The Tools of Fiscal Policy

Changes in taxes and government spending designed to affect the level of aggregate demand in the economy are called *fiscal policy*.

Recall that *aggregate demand* is the total amount of spending on goods and services in the economy during a stated period of time and is made up of consumer spending (C), investment (I), government spending (G), and net exports (Xn). *Aggregate supply* is the total amount of goods and services available in the economy.

During a recession, the short-run equilibrium is below the full-employment level of output. Aggregate demand is too low to bring about full employment of resources. Government can increase aggregate demand by spending more and/or cutting taxes. Increasing aggregate demand to move the economy toward full employment is *expansionary fiscal policy*. Expansionary fiscal policy increases employment but also can raise the price level and result in budget deficits.

If the level of aggregate demand is too high, it creates inflationary pressures. Government can decrease aggregate demand by reducing spending and/or increasing taxes. Decreasing aggregate demand to decrease inflationary pressures is *contractionary fiscal policy*. Contractionary fiscal policy reduces inflationary pressures but can also decrease output and employment. Contractionary fiscal policy can result in budget surpluses (or smaller budget deficits).

! ***Student Alert:* Remember that the multiplier is different for taxes and for spending!**

Decide whether each of the following fiscal policies of the federal government is expansionary or contractionary. Write *expansionary* or *contractionary*, and explain the reasons for your choice.

1. The government cuts business and personal income taxes and increases its own spending.

2. The government increases the personal income tax, Social Security tax, and corporate income tax. Government spending stays the same.

3. Government spending goes up while taxes remain the same.

4. The government reduces the wages of its employees while raising taxes on consumers and businesses. Other government spending remains the same.

Effects of Fiscal Policy

Test your understanding of fiscal policy by completing Table 5-1.1. Your choices for each situation must be consistent—that is, you should choose either an expansionary or contractionary fiscal policy. (Fiscal policy cannot provide a solution to one of the situations.) Fill in the spaces as follows:

Column A: Objective for aggregate demand

Draw an up arrow to increase aggregate demand or a down arrow to decrease aggregate demand.

Column B: Action on taxes

Draw an up arrow to increase taxes or a down arrow to decrease taxes.

Column C: Action on government spending

Draw an up arrow to increase government spending or a down arrow to decrease government spending.

Column D: Effect on federal budget

Write *toward deficit* if your action will increase the deficit (or reduce the surplus) or *toward surplus* if your action will reduce the deficit (or increase the surplus).

Column E: Effect on national bebt

Draw an up arrow if your action will increase the national debt or a down arrow if your action will decrease the national debt.

Table 5-1.1
Effects of Fiscal Policy

	(A) Objective for aggregate demand	(B) Action on taxes	(C) Action on government spending	(D) Effect on federal budget	(E) Effect on national debt
1. National unemployment rate rises to 12 percent.					
2. Inflation is strong at a rate of 14 percent per year.					
3. Surverys show consumers are losing confidence in the economy, retail sales are weak, and business inventories are increasing rapidly.					
4. Business sales and investment are expanding rapidly, and economists think strong inflation lies ahead.					
5. Inflation persists while unemployment stays high.					

Discretionary Fiscal Policy and Automatic Stabilizers

One of the goals of economic policy is to stabilize the economy. This means promoting full employment and stable prices. To accomplish this, aggregate demand must be near the full-employment level of output. If aggregate demand is too low, there will be unemployment. If aggregate demand is too high, there will be inflation.

If aggregate demand is too low, government can use fiscal policy to stimulate the economy through increased spending or decreased taxes. These policies are examples of *expansionary fiscal policy*. If government wants to decrease aggregate demand, it can pursue a *contractionary fiscal policy* by decreasing taxes or increasing spending.

If government has to pass a law or take some other specific action to change taxes or spending, then the action is at the government's discretion and the policy is *discretionary policy*. If the effect happens automatically as the economic situation changes, then the policy is the result of an *automatic stabilizer*. An example of an automatic stabilizer is unemployment compensation. If the economy goes into a recession, some people are laid off and are eligible to receive unemployment compensation. The payment creates income and spending to keep aggregate demand from falling as much as it would have. Unemployment compensation stabilizes the economy automatically during a recession.

For each of the scenarios on the following page, indicate whether it represents an automatic (A) or discretionary (D) stabilizer, and whether it is an example of expansionary (E) or contractionary (C) fiscal policy.

Economic scenarios	Automatic (A) or Discretionary (D)	Expansionary (E) or Contractionary (C)
Example: Recession raises amount of unemployment compensation.	A	E
1. The government cuts personal income tax rates.	______	______
2. The government eliminates favorable tax treatment on long-term capital gains.	______	______
3. Incomes rise; as a result, people pay a larger fraction of their income in taxes.	______	______
4. As a result of a recession, more families qualify for food stamps and welfare benefits.	______	______

Economic scenarios	Automatic (A) or Discretionary (D)	Expansionary (E) or Contractionary (C)
5. The government eliminates the deductibility of interest expense for tax purposes.	________	________
6. The government launches a major new space program to explore Mars.	________	________
7. The government raises Social Security taxes.	________	________
8. Corporate profits increase; as a result, government collects more corporate income taxes.	________	________
9. The government raises corporate income tax rates.	________	________
10. The government gives all its employees a large pay raise.	________	________

Monetary and Fiscal Policy

Tools of Monetary and Fiscal Policy

Both monetary and fiscal policy can be used to influence the inflation rate and real output. In Table 5-3.1, use ↑ or ↓ to indicate what effect each specific policy has on inflation and real output in the short run.

