Deficits, Surpluses and Debt Part I

Wasn't Texas supposed to be thriving even as the rest of America suffered? Didn't its governor declare, during his re-election campaign, that “we have billions in surplus”? But reality has now intruded and that reality has implications for the nation as a whole. For Texas is where the modern conservative theory of budgeting—the belief that you should never raise taxes under any circumstances, that you can always balance the budget by cutting wasteful spending—has been implemented most completely. If the theory can't make it there, it can't make it anywhere.

Paul Krugman

Budget Effects of Fiscal Policy

- Keynesian theory highlights the potential of fiscal policy to solve macro problems.
  - Fiscal Policy is the use of government taxes and spending to alter macroeconomic outcomes.

Budget Surpluses and Deficits

Deficit spending is the use of borrowed funds to finance government expenditures that exceed tax revenues.

Deficits, Surpluses and Debt

The gov't runs a
deficit
when it spends
MORE
than it collects
from taxes.

The gov't runs a
surplus
when it spends
LESS
than it collects
from taxes.

The National Debt =
Every Deficit *minus* Every Surplus
since the founding of the country.

Budget Surpluses and Deficits

A **budget deficit** is the amount by which government spending exceeds government revenue in a given time period.

$$\textit{a budget deficit} = \textit{government spending} - \textit{tax revenues} > 0$$

Budget Surpluses and Deficits

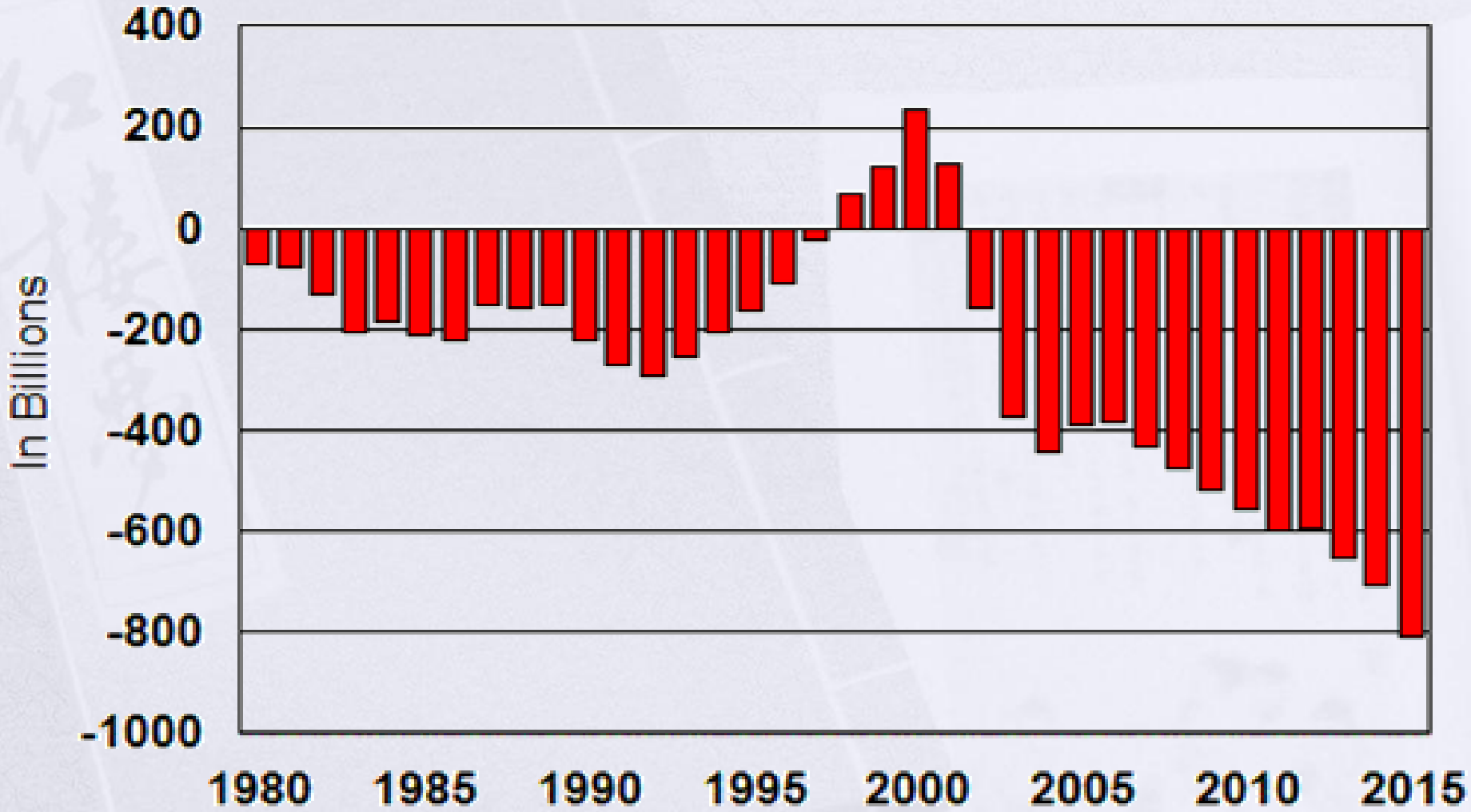
- If the government spends less than its tax revenues, a budget surplus is created.
  - A **budget surplus** is an excess of government revenues over government expenditures in a given time period.

