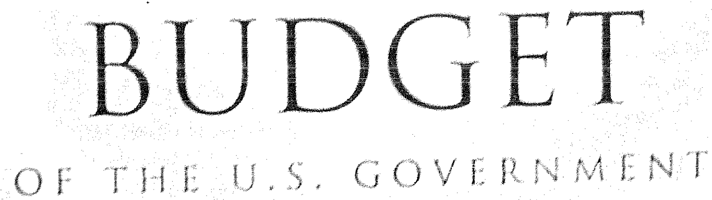
Chapter

15 Fiscal Policy

Essential Question, Chapter 15

How effective is fiscal policy as an economic tool?



FISCAL YEAR 2008

OFFICE OF MANAGEMENT AND BUDGET

- **Section 1:** Understanding Fiscal Policy
- **Section 2:** Fiscal Policy Options
- **Section 3:** Budget Deficits and the National Debt

Economics *on the go*

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SECTION 1 Understanding Fiscal Policy

OBJECTIVES

1. **Describe** how the federal budget is created.
2. **Analyze** the impact of expansionary and contractionary fiscal policy on the economy.
3. **Identify** the limits of fiscal policy.

ECONOMIC DICTIONARY

As you read the section, look for the definitions of these **Key Terms:**

- fiscal policy
- federal budget
- fiscal year
- appropriations bill
- expansionary policy
- contractionary policy

Guiding Question

What are the goals and limits of fiscal policy?

Copy this table and fill it in as you read.

Fiscal Policy	
Goals	**Limits**
• increase economic growth	• difficulty of changing spending levels
•	•
•	•
•	•

Economics and You Does your family have a household budget? Or have you ever tried to budget your own money? Either way, you know that you have to take a close look at how much money you have coming in and how much you have to spend. Your goal is to get those two figures in line. But it's not easy. Sometimes it requires giving something up. Sometimes—although you try to avoid it—it may even require borrowing money. No matter what, making the plan takes time. Somebody has to sit down with a calculator and a stack of bills and a checkbook and a calendar and figure it all out.

Now, imagine how much more effort it would take if your expenses totaled $3.1 *trillion* a year. Suppose everyone in the house had to agree on every single item in the budget, and you had to send it to somebody else for a final okay. Now you have an idea what the U.S. federal government must do before it can spend your tax money.

Principles in Action Unlike a family, the federal government is not just interested in making income meet expenses. As you will see, the government may also use its taxing and spending policies to speed up economic growth—or even to slow it down.

Personal Finance

For tips on creating your own budget, see your Personal Finance Handbook in the back of the book or visit **PearsonSchool.com/PHecon**

Setting Fiscal Policy: The Federal Budget

As you saw in Chapter 14, the federal government takes in and spends huge amounts of money. In fact, it spends an average of $7.7 billion every day. This tremendous flow of cash into and out of the economy has a large impact on aggregate supply and aggregate demand.

Visual Glossary online

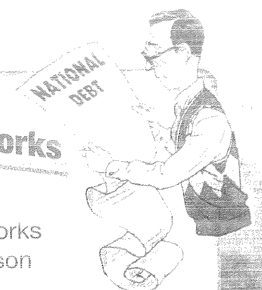
Go to the Visual Glossary Online for an interactive review of **fiscal policy.**

Action Graph online

Go to Action Graph Online for animated versions of key charts and graphs.

How the Economy Works online

Go to How the Economy Works Online for an interactive lesson on the **national debt.**



fiscal policy the use of government spending and revenue collection to influence the economy

federal budget a written document estimating the federal government's revenue and authorizing its spending for the coming year

fiscal year any 12-month period used for budgeting purposes

The government's taxing and spending decisions are shaped both by budgetary needs and by fiscal policy.

Fiscal policy is the use of government spending and revenue collection to influence the economy. Fiscal policy is a tool used to expand or slow economic growth, achieve full employment, and maintain price stability. The federal government makes key fiscal policy decisions—how much to spend and how much to tax—each year when it establishes the federal budget.

Federal Budget Basics

The **federal budget** is a written document estimating the federal government's revenue and authorizing its spending for the coming year. Like any organization's budget, it lists expected income and shows exactly how the money will be spent.

The federal government prepares a new budget for each fiscal year. A **fiscal year** is a 12-month period used for budgeting purposes. It is not necessarily the same as the January-to-December calendar year. The federal government uses a fiscal year that runs from October 1 through September 30.

The federal budget takes about 18 months to prepare. During this time, citizens, Congress, and the President debate the government's spending priorities. There are four basic steps in the federal budget process.

Agencies Write Spending Proposals

The federal budget must fund many offices and agencies in the federal government, and Congress cannot know all of their needs. So, before the budget is put together, each federal agency writes a detailed estimate of how much it expects to spend in the coming fiscal year.

These spending proposals are sent to a special unit of the executive branch, the Office of Management and Budget (OMB). The OMB is part of the Executive Office of the President. As its name suggests, the OMB is responsible for managing the federal government's budget. Its most important job is to prepare that budget.

The Executive Branch Creates a Budget

The OMB reviews the federal agencies' spending proposals. Representatives from the agencies explain their spending proposals to the OMB and try to persuade the OMB to give them as much money as they have requested. Usually, the OMB gives each agency less than it requests.

The OMB then works with the President's staff to combine all of the individual agency budgets into a single budget document. This document reveals the President's overall spending plan for the coming fiscal year. The President presents the budget to Congress in January or February.

Congress Debates and Compromises

The President's budget is only a starting point. The number of changes Congress makes to the President's budget depends on the relationship between the President and Congress. Congress carefully considers, debates, and modifies the President's proposed budget. For help, members of Congress rely on the assistance of the Congressional Budget

Figure 15.1 **Creating the Federal Budget**

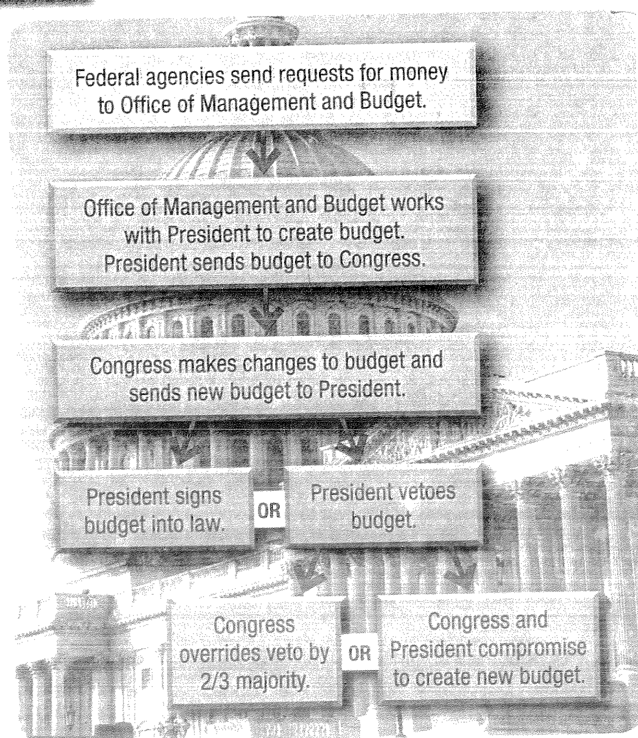


CHART SKILLS

Congress and the White House work together over the course of the year to put together a federal budget.

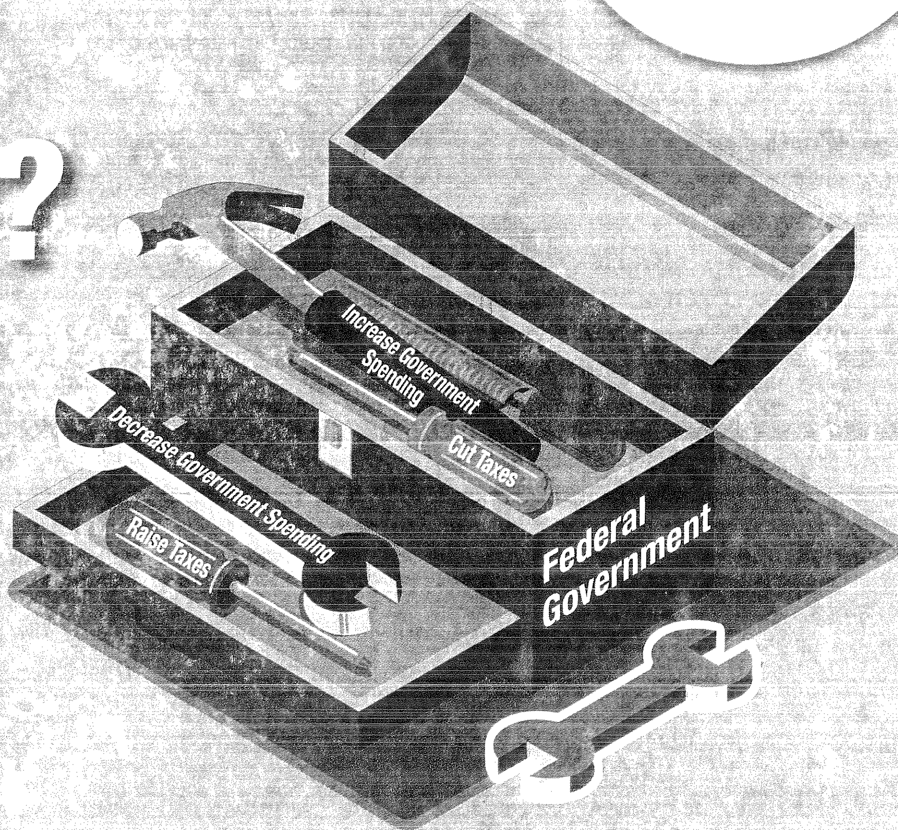
1. Who takes the first step in the budget process?
2. What happens to the proposed budget if it is vetoed by the President?

VISUAL GLOSSARY

What is Fiscal Policy?

◀ **fiscal policy** the use of government spending and revenue collection to influence the economy

Fiscal policy has been described as the economic toolbox of the federal government. ***Choose one of the tools shown in the toolbox here and explain how it might be used to influence the nation's economy.***



◀ This cartoon appeared at a time when the national economy was in a downturn. The man in the balloon is then-President George W. Bush, who believed that tax cuts would lead to economic growth by giving people more money to spend. ***How is Bush's action an example of using fiscal policy? Does the cartoonist believe the plan will work?***

Visual Glossary online

To expand your understanding of this and other key economic terms, visit PearsonSchool.com/PHecon

FUTURE WATCH

CAREER CENTER
BUSINESS AND FINANCE

Possible Careers
- Loan counselor
- Payroll clerk
- Securities & commodities sales agent
- Tax examiner
- Bookkeeper
- **Accountant and auditor**
- Account collector

Profile: Accountant and Auditor

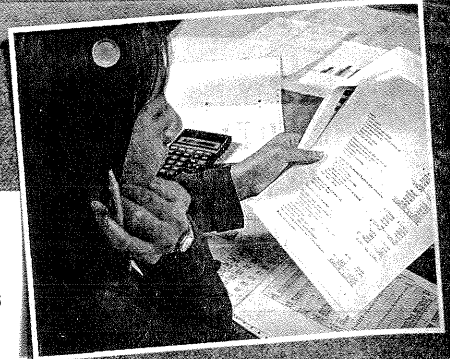
Duties:
- advise clients about tax advantages and disadvantages of certain business decisions
- prepare individual income tax returns
- audit clients' financial statements and inform investors and authorities that the statements have been correctly prepared and reported

Education:
- bachelor's degree in accounting or a related field. Some employers prefer applicants with a master's degree.

