MODULE 32

32 Budget Deficits and Public Debt

The Budget Balance

- The budget balance is the difference between the government's tax revenue and its spending both on goods and services and on government transfers.

$$\boxed{S_{Government} = T - G - TR}$$

- Other things equal, discretionary expansionary fiscal policies—increased government purchases of goods and services, higher government transfers, or lower taxes—reduce the budget balance.

The Budget Balance

- **Expansionary fiscal policies** make a budget surplus smaller or a budget deficit bigger.
- Conversely, **contractionary fiscal policies**—smaller government purchases of goods and services, smaller government transfers, or higher taxes—increase the budget balance, making a budget surplus bigger or a budget deficit smaller.

The Budget Balance

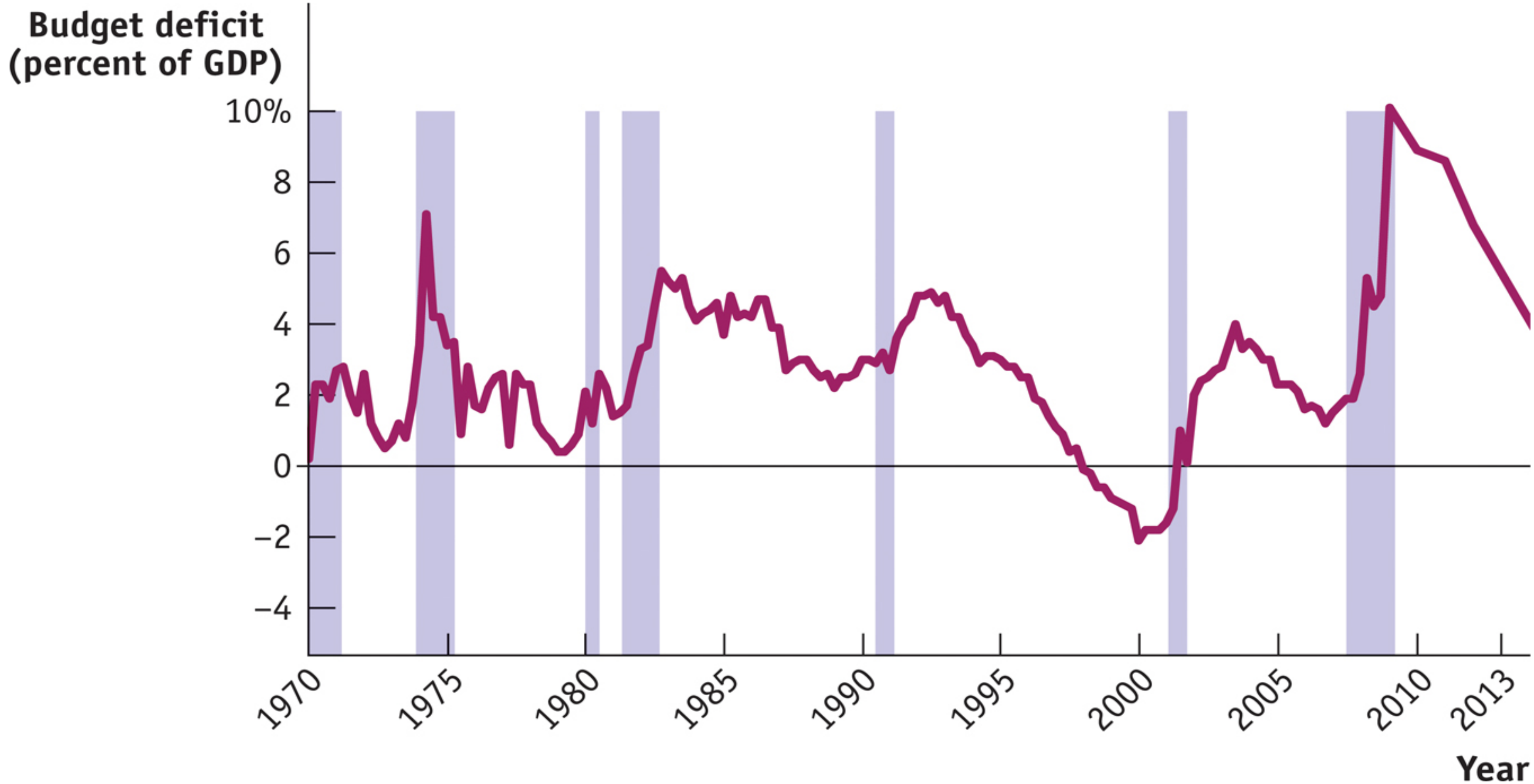
- Some of the fluctuations in the budget balance are due to the effects of the business cycle.

