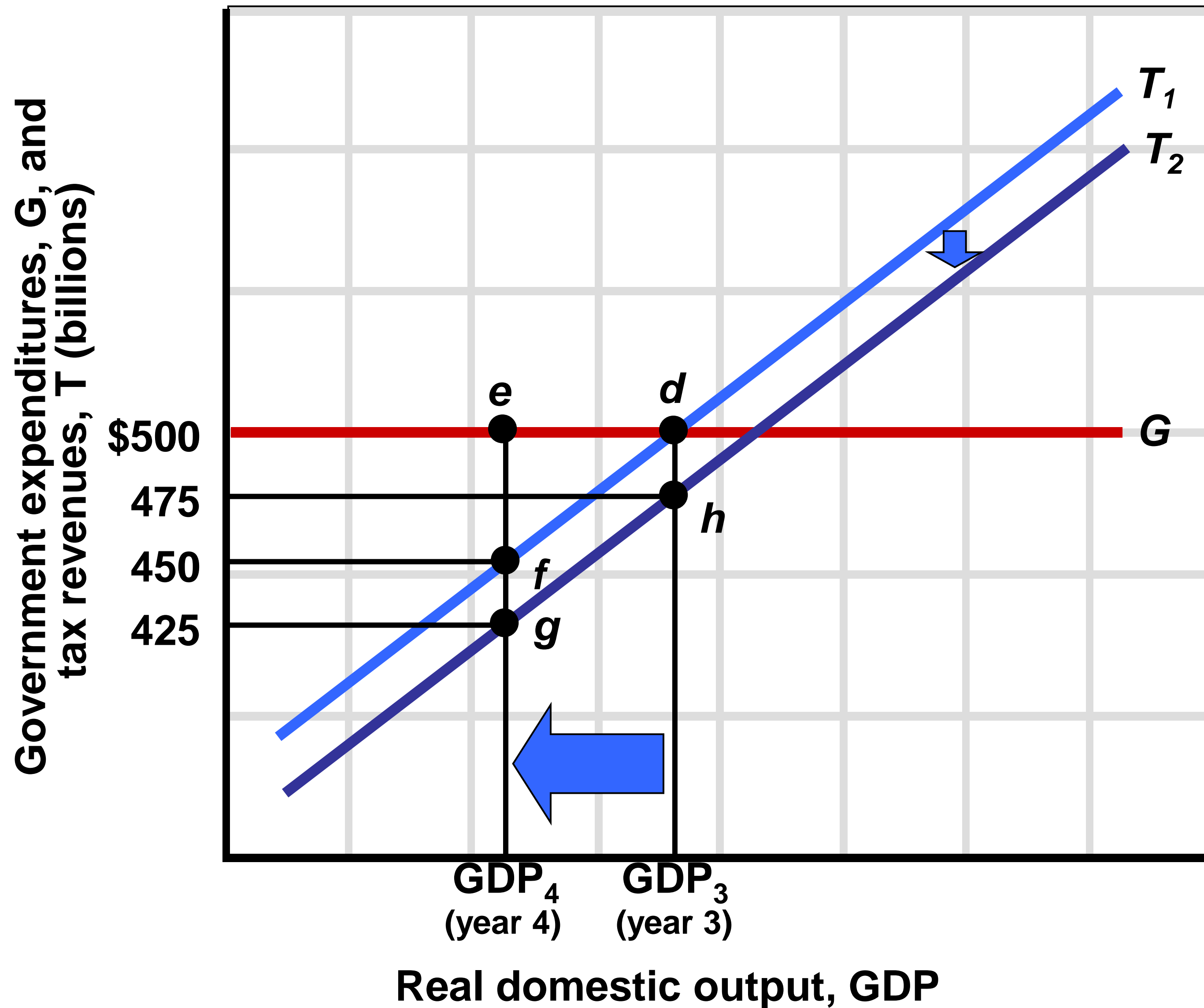
Evaluating Fiscal Policy

- Is the fiscal policy…
  - Expansionary?
  - Neutral?
  - Contractionary?
- Use the cyclically adjusted budget to evaluate

Cyclically Adjusted Budgets



Cyclically Adjusted Budgets



Recent U.S. Fiscal Policy

Federal Deficits (-) and Surpluses (+) as Percentages of GDP, 2000-2009

(1) Year	(2) Actual Deficit – or Surplus +	(3) Cyclically Adjusted Deficit – or Surplus +*
2000	+2.4	+1.1
2001	+1.3	+0.5
2002	-1.5	-1.3
2003	-3.4	-2.7
2004	-3.5	-3.2
2005	-2.6	-2.5
2006	-1.9	-2.0
2007	-1.2	-1.2
2008	-3.2	-2.8
2009	-9.9	-7.3

•As a percentage of potential GDP
Source: Congressional Budget Office, http://www.cbo.gov.

Principles of Taxation

- **Horizontal equity:** Tax code should be written so that those in the same economic circumstances pay the same amount in taxes.
- **Vertical equity:** Tax code should be written so that those in different economic circumstances should pay an unequal amount in taxes.
- **Benefits received principle:** Those who derive more benefits from government programs should pay more taxes.

Some Definitions

- **Taxable income:**

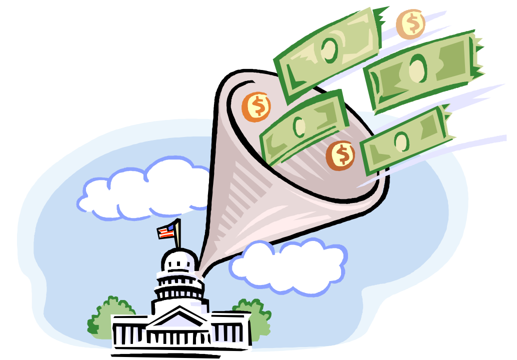
Gross income - income exempt from taxes.
Example: For single filers who use the 1040EZ:

Gross Income:	$35,000
Minus: Standard deduction	7,050
Equals: Taxable income	$27,950

- **Average tax rate (ATR):** Tax payments as a percent of taxable income.

