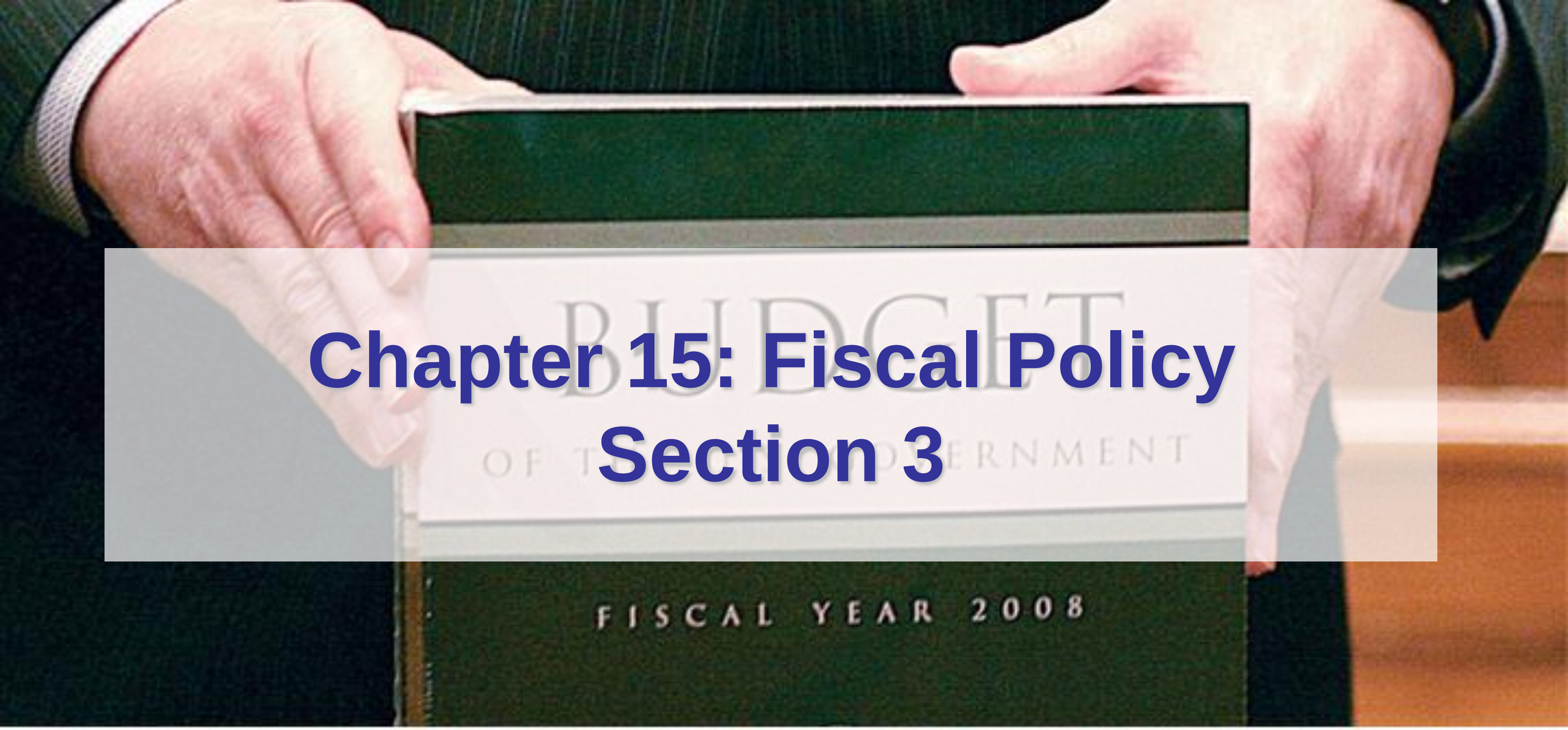

Chapter 15: Fiscal Policy
Section 3

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ECONOMICS
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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 debt.

