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Fiscal Policy

LEARNING OBJECTIVES

1. Explain how government expenditures are funded
2. Compare and contrast the major schools of economic thought
3. Model the effects of expansionary and contractionary fiscal policies
4. Identify potential problems with the use of fiscal policy
5. Discuss the pros and cons of supply-side fiscal policy

GOVERNMENT EXPENDITURES AND TAXES

- **Fiscal policy**—the use of government spending, taxes and transfer payments to help stabilize the economy.

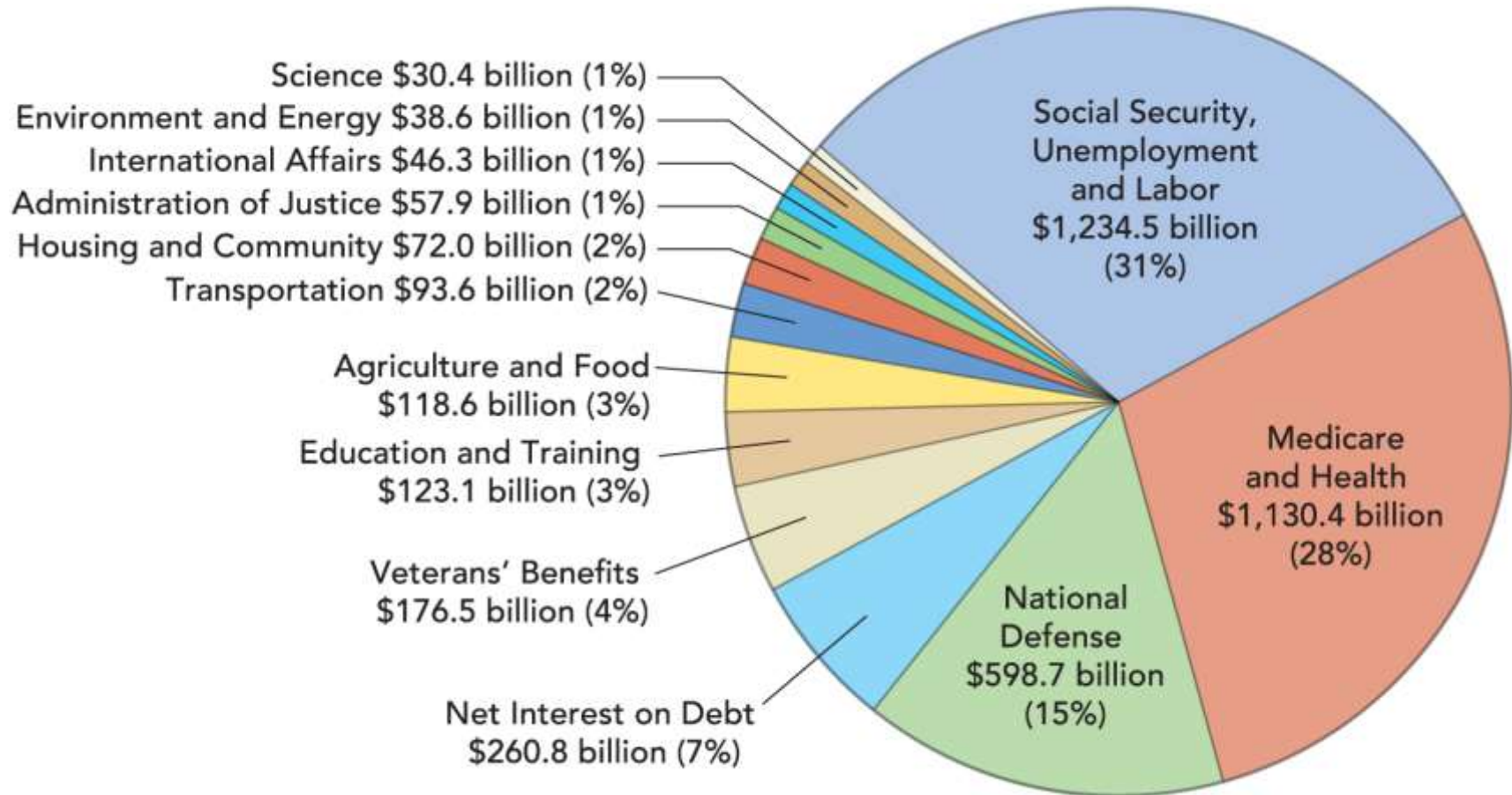
Examples of mandatory spending:

