3 Budget Balancing Philosophies
Econ 202/Haworth

There are 3 approaches government can use when it comes to balancing the government budget. Those approaches are as follows:

(1) Balancing Annually: where the government must balance the budget every year
(2) Balancing over the Business Cycle: where the government balances the budget, but over a longer period of time
(3) Functional Finance: where the government doesn't worry about balancing the budget, but instead, government basically focuses on fixing problems within the economy

Let's consider each approach, and examine (a) how the approach is implemented, and (b) how that approach affects our business cycle graph (i.e. how it affects the economy).

Balancing the Budget Annually

(a) Implementing this approach
Implementation here is very basic, we must maintain a balanced budget by the end of the period, which we can assume is one year. The government's budget must start balanced (e.g. January 1) and end balanced (e.g. December 31), which of course effectively ensures that we'll start balanced next period. Based on our definitions for budget deficits, surpluses and a balanced budget (previous handout), the Balance Annually approach requires that $G - T = 0$. In this situation, we find that in order to increase spending in one area, policymakers (i.e. Congress) must either decrease spending in another area or increase taxes to cover the extra spending being proposed.

(b) Effect of this approach on the economy
To determine the effect on the economy from implementing this approach, we need to ask how policymakers would react to changes in the economy.

The handout called "Contractions and the Government Budget" illustrated how a decrease in GDP, i.e. a contraction in the economy, can lead to a government budget deficit, and how an increase in GDP, i.e. an expansion in the economy, can lead to a government budget surplus. Rather than explain all of that again, we'll take it as given (that's a hint which says you should read that handout if you haven't already).

With that in mind, let's consider what would happen if there's a recession or contraction (i.e. decrease in GDP).

If GDP decreases, then we know that the government's budget will change. During recession, we may observe an increase in government spending (e.g. automatic payments that start going out if people lose their jobs) and decrease in tax revenue (e.g. if you pay 10% of your income in taxes, there's a decrease in tax revenue if you lose your job).

Let's say on June 1, the government realizes that their government budget went from being balanced to involving a deficit. In 6 months from that point, December 31, the budget must be balanced. How does the government balance their government budget when it's currently in a budget deficit? They must either decrease spending or increase tax rates to raise tax revenue (or both). That is, the government will implement measures which may balance the budget, but once implemented cause the economy to contract. In other words, during a period of contraction, where the business cycle graph shows a decreasing line, the government implements measure that cause the economy to contract even more and as a result, the business cycle line decreases even further than what would have otherwise occurred. Balancing the budget during a recession tends to make the recession worse.

If we balanced the budget and then experienced an expansion instead of a recession, then we would get a similar result, but in the opposite direction. I.e., the economy would expand even more quickly and the business cycle graph would reflect a higher peak during that period of time after the budget was balanced.

Balancing the Budget over the Business Cycle

(a) Implementing this approach

Before explaining how to implement this approach, we can ask why the budget must be balanced within 1 year, rather than let's say balanced over a 2 or 3 year period? The goal of this next approach is to seek balance over a period of time, very similar to how households will borrow more when their income is low, and use higher income periods to pay off their debt.

Here's how that translates into a budget balancing approach. With this approach, the idea is that you run government budget deficits during recessions and contractions, and government budget surpluses during expansions. The government debt you incur when the budget is in deficit would then be paid off when the economy enters expansion, because the government's budget would reflect surplus – which means extra tax revenue money that can be devoted to paying off the debt.

(b) Effect of this approach on the economy

Now suppose that the government is able to balance their budget on January 1, but once again, the economy heads into recession. As we said above, regardless of your balancing approach, recession tends to move the government budget into a deficit. What we want to know is how the government will respond? If balancing annually, the government must enact measures which lead to further contraction, but in this situation, the government takes a different approach. Since there's no need to balance right away, the government can implement measures which will help slow the contraction and end the recession. I.e., as the economy heads into contraction, the government can spend more, borrow the money and run the government budget deficit up even more.

What's the effect of government increasing spending, decreasing taxes and incurring a greater government budget deficit? The path to recession slows down, the economy gets better and the business cycle graph reflects this by not decreasing as quickly.

Compare this to the last approach. With balancing annually, a recession leads to a government budget deficit that must be fixed, and the government implements changes which may close the deficit, but negatively impact the economy. I.e., the business cycle graph shows the curve decreasing even more than it otherwise would decrease and the recession worsens. With balancing over the business cycle, a recession also leads to a budget deficit, but now, government would be implementing changes which positive impact the economy and help fix the recession. I.e., the business cycle graph shows the curve decreasing less than it otherwise would, because government is doing things to end the recession, and prevent further decline in the economy.

When we consider what would happen if we started with an expansion instead of contraction, there's a similar result, just in the opposite direction. As the economy moves into an expansion, and government must slow down the economy in order to prevent inflation from spiraling out of control, we see government policy that would create a budget surplus. A budget surplus would slow the expansion, allow government to pay off debt incurred during any previous recession, and keep the business cycle curve from rising as high.

Functional Finance

(a) Implementing this approach

In the previous two approaches, we observed a decreasing emphasis on government balancing their budget right away. Balancing annually implies that balancing must occur within a year, but balancing over the business cycle implies that we can wait for a longer period before worrying about balancing. Similarly, we could argue that with balancing annually, this approach is not too

concerned with its effect on the economy, whereas with balancing over the business cycle, we have a more (dare I say it) balanced approach. I.e., we still want to balance the budget, but we also want to make sure we prevent the economy from experiencing economic problems like recession and inflation.

The Functional Finance approach differs from the other two in that government is solely focused on the economy, fixing macroeconomic problems like recession and inflation, and not worried at all about balancing the budget. Proponents of this approach would argue that the government never needs to worry about balancing the budget, the government should simply focus on the economy and keep us producing at our potential.

(b) Effect of this approach on the economy

Any approach that's even slightly focused on the economy will be an approach that keeps recession and inflation from becoming major problems. These are approaches that prevent the business cycle graph from decreasing as far, and from increasing as much as would otherwise occur if there was no concern over fixing macroeconomic problems.

If government balances their budget on January 1 and the economy experiences a recession on the very next day, then we will reenact what occurred with balancing over the business cycle. In that situation, government will run government budget deficits after increasing their spending and/or decreasing tax rates, which lowers tax revenue. The effect of those government budget deficits is to slow the contraction and end the recession. We get the same effect here that we got with balancing over the business cycle. Overall, we would get the effect illustrated below, where the business cycle graph would transform from the black line to the red line.