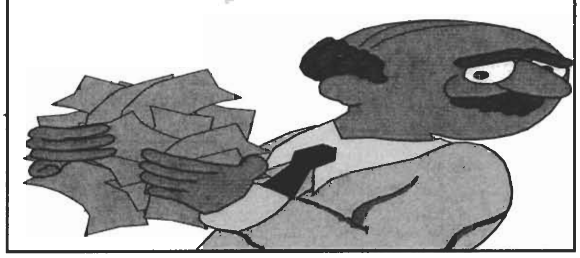
Deficits and debt



Budget Deficits and Public Debt:

•Deficits- a Short fall of revenues

•Debt- accumulated deficits minus accumulated surpluses

•Before the 1940s the government ran surpluses during peacetime and deficits during wartime. Since 1945 the U.S. has run continual deficits

Policy Regimes:

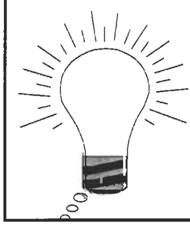
•Before 1945- Classical(balanced budget)

•1945-1980 Keynesian(deficits not bad)

•After 1980- Classical supply-side(tax cuts)

a. Laffer curve

b. increase AS



Deficit reduction acts:

•Gram-Rudman- Hollings act 1985

a. Manditory deficit targets

•Budget enforcement act 1990-

a. spending caps

b. pay as you go

Deficit reduction acts:

•Omnibus budget reconciliation act 1993

a. tax measures

b. spending cuts

•Balanced budget amendment?

A. hard choices

b. everyone wants goods and services, but no one wants to pay for them

Debt relative to assets:

•Country A

debt 3- trillion

assets- 500 trillion

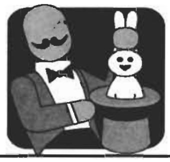
•Country B

debt- 1 trillion

assets- 1 trillion

Difference between individual and government debt:

- Individual has a limited life span
- when an individual dies there is an accounting of assets and debts
- the government never has to settle its accounts
- government can pay for the debt by creating money



Internal vs External debt:

- Internal government debt- government debt owned by its own citizens(transfer from tax payers to bond holders)

- External debt- government debt owed to foreign citizens

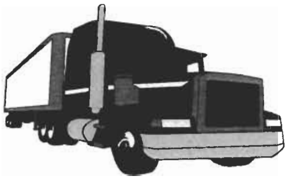
Debt relative to GDP:

- The ability to pay off a debt depends upon a nations productive capacity
- Governments ability to bring in revenue depends on GDP

Real growth and the deficit:

•When a society experiences real growth, it becomes richer and can handle more debt

•real growth has averaged 2.5% per year



Inflation, debt, and the real deficit:

•Inflation- wipes out the debt

•If inflation is wiping out debt and the deficit is equal to the increase in the debt from year to year then inflation also affects the deficit

•nominal deficit- the value generally reported

•real deficit- nominal deficit adjusted for inflation effect on the debt

Funded and unfunded retirement systems:

•Funded pension system- money is collected and invested in a special fund from which pension payments are made

•Unfunded pension system- pensions are paid from current revenues ex: social security

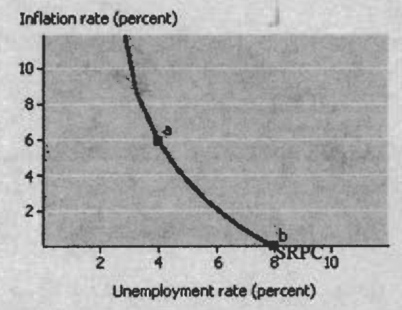
Inflation and unemployment

Inflation:

- Continuous rise in the price level
- Increasing the money supply leads to inflation
- Adaptive expectations- people expect last years rate of inflation to be this years

Phillips curve:

- whenever policy makers fight inflation unemployment increases
- whenever policy makers fight unemployment inflation increases
- Tells what combinations of inflation and unemployment are possible

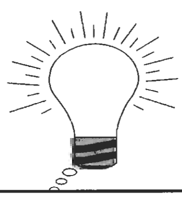


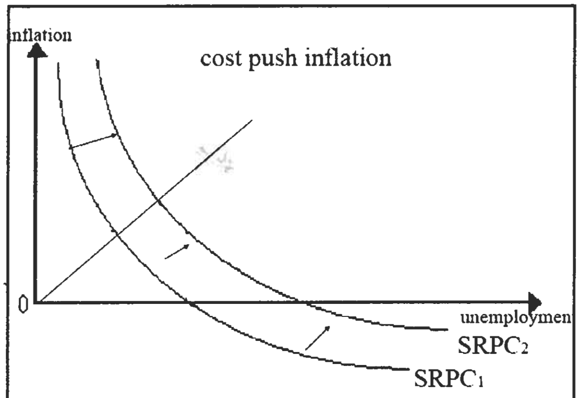
Short run Phillips curve

The Phillips curve illustrates the trade-off found by economist A.W. Phillips between lower unemployment and increased inflation. If unemployment is low at 4 percent, inflation is slightly high at 6 percent(point a). If inflation is eliminated, unemployment increases to 8 percent(point b). The trade of poses a dilemma for policy makers.