Skills:
- aptitude for mathematics and ability to analyze facts and figures quickly
- ability to work with people
- familiarity with basic accounting software
- high standards of integrity

Median Annual Salary:
- $57,060 (2007)

Future prospects:
- An increase in the number of businesses as well as changing financial laws will drive growth.



Career Link *Activity*
Choose another career in business and finance from the list of possible careers. Create a profile for that career similar to the one for Accountant and Auditor.

Office (CBO). Created in 1974, the CBO gives Congress independent economic data to help with its decisions.

Much of the work done by Congress is done in small committees. Working at the same time, committees in the House of Representatives and the Senate analyze the budget and hold hearings at which agency officials and others can speak out about the budget. The House Budget Committee and Senate Budget Committee combine their work to propose one initial budget resolution, which must be adopted by May 15, before the beginning of the fiscal year. This resolution is not intended to be final. It gives initial estimates for revenue and spending to guide the legislators as they continue working on the budget.

Then, in early September, the budget committees propose a second budget resolution that sets binding spending limits. Congress must pass this resolution by September 15, after which Congress cannot pass any new bills that would spend more money than the budget resolution allows.

appropriations bill a bill that authorizes a specific amount of spending by the government

Finally, the Appropriations Committee of each house submits bills to authorize specific spending, based on the decisions Congress has made. By this time, the new fiscal year is about to start and Congress faces pressure to get these **appropriations bills** adopted and submitted to the President quickly before the previous year's funding ends on September 30. If Congress cannot finish in time, it must pass short-term emergency spending legislation known as "stopgap funding" to keep the government running. If Congress and the President cannot even agree on temporary funding, the government "shuts down" and all but the most essential federal offices close.

In the White House

Once Congress approves the appropriations bills, they are sent to the President, who can sign the bills into law. If the President vetoes any of the bills, Congress has two options. It can vote to override the President's veto—a difficult task, because an override requires a 2/3 majority vote. More often, Congress works with the President to write an appropriations bill on which both sides can agree. Once that is completed, the President signs the new budget into law.

CHECKPOINT ***What two offices help the President and the Congress make budget decisions?***

Fiscal Policy and the Economy

Government officials who take part in the budget process debate how much should be spent on specific programs such as defense or education. They also consider how much should be spent in all. The total government spending can be raised or lowered to help increase or decrease the output of the economy. Similarly, taxes can be raised or lowered to help reduce or boost output.

Fiscal policy that tries to increase output is known as **expansionary policy.** Fiscal policy intended to decrease output is called **contractionary policy.** By carefully choosing to follow expansionary or contractionary fiscal policy, the federal government tries to make the economy run as smoothly as possible.

Expansionary Fiscal Policy

Governments use an expansionary fiscal policy to raise the level of output in the economy. That is, they use expansionary policy to encourage growth, either to try to prevent a recession or to move the economy out of a recession. Recall from Chapter 12 that a recession is the part of the business cycle that occurs when output declines for two quarters, or three-month periods, in a row. Expansionary fiscal policy involves either increasing government spending or cutting taxes, or both.

If the federal government increases its spending, or buys more goods and services, it triggers a chain of events that raises output and creates jobs. Government spending increases aggregate demand, which causes prices to rise, as shown in Figure 15.2. According to the law of supply, higher prices encourage suppliers of goods and services to produce more. To do this, firms will hire more workers. In short, an increase in demand will lead to lower unemployment and to an increase in output. The economy will expand.

Tax cuts work much like higher government spending to encourage economic expansion. If the federal government cuts taxes, individuals have more money to spend, and businesses keep more of their profits. Consumers have more money to spend on goods and services, and firms have more money to spend on land, labor, and capital. This spending will increase demand, prices, and output.

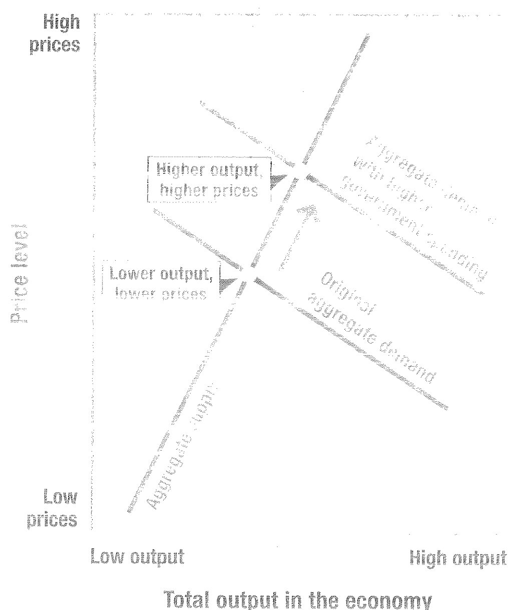
Contractionary Fiscal Policy

At some stages in the business cycle, the government may follow contractionary fiscal policy. Contractionary fiscal policy

expansionary policy a fiscal policy used to encourage economic growth, often through increased spending or tax cuts

contractionary policy a fiscal policy used to reduce economic growth, often through decreased spending or higher taxes

Figure 15.2 Effects of Expansionary Fiscal Policy



GRAPH SKILLS

Expansionary fiscal policy helps the economy by increasing aggregate demand and output.

1. How do increases in government spending affect aggregate supply?
2. How do increases in aggregate supply affect prices?

Action Graph online

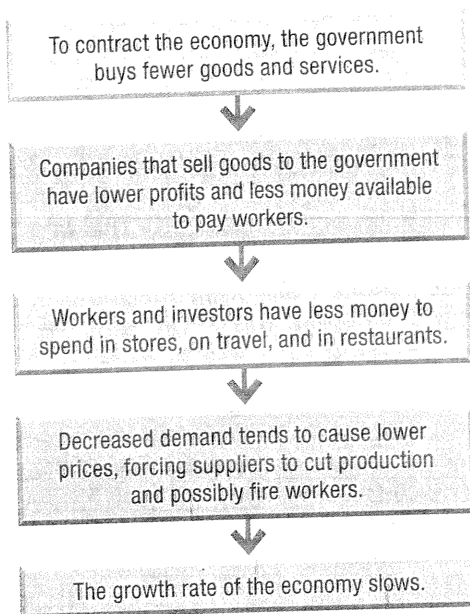
For an animated version of this graph, visit PearsonSchool.com/PHecon

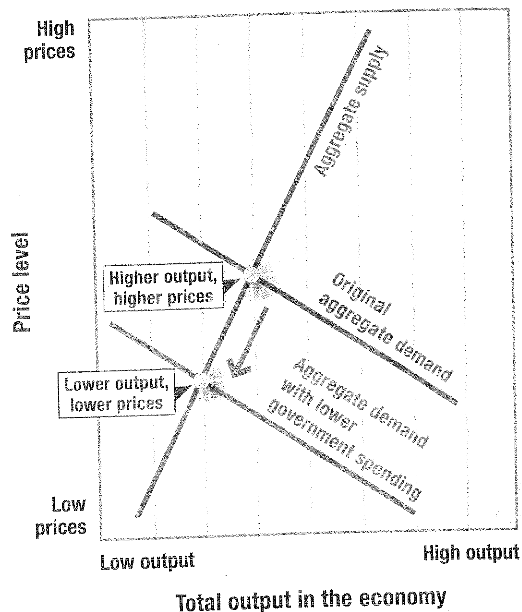
Figure 15.3 Effects of Contractionary Fiscal Policy

GRAPH SKILLS

By cutting spending, the government can slow economic growth.

1. Why would the government want to slow economic growth?
2. How does lower government spending affect equilibrium?





Action Graph online

For an animated version of this graph, visit **PearsonSchool.com/PHecon**

tries to decrease aggregate demand, and by decreasing demand, reduce the growth of economic output. If contractionary fiscal policy is strong enough, it may slow the growth of output to zero, or even lead to a fall in gross domestic product (GDP).

Why would the government institute policies intended to decrease economic output? The government sometimes tries to slow down the economy because fast-growing demand can exceed supply. When demand exceeds supply, producers must choose between raising output and raising prices. If producers cannot expand production enough, they will raise their prices, which can lead to high inflation. Left unchecked, inflation cuts into consumers' purchasing power and discourages economic growth and stability.

Simulation Activity

Expand or Contract?

You may be asked to take part in a role-playing game about the use of expansionary and contractionary fiscal policy.

Contractionary fiscal policy aimed at slowing the growth of total output generally involves two alternatives. The Federal government could decrease spending, or raise taxes, or both.

If the federal government spends less, or buys fewer goods and services, it triggers a chain of events that may lead to slower GDP growth. A decrease in government spending leads to a decrease in aggregate demand, because the government is buying less than before. Decreased demand tends to lower prices. According to the law of supply, lower prices encourage suppliers to cut their production and possibly lay off workers. Lower production lowers the growth rate of the economy and may even reduce GDP. This chain of events is the exact opposite of what happens when the government increases spending. The government uses the same tools to try to influence the economy in both cases, but in different ways, and with very different goals.

When the federal government raises taxes, individuals have less money to spend on goods and services or to save for the future. Firms keep less of their profits and decrease their spending on land, labor, and capital. As a result of these decreases in demand, prices tend to fall. Producers of goods and suppliers of services tend to cut production. This slows the growth of GDP.

CHECKPOINT *What are the two categories of contractionary fiscal policy and two categories of expansionary fiscal policy?*

Limits of Fiscal Policy

On paper, fiscal policy looks like a powerful tool that can keep the economy in perfect balance. In reality, fiscal policy can be clumsy and difficult to put into practice.

Difficulty of Changing Spending Levels

Increasing or decreasing the amount of federal spending is not an easy task. As you read in Chapter 14, many of the spending categories in the federal budget are entitlements that are fixed by law. More than half of the federal budget is set aside for programs such as Medicaid, Social Security, and veterans benefits before Congress even begins the budget process. The government cannot change spending for entitlements under current law. Also, it must continue to pay the interest on the national debt. As a result, significant changes in federal spending generally must come from the smaller, discretionary spending part of the federal budget. This gives the government less leeway for raising or lowering spending.

Predicting the Future

Governments use fiscal policy to prevent big changes in the level of GDP. Despite the statistics, however, it is difficult to know the current state of the economy. As you read in Chapter 12, no one can predict how quickly the business cycle will move from one stage to the next, nor can anyone identify exactly where in the cycle the economy is at any particular time.

Predicting future economic performance is even more difficult.

> "If economists forecast well, then the lag would not matter. They could tell Congress in advance what the appropriate fiscal policy is. But economists do not forecast well. Most economists, for example, badly under predicted both the rise in unemployment in 1981 and the strength of the recovery that began in late 1982. Absent accurate forecasts, attempts to use discretionary fiscal policy to counteract business cycle fluctuations are as likely to do harm as good."
>
> —David N. Weil, professor of economics at Brown University

Delayed Results

Although changes in fiscal policy affect the economy, changes take time. Once government officials decide when and how to change fiscal policy, they have to put these changes into effect within the federal budget, which itself takes more than a year to develop. Finally, they have to wait for the change in spending or taxing to affect the economy.

By the time the policy takes effect, the economy might be moving in the opposite direction. The government could propose massive public spending on highways in the middle of a recession, only to have the economy recover before construction begins. In cases like this, fiscal policy would only strengthen the new trend, instead of correcting the original problem. If the government continued to spend money freely on highways in the middle of a recovery, it could lead to high inflation and a labor shortage.

