Mechanics of Fiscal Policy

Coach Burnett
AP Macroeconomics

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Fiscal Policy

- Government efforts to promote full employment and price stability by changing government spending (G) and/or taxes (T).
- Recession is countered with expansionary policy.
  – Increase government spending (G⬆)
  – Decrease taxes (T⬇)
- Inflation is countered with contractionary policy
  – Decrease government spending (G⬇)
  – Increase Taxes (T⬆)

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Expansionary Fiscal Policy

- In order to combat recession, the government engages in expansionary policy.
- If G⬆ or T⬇, then AD shifts ➡ causing PL⬆ and GDP⬆, which causes the unemployment rate (u%)⬇, and the inflation rate (π%)⬆.
- Remember that if prices rise then that means that <u>inflation</u> occurred in the economy. A side-effect of expansionary policy is inflation.

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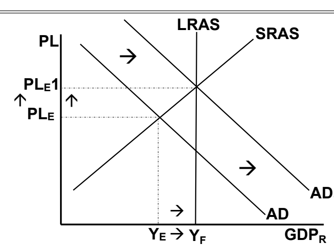
Expansionary Fiscal Policy (Illustrated)



IF REC, THEN G⬆.: AD → .: GDP_R⬆ & PL⬆ .: u%⬇ & π% ⬆

(or)

T⬇ .: DI⬆.: C⬆.: AD → .: GDPR⬆ & PL⬆ .: u%⬇ & π% ⬆

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Contractionary Fiscal Policy

- In order to combat inflation, the government engages in contractionary policy.
- If G⬇ or T⬆, then AD shifts ⬅ causing PL⬇ and GDP⬇, which causes the unemployment rate (u%)⬆, and the inflation rate (π%)⬇.
- Remember that if GDP falls then that means that <u>unemployment rose</u> in the economy. A side-effect of contractionary policy is higher levels of unemployment.

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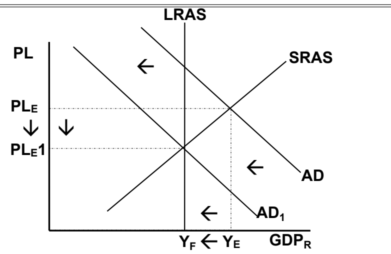
Contractionary Fiscal Policy (Illustrated)



IF INFLATION, THEN G⬇ .: AD⬅ .: GDP_R⬇ & PL⬇ .: u%⬆ & π%⬇

(or) T⬆ .: DI⬇ .: C⬇ .: AD⬅ .: GDP_R⬇ & PL⬇ .: u%⬆ & π%⬇

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Discretionary v. Automatic Fiscal Policies

<u>Discretionary</u>

- Increasing or Decreasing Government Spending and/or Taxes in order to return the economy to full employment. Discretionary policy involves policy makers doing fiscal policy in response to an economic problem

<u>Automatic</u>

- Unemployment compensation & marginal tax rates are examples of automatic policies that help mitigate the effects of recession and inflation. Automatic fiscal policy takes place without policy makers having to respond to current economic problems.

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Weaknesses of Fiscal Policy

- Lags
  - <u>Inside lag</u>: it takes time to recognize economic problems and to promote solutions to those problems
  - <u>Outside lag</u>: it takes time to implement solutions to problems
- Political Motivation
  - Politicians face re-election and are more likely to support expansionary rather than contractionary fiscal policy.
  - Increased government spending and decreased taxes are almost always more popular with voters than increased taxes and decreased spending.
    - Think about it... Ceteris paribus, are you going to vote for the guy that will raise your taxes or lower your taxes?

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Weaknesses: The 'Crowding Out' Effect

- A possible side-effect of increased government spending and reduced taxes is a budget deficit which may lead to the 'crowding-out' of Gross Private Investment (I_G) and Net Exports (X_N)
- When G↑ or T↓, then government must borrow in order to continue spending. This leads to an increase in the demand for loanable funds or a decrease in the supply of loanable funds, which results in r%↑. This change in r% leads to I_G↓. In addition, the increase in r% causes $D_\$$↑ and/or $S_\$$↓ as investors seek higher returns in the U.S. This leads to \$↑ which leads to X↓ and M↑, so X_N↓. Because I_G and X_N are direct components of AD, these decreases offset some of the increase in AD.

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Weaknesses (Cont.): The 'Crowding In' Effect

- A possible side-effect of decreased government spending and increased taxes is a budget surplus which may lead to the 'crowding-in' of Gross Private Investment (I_G) and Net Exports (X_N)
- When G↓ or T↑, then government develops a budget surplus. This leads to a decrease in the demand for loanable funds or an increase in the supply of loanable funds, which results in r%↓. This change in r% leads to I_G↑. In addition, the decrease in r% causes $D_\$$↓ and/or $S_\$$↑ as investors seek higher returns abroad. This leads to \$↓ which leads to X↑ and M↓, so X_N↑. Because I_G and X_N are direct components of AD, these increases offset some of the decrease in AD.

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Summary

- Fiscal policy is the process by which the government tries to return an economy back to full employment equilibrium.
  - Expansionary policy aims to get out of a recession by increasing government spending and/or decreasing taxes whereas Contractionary policy aims to lower inflation by decreasing government spending and/or raising taxes.
- Unintended consequences such as budget surpluses and shortages can arise when the government action taken is too much and are called the Crowding-out and Crowding-in effects respectively and offshoot the changes attempted.

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Summary (Cont.)

- We will continue to build off of the AD/AS model when describing the effects the government is having on the economy. Don't forget, if the AP test mentions the government taking any action to fix the economy, it means we are using fiscal policy to achieve our goals.
- Hopefully this lesson helps solidify the information we discussed in the last unit and it clicks better now.

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