Breakdown of the short run phillips curve:

- 1970s stagflation(increase in unemployment and inflation)
- The short run phillips curve is good at explaining demand pull inflation not cost push inflation





Distinction between the short run and long run:

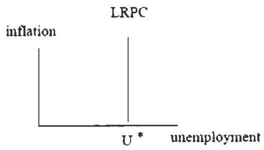
- On each point on the short run phillips curve, expectations of inflation are constant thus expected inflation does not always equal actual inflation
- At each point on the long run phillips curve expectations of inflation change so expected inflation equals actual inflation

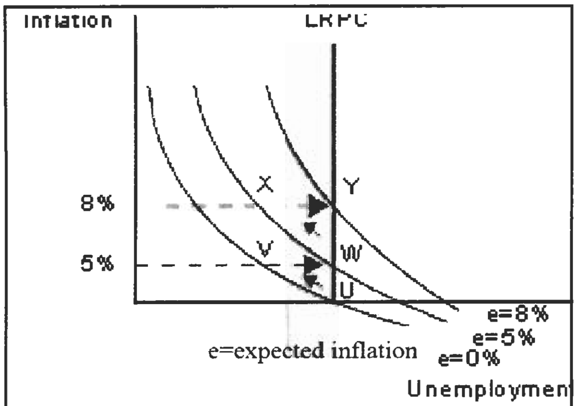
Expectations of inflation:

- When expectations of inflation are higher the same level of unemployment will be associated will a higher rate of inflation

Shape of the long run phillips curve:

• What difference should expectations of inflation make to the target level of unemployment? None

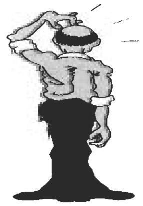




Classical policy:

Monetary rule

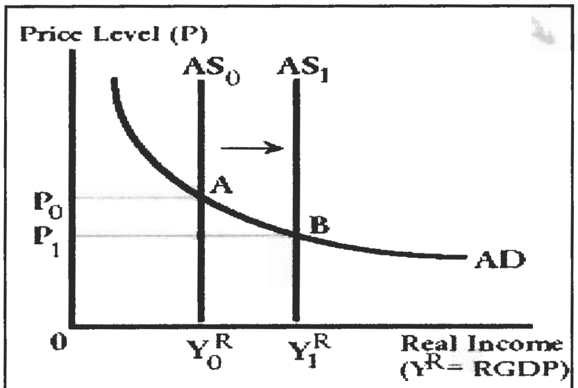
1. Increase money supply 3% per year
2. Don't use the money supply to steer the economy



Supply side

Pure capitalist(no work, no eat):

- Classical economists argue that social welfare programs have reduced people's incentive to work
- Need based social welfare programs discourage work effort, and create incentives for people to become needy



Why Be Thrifty?

"Why be thrifty any longer when your old age and health care are provided for, no matter how profligate you may be in your youth? Why be prudent when the state insures your bank deposits, replaces your flooded-out house, buys all the wheat you can grow? Why be diligent when half your earnings are taken from you and given to the idle?"

David Frum, author, "Dead Right," 1994

Regulation:

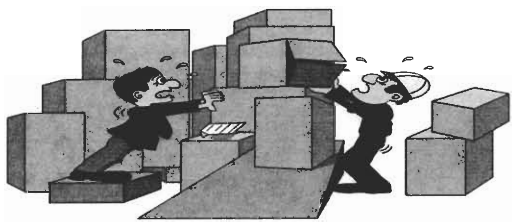
- To start a business in the U.S., one must go through an enormous amount of red tape
- Eliminating these regulations will encourage the starting of more businesses
- There will be more competition and potential output will increase

Reduce benefits to the unemployed:

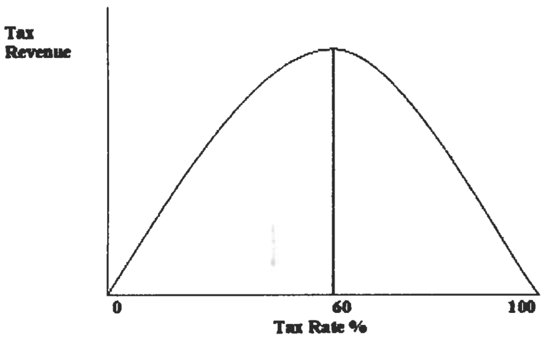
- If a worker had no income after becoming unemployed, the worker would probably be very active in searching for another job

Cut taxes:

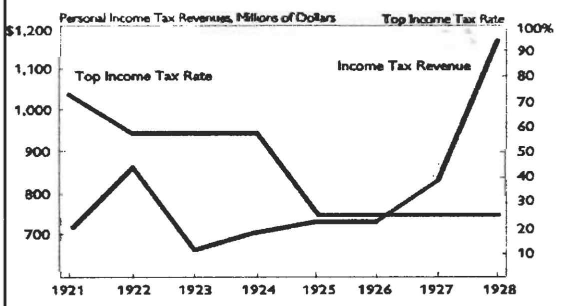
- Reducing income taxes will give workers an incentive to work



Laffer Curve



Lower Tax Rates in the 1920s Meant More Tax Revenue



Sources: Tax Foundation; Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," Staff Study, June 18, 1982.

Keynesians:

•Spending on social welfare will reduce crime. Less crime will lead to more business.

•Social welfare spending will improve nutrition. Half of the people in poverty are children. Improving nutrition increases the productivity of future workers.

Activist industrial policy:

•The government works directly with businesses, providing funds, background research and encouragement to specific industries

Questions about an activist industrial policy:

•Japanese corporations gave politicians options to buy stock in their companies at low prices

•Such problems are likely to arise under any activist industrial policy

•Government decision can mean a difference of hundreds of millions of dollars to firms