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.



Effects of Fiscal Policy

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