- Social Security
- Medicare
- Medicaid

Examples of discretionary spending:

- military
- education
- transportation

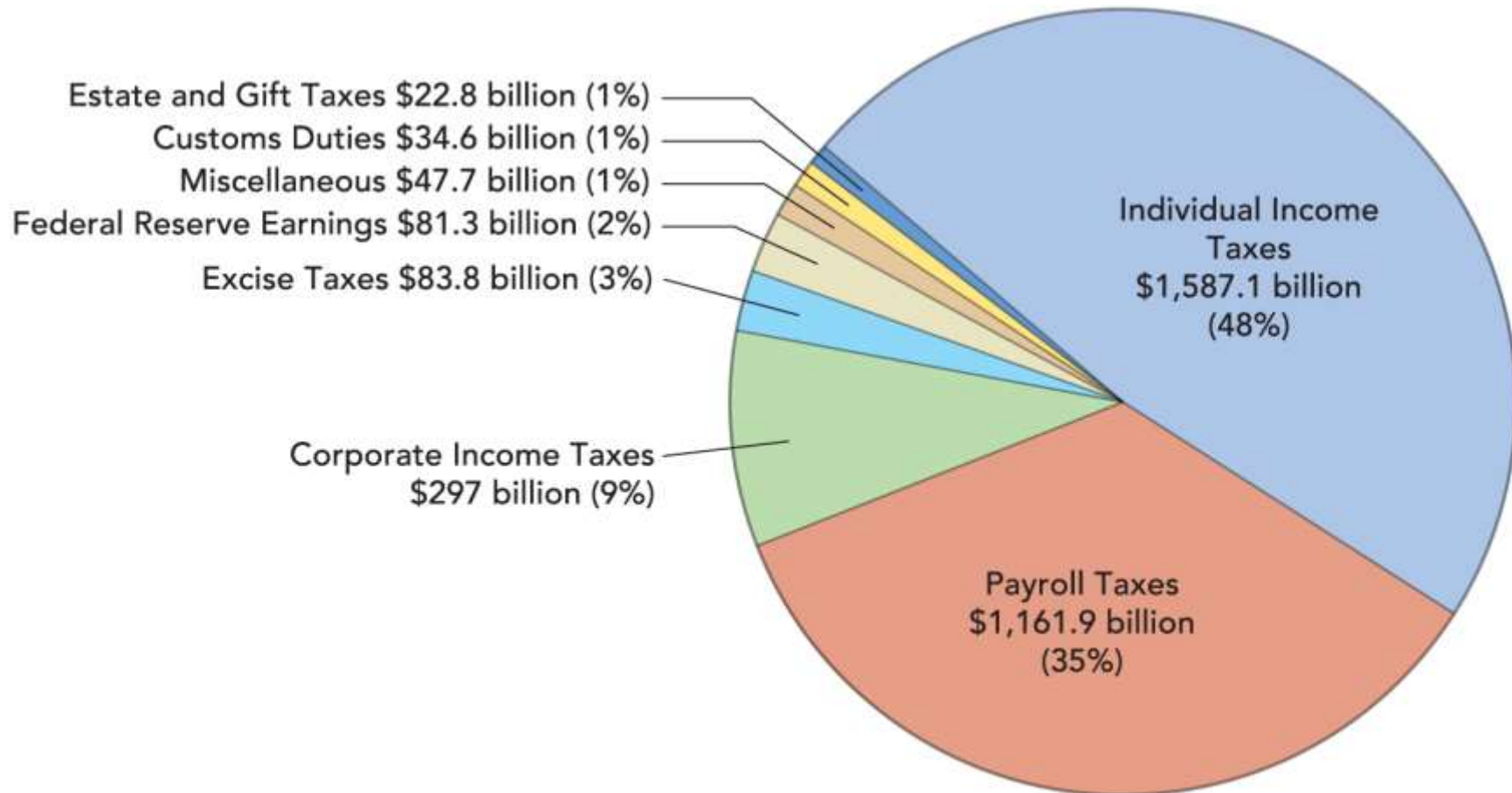
U.S. GOVERNMENT SPENDING



Source: Office of Management and Budget.