- **Marginal tax rate** (**MTR**): The tax rate applied to the last dollar of taxable income.

Definitions, continued

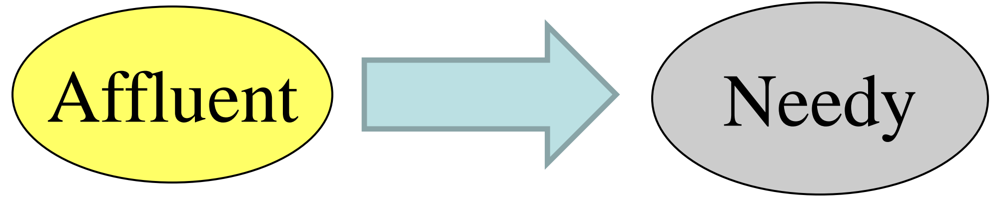


- Progressive tax: The proportion of taxable income taken in taxes increases as taxable income increases.

- Regressive tax: The proportion of taxable income taken in taxes decreases as taxable income increases.

- Proportional tax: The proportion of taxable income taken in taxes is constant as taxable income increases.

The tax code is a tool for income redistribution



By making the tax structure "progressive," governments can make the after-tax distribution of income more equitable (or even).

Federal personal income tax rates under the 1993 Tax Reform Act (married couple filing jointly)

Total Taxable Income	Marginal Tax Rate (%)
$0	0%
0-36,900	15
36,901-89,150	28
89,151-140,000	31
140,001-250,000	36
250,000 and up	39.6

Average and marginal tax rates under the tax reform act of 1993

(for a couple with two children)

Income	Tax	Ave. Tax Rate	Marginal Tax Rate
$10,000	$0	0%	0%
20,000	272	1.4	15
30,000	1,766	5.9	15
50,000	4,766	9.5	15
75,000	10,315	13.8	28
150,000	32,140	21.4	31
250,000	66,802	26.7	36
400,000	128,710	32.2	39.6

Tax Brackets for 2003 under the 2001 Tax Reform Act

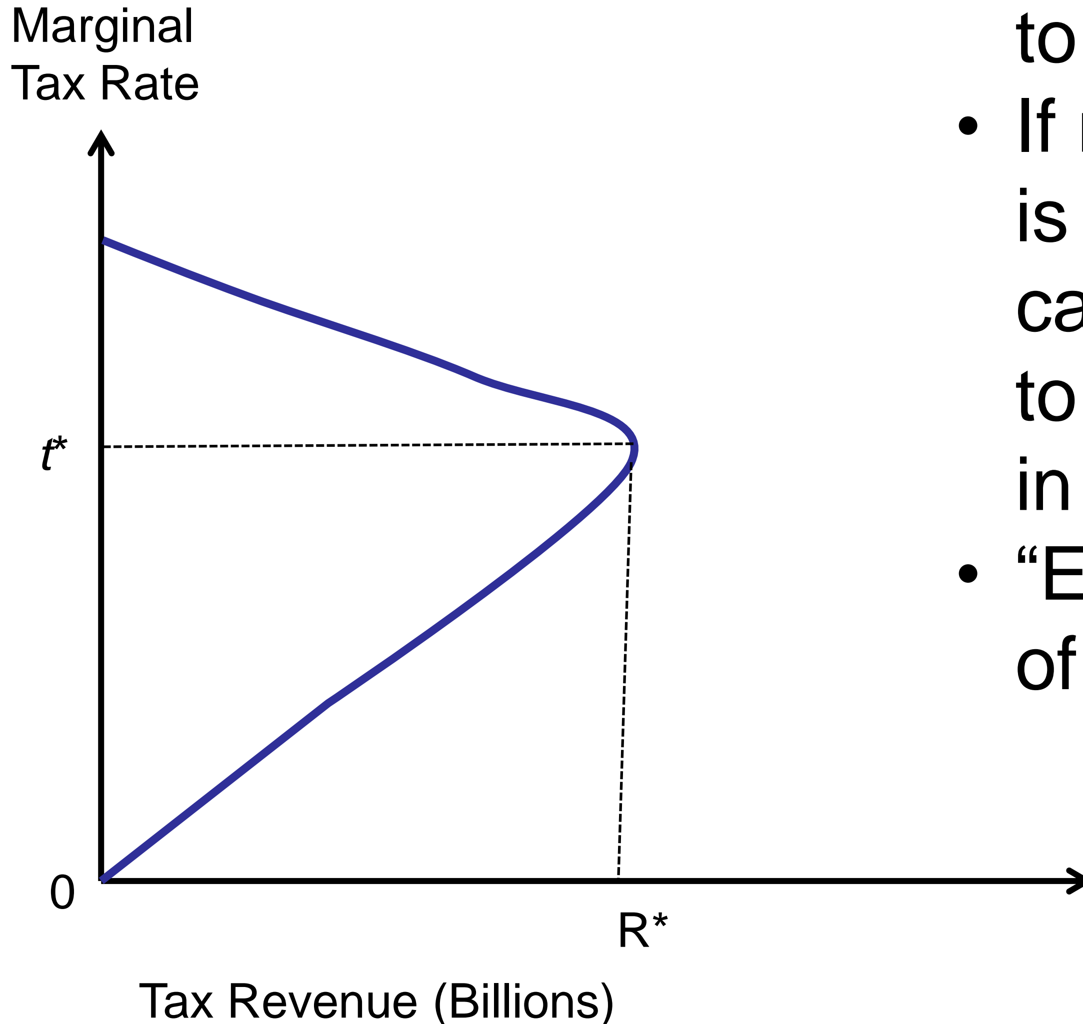
2003 Taxable Income	*Marginal Tax Rate*
$0-$12,000	10.0%
$12,000-$47,500	15.0
$47,500-$114,650	27.0
$114,650-$174,700	30.0
$174,700-$311,950	35.0
Over $311,950	38.6

Source : Wall Street Journal

Quick Facts about President Bush's Tax Bill

- The 39.6% tax rate reduced to 33%
- The 36% tax rate reduced to 33%
- The 31% rate reduced to 25%
- The 28% rate reduced to 25%
- Maximum rate on capital gains reduced from 28 to 15 percent.

