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Introduction to U.S. Economy: Fiscal Policy

What is Fiscal Policy?

Fiscal policy is the means by which the government adjusts its budget balance through spending and revenue changes to influence broader economic conditions. According to mainstream economics, the government can impact the level of economic activity—generally measured by gross domestic product (GDP)—in the short term by changing its levels of spending and tax revenue. This In Focus presents an introduction to fiscal policy. For a more in-depth look at fiscal policy, its effect on the economy, and its use by the government, refer to CRS Report R45723, *Fiscal Policy: Economic Effects*, by Jeffrey M. Stupak.

Expansionary fiscal policy—an increase in government spending, a decrease in tax revenue, or a combination of the two—is expected to temporarily spur economic activity. Conversely, contractionary fiscal policy—a decrease in government spending, an increase in tax revenue, or a combination of the two—is expected to temporarily slow economic activity.

Expansionary Fiscal Policy

Recessions can have serious negative consequences for both individuals and businesses. During a recession, aggregate demand (overall spending) in the economy falls, which generally results in slower wage growth, decreased employment, lower business revenue, and lower business investment. As such, policymakers may want to intervene in the economy when a recession occurs by implementing expansionary fiscal policy to mitigate the decline in aggregate demand.

Expansionary fiscal policy can take the form of increased government spending, decreased tax revenue, or a combination of the two. Government spending takes the form of both purchases of goods and services by the government, which directly increase economic activity, and transfers to individuals, which indirectly increase economic activity as individuals spend those funds. Decreased tax revenue via tax cuts indirectly increases aggregate demand in the economy. For example, an individual income tax cut increases the amount of disposable income available to individuals, enabling them to purchase more goods and services. Standard economic theory suggests that in the short term, fiscal stimulus can lessen a recession's negative impacts or hasten a recovery.

However, expansionary fiscal policy's effectiveness may be limited by its interaction with other economic processes, including interest rates and investment, exchange rates and the trade balance, and the rate of inflation. First, expansionary fiscal policy is expected to result in rising interest rates, which puts downward pressure on investment spending in the economy. Second, it can lead to a

strengthening U.S. dollar, which results in a growing trade deficit. Third, it can lead to accelerating inflation in the economy, which tends to interfere with the efficient operation of the economy. All of these side effects from expansionary fiscal policy tend to put downward pressure on economic activity, and therefore work against the original stimulus generated through expansionary fiscal policy.

Expansionary fiscal policy's ultimate effect on the economy depends on the relative magnitude of these opposing forces. In general, the increase in economic activity resulting from expansionary fiscal policy tends to be greatest during a recession. This is because the positive effect of expansionary policy tends to be largest during a recession and the negative side effects tend to be smallest.

Contractionary Fiscal Policy

As the economy shifts from a recession and into an expansion, broader economic conditions will generally improve, whereby unemployment falls and wages and private spending increase. With improving economic conditions, policymakers may choose to begin withdrawing fiscal stimulus by decreasing the size of the deficit or potentially by applying contractionary fiscal policy and running a budget surplus.

The government can implement contractionary fiscal policy by increasing taxes, decreasing spending, or a combination of the two. When the government raises individual income taxes, for example, individuals have less disposable income and generally decrease their spending on goods and services in response. The decrease in spending temporarily reduces aggregate demand for goods and services, slowing economic growth temporarily. Alternatively, when the government reduces spending, it reduces aggregate demand in the economy, which again temporarily slows economic growth. As such, when the government implements contractionary fiscal policy, regardless of the mix of fiscal policy choices used to do so, aggregate demand is expected to decrease in the near term.

However, contractionary fiscal policy is expected to interact with similar economic processes as does expansionary fiscal policy, except in reverse. Contractionary fiscal policy is expected to reduce interest rates, leading to additional investment, and weaken the U.S. dollar, leading to more U.S. exports and fewer imports and a slowing of inflation. All of these side effects tend to spur additional economic activity, partly offsetting the decline in economic activity resulting from contractionary fiscal policy.

The ultimate impact on the economy of withdrawing fiscal stimulus depends on the relative magnitude of its effects on

aggregate demand, interest rates and investment, exchange rates and the trade deficit, and inflation.