Spending by the U.S. Federal Government in 2017

U.S. GOVERNMENT REVENUE

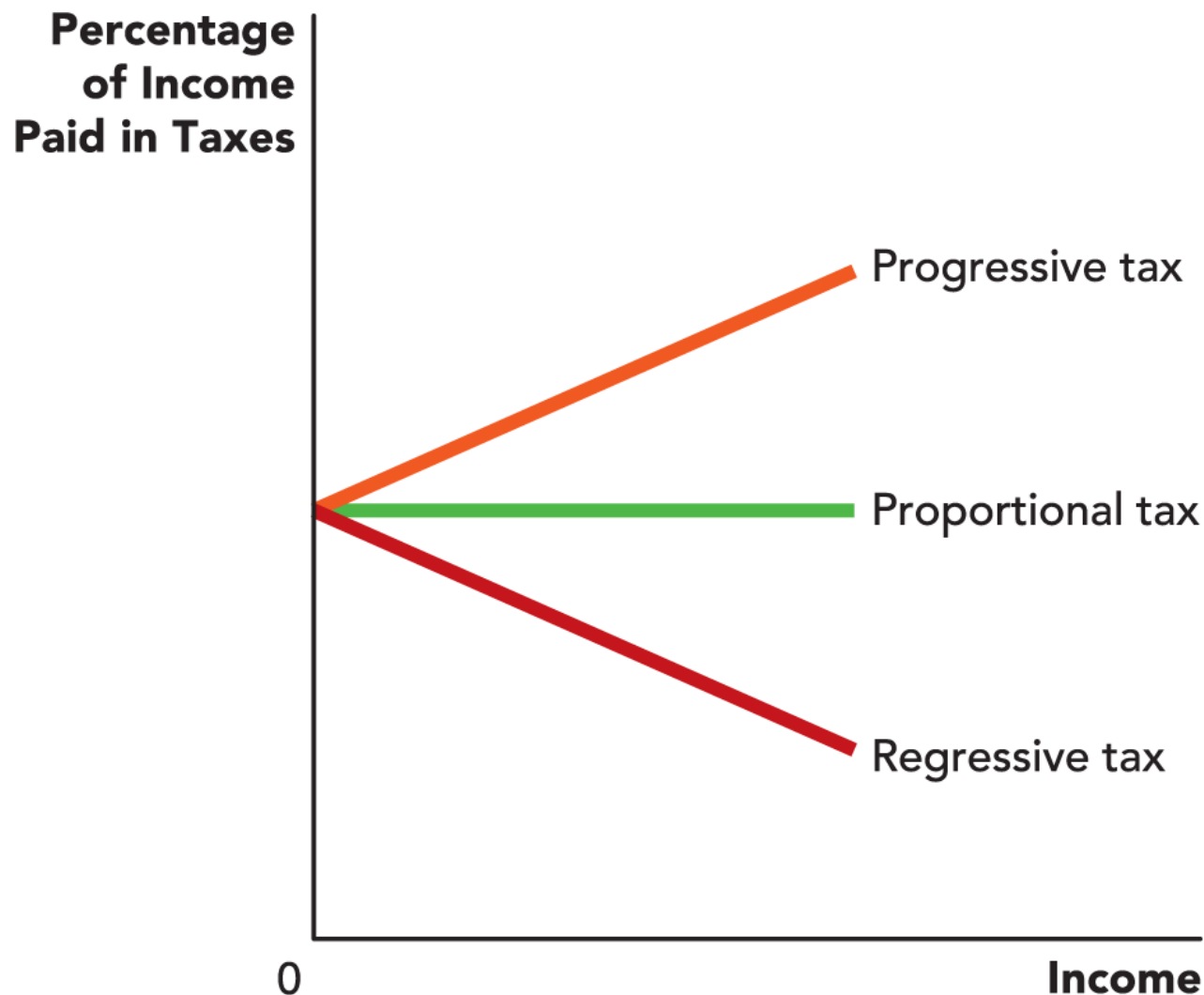


Source: Office of Management and Budget.