Key Terms

ECONOMICS

- **budget surplus:** a situation in which budget revenues exceed expenditures
- **budget deficit**: a situation in which budget expenditures 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 2 to 10 years

Key Terms, cont.

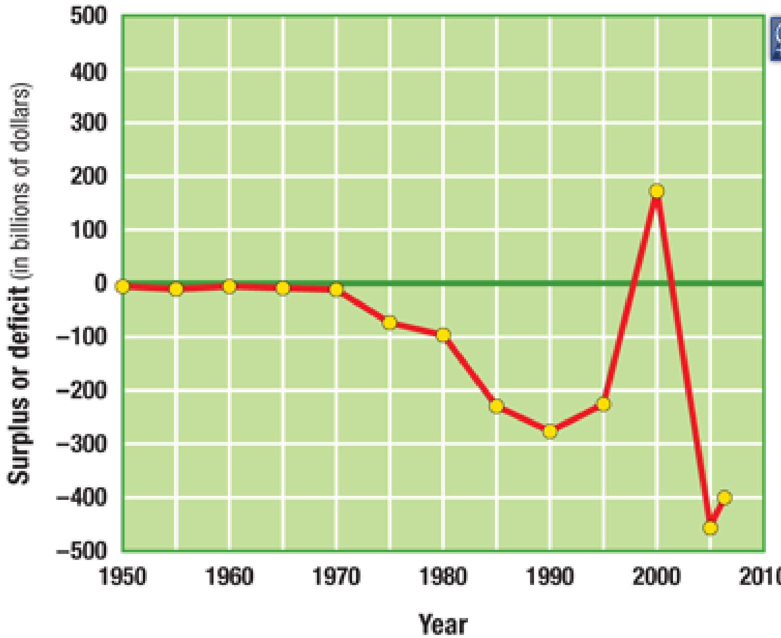
- **Treasury bond**: a government bond that is issued with a term of 30 years
- **national debt**: the total amount of money the federal government owes to bondholders
- **crowding-out effect**: the loss of funds for private investment caused by government borrowing

Introduction

- What are the effects of budget deficits and national debt?
  - A budget deficit leads to an increase in the amount that the government has to borrow.
  - As the government borrows more money, the national debt increases, which means there are fewer funds available for investing.

Balancing the Budget

- The federal budget is the basic tool of fiscal policy. The budget is made up of two parts:
  - Revenue—taxes
  - Expenditures—spending programs
- When revenues and expenditures are equal, the budget is balanced.
- In reality, the federal budget is almost never balanced and it either runs a surplus or a deficit.



SOURCE: *Office of Management and Budget*

In which of the years shown on the graph did the budget have a surplus?

Creating Money

- When the government runs a deficit it can respond by creating money or borrowing money.

- Creating money helps pay workers' salaries and citizens' benefits, which works for relatively small deficits.
  - But this approach can cause problems like inflation or, in some cases, hyperinflation.

Borrowing Money

- The federal government usually responds to a deficit by borrowing money.
  - The government usually borrows money by selling bonds.
  - Savings bonds allow people to loan the government small amounts of money and, in return, they earn interest on the bonds for up to 30 years.
  - Other common forms of government borrowing are Treasury bills, Treasury notes, and Treasury bonds.

