# The Tools of Fiscal Policy

## Part A

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. ***Expansionary. The decrease in personal income taxes increases disposable income and thus increases consumption spending. The business tax cut increases investment spending, and the increase in government spending increases government demand.***

2. The government increases the personal income tax, Social Security tax and corporate income tax. Government spending stays the same. ***Contractionary. Business income and personal disposable income decrease because of the tax increases, thus reducing consumption and investment spending. Government demand is unchanged.***

3. Government spending goes up while taxes remain the same. ***Expansionary. Higher government spending without a corresponding rise in tax receipts increases aggregate demand in the economy.***

4. The government reduces the wages of its employees while raising taxes on consumers and businesses. Other government spending remains the same. ***Contractionary. Reduction in government spending results in a decrease in AD. Increases in taxes on consumers reduce disposable income and consumption, and increased business taxes will reduce investment. The decrease in both consumption and investment will reduce aggregate demand.***

## Part B

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. | ↑ | ↓ | ↑ | *Toward deficit* | ↑ |
| 2. Inflation is strong at a rate of 14 percent per year. | ↓ | ↑ | ↓ | *Toward surplus* | ↓ |
| 3. Surveys show consumers are losing confidence in the economy, retail sales are weak and business inventories are increasing rapidly. | ↑ | ↓ | ↑ | *Toward deficit* | ↑ |
| 4. Business sales and investment are expanding rapidly, and economists think strong inflation lies ahead. | ↓ | ↑ | ↓ | *Toward surplus* | ↓ |
| 5. Inflation persists while unemployment stays high. | ***Fiscal policy is unable to provide a solution to the situation of high inflation and unemployment: stagflation.*** | | | | |