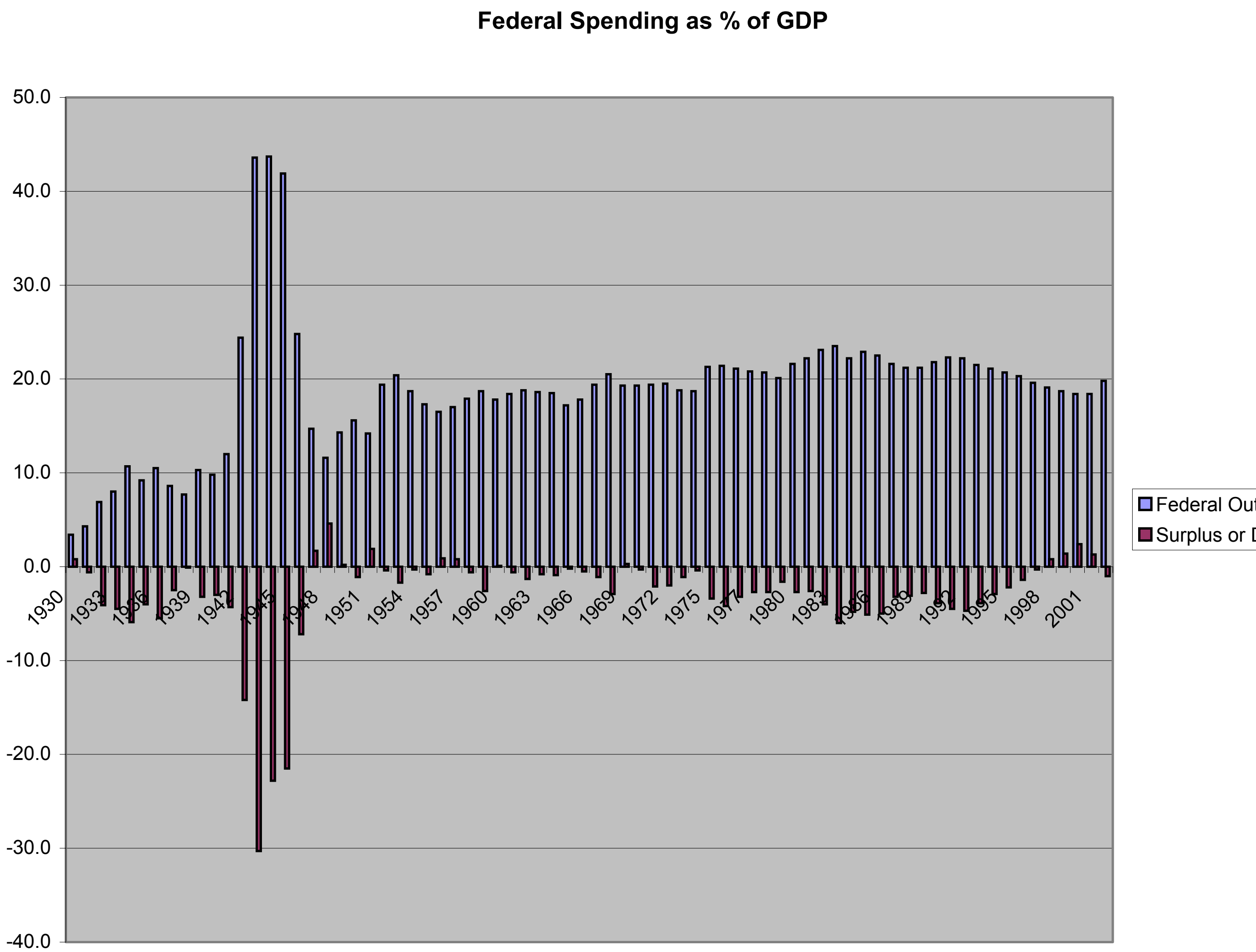
Chapter 17 – Government Fiscal Behavior and Policy

Why is it important to consider government fiscal behavior?



1. Federal government expenditures are approximately 20% of GDP. Total government spending, including state and local government expenditures, are approximately 36% of GDP. Virtually all of the increase in government spending as a % of GDP since 1949 has been at the state and local government level.

