**Aim: What can the government do to adjust the economy?**

**Topic: Fiscal Policy**

**Fiscal Policy:** Government spending policy (passed by Congress). This is changes in government spending (government buying goods or paying for services) and taxes. Fiscal policy is used to fight inflation or recession. Government Spending is known as **Discretionary Spending.**

**Two forms of fiscal policy:**

**1) Expansionary:** the government is trying to expand the economy. (shift graph to the right)

**When:** Recession

**How:** Increase government spending, reduce taxes.

\*a change in taxes does not directly change real GDP. Changes in taxes affect the disposable income of households and/or businesses. These changes are felt through consumption spending and investment spending.

**2) Contractionary:** the government is trying to shrink the economy/reduce spending by other factors (I and C) in economy. (shift graph to the left)

**When:** Inflation

**How:** Decrease government spending, increase taxes.

\* An increase in taxes decreases disposable income of consumers and businesses. A decrease in disposable income decreases consumption, but by less than the increase in taxes.

\*Fiscal policy primarily shifts the aggregate demand curve as it affects Consumer Spending, Investment Spending and Government Spending. Regulations and taxes can also protect against imports and help exports (Nx).

\*Fiscal tax policy focused on businesses may also shift SRAS if this leads to a change in capital production and their ability to produce more/less.

**Discretionary Spending vs. Automatic Stabilizers.**

Besides the direct fiscal policy tools of government spending and taxes, there are many tools embedded in the economy that respond to the different phases of the business cycle. They are government policies already in place that promote **deficit spending (borrowing money to spend and increase economy)** during recessions and **surplus budgets (saving money)** during contractions. These tools are called automatic stabilizers. They are automatic because they adjust without an action by Congress or the President. They serve as stabilizers because they limit the increase in real GDP during inflation/expansions and reduce the decrease in real GDP during a recession.

**Examples of Automatic Stabilizers:**

**1) Income Taxes (both personal and corporate/capital gains tax):** increase as wages rise: people pay a larger fraction of their income in taxes. However, as income falls during a recession, so do income taxes, which help to increase spending

**2) Unemployment Compensation:** when people are unemployed, they receive unemployment checks from the government to help sustain spending in the economy (counters recession)

**3) Anti-Poverty, entitlement programs and “Safety net” programs:** TANF (Temporary Aid to Needy Families), unemployment benefits, social security, food stamps, welfare benefits, etc. These programs are to help struggling families and keep spending in the economy (counters recession)

**1) What are the differences between contractionary and   
expansionary fiscal policy?**

**1a) Why is expansionary policy used during recession?**

**1b) Why is contractionary policy used during inflation?**

**2) Why does fiscal policy primarily shift the AD curve?**

**3) Why might fiscal policy focused on capital investment shift LRAS/SRAS over the long term?**

**4) What are the differences between discretionary spending and automatic stabilizers?**

**5) Define: Deficit, Debt and Surplus. How is each created?**

**Exercises for each scenario:**

**1) What is the economy experiencing? Illustrate this on a full employment graph.**

**2) What type of policy should the government recommend (expansionary/contractionary)**

**3) Give an example of expansionary/contractionary policy**

**4) What will be the effect of price level and output**

**5) Draw the shift of the graph**

**Example #1**

The economy has experienced negative growth for the last three quarters in a row while unemployment has risen from 2 to 6 percent over the same three quarters.

**Example #2**

GDP has increased over the last three quarters, however, the Consumer Price Index has increased from 100 to 160.

**Example #3**

A shortage of oil has caused oil prices to increase, a reduction in gross private investment and therefore a reduction in GDP and an increase in unemployment.