Sources of Federal Government Revenue in 2017

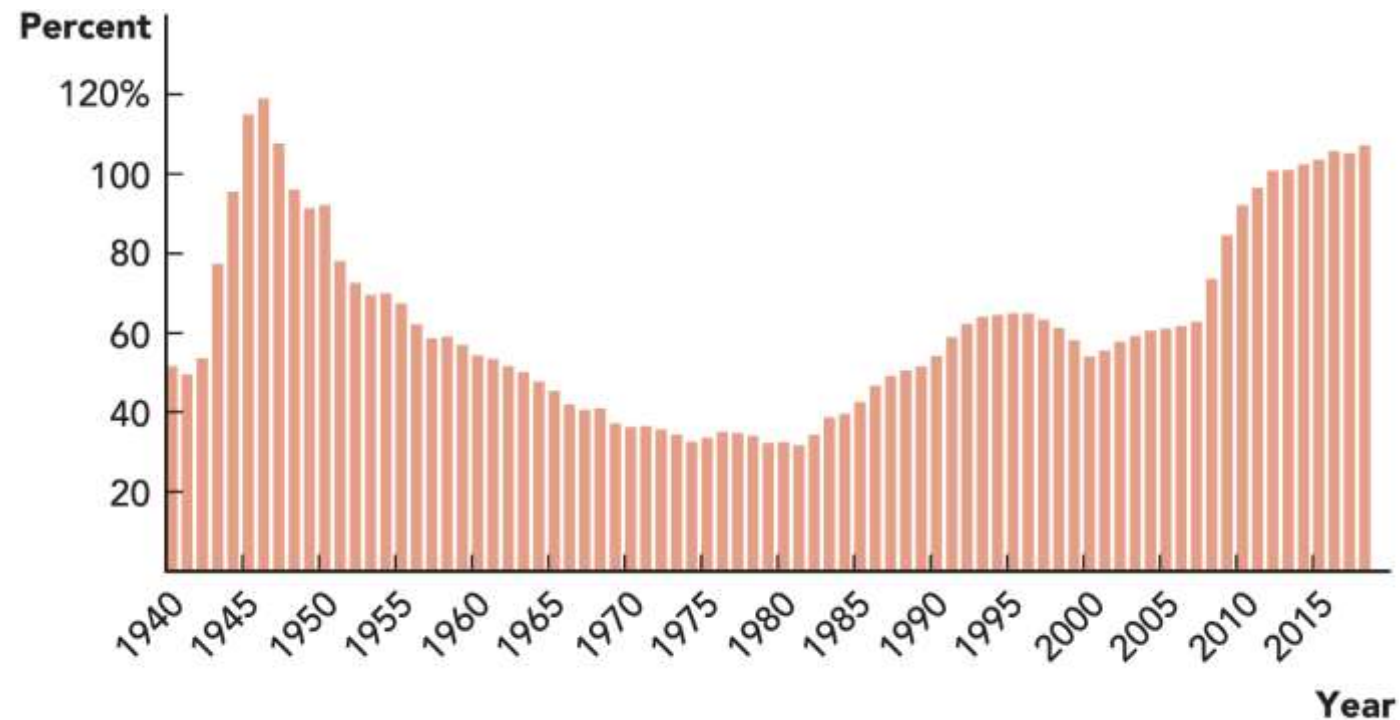
TYPES OF TAXES

- **Regressive tax**—a tax system under which low-income people pay a higher proportion of their income in taxes than high-income people do.
- **Progressive tax**—a tax system under which high-income people pay a higher proportion of their income in taxes than low-income people do.
- **Proportional tax**—a tax system under which everyone pays the same proportion of their income in taxes.