2. Federal government expenditures were a very small percentage of GDP prior to 1930. Yet, there were volatile business cycles in the U.S. economy prior to 1930. This is strong support for the argument that government is not the determining factor in business cycles as the monetarists claim.

3. Deficits have definite cyclical characteristics.

4. There was a deficit in federal spending every single year from 1970 to 1997.

5. In analyzing business cycle expansions and contractions, it is important to segregate the wartime cycles from the peacetime cycles (both expansions and contractions) because the federal government increases military spending very sharply in the wartime cycles.

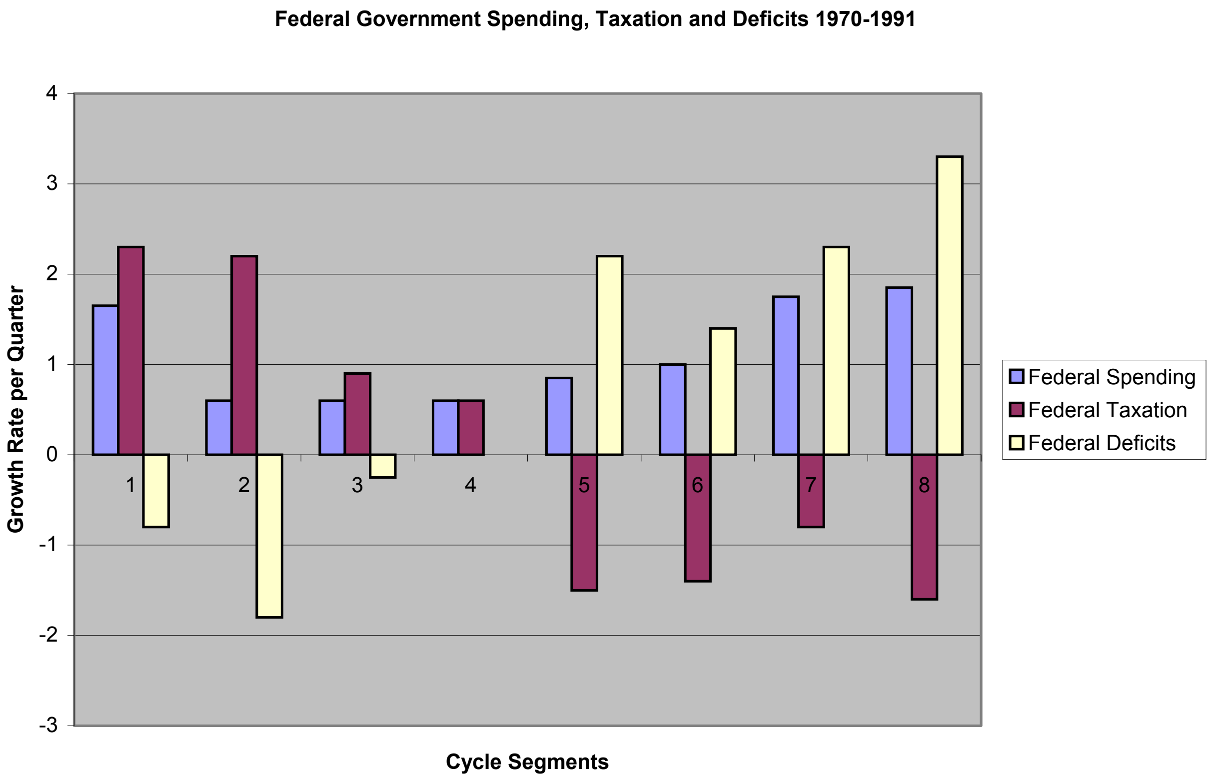
    i. Federal Government Expenditures: Rate of Growth per Quarter in Constant $

	1. Expansion	Contraction
ii. Average 2 War Cycles -- iii. 1949-54 and 1961-70.	2.6%	-1.6%
iv. Average 6 Peacetime v. Cycles – 1954-1991	0.5%	2.6%

    vi. This atypical pattern is caused by high military spending the expansions during wartimes and recessions following the wars. Each wartime has been followed by a recession.

6. In analyzing fiscal policy, economists split the policies into two categories; **automatic stabilizers** such as unemployment benefits and the tax system (increases in income and corporate taxes are a larger % of GDP in expansions because these tax rates are progressive) and **discretionary fiscal policy** such as tax cuts.