- In order to separate the effects of the business cycle from the effects of discretionary fiscal policy, governments estimate the **cyclically adjusted budget balance**.

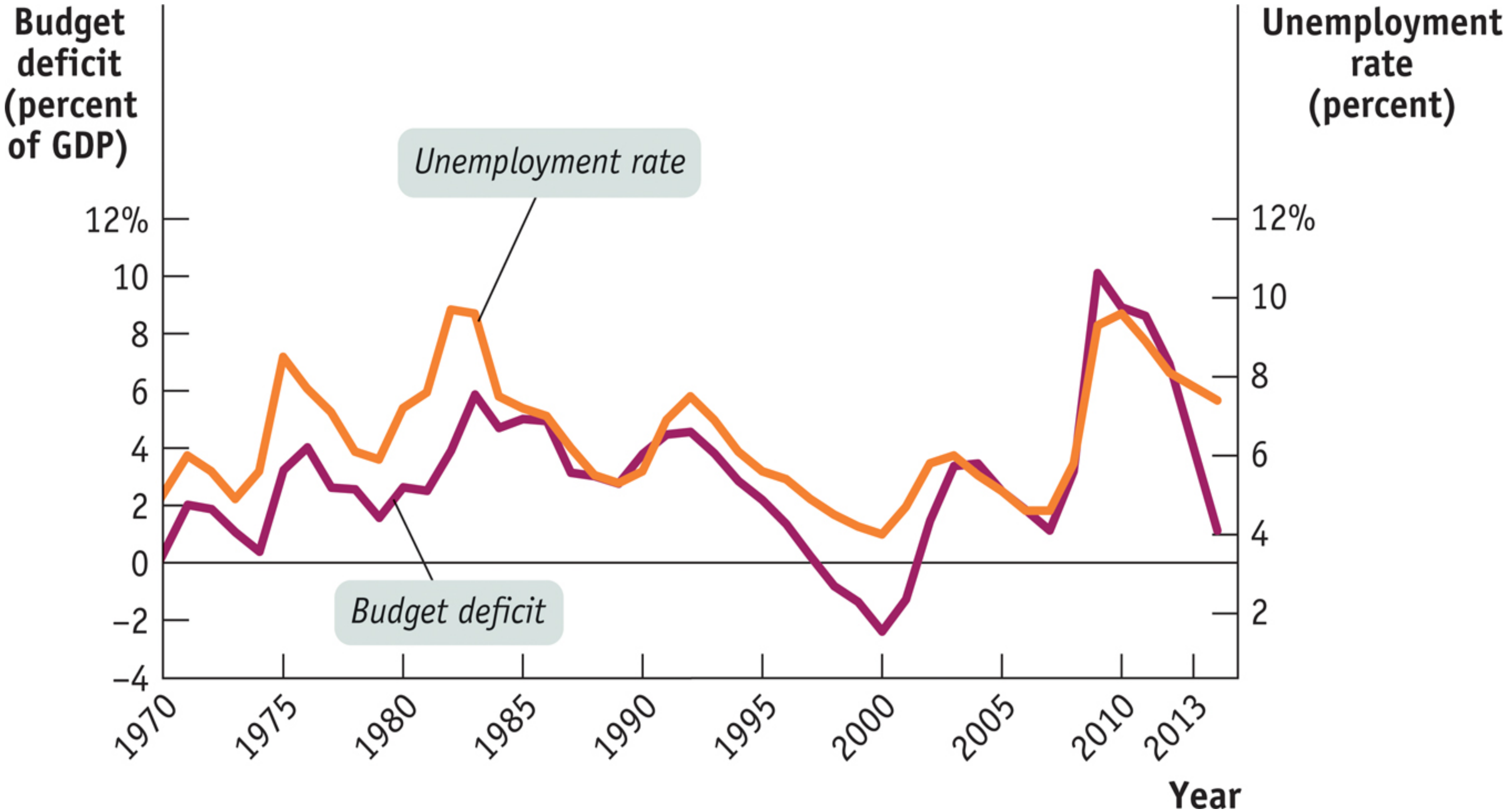
- The cyclically adjusted budget balance is an estimate of the budget balance if the economy were at potential output.