Long-Term Fiscal Policy Considerations

Persistently applying fiscal stimulus can negatively affect the economy through three main avenues. First, persistent large budget deficits can result in a rising debt-to-GDP ratio and lead to an unsustainable level of debt. A rising debt-to-GDP ratio can be problematic if the perceived or real risk of the government defaulting on that debt begins to rise. As the perceived risk of default begins to increase, investors will demand higher interest rates to compensate themselves. Second, persistent fiscal stimulus—particularly during economic expansions—can limit long-term economic growth by crowding out private investment, as it is an important determinant of the economy’s long-term size. Third, rising public debt will require a growing portion of the federal budget to be directed toward interest payments on the debt, potentially crowding out spending on other policy priorities.

Monetary Policy

Fiscal policy is not the only policy lever available if the government wishes to influence broader economic conditions. The Federal Reserve implements monetary policy by influencing interest rates throughout the economy. The Federal Reserve can spur economic activity by lowering interest rates and slow economic activity by doing the opposite. Monetary policy can also be used in conjunction with fiscal policy to limit the undesirable aspects of expansionary or contractionary fiscal policy. For example, expansionary fiscal policy tends to have the undesirable effect of increasing interest rates; however, the Federal Reserve could combat this by pushing interest rates down through monetary policy. Monetary policy is set independently of fiscal policy, so it is also possible for the Federal Reserve to pursue monetary policy that neutralizes fiscal policy. For a more detailed discussion regarding monetary policy, refer to CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte.

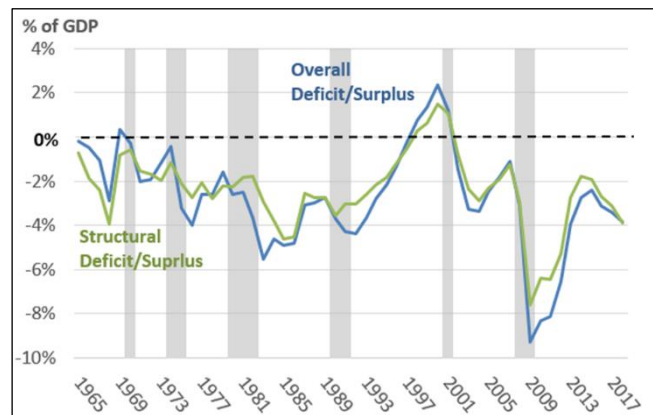
Fiscal Policy Stance

As shown in **Figure 1**, the federal government has generally been running a budget deficit for much of the past 50 years—save for two short periods in the 1960s and 1990s. This suggests that the federal government has been applying some level of fiscal stimulus to the economy for much of the previous several decades, although the level of stimulus has increased and decreased over time.

Examining the overall budget deficit to judge the level of fiscal stimulus can be misleading, as the levels of federal spending and revenue differ over time due to changes in the state of the economy, rather than deliberate choices made each year by Congress. During economic expansions, tax revenue tends to increase and spending tends to decrease automatically, as rising incomes and employment result in

greater individual and corporate income tax revenues. Federal spending on income support programs, such as food stamps and unemployment insurance, tends to fall during economic expansions as fewer people need financial assistance and file unemployment claims. The combination of rising tax revenue and falling federal spending tends to improve the government’s budget deficit. The opposite is true during recessions, when federal spending rises and revenue shrinks. These cyclical fluctuations in revenue and spending are often referred to as *automatic stabilizers*. Therefore, when examining fiscal policy, it is often beneficial to estimate the budget deficit excluding these automatic stabilizers, referred to as the *structural deficit*, to get a sense of the affirmative fiscal policy decisions made each year by Congress.

Figure 1. Federal Budget Deficit/Surplus



Source: Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget, <https://fred.stlouisfed.org/series/FYFSGDA188S>.

Note: Grey bars denote recessions as determined by the National Bureau of Economic Research.

As shown in **Figure 1**, budget deficits tend to increase during and shortly after recessions (denoted by grey bars) as policymakers attempt to buoy the economy by applying fiscal stimulus. This can be seen explicitly by viewing the structural deficit or surplus, as this only shows affirmative changes in fiscal policy made by Congress. The budget deficit then tends to shrink as the economy enters into recovery and fiscal stimulus is less necessary to support economic growth. However, in recent years, the federal budget has bucked this trend. After the structural deficit peaked in 2009 at roughly 7.5% of GDP, it began to decline through 2014, falling to about 2.0% of GDP. Beginning in 2016, despite relatively strong economic conditions, the structural deficit has started to rise again, nearing 4.0% of GDP in 2018.

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