Laffer Curve



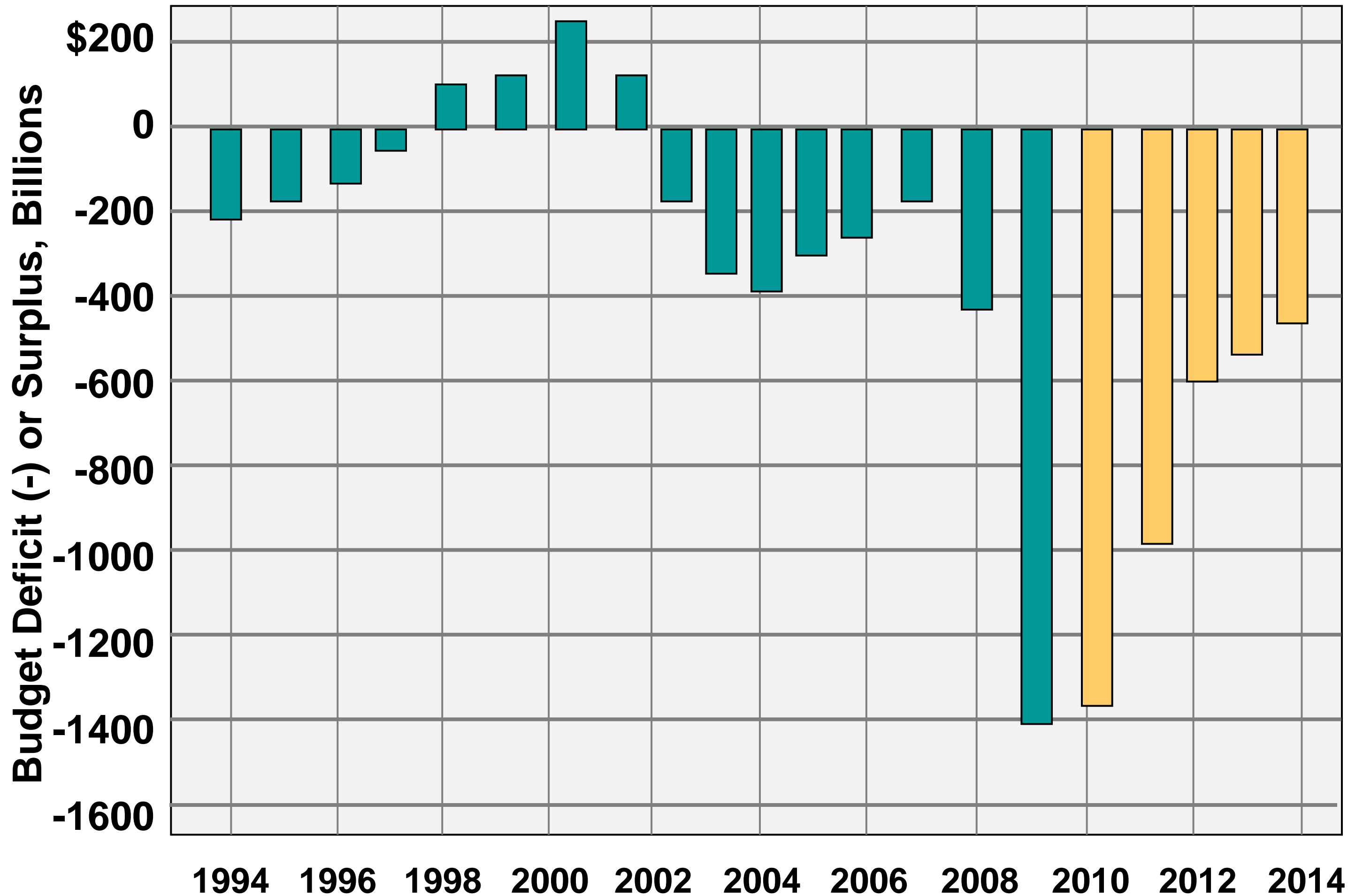
Supply-Sider view:

- High marginal tax rates create a disincentive to work and investment
- If marginal tax rate is above t*, reducing it can actually lead to an *increase* in tax revenues.
- “Effort-releasing” effect of lower marginal rates.