The Budget Balance

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

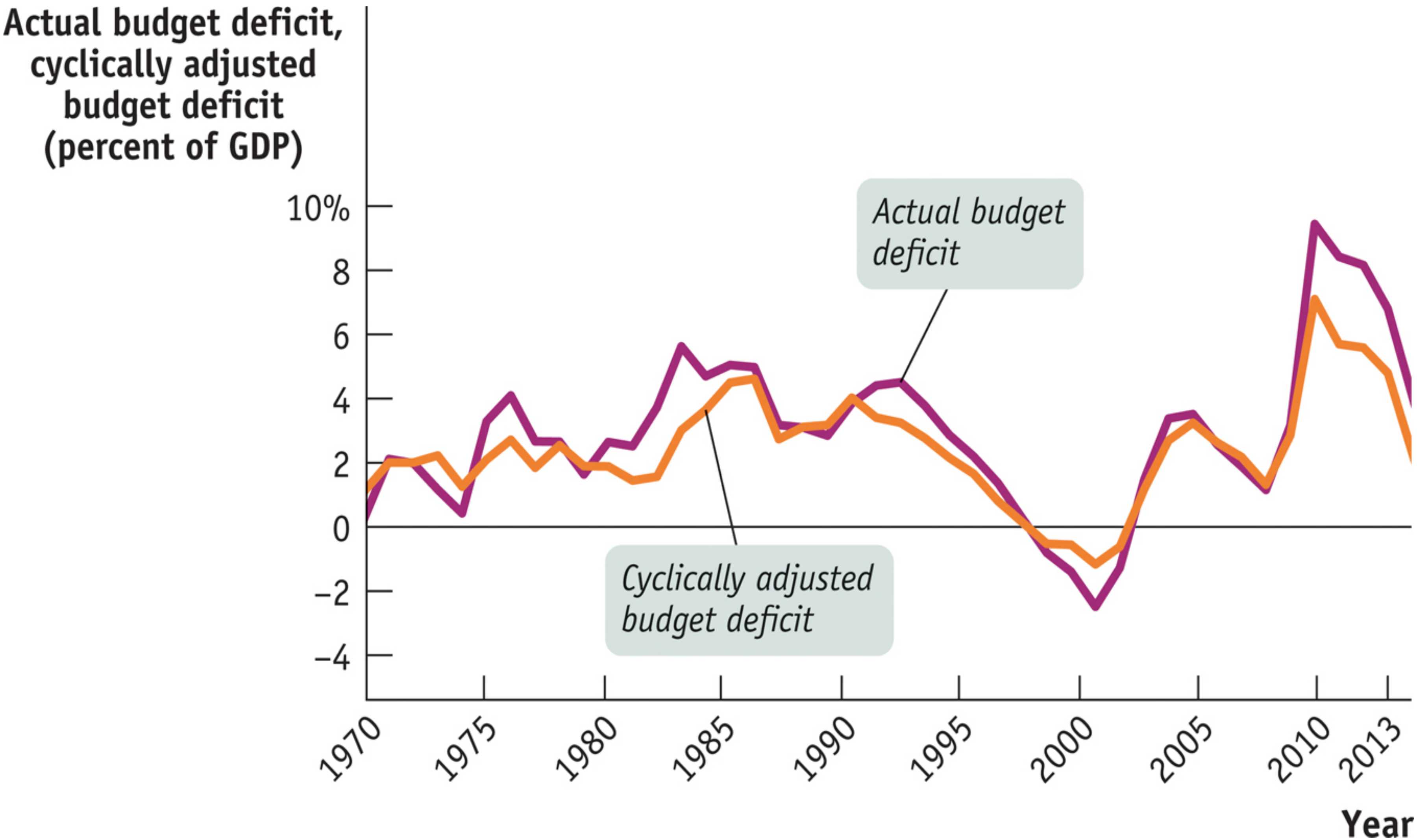


The Budget Balance



The budget deficit as a percentage of GDP moves closely in tandem with the unemployment rate.

The Budget Balance



Should the Budget Be Balanced?