Table: Budget Deficits and Surpluses

Budget Totals
(in billions of dollars)

Fiscal Year	2010	2011	2012	2013	2014
Receipts	$2,163	$2,304	$2,450	$2,775	$3,021
Outlays	-3,457	-3,603	-3,537	-3,455	-3,506
Surplus (Deficit)	(1,294)	(1,300)	(1,087)	(680)	(485)

Chart: A String of Deficits



Keynesian View

- Budget deficits and surpluses are a routine feature of counter-cyclical fiscal policy.
- The goal of macro policy is not to balance the budget but to balance the *economy* at full-employment.

Discretionary vs. Automatic Spending

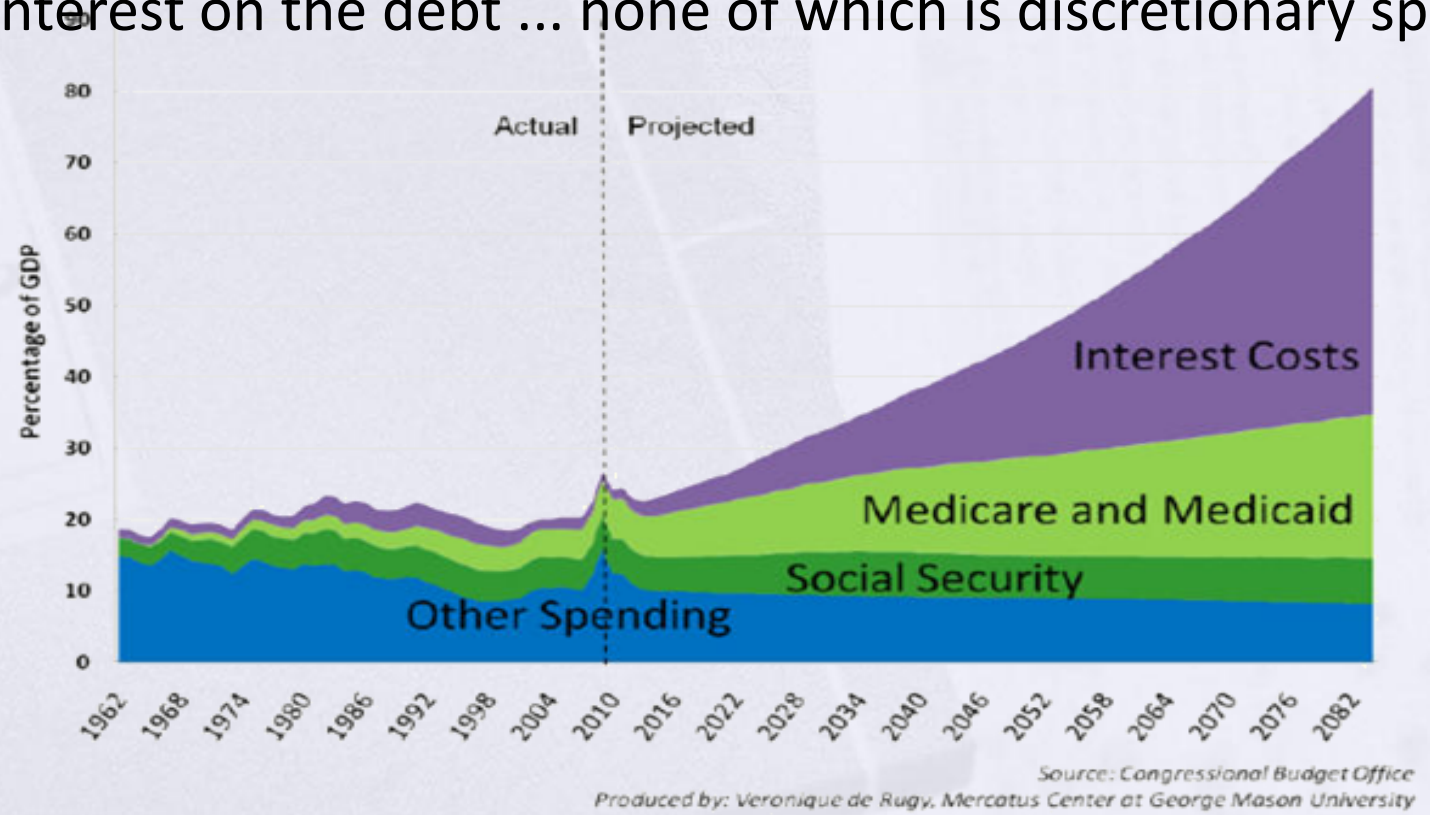
- At the beginning of each year, the President and Congress put together a budget blueprint for the next fiscal year.
  - The fiscal year (FY) is the twelve-month period used for accounting purposes. It begins on October 1 for the federal government.