Cyclical Behavior of Federal Government Spending, Taxation and Deficits



Federal spending rises moderately in recovery, more slowly in prosperity, pick up speed again in the crisis and rise most rapidly in the depression phase. Federal spending is, therefore, counter-cyclical.

Federal tax receipts are very pro-cyclical. They most rapidly in the recovery, less so in prosperity, and decline all through the contraction. Receipts follow the pattern of national income, but rise and fall somewhat faster.

As a result of the spending and taxing pattern, deficits are a significant counter-cyclical factor. Deficits decline in recovery, are flat in prosperity and rise rapidly and remain high in both the crisis and depression phases. Deficits are high in the crisis and depression phases because Federal spending is high and rising while Federal taxation is falling.

In the prosperity phase when the private economy is slowing its rate of growth, the decline of deficit spending removes some support for the expansion. Government fiscal policy does not cause the downturn, but the decline in the deficit does reduce the rate of growth of demand. In the crisis and depression phases, deficits rise and increase the rate of growth for demand. Therefore, government fiscal policy is largely endogenous (at least the automatic stabilizers are) and part of the business cycle.

TABLE 17.5
CYCLICAL PATTERN OF FISCAL ACTIVITY (AVERAGE, 3 CYCLES, 1970-1991, RATE OF GROWTH PER QUARTER, CONSTANT DOLLARS. **INCLUDES ALL FEDERAL, STATE AND LOCAL, AND TOTAL GOVERNMENT ACTIVITY.**)

EXPENDITURES

	Expansion	Contraction
Federal	0.8	1.8
State and Local	0.3	0.5
Total Government	0.6	1.1

RECEIPTS

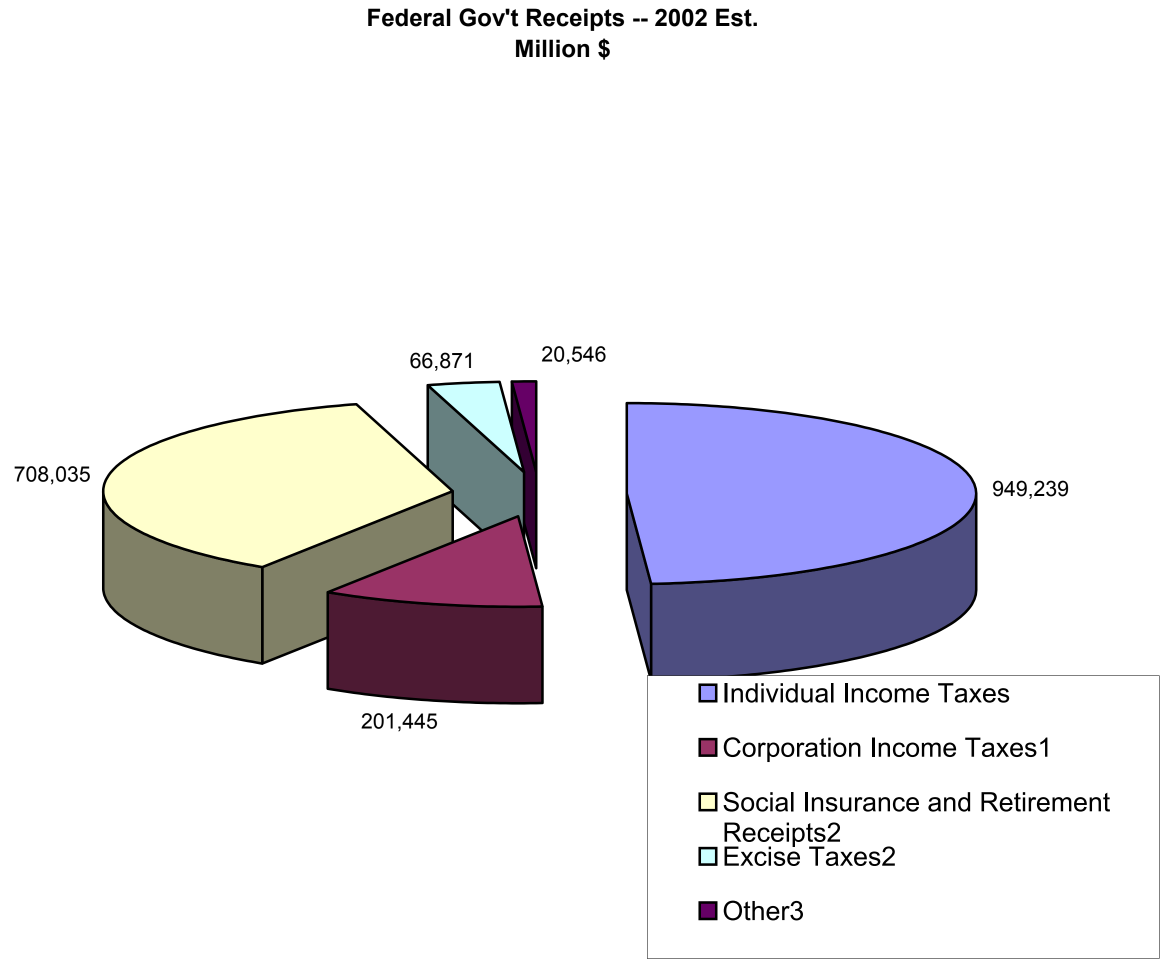
	Expansion	Contraction
Federal	1.4	-1.2
State and Local	0.6	-0.1
Total Government	1.2	-0.7