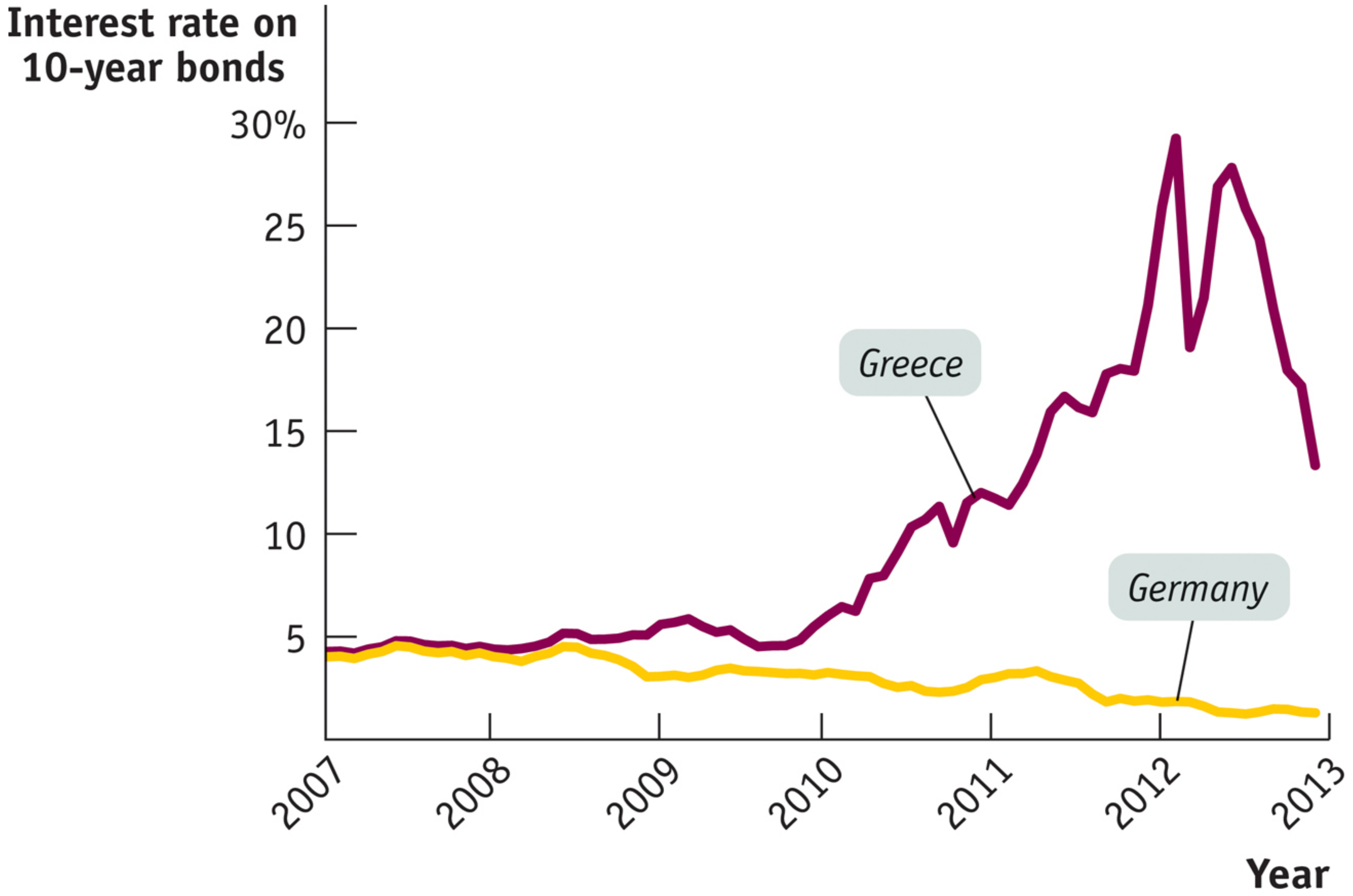
- Most economists don't believe the government should be forced to run a balanced budget *every year* because this would undermine the role of taxes and transfers as automatic stabilizers.

- Yet, policy makers concerned about excessive deficits sometimes feel that rigid rules prohibiting—or at least setting an upper limit on—deficits are a good idea.