Political Pressures

The President and members of Congress, who develop the federal budget and the federal government's fiscal policy, are elected officials. If they wish to be reelected, they must make decisions that please the people who elect them, not necessarily decisions that are good for the overall economy.

For example, government officials have an incentive to practice expansionary fiscal policy by boosting government spending and lowering taxes. These actions are usually popular with voters. Government spending benefits the firms that receive government contracts and the individuals who receive direct payments from the government. Lower taxes leave more disposable income in people's pockets.

On the other hand, contractionary fiscal policy, which decreases government spending or raises taxes, is often unpopular. Firms and individuals who expect income from the government are not happy when the income is reduced or cut off. No one likes to pay higher taxes, unless the tax revenue is spent on a specific, highly valued good or service.

Coordinating Fiscal Policy

For fiscal policy to be effective, various branches and levels of government must plan and work together. This is very difficult to do. For example, if the federal government is pursuing contractionary policy, state and local governments should, ideally, pursue a similar fiscal policy. Yet, state and local

governments may be pursuing different fiscal policies than the federal government.

For example, after the federal government cut income taxes in 2001 and 2003, many state and local governments raised income and property taxes to close budget deficits and avoid deep spending cuts. The federal government was willing to cut taxes and run a deficit in poor economic times, but most state and local governments were legally forbidden to do so.

Businesspeople, politicians, and economists often disagree about how well the economy is performing and what the goals of fiscal policy should be. Also, different regions of the economy can experience very different conditions. California and Hawaii may have high unemployment while Nebraska and Massachusetts face rising prices and a labor shortage.

In addition, in order for the federal government's fiscal policy to be effective, it must also be coordinated with the monetary policy of the Federal Reserve. You'll read more about monetary policy in the next chapter.

Even when all of these obstacles are overcome, governments must recognize that the short-term effects of fiscal policy will differ from the long-term effects. For example, a tax cut or increased government spending will give a temporary boost to economic production and to employment. However, as the economy returns to full employment, high levels of government spending combined with increased market spending will lead to increased inflation and higher interest rates.

Similarly, an increase in taxes or fees or a decrease in government spending may "cool" the economy and lead to a recession. However, in the long run, reduced government spending will allow other types of spending to increase without risking higher inflation. If there is more private investment spending, this could lead to higher economic growth in the long run. In this way, slow growth or even recession in the short term can lead to prosperity and more jobs in the future.

CHECKPOINT ***Why is it so difficult for government to change spending levels?***

Essential Questions Journal To continue to build a response to the Essential Question, go to your **Essential Questions Journal.**

SECTION 1 ASSESSMENT

Guiding Question

1. Use your completed table to answer this question: What are the goals and limits of fiscal policy?
2. **Extension** Like the government, individuals benefit from budgets. Plan your coming month's expenditures. Start with your current income. List your necessary expenditures. What, if anything, is left for discretionary spending?

Key Terms and Main Ideas

3. Explain **fiscal policy** and how it relates to the **federal budget.**
4. When does the federal government's **fiscal year** begin?
5. What is an **appropriations bill**?
6. What is **expansionary policy**?

Critical Thinking

7. **Analyze (a)** What are the four basic steps in the federal budget process? **(b)** What is the advantage of having both the President and Congress involved in the budget process?
8. **Identify Effects (a)** Identify entitlement programs. **(b)** How do they affect creation of the federal budget?
9. **Solve Problems** Which fiscal policy strategy do you think policymakers would use in each of these scenarios and why? **(a)** Inflation is rising, and real GDP is up by 4 percent. **(b)** GDP is down, and the unemployment rate has increased to 10 percent.

Math Skills

10. **Creating a Graph** Use the information from the chart below to create a line graph showing consumer confidence in January of each of the years shown. **(a)** In which two-year period did consumer confidence rise the most? **(b)** What was the percent of decline in consumer confidence over the period from 2000 through 2003?
Visit PearsonSchool.com/PHecon for additional math help.

Consumer Confidence Index
Annual Average (1985 = 100)

2000	2001	2002	2003	2004	2005	2006	2007	2008
144.7	115.7	97.8	78.8	97.7	105.1	106.8	110.2	87.9

SOURCE: www.pollingreport.com

SECTION 2 Fiscal Policy Options

OBJECTIVES

1. **Compare and contrast** classical economics and Keynesian economics.
2. **Explain** the basic principles of supply-side economics.
3. **Describe** the role that fiscal policy has played in American history.

ECONOMIC DICTIONARY

As you read the section, look for the definitions of these **Key Terms:**

- classical economics
- productive capacity
- demand-side economics
- Keynesian economics
- multiplier effect
- automatic stabilizer
- supply-side economics

Guiding Question

What economic ideas have shaped fiscal policy?

Copy this chart and fill it in as you read.

Fiscal Policy Options		
Classical economics	Keynesian (demand-side) economics	Supply-side economics
• free markets regulate themselves • fiscal policy limited •	• • •	• • •

Economics and You Look at the picture of the two children on this page. They are poor and hungry, and the family breadwinner is out of work. Even if you have never been in a situation like this, it's probably not hard to imagine how these children feel. And the time is the Great Depression, so there are millions of families facing the same problem.

"WHY CAN'T YOU GIVE MY DAD A JOB?" But who is the boy asking? A factory owner? The local supermarket? Or is he asking the government itself? Would *you* expect the government to spend large amounts of money to give your father or mother—as well as thousands of other people—a job?

Principles in Action Nowadays, many of us are used to the idea that the government might use its spending power to stimulate the economy. But at the time of the Depression, this was a radical new idea. And today, there are plenty of people who think that there are better ways the government can stimulate the economy than by spending. In this section, you will look at two very different fiscal policy options that the government can pursue. In the Economics & You feature, you will see how tax policy can affect your income and the services you use.

classical economics a school of thought based on the idea that free markets regulate themselves

Classical Economics

Throughout this book, you have read about the workings of a free-market economy. In a free market, people act in their own self interest, causing prices to rise or fall so that supply and demand will always return to equilibrium. This idea that free markets regulate themselves is central to the school of thought known as **classical economics**. Adam Smith, David Ricardo, and Thomas Malthus all contributed basic ideas to this school. For well over a century, classical economics dominated economic theory and government policies. Some aspects of classical economic thought are still widely followed today.

The Great Depression, which began in 1929, challenged the classical theory. Prices fell over several years, so demand should have increased enough to stimulate production as consumers took advantage of low prices. Instead, demand also fell as people lost their jobs and bank failures

▲ These children are taking part in a protest march of the unemployed during the Great Depression.

productive capacity the maximum output that an economy can sustain over a period of time without increasing inflation

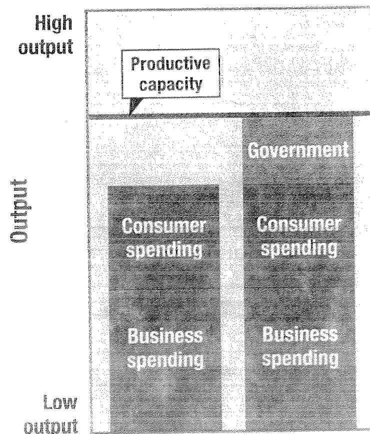
demand-side economics a school of thought based on the idea that demand for goods drives the economy

wiped out their savings. According to classical economics, the market should have reached equilibrium, with full employment. But it didn't, and millions suffered from unemployment and other hardships. Farmers lost their farms because corn was selling for seven cents a bushel, beef for two and a half cents a pound, and apples for less than a penny. Still, many people were too poor to buy enough food for their families.

The Great Depression highlighted a problem with classical economics: it did not address how long it would take for the market to return to equilibrium. Classical economists recognized it could take some time, and looked to the long run for equilibrium to reestablish itself. One economist, who was not satisfied with the idea of simply waiting for the economy to recover on its own, commented, "In the long run we are all dead." That economist was John Maynard Keynes (pronounced CANES).

CHECKPOINT ***What event challenged the dominance of the classical economics school of thought?***

Figure 15.4 Keynesian Economics



In a recession or depression, businesses and consumers do not demand as much as the economy can produce. Keynes argued that government spending can bring the economy up to its productive capacity.

GRAPH SKILLS

John Maynard Keynes added government spending to the classical model of demand.

1. What role did Keynes envision for government in the economy?
2. How might this government intervention affect the business cycle?

Keynesian Economics

British economist John Maynard Keynes developed a new theory of economics to explain the Depression. Keynes presented his ideas in 1936 in a book called *The General Theory of Employment, Interest, and Money*. He wanted to develop a comprehensive explanation of macroeconomic forces. Such an explanation, he argued, should tell economists and politicians how to get out of economic crises like the Great Depression. In sharp contrast to classical economics, Keynes wanted to give government a tool it could use immediately to boost the economy in the short run.

A Broader View

Classical economists had always looked at how the equilibrium of supply and demand applied to *individual products*. In contrast, Keynes focused on the workings of the economy *as a whole*.

Keynes looked at the productive capacity of the entire economy. **Productive capacity,** often called full-employment output, is the maximum output that an economy can sustain over a period of time without increasing inflation. Keynes attempted to answer the difficult question posed by the Great Depression: Why does actual production in an economy sometimes fall far short of its productive capacity?

Keynes argued that the Depression was continuing because neither consumers nor businesses had an incentive to spend enough to cause an increase in production. After all, why would a company spend money to increase production when demand for its products was falling? How could consumers significantly increase demand when they had barely enough money to survive?

The only way to end the Depression, Keynes thought, would be to find a way to boost demand. Economists who agreed with the idea that demand drives the economy developed a school of thought known as **demand-side economics.** They asked themselves this question: Who could spend enough to spur demand and revitalize production?

A New Role for Government

Keynes thought that the spender should be the federal government. In the early 1930s, only the government still had the resources to spend enough to affect the whole economy. The government could, in effect, make up for the drop in private spending by buying goods and services on its own. This, Keynes argued, would encourage production and increase employment. Then, as people went back to work, they would spend their wages on more goods and services, leading to even higher levels of production. This ever-expanding cycle would carry the economy out of the Depression. Once the crisis was over, the government could then step back and reduce its spending.

These ideas form the core of Keynes's approach to resolving problems with the economy. **Keynesian economics** uses demand-side theory as the basis for encouraging government action to help the economy. Keynesian economics proposes that the government can, and should, use fiscal policy to help the economy.

Avoiding Recession

Keynes argued that fiscal policy can be used to fight the two fundamental macroeconomic problems. These two opposing problems are periods of recession and periods of inflation.

The federal government, Keynes argued, should keep track of the total level of spending by consumers, businesses, and government. If total spending begins to fall far below the level required to keep the economy running at full capacity, the government should watch out for the possibility of recession.

The government can respond by increasing its own spending until spending by the private sector returns to a higher level. Or it can cut taxes so that spending and investment by consumers and businesses increases. As you read in the previous section, raising government spending and cutting taxes are expansionary fiscal policies.

After he was elected President in 1932, Franklin D. Roosevelt carried out expansionary fiscal policies. His New Deal put people to work—whether planting forests, building dams and schools, or painting murals. The federal budget paid for all these programs.

