Fiscal policy is the government’s use of taxing and spending to keep the nation’s economy stable. Decisions about fiscal policy are used to create the federal budget, a written document showing how much money the government expects to receive and spend in a year.

The budget process begins when each federal agency estimates spending for the next year. They send these estimates to the executive branch’s Office of Management and Budget (OMB). The OMB reviews proposals and, with the President’s staff, combines all budgets into one document, which the President presents to Congress. Congress reviews the budget with help from the Congressional Budget Office. Congress then proposes its modified budget and authorizes specific spending in appropriations bills, which the President can sign or veto.

Expansionary policies are designed to increase economic output. When the government increases its spending it buys more goods and services, leading to economic growth. When government cuts taxes, people have more money to spend, a situation which also leads to economic growth. Policies intended to decrease output are contractionary policies. These policies allow government to decrease its spending or raise taxes, both of which will lead to slower economic growth.

Fiscal policy is not easy to put into practice. Changes in the economy come slowly. During the time it takes to pass a budget and implement fiscal policy, the business cycle may change on its own.

**THE BIG IDEA**

Federal government decisions on taxes, borrowing, and spending have a powerful impact on the nation’s economy.

**GRAPHIC SUMMARY:** Creating the Federal Budget

1. Federal agencies send requests for money to the Office of Management and Budget.

2. The Office of Management and Budget works with the President to create a budget. In January or February, the President sends this budget to Congress.

3. Congress makes changes to the budget and sends this new budget to the President.

4. The President signs the budget into law.

5. The President vetoes the budget. If Congress cannot get a 2/3 majority to override the President’s veto, Congress and the President must work together to create a new, compromise budget.

**REVIEW QUESTIONS**

1. What are expansionary policies?
2. Diagram Skills What happens if the President vetoes the budget?
FISCAL POLICY OPTIONS

TEXT SUMMARY

Classical economics was a school of thought stating that markets regulate themselves and will return to equilibrium without government interference. The Great Depression challenged this view. Although prices fell, demand did not increase because so many people lacked jobs and money. John Maynard Keynes introduced a theory, called Keynesian economics, which emphasized the role of government in the economy. Keynes said the Depression continued because neither consumers nor businesses had an incentive to increase spending. Companies would not increase production if consumers had no money to buy their products. Consumers who were unemployed had no money to spend. Keynes argued that the government could buy more goods and services, encouraging production, which in turn would put more people back to work.

Fiscal policy is powerful because of the multiplier effect, the idea that every dollar change in fiscal policy creates a greater than one dollar change in the national economy. For example, if the government buys $10 billion in goods and services, GDP increases by more than $10 billion because firms spend money on wages, raw materials, and investment. Workers, suppliers, and stockholders will have money to spend.

Supply-side economics states that taxes have a negative effect on economic output. Supply-siders argue that lower taxes put more money in people’s pockets, which in turn leads to greater investment and more jobs. Under President Ronald Reagan in the 1980s, the government cut taxes and implemented supply-side policies.

GRAPHIC SUMMARY: Comparing Economic Theories

<table>
<thead>
<tr>
<th>Classical Economics</th>
<th>Keynesian Economics</th>
<th>Supply-Side economics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Markets regulate themselves. As prices rise and fall, supply and demand adjust and the market returns to equilibrium.</td>
<td>In a recession, demand may not increase even if prices drop. If neither consumers nor businesses can spend money, the government spends more to increase aggregate demand.</td>
<td>Aggregate supply is more important than aggregate demand. Lower tax rates are the key to increasing aggregate supply because they make more money available to investors.</td>
</tr>
</tbody>
</table>

Different economic theories have different views about the government’s role in encouraging growth.

DIFFERENT SCHOOLS OF ECONOMIC THEORY PROVIDE DIFFERENT VIEWS ABOUT THE GOVERNMENT’S ROLE IN ENCOURAGING GROWTH.

REVIEW QUESTIONS

1. What is the multiplier effect?

2. Chart Skills Which theory advocates focuses on aggregate demand? Which focuses on aggregate supply?
TEXT SUMMARY

When government revenues equal spending, a balanced budget exists. In reality, the federal budget is rarely balanced. A budget surplus occurs when annual revenues are higher than spending. A budget deficit occurs when spending is higher than revenues.

When the government runs a deficit, it must find a way to pay for the extra expenditures. It can either create money or borrow money. Covering huge deficits with created money can lead to hyperinflation, or very high inflation. The main way that government borrows money is by selling bonds, such as United States Savings Bonds.

When government borrows money, it creates a national debt, the total amount of money the government owes to bondholders. Two problems arise from a national debt. First, it reduces funds available for businesses to borrow and invest because people buy government bonds instead of investing in business. Second, government pays interest to bondholders, and money spent paying interest cannot be spent elsewhere.

In the 1980s, huge deficits led Congress to pass laws cutting federal spending. After the Supreme Court found many of these laws unconstitutional, some people suggested amending the Constitution to require a balanced budget. Opponents said an amendment would prevent government from dealing with rapid economic changes.

At the beginning of the twenty-first century, budget surpluses occurred for the first time in thirty years. However, many long-term projections predict that deficits will return.

GRAPHIC SUMMARY: Budget Surpluses and Deficits

The BIG IDEA

When the federal spending is greater than revenue, budget deficits and a national debt are the result.

In the years since 1940, the United States government has had more years of budget deficits than budget surpluses.

SOURCE: The World Almanac and Book of Facts

REVIEW QUESTIONS

1. What is the difference between a budget surplus and a budget deficit?

2. Graph Skills When did the federal government run the largest deficit? The largest surplus?
1. What is the main goal of government’s fiscal policy?
   A. to have a budget surplus
   B. to have a budget deficit
   C. to produce a balanced budget
   D. to maintain a stable economy

2. The federal budget process begins with
   A. appropriations bills.
   B. federal agency estimates.
   C. Congress.
   D. the Congressional Budget Office.

3. Which of the following might be part of an expansionary policy?
   A. increased taxes
   B. a tax cut
   C. lower government spending
   D. mandatory spending

4. Classical economics states that
   A. markets should be allowed to regulate themselves.
   B. government should spend in a recession.
   C. government should cut taxes in a recession.
   D. government should raise taxes in a recession.

5. John Maynard Keynes believed that to end the Great Depression, government should
   A. allow the markets to regulate themselves.
   B. spend and buy more goods and services.
   C. lower taxes.
   D. raise taxes.

6. The main idea of the multiplier effect is that
   A. government should create new money to put an end to inflation.
   B. every dollar the government spends creates a greater than one dollar change in economic output.
   C. taxes multiply each year and create a greater deficit.
   D. as the economy grows, more jobs are created.

7. A supply-side economist would be in favor of
   A. cutting taxes.
   B. raising taxes.
   C. increasing government spending.
   D. regulating markets.

8. When government revenues and expenditures are equal, there is
   A. a budget surplus.
   B. a budget deficit.
   C. hyperinflation.
   D. a balanced budget.

9. The national debt is
   A. all the money individuals owe on their credit cards.
   B. the interest the government pays on bonds.
   C. the total amount of money the federal government owes.
   D. the same as a budget deficit.

10. What was the budget situation of the federal government at the beginning of the twenty-first century?
    A. There was no longer a national debt.
    B. The budget deficit was larger than ever.
    C. There was a budget surplus.
    D. The budget was balanced.