Table 5-3.1
Monetary Policy

Monetary policy	Price level	Real output
1. Raise the federal funds rate		
2. Decrease the discount rate		
Decrease reserve requirement		

Fiscal policy	Price level	Real output
4. Increase government spending		
5. Increase taxes		

Policy Effects on Aggregate Supply

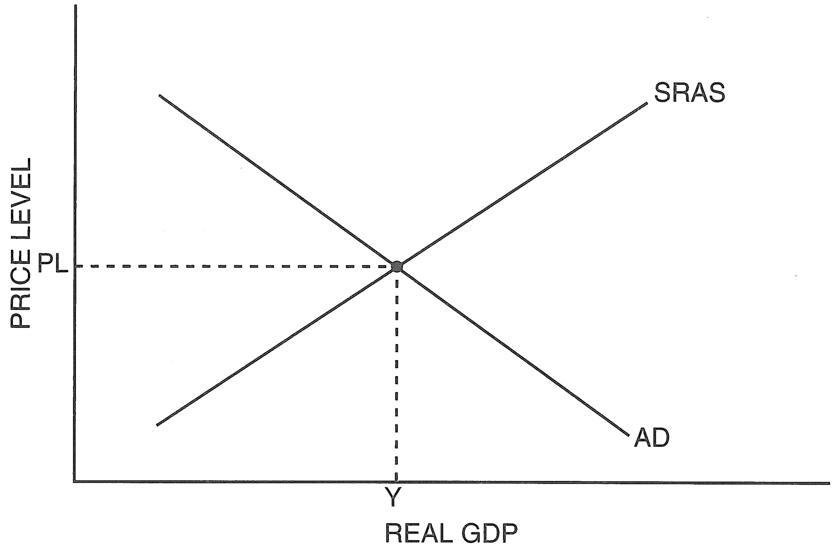
Fiscal and monetary policy affect the economy through changes in aggregate demand (AD). There are also policies that can affect the short-run aggregate supply (SRAS) and long-run aggregate supply (LRAS). Any policy that changes a determinant of SRAS or leads to long-run economic growth will affect the macroeconomy through the supply side. The determinants of SRAS include changes in economy-wide input prices (like wages and the price of oil) and productivity. Factors that affect the LRAS include increases in available resources, higher quality resources, or technological advances.

1. Assume the government grants businesses a substantial tax credit on capital investment. Circle the correct symbol (↑ for increase, ↓ for decrease) to indicate what will happen to the following as a result of the tax credit.

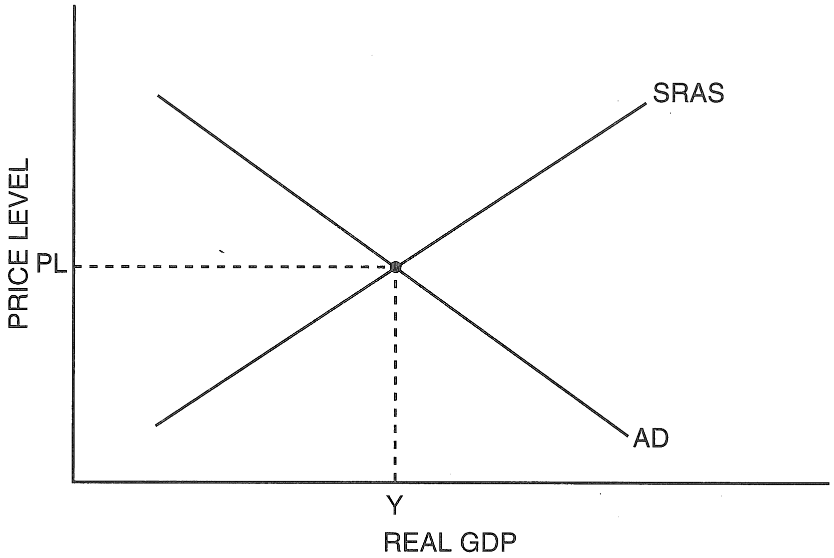
(A) Capital investment	↑	↓
(B) AD	↑	↓
(C) The amount of capital available to labor	↑	↓
(D) Productivity	↑	↓
(E) Firms' unit cost of production	↑	↓
(F) SRAS	↑	↓
(G) LRAS	↑	↓
(H) Real gross domestic product (GDP)	↑	↓

2. How will a decrease in business taxes affect firms' per unit costs?

3. Use the AS/AD diagram below to show the effect of a decrease in business taxes on SRAS, real GDP, and the price level.



4. How will firms' unit cost of production change when there is an increase in government regulation? (*Hint:* compliance with regulations creates a cost for firms.) Use the following AS/AD diagram to show how an increase in regulations on firms affects SRAS, real GDP, and the price level.



Assume that the economy suffers a negative supply shock and that input prices are completely flexible. In the absence of any fiscal or monetary policy, explain how the economy will return to full employment. To help you reach the correct conclusion, answer the following questions.

5. Immediately following the supply shock, what happens to unemployment?

6. How will high unemployment in the economy affect both product prices and wages if prices and wages are completely flexible?

7. How do firms respond to a decrease in input prices?

8. What effect will firms' response to the decrease in input prices have on SRAS?