▲ During the Great Depression, the Civilian Conservation Corps (CCC) employed more than 2 million young men in jobs such as planting forests and digging irrigation ditches. ***How did the CCC meet the goals of Keynesian economics?***

Many people argue that instead of creating new jobs, such public works projects only shift employment from the private to the public sector. The dispute over Keynes' ideas is reflected today generally in the philosophies of the two political parties. Republicans generally have been associated with using tax cuts to stimulate the economy. Democrats, generally, have favored more expansive government programs to stimulate the economy.

Controlling Inflation

Keynes also argued that the government could use a contractionary fiscal policy to prevent inflation or reduce its severity. The government can reduce inflation either by increasing taxes or by reducing its own spending. Both of these actions decrease overall demand.

Keynesian economics a school of thought that uses demand-side theory as the basis for encouraging government action to help the economy

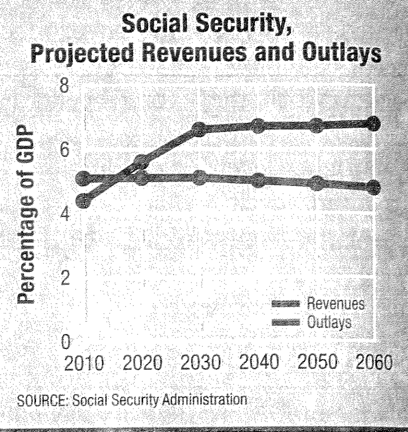
The Multiplier Effect

Fiscal policy, although difficult to control, is an extremely powerful tool. The key to its power is the multiplier effect. The **multiplier effect** in fiscal policy is the idea that every one dollar change in fiscal policy—whether an increase in spending or a decrease in taxes—creates a change

multiplier effect the idea that every one dollar change in fiscal policy creates a change greater than one dollar in the national income

Case Study

THE WALL STREET JOURNAL. CLASSROOM EDITION



SOURCE: Social Security Administration

Willing to Sacrifice

FISCAL POLICY PREFERENCES

What steps are voters prepared to accept to reduce the government's mammoth deficit?

By Jonathan Weisman
The Wall Street Journal

Frustrated voters, fixing on the $1.5 trillion federal deficit as a symbol of paralysis in Washington, appear increasingly willing to take drastic steps to address the red ink.

Leonard Anderson, 56, an engineer and a Republican, said he would accept a national sales tax to raise revenue. Kimberly Moore, 46, a Democrat and bank worker, says everyone will have to accept budget cuts. And at 67, Paul DesJardins, a Republican, says he would accept higher Medicare co-payments and deductibles.

"As Americans, we're all going to have to take less," says Lois Profitt, a 58-year-old small-business owner and political independent.

Both the Democratic and Republican parties are trying to talk about the deficit without addressing the specifics of how they would tackle it. Leaders on both sides worry about being attacked if they produce a package of painful spending cuts or tax increases. And to reinforce lawmakers' anxiety, voters remain divided about what ought to be done.

"It's a brutal predicament for politicians because the rhetoric of deficit cutting is enormously popular, but the details are incredibly unpopular," says Matt Bennett, a vice president at the Democratic group Third Way.

Participants in a *Wall Street Journal* focus group in Virginia say they want their leaders to take a stand. "I wish the politicians would be [firm] and be like, 'You know what? It's going to be horrible for the next few years, but you've got to shut up,'" says Jennifer Ciminelli, a 35-year-old independent.

At current levels, the federal deficit exceeds all defense and nondefense spending at Congress's discretion by $110 million. In other words, lawmakers could eliminate the entire military, all federal education, agricultural, housing programs, federal prisons, the CIA, FBI, Coast Guard and border patrol, and the nation would still be in the red.

Half of the current deficit stems from falling tax revenues and rising spending on programs associated with the recession, such as unemployment insurance, food stamps and the Wall Street bailout. The administration projects that the deficit will shrink as these programs end and the economy recovers.

But then long-term problems kick in. With the baby boom generation retiring, the deficit will begin rising again because of rising Social Security, Medicare and Medicaid spending.

"The country's going to deteriorate," says Mary Beth Davis, 27, a photographer and independent. "It already is."

Applying Economic Principles

According to this article, it will be difficult to reduce the federal deficit. How can changes in spending and taxation each affect budget deficits or surpluses?

Video News Update Online Powered by *The Wall Street Journal* Classroom Edition

Use videos at **PearsonSchool.com/PHecon** as a springboard for a discussion on a current topic.

much greater than one dollar in the national income. In other words, the effects of changes in fiscal policy are multiplied.

Suppose the federal government finds that business investment is dropping. To prevent a recession, in the next budget the government decides to spend an extra $10 billion to stimulate the economy. How will this affect the economy?

With this government spending, demand, income, and GDP will increase by $10 billion. After all, if the government buys an extra $10 billion of goods and services, then an extra $10 billion of goods and services have been produced. However, the GDP will increase by more than $10 billion. Here's why:

The businesses that sold the $10 billion in goods and services to the government have earned an additional $10 billion. These businesses will spend their additional earnings on wages, raw materials, and investment, sending money to workers, other suppliers, and stockholders. What will the recipients do with this money? They will spend part of it, perhaps 80 percent, or $8 billion. The businesses that benefit from this second round of spending will then pass it back to households and other businesses, who will again spend 80 percent of it, or $6.4 billion. The next round will add an additional $5.1 billion to the economy, and so on.

When all of these rounds of spending are added up, the initial government spending of $10 billion leads to an increase of about $50 billion in GDP. The multiplier effect gives fiscal policy initiatives a much bigger kick than the initial amount spent.

Automatic Stabilizers

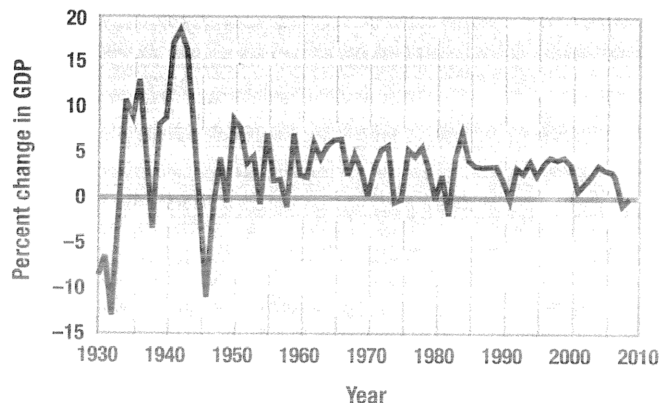
Fiscal policy is used to achieve many economic goals. One of the most important things that fiscal policy can achieve is a more stable economy. A stable economy is one in which there are no rapid changes in the economic indicators you read about in Chapter 12. What's more, set up properly, fiscal policy can come close to stabilizing the economy *automatically*.

Figure 15.5 shows how real GDP in the United States changed each year from 1930 to 2009. Prior to World War II, there were much larger changes in GDP from year to year than after World War II. Although GDP still fluctuates, these fluctuations have been smaller than they were before the war. Economic growth has been much more stable in the United States in the last 60 or so years.

Why did this happen? After the war, federal taxes and spending on transfer payments—two key tools of fiscal policy—increased sharply. Taxes and transfer payments, or transfers of cash from the government to consumers, stabilize economic growth. When national income is high, the government collects more in taxes and pays out less in transfer payments. Both of these actions take money away from consumers, and therefore reduce spending. This decrease in spending balances out the increase in spending that results from rising income in a healthy economy.

The opposite is also true. When income in the country is low, the government collects less in taxes and pays out more in transfer payments. Both actions increase the amount of money held by consumers, and thus increase spending. This increase in spending balances out the decrease in spending resulting from decreased income.

Figure 15.5 **Annual Change in GDP, 1930–2009**



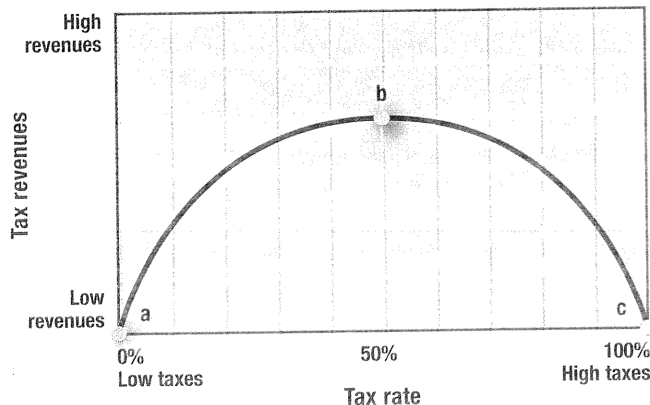
SOURCE: Bureau of Economic Analysis, *Historical Statistics of the United States*

GRAPH SKILLS

The United States experienced strong economic swings before World War II.

1. How do the years after the war show the effect of automatic stabilizers on the economy?
2. Why did the 1930s see the largest percent losses in GDP?

Figure 15.6 Laffer Curve



GRAPH SKILLS

The Laffer Curve illustrates the effects of high taxes on revenues.

1. According to the Laffer curve, what do both a high tax rate and a low tax rate produce?
2. Why do higher tax rates sometimes cause revenues to fall?

Action Graph online

For an animated version of this graph, visit PearsonSchool.com/PHecon

Taxes and transfer payments do not eliminate changes in the rate of growth of GDP, but they do make these changes smaller. Because they help make economic growth more stable, they are known as stabilizers. Policymakers do not have to make changes in taxes and transfer payments for them to have their stabilizing effect. Taxes and most transfer payments are tied to the GDP and to personal income, so they change automatically. Thus they are called **automatic stabilizers**—tools of fiscal policy that increase or decrease automatically depending on changes in GDP and personal income.

Some stabilizers are no longer automatic. The former Aid to Families with Dependent Children (AFDC), often called "welfare," lost its entitlement status in 1996 and was renamed Temporary Assistance for Needy Families (TANF). Now the federal government gives the states a set amount of money each year to spend as they wish. However, the stabilizer effect was not completely lost. When the economy boomed in the late 1990s, state spending on TANF fell.

automatic stabilizer a tool of fiscal policy that increases or decreases automatically depending on changes in GDP and personal income

supply-side economics a school of thought based on the idea that the supply of goods drives the economy

CHECKPOINT ***How did Keynes favor ending the Great Depression?***

Supply-Side Economics

Another school of economic thought promotes a different direction for fiscal policy. **Supply-side economics** is based on the idea that the supply of goods drives the economy. While Keynesian economics tries to encourage economic growth by increasing aggregate demand, supply-side economics relies on increasing aggregate supply. It does this by focusing on taxes.

The Laffer Curve

Supply-side economists believe that taxes have a strong negative impact on economic output. They often use the Laffer curve, named after the economist Arthur Laffer, to illustrate the effects of taxes. The Laffer curve shows the relationship between the tax rate and the total tax revenue that the government collects. The total revenue depends on both the tax rate and the health of the economy. The Laffer curve suggests that high tax rates may not bring in much revenue if they cause economic activity to decrease.

Figure 15.6 depicts the Laffer curve. Suppose the government imposes a tax on the wages of workers. If the tax rate is zero, as at point *a* on the graph, the government will collect no revenue, although the economy will benefit from the lack of taxes. As the government raises the tax rate, it starts to collect some revenue. Follow this change in **Figure 15.6** by tracing the curve from no taxes at point *a* to 50 percent taxation at point *b*.

From point *a* to point *b* on the curve, rising tax rates discourage some people from working as many hours and hinder companies from investing and increasing production. The net effect of a higher tax rate and a slightly lower tax base is an increase in revenue.

