

Politics, Deficits, and Debt

Chapter 15

Laugher Curve

- When Albert Einstein died, he met three New Zealanders in the queue outside the pearly gates.
- To pass the time, he asked what were their IQs.
- The first replied 190.
- "Wonderful," exclaimed Einstein, "We can discuss the contribution made by Earnest Rutherford to atomic physics and my theory of general relativity."
- The second answered 150.
- "Good," said Einstein, "I look forward to discussing the role of New Zealand's nuclear-free legislation in the quest for world peace."
- The third New Zealander mumbled 50.
- Einstein paused, and then asked, "So what is your forecast for the budget deficit next year?"

Introduction

- In the long-run framework, surpluses are good because they provide additional _____ for an economy.
- Deficits are bad because they reduce _____, _____, and _____.
- In a short-run framework, whether surpluses and deficits are good or bad depends on the state of the economy relative to its potential.
- If the economy is running _____ its potential output, deficits are good and surpluses are bad.
- Combining the long-and short-run frameworks gives the following policy:

Whenever possible, run _____, or at least a balanced budget, to help stimulate long-term growth.

Defining Surpluses and Debt

- A **surplus** is an _____ of revenues over payments.
- A **deficit** is a _____ of revenues over payments.

Financing the Deficit

- The government finances its deficit by selling bonds to private individuals and to the central bank.
- **Bonds** – promises to pay back the money in the future.

Financing the Deficit

- A central bank is able to _____ to buy its government's bonds.
- Potentially, the central bank can print an unlimited amount of money to buy bonds.
- Printing too much money means _____ which can have a negative effect on the economy.

Arbitrariness in Defining Surpluses and Deficits

- Whether a nation has a deficit depends on what is included as a revenue and what is included as an expenditure.
- This accounting issue is central to the debate about whether we should be concerned about a deficit.
- How the Social Security system is accounted for plays an important role in the size of the budget deficit.

Social Security System - a social insurance program that provides financial benefits to the elderly and disabled and to their eligible dependents and/or survivors.

Many Right Definitions

- There are many ways to measure expenditures and receipts.
- There are many ways to measure deficits and surpluses.

- All definitions are not necessarily correct.

Deficits and Surpluses as Summary Measures

- Deficits and surplus figures are simply summary measures of the financial health of the economy.
- To understand the summary, you must understand the methods that were used to calculate it.
- What is important is not whether a budget is in surplus or deficit; what is important is the economic health of the economy.
- Not all government expenditures are independent of the level of income in the economy.
- The budget deficit could result from policies designed to affect the economy or from income deviating from its potential.

Structural and Passive Surpluses and Deficits

- A ***structural deficit or surplus*** –

- A ***passive deficit or surplus***

Structural and Passive Surpluses and Deficits

- When an economy is operating above its potential, it has a _____ surplus.

If the economy is operating below its potential, the _____ deficit would be larger than the structural deficit.

- There is a significant debate about what is an economy's potential income level.

There is disagreement about what percentage of a deficit is structural and what part is passive.

Budget Deficits and Surpluses: Actual, Passive, and Structural

Nominal and Real Surpluses and Deficits

■ A **nominal deficit** is determined by

■ A **real deficit** is the nominal deficit adjusted for _____.

Nominal and Real Surpluses and Deficits

■ Inflation reduces the value of the _____.

That reduction is taken into account when the real deficit is calculated.

■ The real deficit is calculated by adjusting the nominal deficit for inflation.

Real deficit =

Nominal and Real Surpluses and Deficits

■ The lowering of the real deficit by inflation is not _____ to the government.

Persistent inflation gets built into expectations and causes higher _____.

The Definition of Debt and Assets

■ **Debt**

■ Deficits and surpluses are _____ concepts.

■ Debt is a _____ concept.

Debt Management

■ The U.S. Treasury must sell new bonds when running a deficit and refinance previously issued bonds as they come due.

The Need to Judge Debt Relative to Assets

- Debt needs to be judged relative to assets.
- Debt is a summary measure of a nation's financial situation.
- As a summary measure, debt has even more problems than deficit.

- Debt by itself is only half the picture.

The other half is assets.

- For a nation, assets include:

- For a government, assets include:

- When the government runs a deficit, it might be spending on projects that increase its assets.

If the assets are valued at more than their costs, then the deficit is making the society better off.

- When businesses spend on projects that increase its assets, such expenditures are included in a capital budget.

These assets earn money in the future for the business.

- Government does not have a capital budget.

Determining what is an investment in government is extraordinarily difficult.

■ Most government goods earn no _____, they are supplied free to individuals and are paid for by taxes.

■ Thus,

Arbitrariness in Defining Debt and Assets

■ Defining debt and assets can be arbitrary.

■ As was the case with income, revenues, and deficits, there is no perfect answer as to how assets and debt should be valued.

■ Even after assets are taken into account, you still have to be careful when deciding whether or not to be concerned about debt.

■ Much of the government debt is internal to the government.

The government holds about 44 percent of its own debt, most of it in the Social Security trust fund.

Arbitrariness in Defining Debt and Assets

Difference Between Individual and Government Debt

■ Government debt is different from an individual's debt for three reasons:

Difference Between Individual and Government Debt

■ Paying interest on the internal debt involves a _____ among citizens of the country.

It does not involve a net reduction in income of the average citizen.

- _____ debt is more like an individual's debt.