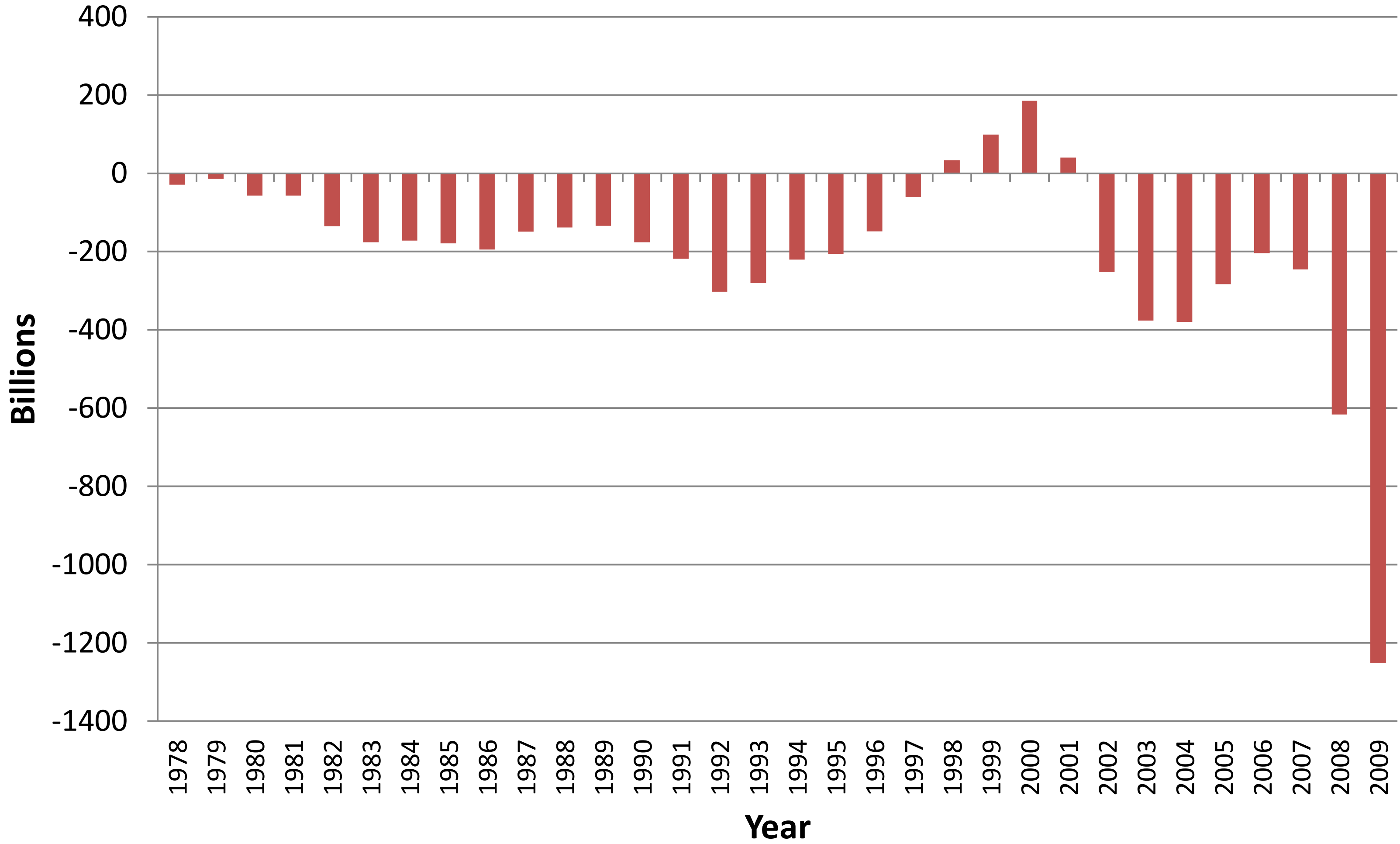
Fiscal Policy: The Great Recession

- Financial market problems began in 2007
- Credit market freeze
- Pessimism spread to the overall economy
- Recession officially began December 2007 and lasted 18 months

Budget Deficits and Projections



Source: Congressional Budget Office, http://www.cbo.gov.


Federal Surplus/Deficit
Billions
400
200
0
-200
-400
-600
-800
-1000
-1200
-1400
1978
1979
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1981
1982
1983
1984
1985
1986
1987
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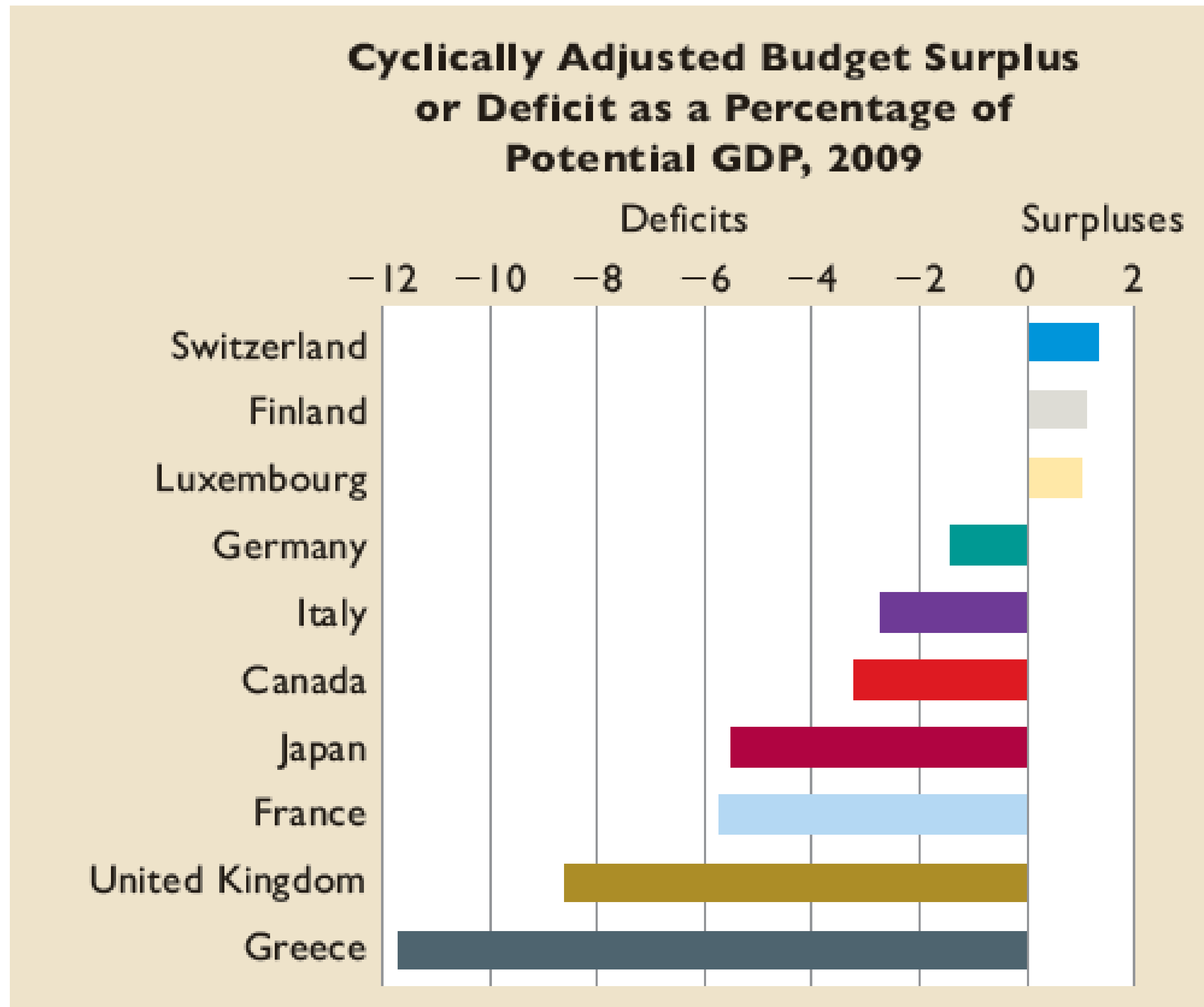
2007
2008
2009
Year