The National Debt

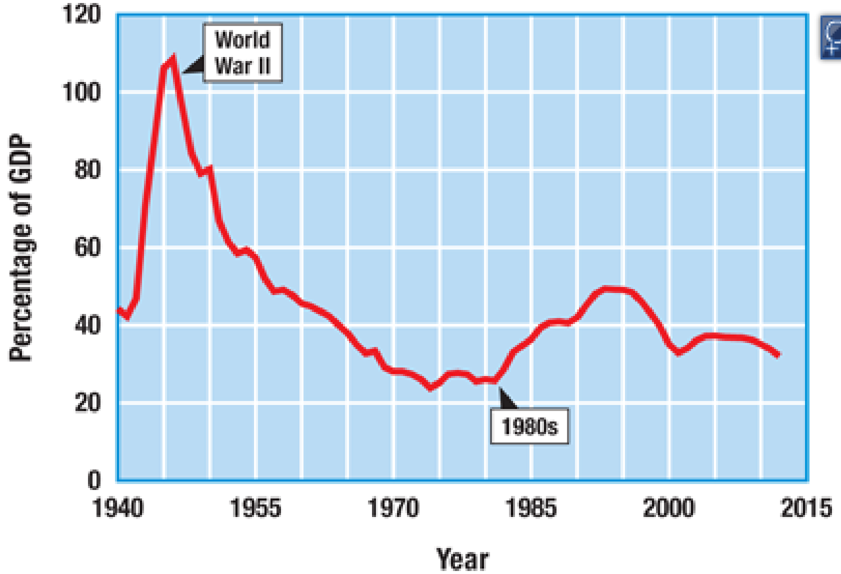
- Checkpoint: To whom does the government owe the national debt?
  - When the government borrows money it goes into debt.
  - The national debt is the total amount of money the federal government owes to bondholders.
  - Every year there is a budget deficit and the federal government borrows money to cover it, the national debt increases.

The National Debt, cont.

- The deficit and the debt are two different things.
  - The deficit is the amount of money the government borrows for one fiscal year while the debt is the sum of all government borrowing before that time minus the borrowing that had been repaid.

A Percentage of GDP

- In 2008, the national debt exceeded $9.4 trillion.
- Since this number is so large and is difficult to analyze, the size of the national debt is best looked at as a percentage of the gross domestic product (GDP) over time.
  - Why does the national debt as a percentage of GDP soar during times of war?



Note: Figures for the years 2007–2012 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 2008. Historical Tables.*

Problems of a National Debt

- A national debt reduces the funds available for businesses to invest because in order to sell its bonds the government must offer a high interest rate.
- Individuals and businesses thus buy these bonds instead of investing in private business, which is known as the crowding-out effect.

Problems, cont.

- The second problem with a high national debt is that government must pay interest to bondholders.
  - Over time, these interest payments have become very large and the government must pay out this interest and cannot spend this money on other programs such as defense, healthcare, or infrastructure.

Problems, cont.

- Another possible problem is that the debt may be foreign-owned and some fear that foreign countries may use their bondholdings as a tool to extract favors from the United States.
  - Checkpoint: What are the problems of having a huge national debt?

Other Views

- Some people, like traditional Keynesian economists, believe that the benefits of achieving full productive capacity outweigh the costs of interest on the national debt.
  - In the short term, deficit spending may help create jobs and encourage economic growth.
  - But a budget deficit can be an effective tool only if it is temporary.

Controlling the Deficit

- Gramm-Rudman-Hollings Act: Created automatic across-the-board cuts in federal expenditures if the deficit exceeded a certain amount.
  - Many programs, however, were exempt from cuts.
  - The Supreme Court found some parts of this Act to be unconstitutional.

Controlling the Deficit, cont.

- 1990 Budget Enforcement Act: Created a "pay-as-you-go" system that required Congress to raise enough revenue to cover increases in direct spending that would otherwise contribute to the budget deficit.

- A Constitutional amendment requiring a balanced budget has been suggested but it has yet to pass through Congress.
  - In the late 1990s, the federal government actually ran a surplus. This surplus was the result of budget procedures that helped control government spending, tax increases under President Clinton, and a generally strong economy.

Return to Deficits

- The surplus of the late 1990s was short-lived.
- The end of the stock market boom, an economic slowdown, and a new federal income tax cut reduced federal revenues.
  - The 9/11 attacks also added to the downturn in the economy.

- As a result, the federal government returned to deficit spending and we remain in a deficit today.

Review

- Now that you have learned about the effects of budget deficits and national debt, go back and answer the Chapter Essential Question.
  - How effective is fiscal policy as an economic tool?