Name Date

Session 21

The Tools of Fiscal Policy

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

Aggregate demand is the total amount of spending on goods and services in the economy during a stated period of time. Aggregate demand consists of consumer spending, government spending, investment spending and net exports.

Aggregate supply consists of the total amount of goods and services available in the economy during a stated period of time.

During a recession, aggregate demand is usually too low to bring about full employment of resources. Government can increase aggregate demand by spending more, cutting taxes or doing both. These actions often result in budget deficits because the government spends more than it collects in taxes. Increasing government spending without increasing taxes or decreasing taxes without decreasing government expenditures should increase aggregate demand. Such an *expansionary fiscal policy* should increase employment, the price level or both.

If the level of aggregate demand is too high, creating inflationary pressure, government can reduce its spending, increase taxes or do both. These actions should result in a larger budget surplus or a smaller budget deficit than existed before. Such a *contractionary fiscal policy* should lower the level of aggregate demand, and the economy will experience less employment, a lower price level or both.

From *Master Curriculum Guide in Economics: Teaching Strategies for High School Economics Courses* (New York: National Council on Economic Education, 1985), pp. 151-152

Part A

Decide whether each of the following fiscal policies of the federal government is expansionary o 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 incom 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.

Part B
Effects of Fiscal Policy

Test your understanding of fiscal policy by completing the table in Figure 30.1. 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 if you wish to increase aggregate demand.
Draw a down arrow if you wish to decrease aggregate demand.

Column B: Action on Taxes
Draw an up arrow if you wish to increase taxes.
Draw a down arrow if you wish to decrease taxes.

Column C: Action on Government Spending
Draw an up arrow if you wish to increase government spending.
Draw a down arrow if you wish to decrease government spending.

Column D: Effect on Federal Budget
Write *toward deficit* if your action will increase the deficit (or reduce the surplus).
Write *toward surplus* if your action will reduce the deficit (or increase the surplus).

Column E: Effect on the National Debt
Draw an up arrow if you think the national debt will increase.
Draw a down arrow if you think the national debt will decrease.

Figure 30.1
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 the National Debt
1. National unemployment rate rises to 12 percent.					
2. Inflation is strong at a rate of 14 percent per year.					
3. Surveys 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.					