To the right of point *b*, the decrease in workers' effort is so large that the higher tax rate actually decreases total tax revenue. In other words, high rates of taxation will eventually discourage so many people from working that tax revenues will fall. In the extreme case of a 100 percent tax rate, no one would want to work! In this case, shown at point *c* on the curve, the government would collect no revenue.

Taxes and Output

The heart of the supply-side argument is that a tax cut increases total employment so much that the government actually collects more in taxes at the new, lower tax rate. Suppose the initial tax on labor is $3 an hour, and the typical worker works 30 hours per week, paying a total of $90 in taxes each week. If the government cuts the tax on labor to $2 an hour, and the worker responds by working 50 hours per week, the worker will pay $100 in taxes a week, an increase of $10.

Actual experience has proven that while a tax cut encourages some workers to work more hours, the end result is a relatively small increase in the number of hours worked. In the example above, if the tax cut increased the hours worked from 30 hours to 35 hours, the worker would pay only $70 in taxes ($2 per hour times 35 hours), down from $90 ($3 per hour times 30 hours). In general, taxpayers do not react strongly enough to tax cuts to increase tax revenue.

CHECKPOINT ***How does the theory of supply-side economics link taxation to employment levels?***

Fiscal Policy in American History

As you recall, Keynes presented his ideas at a same time when the world economy was engulfed in the Great Depression. President Herbert Hoover, a strong believer in classical economics, thought that the economy was basically sound and would return to equilibrium on its own, without government interference. His successor, President Franklin D. Roosevelt, was much more willing to increase government spending to help lift the economy out of the Depression.

World War II

Keynes's theory was fully tested in the United States during World War II. As the country geared up for war, government spending increased dramatically. The government spent large sums of money to feed soldiers and equip them with everything from warplanes to rifles to medical supplies. This money was given to the private sector in exchange for goods. Just as Keynesian economics predicted, the additional demand for goods and services moved the country sharply out of the Great Depression and toward full productive capacity.

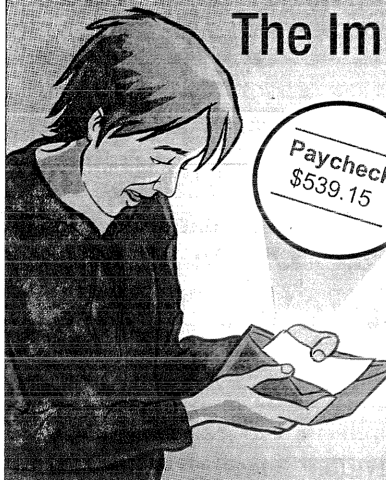
After World War II ended, Congress created the Council of Economic Advisers (CEA). Made up of three respected economists, the CEA advised the President on economic policy.

Postwar Keynesian Policy

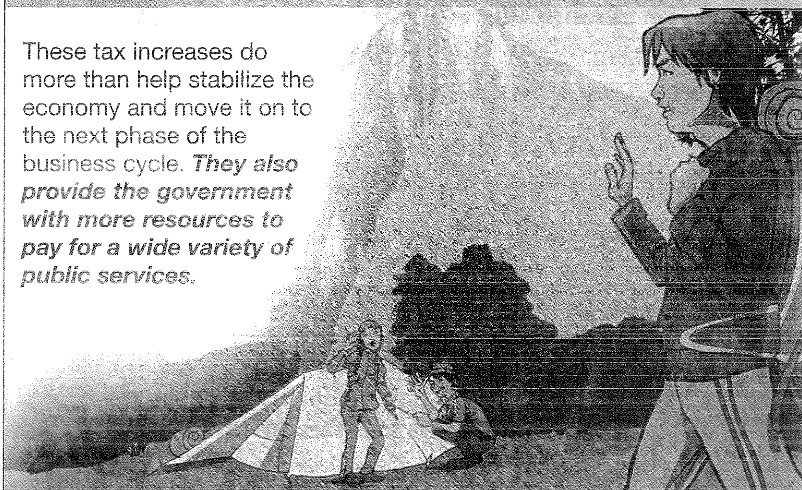
Between 1945 and 1960, the U.S. economy was generally healthy and growing, despite a few minor recessions. The last recession continued into the term of President John F. Kennedy, with unemployment reaching a level of 6.7 percent.

Economics & YOU

The Impact of Taxes



Sometimes, when the economy is overheated, the government resorts to increasing taxes on individuals. ***Tax increases can be very painful because they leave you with less money to spend on goods and services or to save for the future.***



These tax increases do more than help stabilize the economy and move it on to the next phase of the business cycle. ***They also provide the government with more resources to pay for a wide variety of public services.***

▲ Sometimes the government lowers taxes to stimulate the economy. ***If you had a few more dollars each week from a tax cut, would you save it or spend it?***

Innovators

John Kenneth Galbraith

"The conventional view serves to protect us from the painful job of thinking."

John Kenneth Galbraith was the world's most famous economist for the last half of the twentieth century. He was also a witty commentator on politics and social life and the author of a number of bestselling books.

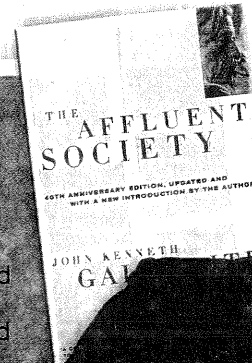
During World War II, Galbraith was selected by President Roosevelt to lead the Office of Price Administration, which meant he had total control over the prices charged by U.S. companies.

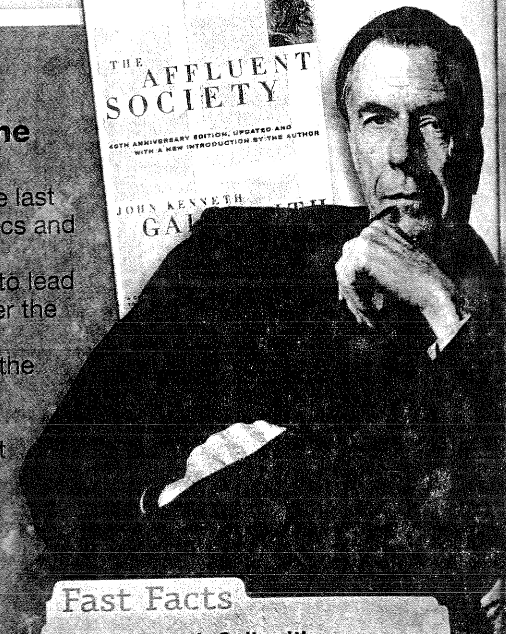
After the war, Galbraith wrote a number of widely read books about the government's role in society. He favored an active government, using funds provided by a progressive income tax and high sales taxes. He warned against "the affluent society," an economy that produced a glut of frivolous goods for the affluent while the public sector —education, roads and bridges, parks and concert halls—suffered neglect.

Galbraith advised President John F. Kennedy, who appointed him Ambassador to India in 1960. Later, he was the inspiration for President Lyndon B. Johnson's Head Start program, an early childhood education program for poor children.

Galbraith's long service to America did not go unnoticed. He received the Presidential Medal of Freedom, the nation's highest civilian honor, twice.

Critical Thinking: ***Galbraith once said "The only function of economic forecasting is to make astrology look respectable." What did he mean by that? Do you agree with him?***





Fast Facts

John Kenneth Galbraith

Born: 1908 in Ontario, Canada

Died: 2006 in Cambridge, MA

Education: Ph.D., University of California at Berkeley

Claim to Fame: Wrote about the dangers of an affluent society

Kennedy's chief financial policy advisor, Walter Heller, thought that the economy was below its productive capacity. He convinced Kennedy that tax cuts would stimulate demand and bring the economy closer to full productive capacity.

As **Figure 15.7** shows, tax rates were extremely high in the early 1960s. The highest individual income tax rate was about 90 percent, compared with about 40 percent in 2007. Kennedy proposed tax cuts, both because he agreed with Heller and because tax cuts are popular.

A version of Kennedy's tax cuts was enacted in 1964, under President Lyndon Johnson. At the same time, the Vietnam War raised government spending. Over two years, consumption and GDP increased by more than 4 percent a year. There is no way to prove that the tax cut caused this growth, but the result was generally what Keynesian economics predicted.

Keynesian economics was used often in the 1960s and 1970s. One Keynesian economist, John Kenneth Galbraith, greatly influenced national policies. Galbraith, a strong supporter of public spending, helped develop the social welfare programs that lay at the heart of President Johnson's vision of a Great Society.

Supply-Side Policy in the 1980s

During the late 1970s, with Keynesian fiscal policy in place, unemployment and inflation rates soared. When Ronald Reagan became President in 1981, he vowed to cut taxes and spending. An "anti-Keynesian," Reagan did not believe that government should spend its way out of a recession:

> "Government spending has become so extensive that it contributes to the economic problems it was designed to cure. More government intervention in the economy cannot possibly be a solution to our economic problems."
>
> —Ronald Reagan, White House Report on the Program for Economic Recovery, 1981

Reagan instituted policies based on supply-side economics, a theory promoted by economists such as George Gilder. Among Reagan's advisers was Milton Friedman, a

former professor of economics. Friedman supported individual freedom and pushed for more laissez-faire policies—hallmarks of classical and supply-side economics. (You will read a profile of Friedman in the next chapter.)

In 1981, Reagan proposed a tax cut that reduced taxes by 25 percent over three years. In a short time, the economy recovered and flourished. Still, tax cuts plus an increased defense budget led to deficit spending; just as Keynesian policy would.

Under the next few Presidents, the federal government spent much more money than it took in. As you will read in the next section, this gap caused increasing concern among economists and policymakers.

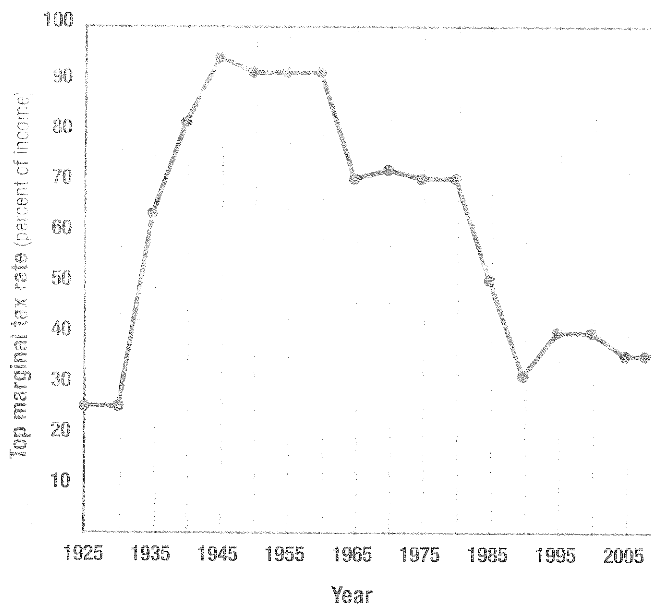
Return to Keynesian Policy?

In late 2008, the United States was hit with what many economists believed was the worst financial crisis since the Great Depression. A number of major financial institutions failed. Credit became harder to get, consumer spending dropped, and unemployment rose.

That year, voters elected a new President, Barack Obama. He promised to take firm action to stimulate the economy. Obama signed a stimulus bill which included spending on major public works programs, such as repairing the nation's infrastructure. To many observers, such proposals seemed to signal a shift back to a Keynesian fiscal policy, as in the New Deal.

✔ **CHECKPOINT** ***What Keynesian fiscal policy tool did President Kennedy use?***

Top Marginal Tax Rate, 1925–2007



SOURCE: Tax Policy Center: Urban Institute and Brookings Institute

GRAPH SKILLS

Tax rates varied widely throughout the last century.