Discretionary vs. Automatic Spending

- To a large extent, current revenues and expenditures are the result of decisions made in prior years.
- Discretionary fiscal spending are those elements of the federal budget not determined by past legislative or executive commitments.

Long-Term Federal Spending Predictions

This chart by Mercatus Center Senior Research Fellow Veronique de Rugy shows the long-term path of federal spending, isolating three of its largest components: Social Security, Medicare and Medicaid, and interest on the debt ... none of which is discretionary spending.



Discretionary vs. Automatic Spending

- Since most of the budget is uncontrollable, fiscal restraint or fiscal stimulus are less effective.
  - Fiscal restraint – tax hikes or spending cuts intended to reduce (shift) aggregate demand
  - Fiscal stimulus – tax cuts or spending hikes intended to increase (shift) aggregate demand

Automatic Transfers

- Most of the uncontrollable line items in the federal budget *change* with economic conditions.
- Outlays for unemployment compensation and welfare benefits increase when the economy goes into a recession.

Automatic Transfers

Income transfers are payments to individuals for which no current goods or services are exchanged, such as social security, welfare, unemployment benefits.

Automatic Transfers

Automatic stabilizers are federal expenditures or revenue items that automatically respond counter-cyclically to changes in national income.

Automatic Transfers

- Automatic stabilizers also exist on the revenue side of the budget.
  - Income taxes move up and down with the value of spending and output.
  - Being progressive, personal taxes siphon off increasing proportions of purchasing power as incomes rise.

Cyclical Deficits

- The size of the federal deficit or surplus is sensitive to the expansion and contraction of the macro economy.
- Budget deficits and surpluses may be due to economic conditions as much as policy decisions.

Cyclical Deficits

- The cyclical deficit is that portion of the budget deficit attributable to unemployment or inflation.
  - The cyclical deficit widens when GDP growth slows or inflation decreases.
  - The cyclical deficit shrinks when GDP growth accelerates or inflation increases.

Structural Deficits

To isolate the effects of fiscal policy, the deficit is broken down into cyclical and structural components.

total budget deficit = cyclical deficit + structural deficit

Structural Deficits

The structural deficit is federal revenues at full-employment minus expenditures at full employment under prevailing fiscal policy.

Structural Deficits

- Part of the deficit comes from cyclical changes in the economy.
- The rest is the result of discretionary fiscal policy.
- *Only changes in the structural deficit measure the thrust of fiscal policy*.

Structural Deficits

- Fiscal policy is categorized as follows:
  - Fiscal *stimulus* is measured by the increase in the structural deficit (or shrinkage in the structural surplus).
  - Fiscal *restraint* is gauged by the decrease in the structural deficit (or increase in the structural surplus).