DEFICITS (EXPENDITURES – RECEIPTS)

	Expansion	Contraction
Federal	-0.6	3.0
State and Local	-0.4	0.5
Total Government	-0.5	1.8

What is Included in the Federal Government's Budget?

Source: Economic Report of the President



Superfunction and Function	2002 estimate	% Total Outlays
National defense	**347,986**	**16.96%**
Education, training, employment, and social services	71,697	3.49%
Health	**195,237**	**9.51%**
Medicare	**226,395**	**11.03%**
Income security	**310,733**	**15.14%**
Social security	**459,662**	**22.40%**
Veterans benefits and services	51,527	2.51%
Energy	561	0.03%
Natural resources and environment	30,238	1.47%
Commerce and housing credit	3,764	0.18%
Transportation	62,130	3.03%
Community and regional development	15,365	0.75%
Net interest	**178,385**	**8.69%**
International affairs	23,520	1.15%
General science, space and technology	21,759	1.06%
Agriculture	28,830	1.40%
Administration of justice	34,442	1.68%
General government	18,262	0.89%
Allowances	27,000	1.32%
Total, Federal outlays	**2,052,320**	**100.00%**
(On-budget)	1,690,621	
(Off-budget)	361,699	

The counter-cyclical government fiscal policies largely result from a neoclassical-Keynesian consensus among economists and politicians in the 1950's and 1960's. This consensus relied (and still does) on government fiscal policies to "fine-tune" the economy. The private economy is unable to adjust to full employment because of wage and price rigidities and monopolistic industries and needs government fiscal policies to smooth out the business cycle. If there is unemployment and no inflation, then the consensus recommends increased government spending and reducing government taxes (i.e. deficits are OK in this case). If there is inflation and low unemployment, reduce government spending and increase taxes.

There are the following limitations on these policies:

1. Administrative -- primarily the long lag times required to gather the information, interpret it, plan, legislate and execute these policies. These time lags often result in a stimulus program being enacted in mid-expansion.

2. Political -- no one can agree on what programs to cut, what programs to expand, or even what is the acceptable level of unemployment. Every government spending program has natural allies and private enterprise opponents.

3. Economic -- there are at least four serious economic limitations to using government fiscal policies to dampen the business cycle:

   - Redistribution of income to the poor or middle class can reduce entrepreneurial incentives to invest.

   - Any non-military direct investment by the government does compete with private capital. Private enterprise is often better organized to provide a service or a good than government agencies.

   - Government fiscal policies will impact the exchange value of the dollar and foreign trade. For example, if the U.S. continues to run large budget deficits, the value of the dollar may decline and cause import prices to rise and/or foreign investment in the U.S. to decline.

   - The trade-off between unemployment and inflation is poorly understood. Policies designed to reduce unemployment may result in higher inflation. It is almost certain that inflation moves in a longer-term cycle than the business cycle.