1. When were top marginal income tax rates at their highest?
2. What has been the trend in tax rates since 1985?

SECTION 2 ASSESSMENT

Essential Questions Journal To continue to build a response to the Essential Question, go to your Essential Questions Journal.

Guiding Question

1. Use your completed chart to answer this question: What economic ideas have shaped fiscal policy?
2. **Extension** You're a struggling worker during a recession. Leading economists urge you to be patient because the economy will right itself. How do you reply?

Key Terms and Main Ideas

3. What is **classical economics**?
4. How is full employment related to **productive capacity**?
5. What is the **multiplier effect**?
6. Compare and contrast **Keynesian economics** and **supply-side economics**.

Critical Thinking

7. **Analyze (a)** What might be the costs and benefits of Keynesian economic policies? **(b)** How did Keynes's policies work during the Great Depression?
8. **Analyze Causes and Effects** Why can low tax rates encourage investment and increase jobs and wages?
9. **Contrast** Choose two Presidents and explain how their fiscal policies reflected differing economic beliefs.

Quick Write

10. Write a brief position paper supporting or opposing the use of tax funds to put people to work today. Include at least two arguments to support your position, indicating which argument you feel is most important. Make sure your final sentence strongly restates your position.

SECTION 3 Budget Deficits and the National Debt

OBJECTIVES

1. **Explain** the importance of balancing the budget.
2. **Analyze** how budget deficits add to the national debt.
3. **Summarize** the problems caused by the national debt.
4. **Identify** how political leaders have tried to control the deficit.

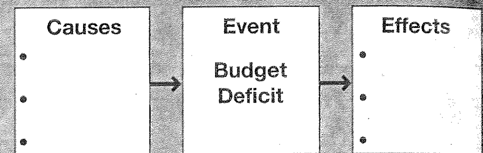
ECONOMIC DICTIONARY

As you read the section, look for the definitions of these **Key Terms:**

- budget surplus
- budget deficit
- Treasury bill
- Treasury note
- Treasury bond
- national debt
- crowding-out effect

Guiding Question
What are the effects of budget deficits and national debt?

Copy this cause-and-effect chart and fill it in as you read.



Economics and You If you have used a credit card, you might have some idea about how easy it is to spend money that you don't have. If you fail to pay the credit-card bill in full each month, the high interest rate may mean that the amount you owe just keeps increasing. Soon you may face a mountain of debt.

The federal government is no stranger to spending more than it has. You have been reading about how the government uses spending as a fiscal policy tool to improve the economy.

Principles in Action As you will see in this section, unchecked spending can lead to a soaring national debt. The How the Economy Works feature shows how that debt resulted from numerous budget decisions. The costs of this debt must be measured against the benefits of government spending.

Balancing the Budget

The basic tool of fiscal policy is the federal budget. It is made up of two fundamental parts: revenue (taxes) and expenditures (spending programs). When the federal government's revenues equal its expenditures in any particular fiscal year, the federal government has a balanced budget.

In reality, as **Figure 15.8** shows, the federal budget is almost never balanced. Usually, it is either running a surplus or a deficit. A **budget surplus** occurs in any year when revenues exceed expenditures. In other words, there is more money going into the Treasury than coming out of it. A **budget deficit** occurs in any year when expenditures exceed revenues. In other words, there is more money coming out of the Treasury than going into it.

Assume the federal government starts with a balanced budget. If the government decreases expenditures without changing anything else, it will run a budget surplus. Similarly, if it increases taxes—revenues—without changing anything else, it will run a surplus.

This analysis also explains budget deficits. If the government increases expenditures without changing anything else, it will run a deficit. Similarly, if it decreases taxes without changing anything else, it will run a deficit. The deficit can grow or shrink because of forces beyond the government's control. Surpluses and deficits can be very large figures. The largest deficit, in 2009, was nearly $1.8 trillion.

budget surplus a situation in which budget revenues exceed expenditures

budget deficit a situation in which budget expenditures exceed revenues

Responding to Budget Deficits

When the government runs a deficit, it is because it did not take in enough revenue to cover its expenses for the year. When this happens, the government must find a way to pay for the extra expenditures. There are two basic actions the government can take to do so.

Creating Money

The government can create new money to pay salaries for its workers and benefits for citizens. Traditionally, governments simply printed the bills they needed. Today, the government can create money electronically by actions that effectively deposit money in people's bank accounts. The effect is the same. This approach works for relatively small deficits but can cause severe problems when there are large deficits. What are these problems?

When the government creates more money, it increases the amount of money in circulation. This increases the demand for goods and services and can increase output. But once the economy reaches full employment, output cannot increase. The increase in money will mean that there are more dollars but the same amount of goods and services. Prices will rise so that a greater amount of money will be needed to purchase the same amount of goods and services. In other words, prices go up, and the result is inflation.

Covering very large deficits by printing more money can cause hyperinflation. This happened in Germany and Russia after World War I, in Brazil and Argentina in the 1980s, and in Ukraine in the 1990s. If the United States experienced hyperinflation, a shirt that cost $30 in June might cost $50 in July, $80 in August, and $400 in December!

Borrowing Money

The federal government usually does not resort to creating money to cover a budget deficit. Instead, it borrows money. The government commonly borrows money by selling bonds. As you read in Chapter 11, a bond is a type of loan: a promise to repay money in the future, with interest. Consumers and businesses buy bonds from the government. The government thus has the money to cover its budget deficit. In return, the purchasers of the bonds earn interest on their investment over time.

United States Savings Bonds ("EE Bonds") allow millions of Americans to lend small amounts of money to the federal government. In return, they earn interest on the bonds for up to 30 years. Other common forms of government borrowing are Treasury bills, notes, and bonds. **Treasury bills** are short-term bonds that have maturity dates of 26 weeks or less. **Treasury notes** have terms of from 2 to 10 years. **Treasury bonds** mature 30 years after issue.

Federal borrowing lets the government undertake more projects than it could otherwise afford. Wise borrowing allows the government to create more public goods and services. Federal borrowing, however, also has serious disadvantages.

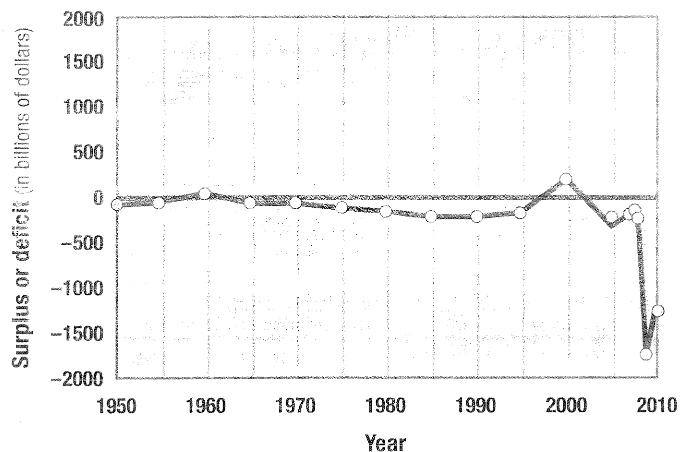
CHECKPOINT ***What is the most common way that the federal government pays for expenditures that exceed revenues?***

Treasury bill a government bond with a maturity date of 26 weeks or less

Treasury note a government bond with a term of from 2 to 10 years

Treasury bond a government bond that is issued with a term of 30 years

Figure 15.8 **Budget Surpluses and Deficits, 1950–2010**



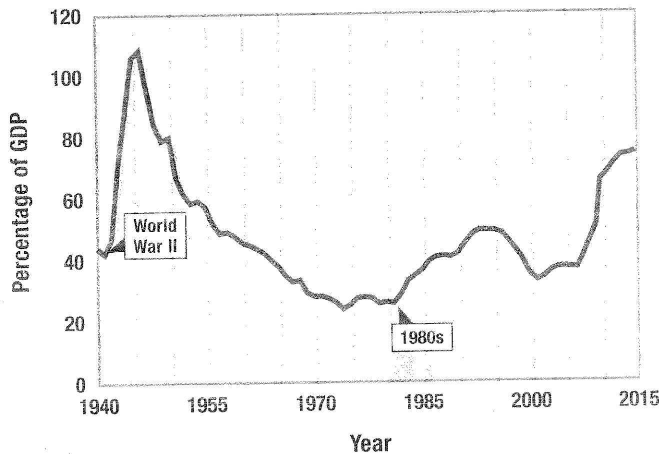
SOURCE: *U.S. Government Printing Office*

GRAPH SKILLS

Budget deficits swelled in the early 2000s due to recession, tax cuts, and defense spending.

1. In which of the years shown on the graph did the budget have a surplus?
2. What was the dominant trend in deficits in the late 1990s?

Figure 15.9 National Debt as a Percentage of GDP



Note: Figures for the years 2010–2015 are projected.
SOURCE: *The Executive Office of the President of the United States, The Office of Management and Budget. The Budget of the United States Government, Fiscal Year 2011. Historical Tables.*

GRAPH SKILLS

1. Do you think budgets are in surplus, balanced, or in debt during times of war?
2. Why does the national debt as a percentage of GDP soar during times of war?

FUTURE WATCH

Personal Finance
For tips on managing your own debt, see your Personal Finance Handbook in the back of the book or visit **PearsonSchool.com/PHecon**

The National Debt

Like people, when the government borrows money, it goes into debt. The **national debt** is the total amount of money the federal government owes to bondholders. Every year that there is a budget deficit and the federal government borrows money to cover it, the national debt will grow.

The national debt is owed to investors who hold Treasury bonds, bills, and notes. These bonds are considered to be among the safest investments in the world. As such, they offer a secure investment for individuals and businesses. Because the United States is widely viewed as stable and trustworthy, the federal government can borrow money at a lower rate of interest than private citizens or corporations can. Lower interest rates benefit taxpayers by reducing the cost of government borrowing.

national debt the total amount of money the federal government owes to bondholders

The Difference Between Deficit and Debt

Many people are confused about the difference between the deficit and the debt. The deficit is the amount of money the government borrows for one budget, representing one fiscal year. The debt, on the other hand, is the sum of all the government borrowing before that time, minus the borrowings that have been repaid. Each deficit adds to the debt. Each surplus subtracts from it.

Measuring the National Debt

In dollar terms, the size of the national debt is extremely large. In 2008, it exceeded $10.6 trillion! Such a large number can best be analyzed in relation to the size of the economy as a whole. Therefore, let's look at the size of the debt as a percentage of gross domestic product (GDP) over time. This can be seen in **Figure 15.9**. Historically, debt as a percentage of GDP rises during wartime, when government spending increases faster than taxation, and it falls during peacetime.

Notice how the pattern changed in the 1980s, when the United States began to run a large debt, even though the country wasn't at war. The debt was in part a result of increases in spending during President Ronald Reagan's terms. As you read in the previous section, the Reagan administration also cut taxes. The combined effect of higher spending and lower tax rates was several years of increased budget deficits. The government borrowed billions of dollars to cover these deficits, adding to the national debt. As a result, the ratio of debt to GDP grew very large for peacetime.

CHECKPOINT *To whom does the government owe the national debt?*

Is the Debt a Problem?

The growth of the national debt during the Reagan administration led many to focus on the problems caused by a national debt. In general, three problems can arise from a national debt.