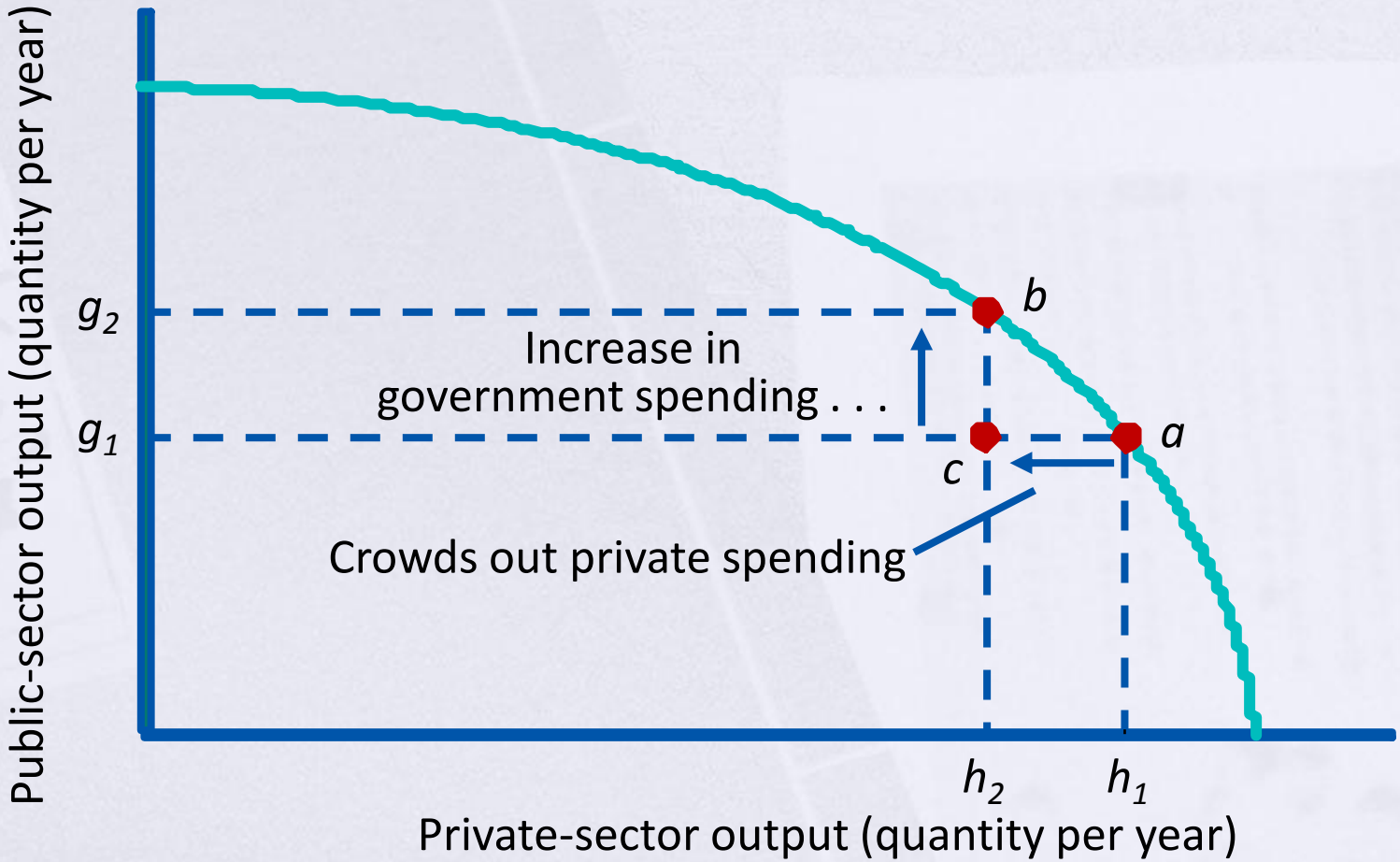
Economic Effects of Deficits

- There are a number of consequences of budget deficits:
  - crowding out
  - opportunity cost
  - interest-rate movements

Crowding Out

- Crowding-out is the reduction in private-sector borrowing (and spending) caused by increased government borrowing.
- Crowding out implies less private-sector output.

Chart: Crowding Out



Opportunity Cost

- Crowding out reminds us that there is an opportunity cost to government spending.
  - Opportunity cost is the most desired goods or services that are forgone in order to obtain something else.

Interest-Rate Movements

Rising interest rates are both a symptom and a cause of crowding out.

Economic Effects of Surpluses

The economic effects of budget surpluses are the mirror image of those for deficits.

Crowding In

- There are four potential uses for a budget surplus:
  - Cut taxes.
  - Increase income transfers.
  - Spend it on goods and services.
  - Pay off old debt (“save it”).

Crowding In

Crowding in is the increase in private sector borrowing (and spending) caused by decreased government borrowing.

Cyclical Sensitivity

- Crowding in depends on the state of the economy.
- In a recession, a decline in interest rates is not likely to stimulate much spending if consumer and investor confidence is low.

The Accumulation of Debt

- The United States has accumulated a large national debt.
- The national debt is the accumulated debt of the federal government.

Debt Creation

- When the Treasury borrows funds it issues treasury bonds.
  - Treasury bonds are promissory notes (IOUs) issued by the US Treasury.
- The national debt is a stock of IOUs created by annual deficit flows.

Early History, 1776-1900

By 1783, the United States had borrowed over $8 million from France and $250,000 from Spain to finance the Revolutionary War.

Early History 1776-1900

- During the period 1790-1812 the US often incurred debt but typically repaid it quickly.
- The War of 1812 caused a massive increase in national debt and, by 1816, the national debt was over $129 million.

Early History 1776-1900

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

Early History 1776-1900

- By the end of the Civil War (1861-65), the North owed over $2.6 billion, nearly half of its national income.
- After the South lost, Confederate currency and bonds had no value.

The Twentieth Century

- The Spanish-American War (1898) also increased the national debt.
- World War I raised the debt from 3% to 41% of the national income.

The Twentieth Century

National debt declined during the 1920's but rose again during the Great Depression.

World War II

- The greatest increase in national debt occurred during World War II.
  - Rather than raise taxes, the government rationed consumer goods.
  - US War Bond purchases raised the debt from 45% of GDP to over 125% of GDP by 1946.

CONTINUED IN DEFICITS, SURPLUSES AND DEBT PART II