External debt –

U.S. Government Deficits and Debt: The Historical Record

- The U.S. government ran almost continual deficits from World War II until recently.
- Deficits as a percentage of GDP _____ rise significantly in the 1970s and 1980s.
- Debt relative to GDP has _____ been continuously increasing.
- Deficits and debt relative to GDP provide a measure of a country's ability to pay off a deficit and service its debt.

Budget Deficits as a Percentage of GDP

Debt as a Percentage of GDP

The Debt Burden

- Most of the decrease in the U.S. debt-to-GDP ratio occurred through growth in GDP.
- When GDP grows, the government can reasonably handle more debt.
- Real growth in the U.S. has averaged about 2.5-3.5 percent a year.

This means that U.S. debt can grow between _____ percent a year without increasing debt/GDP ratio.

U.S. Debt Relative to Other Countries

- U.S. debt is _____ large relative to other countries.

U.S. Debt Compared to Foreign Countries' Debt

Interest Rates and Debt Burden

- The interest rate determines annual debt service.
- The annual *debt service* is
- Interest payments on the debt is government revenue that cannot be spent on defense or welfare.

That is what people mean when they say a deficit is burdening future generations.

Interest Rates and Debt Burden

- The U.S. can actually afford more debt since U.S. government securities are considered the safest in the world.

Federal Interest Payments Relative to GDP

The Current Budget Debate

- Why did the surplus come about?

Why Did the Surpluses Come About?

- The adoption of Keynesian policy of deficits to stimulate the economy has led to nearly continual budget deficits since the end of World War II.
- In the 1980s, both political parties pushed the economy toward deficits.
 - The Democrats by spending.
 - The Republicans by cutting taxes.
- The Budget Enforcement Act of 1990 put caps on certain aspects of federal spending, and established a “pay-as-you-go” test for new spending or tax cuts.

It did not, on its own, create the surpluses in the late 1990s.

- The Budget Enforcement Act of 1990 worked to _____ deficits.
- The _____ of the U.S. economy coupled with a _____ contributed to the growth in the surplus.
- Interest rates stayed _____, holding down government interest payments.
- The stock market _____ brought capital gains revenue to the government.

Where did the surplus go?

- The Economic Growth and Tax Relief Reconciliation Act of 2001 cut _____ and increased _____.

The September terrorist attacks and the war on terrorism lead to increased defense and homeland security spending.

- In 2002, the budget fell into deficit and was predicted to stay in deficit for the next few years.
 - Political pressure against deficits melted with the war on terrorism.
 - The Budget Enforcement Act wasn't extended.

Social Security and Lockboxes

- Because the government uses a cash flow accounting system, statistics do not adequately describe the actual surplus.

■ *Cash flow accounting system* –

- The Social Security System is currently running a large _____ in its portion of the budget.
- Some politicians have argued that a _____ should be created to use the surplus to pay down the debt held by the public.

Pay-as-You-Go System

- The Social Security system was set up as a pay-as-you-go system

- *Pay-as-you-go* system –

- The Social Security system is a partially unfunded pension system.

 - *Funded pension system* –

 - *Unfunded pension system* –

- An unfunded pension system works smoothly as long as the population's age distribution, the annual death rate, and the number of people working do not change much.

The Effect of the Baby Boom

- An unfunded system presents a potential problem if the amount paid in differs from the amount paid out.

- With a baby boom, the size of the retired elderly, the workers, and the very young who are not working, are no longer equal.

- When baby boomers retire, there will not be enough new entrants into the work force to pay their benefits.

Payments per beneficiary must decrease, real contributions per worker coming in must increase, or some combination of the two must occur.

Projection of Workers Compared to Retirees

The Social Security Trust Fund

- In 1983 legislation was passed to aid Social Security.
 - It _____ the age of eligibility slightly.
 - Social Security tax rates were _____.
 - Social Security payments became subject to _____ for some beneficiaries.

- The social security system currently accounts for _____ the government surplus.

The portion of surpluses held by Social Security is not available for spending – it is saved for the Trust Fund.

- Because the elderly use significantly more medical services than younger people, the Medicare program will also experience significant funding problems in the future.

The Real Problem and the Real Solution

- The real problem and the real solution are different from the financial problem.

- Even a fully funded Trust Fund will not solve the Social Security problem.

- The reason is that the Trust Fund is simply a financial solution, not a real solution.

A real solution would deal with the supply and demand of _____ resources, not with _____ amounts.

- When the baby boomers retire in 2030:
 - Workers must produce enough goods for themselves and their families.

 - They must also produce enough for the retired baby boomers.

- Workers will have to produce enough both for themselves and for the large number of retirees.

Real _____ per worker must increase but the real _____ of workers must not increase.

The Trust Fund Illusion

- The Trust Fund is an accounting illusion.
- It backs one government obligation with another government obligation.
- The Trust Fund has a positive effect on the problem, even if it does not solve the problem completely.

Politics and Economic Policy

- Politics affects economic policy.
 - A proposal to help the elderly with their drug expenses will, in 2020,

 - Another proposal is to invest the Trust Fund in the stock market –

Politically Unpopular Policies

- Politically unpopular policies may be needed.
 - The real solution is any policy that brings the real forces of aggregate supply and demand into equilibrium.

 - The real amount baby boomers spend when they retire must be reduced otherwise taxes on those still working must be increased.
- There are a number of ways this can be done, none of them politically appetizing.
 - Increase _____ on those working in 2030.
 - Cut _____ once baby boomers start retiring.
 - Make Social Security _____ tested.
 - Increase the retirement _____.

Politics, Deficits, and Debt End of Chapter 15