Problems of a National Debt

The first problem with a national debt is that it reduces the funds available for businesses to invest. This is because in order to sell its bonds, the government must offer a higher interest rate. Individuals and

businesses, attracted by the higher interest rates and the security of investing in the government, use their savings or profits to purchase government bonds.

However, every dollar spent on a government bond is one dollar less that can be invested in private business. Less money is available for companies to expand their factories, conduct research, and develop new products, and so interest rates rise. This loss of funds for private investment caused by government borrowing is called the **crowding-out effect.** Federal borrowing "crowds out" private borrowing by making it harder for private businesses to borrow. A national debt, then, can hurt investment and slow economic growth over the long run.

The second problem with a high national debt is that the government must pay interest to bondholders. The more the government borrows, the more interest it has to pay. Paying the interest on the debt is sometimes called servicing the debt. Over time, the interest payments have become very large. About the year 2000, the federal government spent about $250 billion a year servicing the debt. Moreover, there is an opportunity cost—dollars spent servicing the debt cannot be spent on something else, such as defense, healthcare, or infrastructure.

A possible third problem involves foreign ownership of the national debt. The biggest holder of that debt is the United States government itself. The government uses bonds as a secure savings account for holding Social Security, Medicare, and other funds. But about a quarter of the debt is owned by foreign governments, including Japan, China, and the United Kingdom. Some critics of the debt fear that a country like China could use its large bond holdings as a tool to extract favors from the United States. Others disagree, arguing that foreign states own too little of the debt to cause any concern.

crowding-out effect the loss of funds for private investment caused by government borrowing

Other Views of a National Debt

Some people insist that the national debt is not a big problem. Traditional Keynesian economists believe that fiscal policy is an important tool that can be used to help achieve full productive capacity. To these analysts, the benefits of a productive economy outweigh the costs of interest on national debt.

In the short term, deficit spending may help create jobs and encourage economic growth. However, a budget deficit can be an effective tool only if it is temporary. Most people agree that if the government runs large budget deficits year after year, the costs of the growing debt will eventually outweigh the benefits.

CHECKPOINT ***What are the problems of having a huge national debt?***

Figure 15.10 Effects of the Budget Deficit on Investment

CHART SKILLS

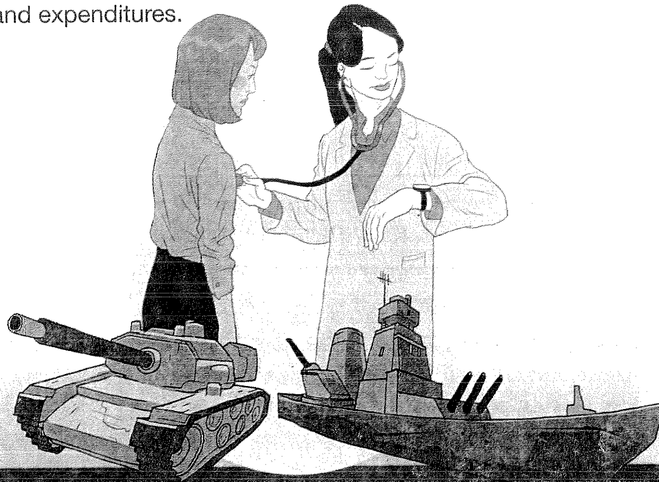
Government borrowing tends to reduce private investment by taking away some funds that could have been invested in private business. Economists describe this phenomenon as the crowding-out effect.

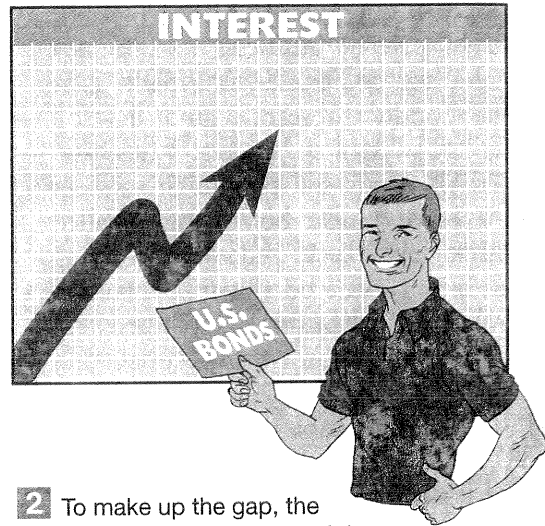
1. Why do lenders put their money in government bonds rather then use it for private investment?
2. What are some ways that private investors and banks deal with the crowding-out effect?

What causes the national debt to spiral?

The National Debt is the amount of money the United States government owes to the people and institutions who hold its bonds, bills, and notes. In the past 30 years, the national debt has grown enormously. Here is why the debt has grown.

1 Each year, the federal government has to pay for hundreds of essential services, from military protection to healthcare. Tax revenues pay for most of these expenses. But in most years, there is a gap between revenue and expenditures.





2 To make up the gap, the government borrows money. It issues Treasury bonds, bills, and notes. The interest paid on this money becomes part of the federal budget.

Expenses **Borrowing**

Controlling the Deficit

During the 1980s and the early 1990s, annual budget deficits added substantially to the national debt. Several factors frustrated lawmakers in their attempts to control the deficit. As we have seen, much of the budget consists of entitlement spending that is politically difficult to change. Another large part of the budget consists of interest that must be paid to bondholders. Finally, specific budget cuts are often opposed by interest groups.

Efforts to Reduce Deficits

Concerns about the budget deficits of the mid-1980s caused Congress to pass the Gramm-Rudman-Hollings Act. This law created automatic across-the-board cuts in federal expenditures if the deficit exceeded a certain amount. The automatic nature of the cuts saved lawmakers from having to make difficult decisions about individual funding cuts. However, the act exempted significant portions of the budget (such as interest payments and many entitlement programs such as Social Security) from the cuts.

The Supreme Court found that some parts of the Gramm-Rudman-Hollings Act were unconstitutional. Congress attempted to correct the flaws. In 1990, however, lawmakers realized that the deficit was going to be much larger than expected. Because Congress had exempted so many programs from automatic cuts, funding for nonexempt programs would be dramatically slashed.

To resolve the crisis, President George H. W. Bush and congressional leaders negotiated a new budget system that replaced Gramm-Rudman-Hollings. The 1990 Budget Enforcement Act created a

How the Economy Works online

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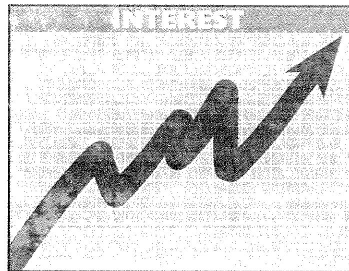
3 Economic downturns or external shocks such as natural disasters may add unplanned costs to the federal budget. This leads to even more borrowing.

4 As the government borrows more, the slice of the federal budget taken up by interest payments grows. The more interest, the greater the gap between revenue and expenses...and the greater the gap, the more the government borrows.



5 Large deficits over a period of years have caused the national debt to spiral to enormous proportions. However, economists differ on whether this large debt is a serious problem to the U.S. economy.

Check Your Understanding

1. How does borrowing lead to greater interest payments and greater debt?
2. How important do you think it is to immediately reduce the national debt?

More Expenses → **More Borrowing**

"pay-as-you-go" system (also known as PAYGO). PAYGO required Congress to raise enough revenue to cover increases in direct spending that would otherwise contribute to the budget deficit. This law expired in 2002, but in 2007 the House and Senate restored PAYGO in the form of special budget rules.

At various times, citizens and politicians have suggested amending the Constitution to require a balanced budget. In 1995, a balanced budget amendment gained the two-thirds majority it needed to pass the House, but the next year it failed by a single vote in the Senate. Supporters argued that the amendment would force the federal government to be more disciplined about its spending. Opponents said that a constitutional amendment requiring a balanced budget would not give the government the flexibility it needed to deal with rapid changes in the economy.

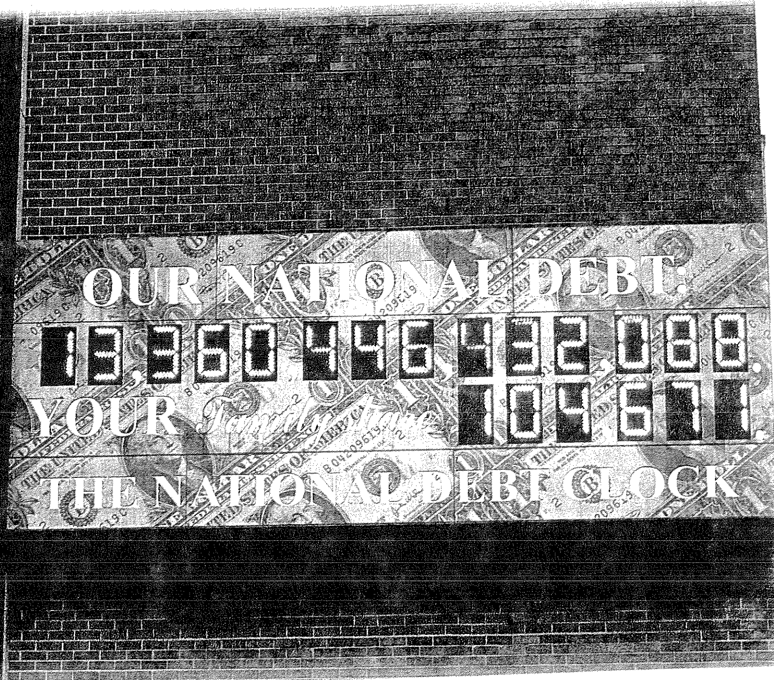
End-of-Century Surpluses

The late 1990s brought a welcome reversal of fortune. For the first time in thirty years, the President and the Office of Management and Budget were able to announce that the federal government was running a surplus.

How did this happen? First, the new budget procedures begun under President Bush and extended under President Clinton did help Congress control the growth of government spending. Second, tax increases by President Clinton in 1993 resulted in more federal revenue. Finally, the strong economy and low unemployment meant that more individuals and corporations were earning more money—and thus paying more to the government in taxes.

Return to Deficits

The changeover from deficits to surplus brought with it a different set of political



▲ Created in 1989, the National Debt Clock in New York continually ticks off the growing national debt plus each family's share. There are similar clocks in other cities and on the Internet. ***Why do you think someone decided to build the National Debt Clock?***

concerns. Investors who had come to rely heavily upon Treasury bonds as the basic "safe" investment worried that the federal government would remove all bonds from the market as it repaid its debt.

Americans debated how to make best use of the budget surplus. As a presidential candidate in 2000, George W. Bush pledged to use the surplus to guarantee Social Security into the new century, provide additional medical benefits to seniors, and reduce income taxes.

However, the surplus was short-lived. The end of the stock market boom, an economic slowdown, and a new federal income tax cut reduced federal revenues. The terrorist attacks of September 11, 2001, dealt a double blow to the federal budget by disrupting the economy and imposing a new set of defense costs.

In response, the federal government returned to deficit spending. The federal budget continued to show a large deficit for the next several years, due in part to counterterrorism efforts and the very costly wars in Afghanistan and Iraq. In fiscal year 2008 alone, the President's funding requests for the war on terrorism approached $200 billion.

The long-term outlook for the federal budget is uncertain. Funding for stimulus projects and new healthcare initiatives may cause long-term spending to increase. Social Security and Medicare are projected to rise sharply in the next 30 years as large numbers of baby boomers leave the job market and retire. Balancing the budget is expected to become even more difficult.

