

## 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)
<i>Example:</i> 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.	_____	_____