Global Perspective



Problems, Criticisms, & Complications

- Problems of Timing
  - Recognition lag
  - Administrative lag
  - Operational lag
- Political business cycles
- Future policy reversals
- Off-setting state and local finance
- Crowding-out effect

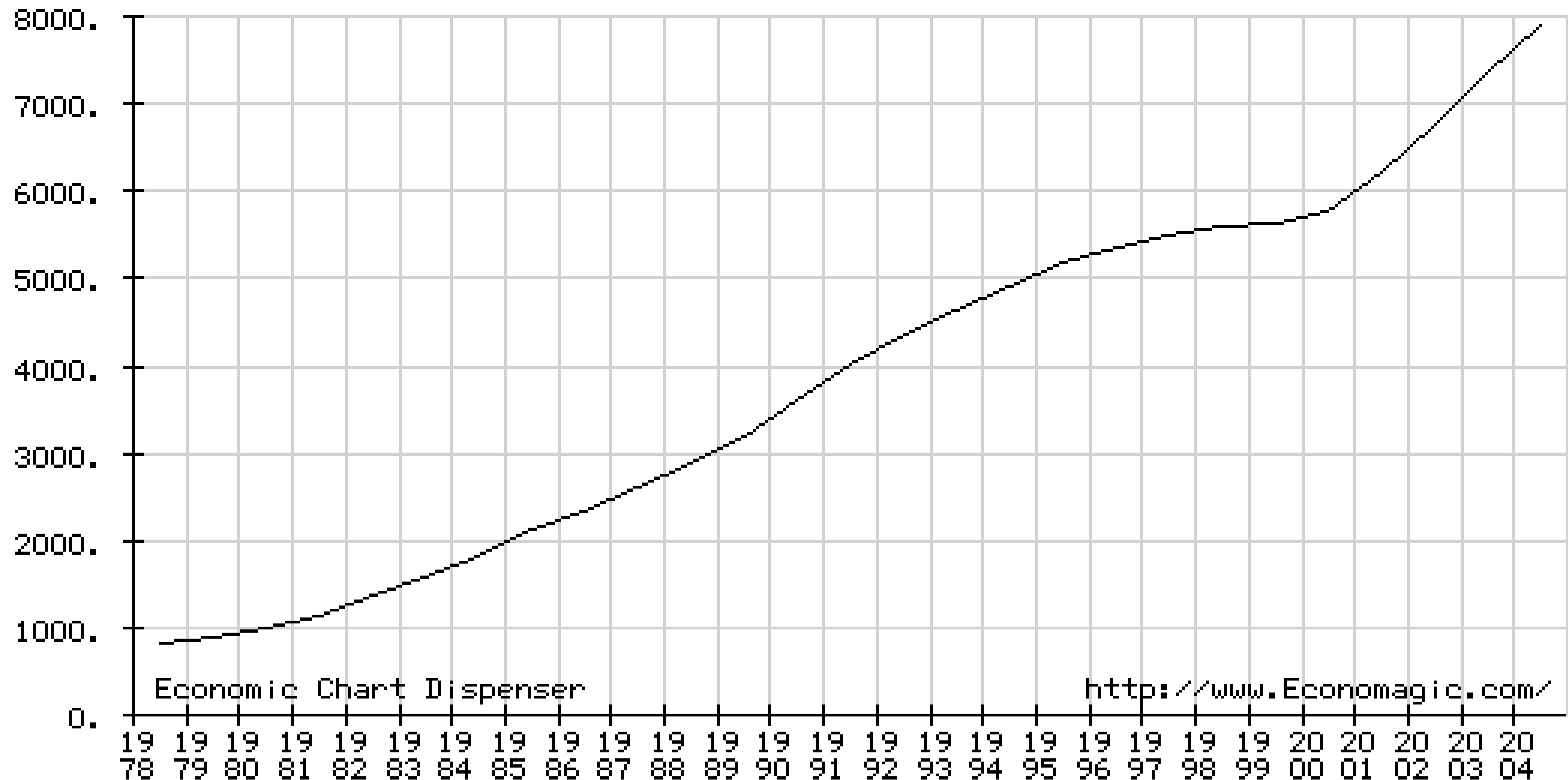
Current Thinking on Fiscal Policy

- Let the Federal Reserve handle short-term fluctuations
- Fiscal policy should be evaluated in terms of long-term effects
- Use tax cuts to enhance work effort, investment, and innovation
- Use government spending on public capital projects