✔ **CHECKPOINT** ***What factors contributed to the deficit spending of the 2000s?***

Essential Questions Journal To continue to build a response to the Essential Question, go to your **Essential Questions Journal.**

SECTION 3 ASSESSMENT

Guiding Question

1. Use your completed cause-and-effect chart to answer this question: What are the effects of budget deficits and national debt?
2. **Extension** Look at a credit card statement. Notice how finance charges add to the original purchase expenses. If one does not pay the full amount owed, there are additional interest charges. There are also transaction, over-limit, and late fees. Even without additional purchases, the amount owed continues to grow—until the debt is paid in full. How does this compare to the way increased federal deficits add to the national debt?

Key Terms and Main Ideas

3. What causes a **budget surplus**?
4. How does a **Treasury note** differ from a **Treasury bill**?
5. How might a **budget deficit** be related to the **national debt**?
6. Explain the **crowding-out effect** that results from national debt.

Critical Thinking

7. **Evaluate (a)** Why does the federal government usually not create new money to cover a budget deficit? **(b)** Do you think this is sound reasoning? Explain why or why not.
8. **Rank (a)** What are three possible problems with having a national debt? **(b)** Which problem do you see as most serious? Explain.
9. **Predict (a)** Why did the federal budget show a large deficit for several years following 2001? **(b)** What federal spending is projected to increase greatly during the coming years, and why? **(c)** How could lowering income taxes during an economic downturn lead to increased national debt?

Math Skills

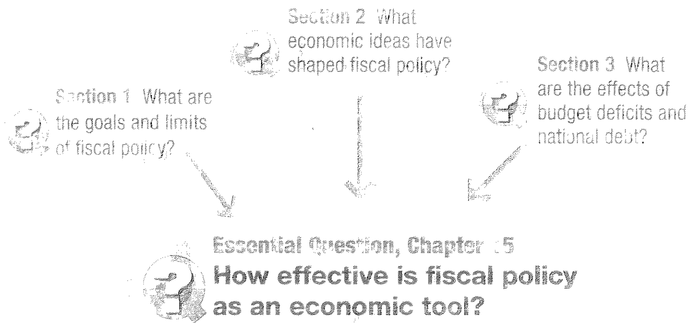
10. **Relating Graphs to Events** Use the data in **Figure 15.8** to determine the approximate size of the largest budget deficits in each of the following decades: **(a)** 1950s, **(b)** 1970s, **(c)** 1990s, **(d)** 2000s.

Visit PearsonSchool.com/PHecon for additional math help.

QUICK STUDY GUIDE

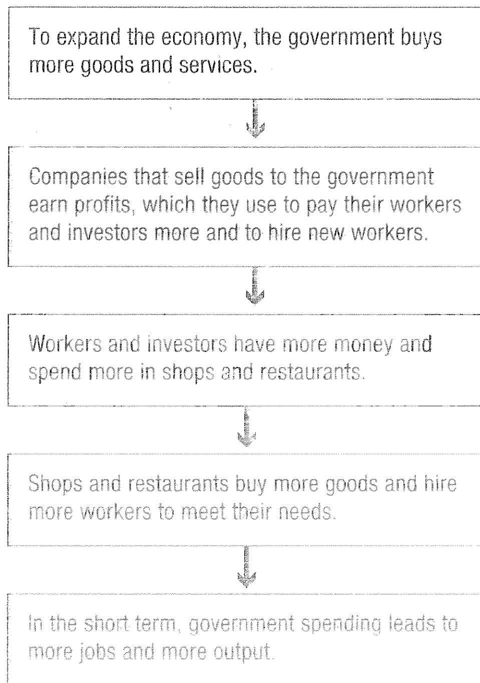
QUICK STUDY GUIDE

Chapter 15: Fiscal Policy



Essential Question, Chapter 15
How effective is fiscal policy as an economic tool?

Effects of Expansionary Fiscal Policy



Economic Dictionary

- fiscal policy, *p. 392*
- federal budget, *p. 392*
- fiscal year, *p. 392*
- appropriations bill, *p. 394*
- expansionary policy, *p. 395*
- contractionary policy, *p. 395*
- classical economics, *p. 399*
- productive capacity, *p. 400*
- demand-side economics, *p. 400*
- Keynesian economics, *p. 401*
- multiplier effect, *p. 401*
- automatic stabilizer, *p. 404*
- supply-side economics, *p. 404*
- budget surplus, *p. 408*
- budget deficit, *p. 408*
- Treasury bill, *p. 409*
- Treasury note, *p. 409*
- Treasury bond, *p. 409*
- national debt, *p. 410*
- crowding-out effect, *p. 411*

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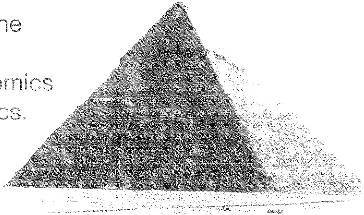
CHAPTER 15 ASSESSMENT

Self-Test online To test your understanding of key terms and main ideas, visit **PearsonSchool.com/PHecon**

Key Terms and Main Ideas

To make sure you understand the key terms and main ideas of this chapter, review the Checkpoint and Section Assessment questions and look at the Quick Study Guide on the preceding page.

Critical Thinking



1. **Compare (a)** Describe the fundamental differences between classical economics and Keynesian economics. **(b)** Keynes suggested that building pyramids was good for the economy of ancient Egypt. Why would Keynes have suggested this? **(c)** Provide a similar example in our society for the building of the pyramids. Explain your answer.
2. **Main Ideas (a)** Make a list of ways in which government fiscal policy affects your daily life. **(b)** Which aspects of fiscal policy have the greatest effect on you? Explain.
3. **Infer (a)** How do automatic stabilizers affect our economy? **(b)** What would our economy be like without them?
4. **Analyze (a)** In your own words, describe the crowding-out effect. **(b)** Explain how it can influence economic growth over the long term.
5. **Evaluate (a)** What are the benefits and drawbacks of a balanced budget amendment? **(b)** Would you support such an amendment? Explain why or why not?
6. **Main Ideas (a)** How is the federal budget a tool of fiscal policy? **(b)** How effective has this tool been in promoting full employment and economic growth?

Applying Your Math Skills

Comparing Circle Graphs

The two pie graphs below show categories of federal spending in the national budgets for 2000 and 2007. Look at the graphs and answer the questions that follow.

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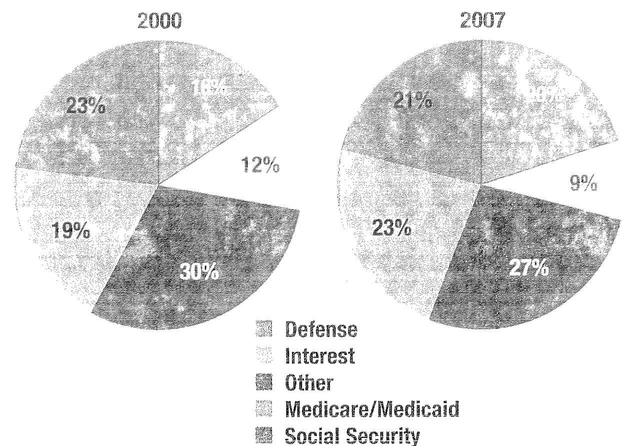
Federal Spending, 2000 and 2007



SOURCE: U.S. Senate and U.S. House Budget Offices

7. How did the percentage of federal spending on interest payments change between 2000 and 2007?
8. Which categories of federal spending have seen the same percentage increase since 2000?
9. **(a)** How have Social Security outlays changed as a percentage of the federal budget? **(b)** Do you think this pattern will continue? Explain why or why not.

Essential Question Activity

To respond to the chapter Essential Question, go to your **Essential Questions Journal.**

10. Complete this activity to answer the Essential Question **How effective is fiscal policy as an economic tool?** Work in small groups, with each group researching the administrations of John F. Kennedy to the current President. Using the worksheet in your Essential Questions Journal or the electronic worksheet available at **PearsonSchool.com/PHecon**, gather the following information:
    - **(a)** Identify the President by political party and years in office.
    - **(b)** Identify the main economic goals and challenges under that administration.
    - **(c)** Describe any tax and spending changes that grew out of the administration's fiscal policy.
    - **(d)** Evaluate how successful that administration was at meeting its goals.
11. **Modify** After your group has filled out its worksheet, make enough copies to distribute to the other groups in the class.
    - **(a)** Each group will take the worksheets and evaluate which President they think had the most successful fiscal policy. Place the sheets in order from most effective to least effective.
    - **(b)** The class will share and compare their conclusions.
    - **(c)** As a class, make a generalization about the use of fiscal policy by Presidents since 1960 to stabilize economic conditions, stimulate growth, or cool down an overheated economy.

DOCUMENT-BASED ASSESSMENT

Is the national debt a threat to the country?

Many economists blame the huge U.S. national debt for many economic problems, including high interest rates, unemployment, and trade deficits. However, some economists believe that the problems of the national debt are exaggerated.

Document A

Interest on the National Debt

Fiscal Year	Percentage of Federal Outlays for Interest on Debt
1990	14.7
1992	14.4
1994	13.9
1996	15.4
1998	14.6

Fiscal Year	Percentage of Federal Outlays for Interest on Debt
2000	12.5
2002	8.5
2004	7.0
2006	8.5
2008	8.3
2010*	9.1

*Estimated

Document B

"Within 12 years . . . the largest item in the federal budget will be interest payments on the national debt," says former U.S. Comptroller General David Walker. "[They are] payments for which we get nothing."

Economic forecasters say future generations of Americans could have a substantially lower standard of living than their predecessors' for the first time in the country's history if the debt is not brought under control.

Government debt, which fuels the risk of inflation, could make everyday Americans' savings worth less. Higher interest rates would make it harder for consumers and businesses to borrow. Wages would remain stagnant and fewer jobs would be created. The government's ability to cut taxes or provide a safety net would also be weakened, economists say.

—"Drowning in Debt: What the Nation's Budget Woes Mean for You," Devin Dwyer, abcnews.go.com

Document C

Now and Later

Spend now, while the economy remains depressed; save later, once it has recovered. How hard is that to understand?

Very hard, if the current state of political debate is any indication. All around the world, politicians seem determined to do the reverse. They're eager to shortchange the economy when it needs help, even as they balk at dealing with long-run budget problems.... Penny-pinching at a time like this isn't just cruel; it endangers the nation's future. And it doesn't even do much to reduce our future debt burden, because stinting on spending now threatens the economic recovery, and with it the hope for rising revenues.

—"Now and Later" by Paul Krugman from *The New York Times, June 20, 2010*

ANALYZING DOCUMENTS

Use your knowledge of the national debt and Documents A, B, and C to answer Questions 1–3.

1. **According to Document A, the percentage of the federal budget devoted to paying interest on the national debt**
   A. has risen steadily since 1990.
   B. has fallen steadily since 1990.
   C. has fluctuated wildly from year to year.
   D. began to rise again after reduction.

2. **According to Document B, the large national debt could lead to**
   A. a lower standard of living.
   B. more tax cuts.
   C. increased investment.
   D. lower interest rates.

3. **In Document C, Paul Krugman argues that spending now**
   A. is cruel and dangerous.
   B. will stimulate the economy.
   C. might hurt the hope for rising revenues.
   D. threatens economic recovery.

WRITING ABOUT ECONOMICS

The ever-growing national debt causes much debate during budget preparation each fiscal year. Use the documents on this page and resources on the Web site below to answer this question: **Is the national debt a threat to the country?** Use the sources to support your opinion.

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