Long-Run Implications of Fiscal Policy

- U.S. government budget accounting is calculated on the basis of **fiscal years.**
- A **fiscal year** runs from October 1 to September 30 and is labeled according to the calendar year in which it ends.
- Persistent budget deficits have long-run consequences because they lead to an increase in **public debt.**

Greek and German Long-Term Interest Rates



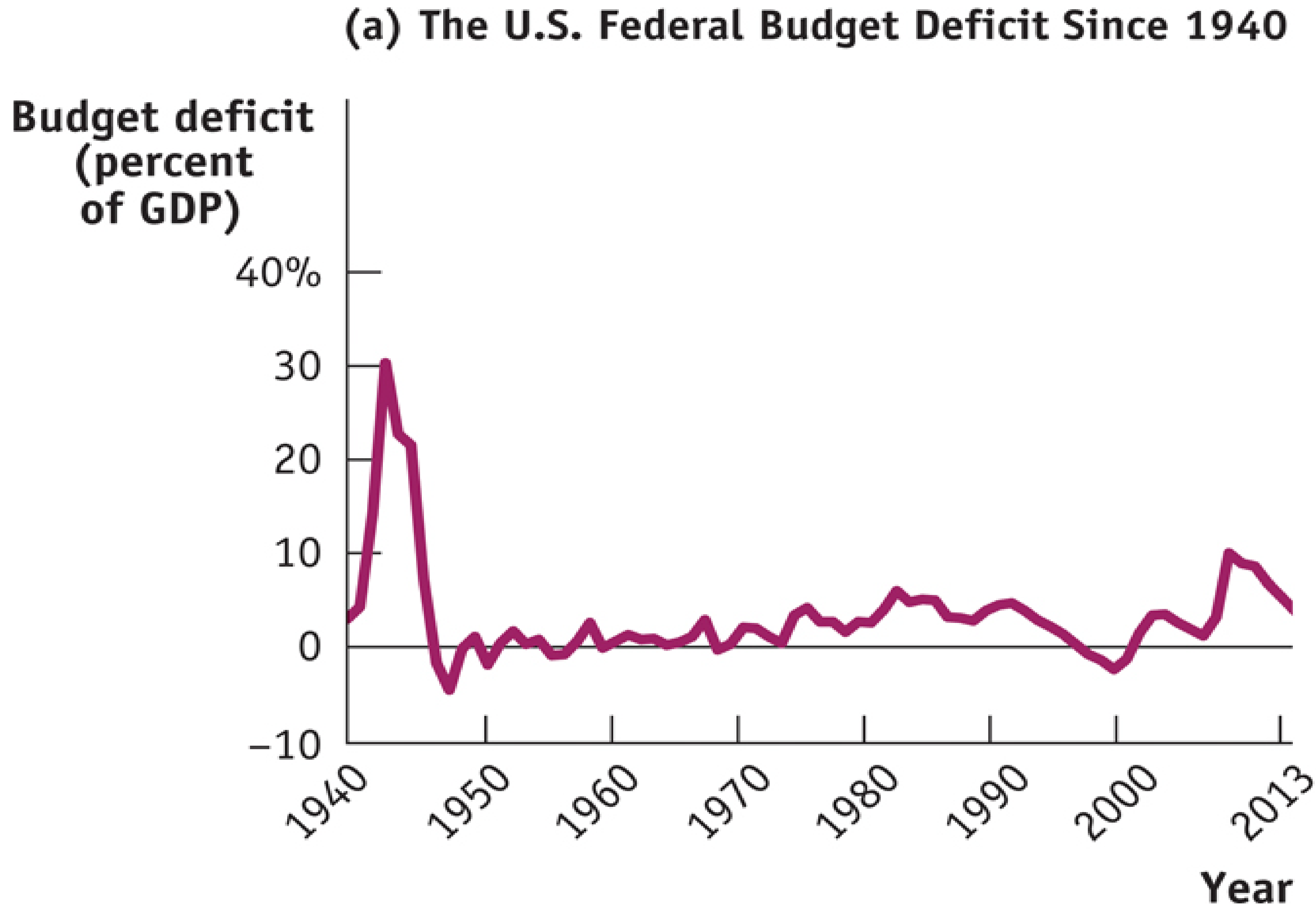
Problems Posed by Rising Government Debt

- Public debt may “crowd out” investment spending, which reduces long-run economic growth.
- And in extreme cases, rising debt may lead to government **default**, resulting in economic and financial turmoil.
- Can’t a government just print money to pay its bills?
- Yes, but this leads to another serious problem: **inflation**!