The U.S. Public Debt

- $11.9 trillion in 2009
  - The accumulation of years of federal deficits and surpluses
- Owed to the holders of U.S. securities
  - Treasury bills
  - Treasury notes
  - Treasury bonds
  - U.S. savings bonds

For updated information, check the National Debt Clock

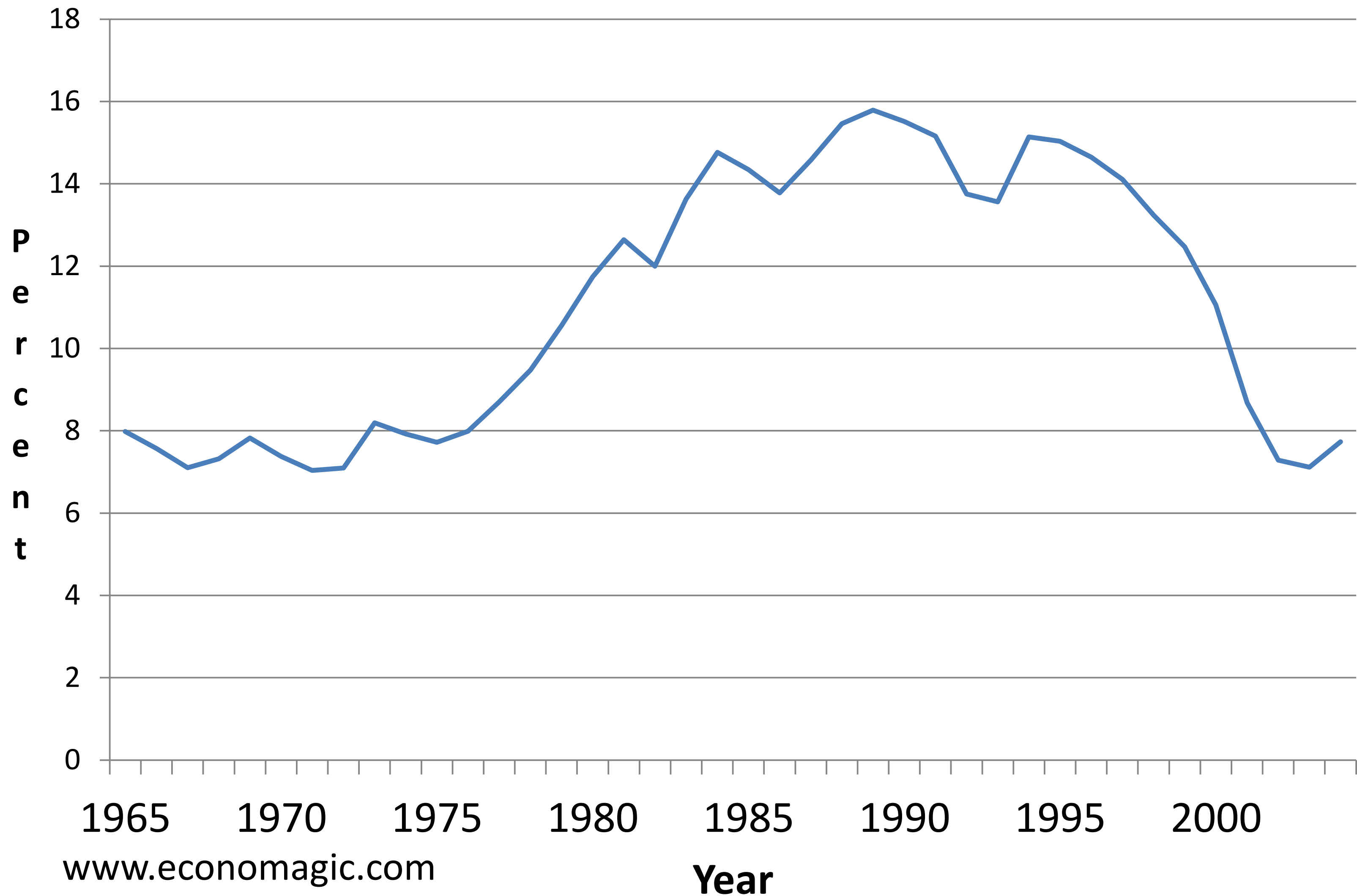


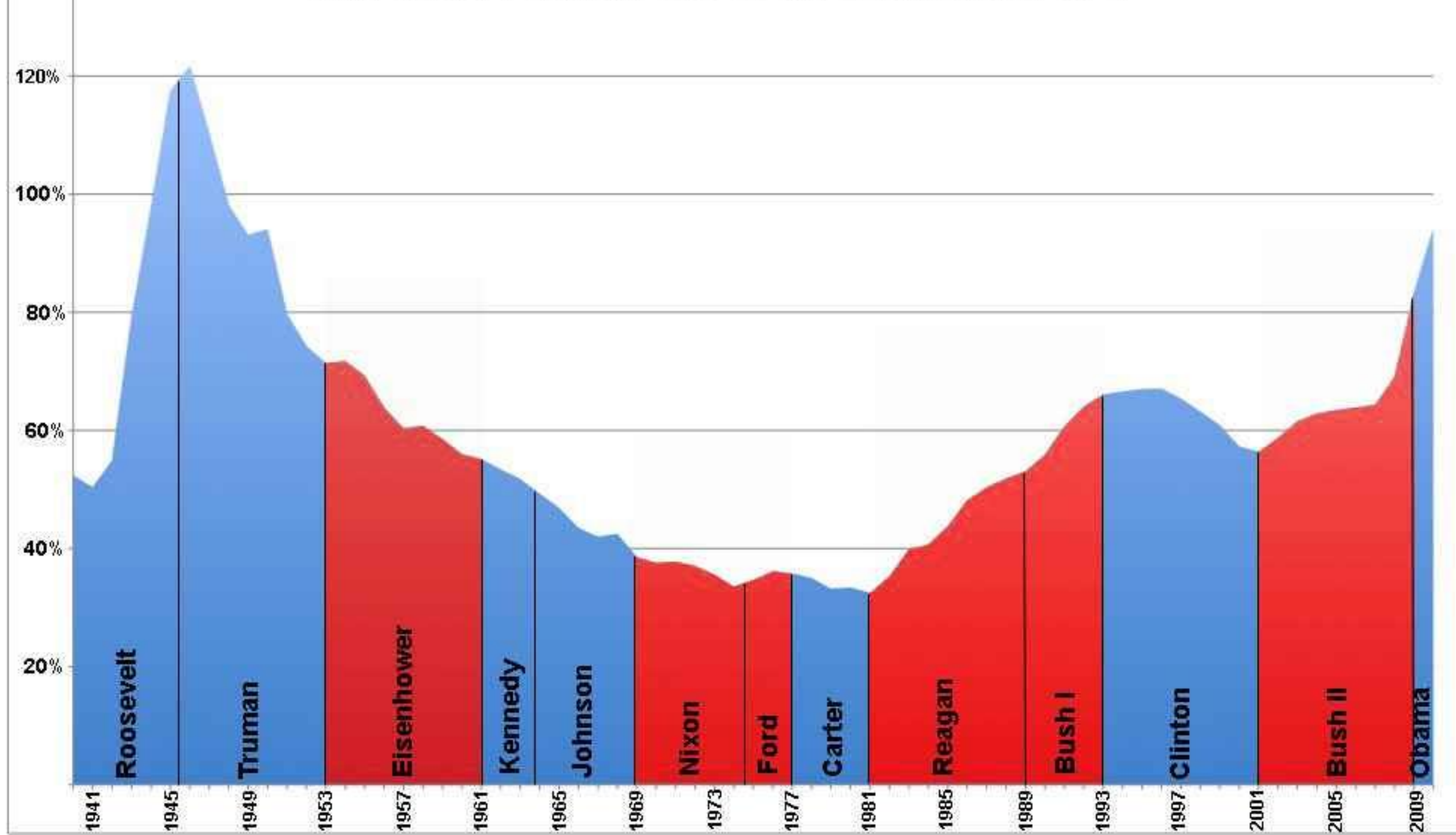
Is a large national debt a bad thing?

Arguments against a large national debt include:

- The "burden on future generations" argument.
- A large national debt means that a significant share of federal spending must be allocated for interest payments — leaving less for other priorities.
- A large national debt makes the U.S. too dependent on foreign financial inflows.
- Federal borrowing "crowds out" private sector borrowing units — i.e., firms and households.

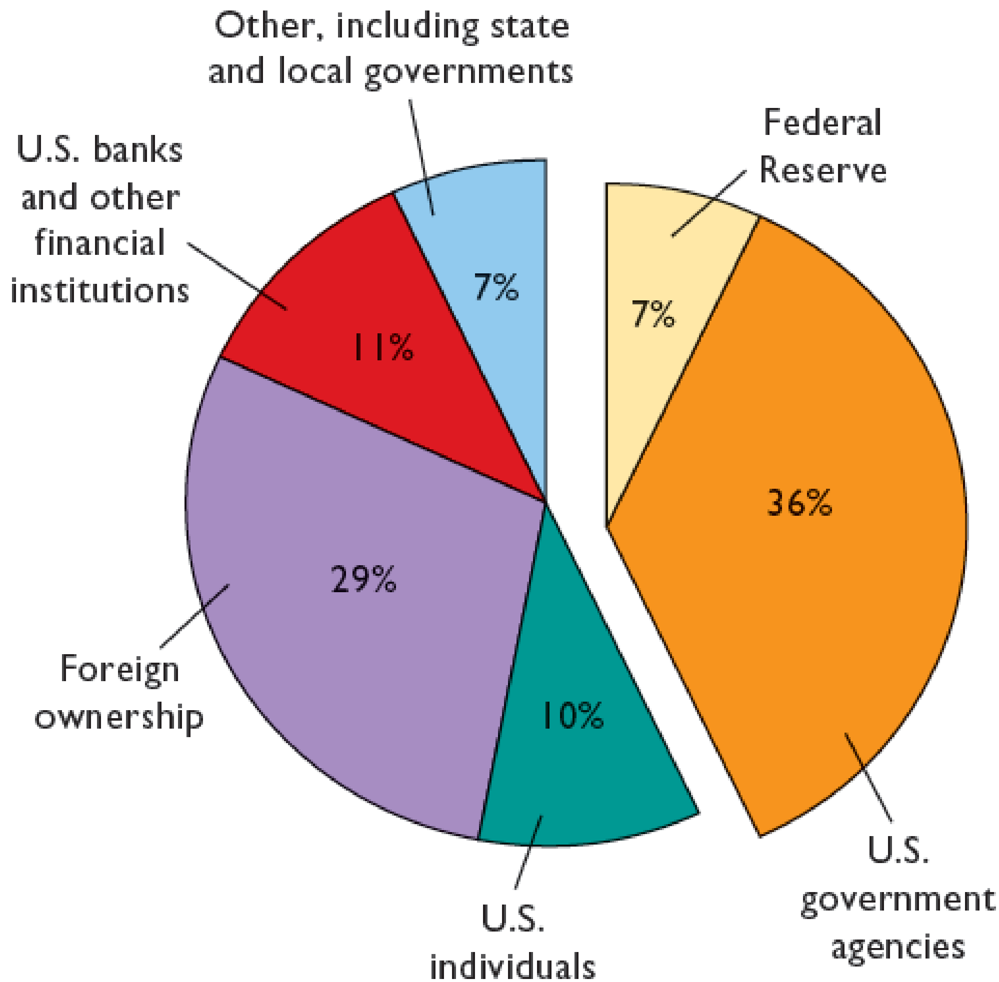
Interest payments as a Percent of Federal Expenditures (Annual)




