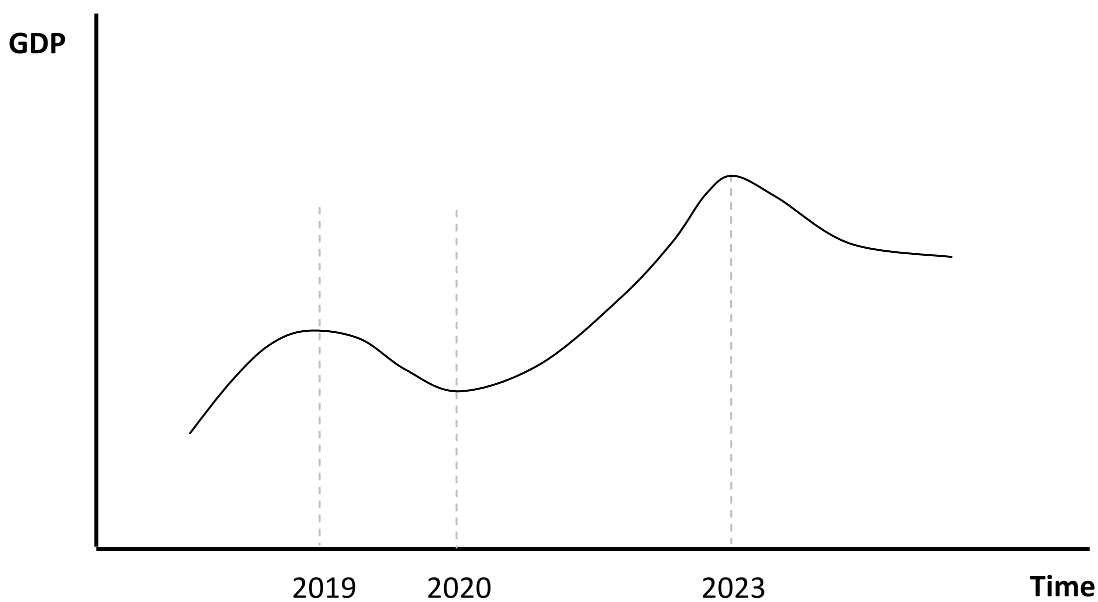
The government's budget and the business cycle
Econ 202/Haworth

To understand how differences in how government approaches balancing the government budget, we must look at two important concepts. First, our ability to describe the economy by examining how GDP changes over time (which we call a study of the business cycle), and second, we must understand the government's budget.

The Business Cycle
Our study of the business cycle is really just a study of how the economy changes over time, and the best indicator of that is changes in GDP. When we're doing well and the economy is producing at our potential, we're producing an appropriate level of GDP. If we begin to sink into recession, then GDP begins to fall, and of course, if the economy is overheating, because we are producing too much and inflation begins to become a problem, the GDP is rising. When we look at how GDP changes over time, the result looks something like the figure depicts below.



Although this is only a general illustration of what happened to GDP between 2019 and 2023, this figure shows us both expansion and contraction within the economy (i.e. rising and falling GDP). E.g., leading up to 2019, the economy expanded until reaching a peak. After 2019, as we went into what's been called "the Covid recession", GDP began falling, hitting a low point in 2020 and then slowly rose up through 2023. If the figure is correct, then we'd be heading into a contraction and accompanying recession after 2023.

Government budget

When we analyze changes in the government's budget, we are looking at the difference between government spending and government tax revenue. If the government spends more than is available as tax revenue, then we have a government budget deficit. If it's less, then we have a government budget surplus, and if it's exactly the same, then the government's budget is balanced. Of course, this situation is not static. Although changes in fiscal policy directly affect the government's budget, we know that changes in the economy can affect the government's budget as well. You'll want to read the handout "Contractions and the Government Budget" for a discussion on how recession can lead to the government's budget going from balanced to a deficit.

Summarizing, the government's budget situation is determined by looking at the difference between G (government spending) and T (tax revenue). I.e., we can talk about the government's budget being balanced, in deficit or in surplus by calculating (G – T). Using this calculation, we can say:

- If $G - T > 0$, then we are spending more than we bring in with tax revenue and there's a government budget deficit
- If $G - T < 0$, then we are spending less than we bring in with tax revenue (i.e. we have "extra money" laying around) and there's a government budget surplus
- If $G - T = 0$, then we are spending the same amount of money that tax revenue brings in, and the government's budget is balanced

With that information in hand, we want to turn toward asking the following two questions.

(1) How does the business cycle, where the economy's GDP is rising and falling over time, affect the government's budget?

The answer to this question is found in the next handout, "Contractions and the Government Budget".

(2) Given that there are different philosophies regarding whether to balance the budget, how do each of these philosophies affect the business cycle (i.e. how do they affect the economy)?

The answer to this question is found in the final handout, the handout that talks about 3 different budget balancing philosophies.