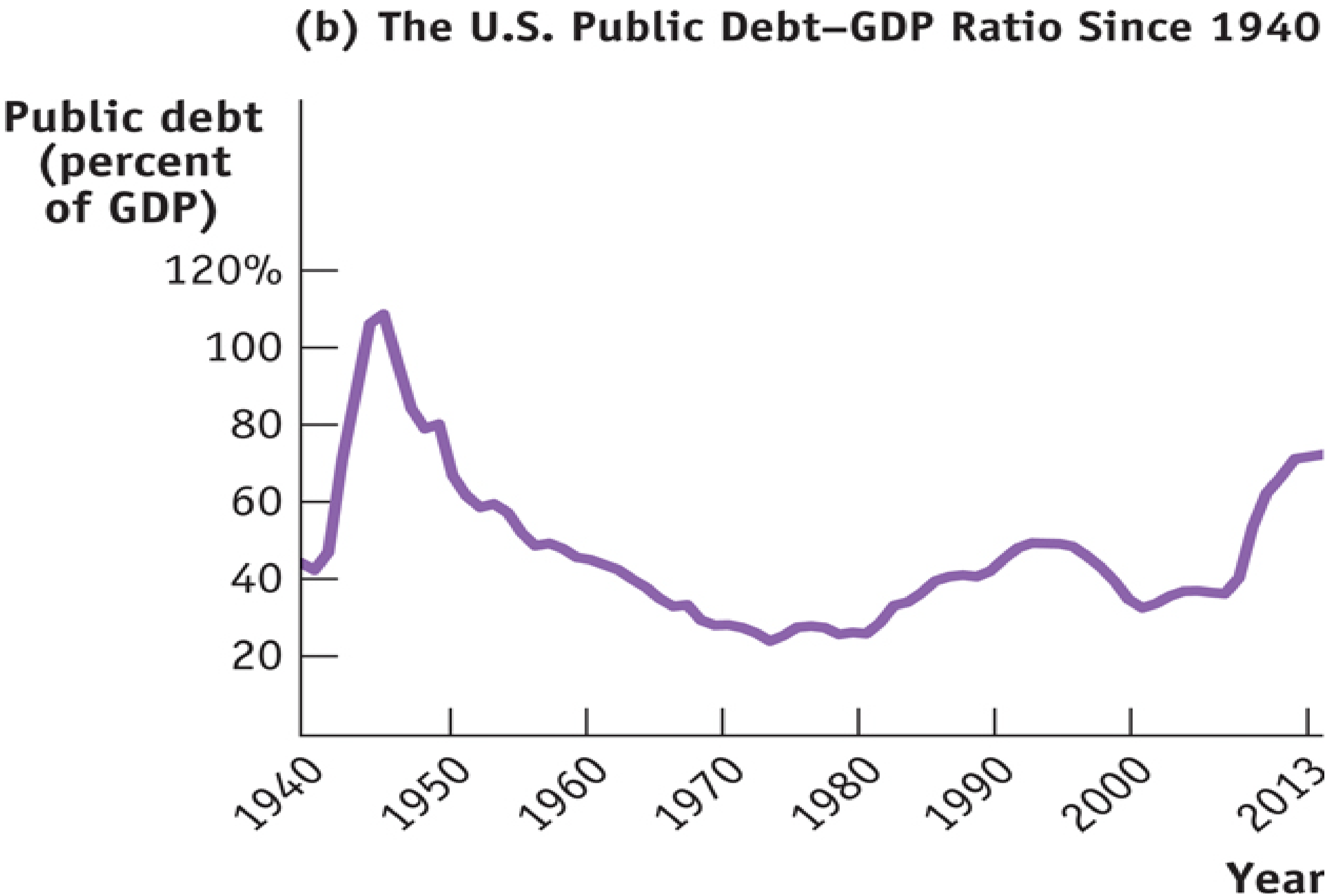
Deficits and Debt in Practice

- A widely used measure of fiscal health is the **debt–GDP ratio.**
- This number can remain stable in the face of moderate budget deficits if GDP rises over time.

U.S. Federal Deficits and Debt



U.S. Federal Deficits and Debt



Implicit Liabilities and Capital Budgeting

- **Implicit liabilities** are spending promises made by governments that are effectively a debt despite the fact that they are not included in the usual debt statistics.

- Some have argued in favor of **capital budgeting**, a budget procedure that accounts for assets as well as liabilities. However, capital budgeting is less transparent.

Future Demands on the Federal Budget