U.S. Gross Federal Debt as a Percentage of GDP
120%
100%
80%
60%
40%
20%
Roosevelt
Truman
Eisenhower
Kennedy
Johnson
Nixon
Ford
Carter
Reagan
Bush I
Clinton
Bush II
Obama
1941
1945
1949
1953
1957
1961
1965
1969
1973
1977
1981
1985
1989
1993
1997
2001
2005
2009

The U.S. Public Debt

Debt held outside the federal government and the Federal Reserve: 57%



Debt held by the federal government and the Federal Reserve: 43%

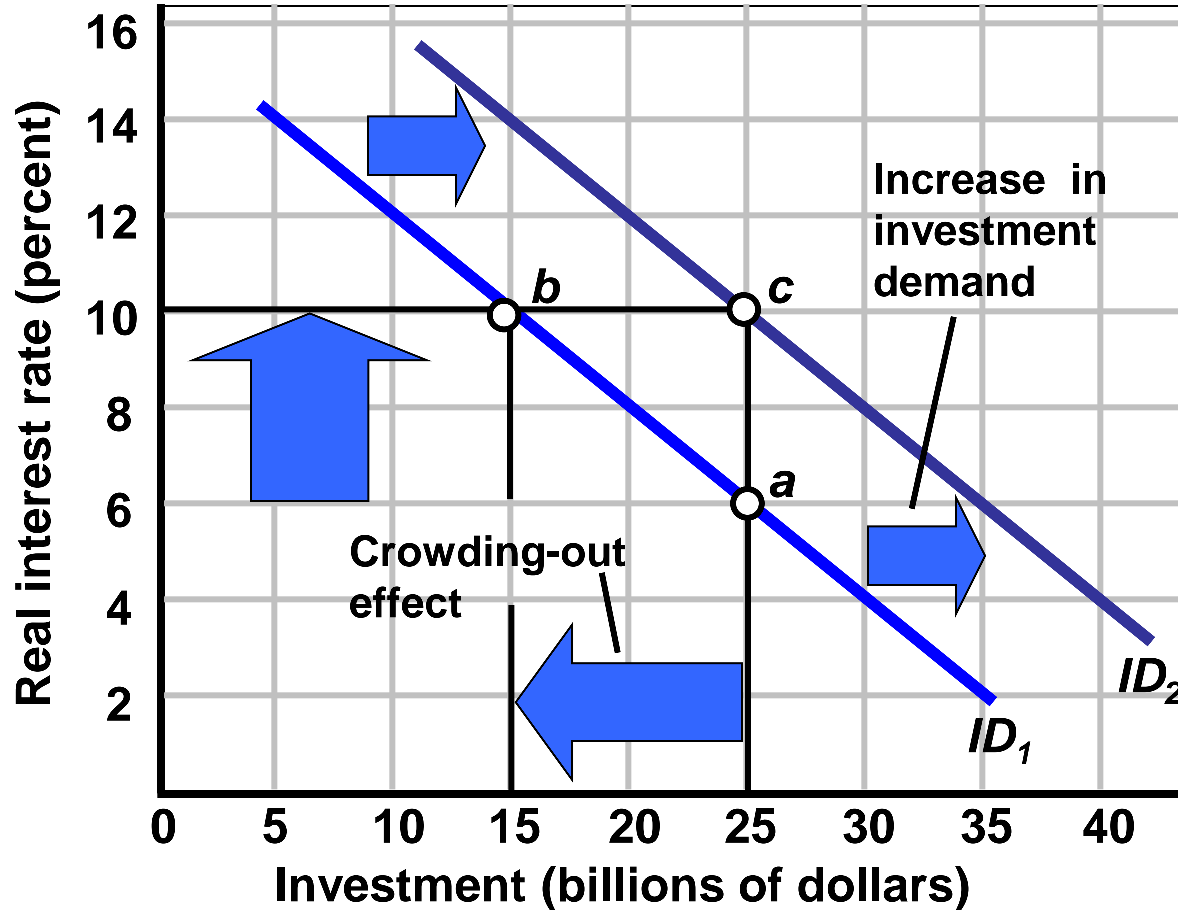
The U.S. Public Debt

- Interest charges on debt
  - Largest burden of the debt
  - 1.3% of GDP in 2009
- False Concerns
  - Bankruptcy
    - Refinancing
    - Taxation
  - Burdening future generations

Substantive Issues

- Incentives
- Foreign-owned public debt
- Crowding-out effect revisited
  - Future generations
  - Public investment

Crowding-Out Effect



Social Security, Medicare Shortfalls

- More Americans will be receiving benefits as they age
- Social security shortfalls
  - Income during retirement
  - Funds will be depleted by 2037
- Medicare shortfalls
  - Medical care during retirement
  - Funds will be depleted by 2017

Social Security, Medicare Shortfalls

- Possible options “to fix” include:
  - Increasing the retirement age
  - Increasing the portion of earnings subject to the social security tax
  - Disqualifying wealthy individuals
  - Redirecting low-skilled immigrants to higher-skilled, higher paying work
  - Defined contribution plans owned by individuals