IMBALANCES IN THE BUDGET

- **Budget surplus**—the excess of government revenues over government expenditures over a given period, usually one year.
- **Budget deficit**—the excess of government expenditures over government revenues over a given period, usually one year.
- **Debt**—the accumulation of past budget deficits minus past budget surpluses.



Source: Office of Management and Budget.

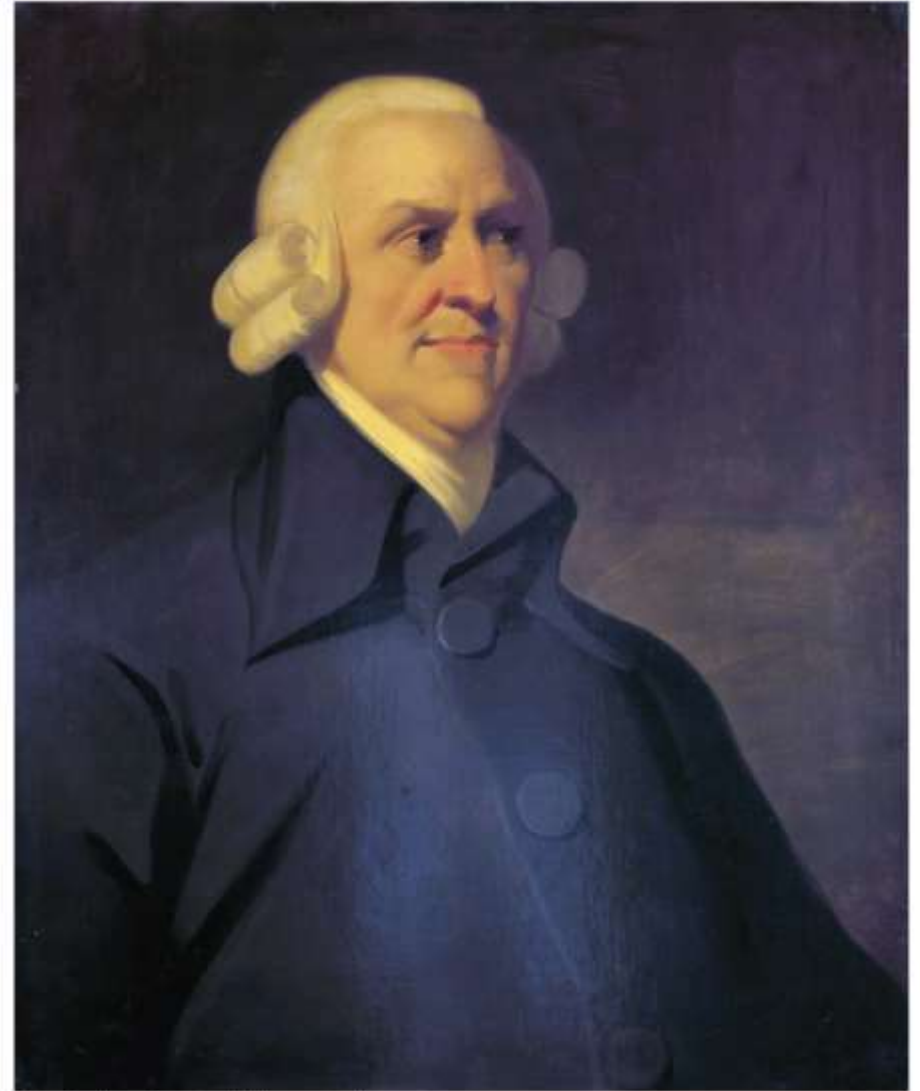
Federal Debt as a Percentage of GDP, 1940–2018

SCHOOLS OF ECONOMIC THOUGHT

- Classical theory
- Keynesian theory
- Monetarist theory

CLASSICAL THEORY

- **Classical theory**—economic theory rooted in the idea that the economy can stabilize itself.
- **Say's law**—a theory that supply creates its own demand.

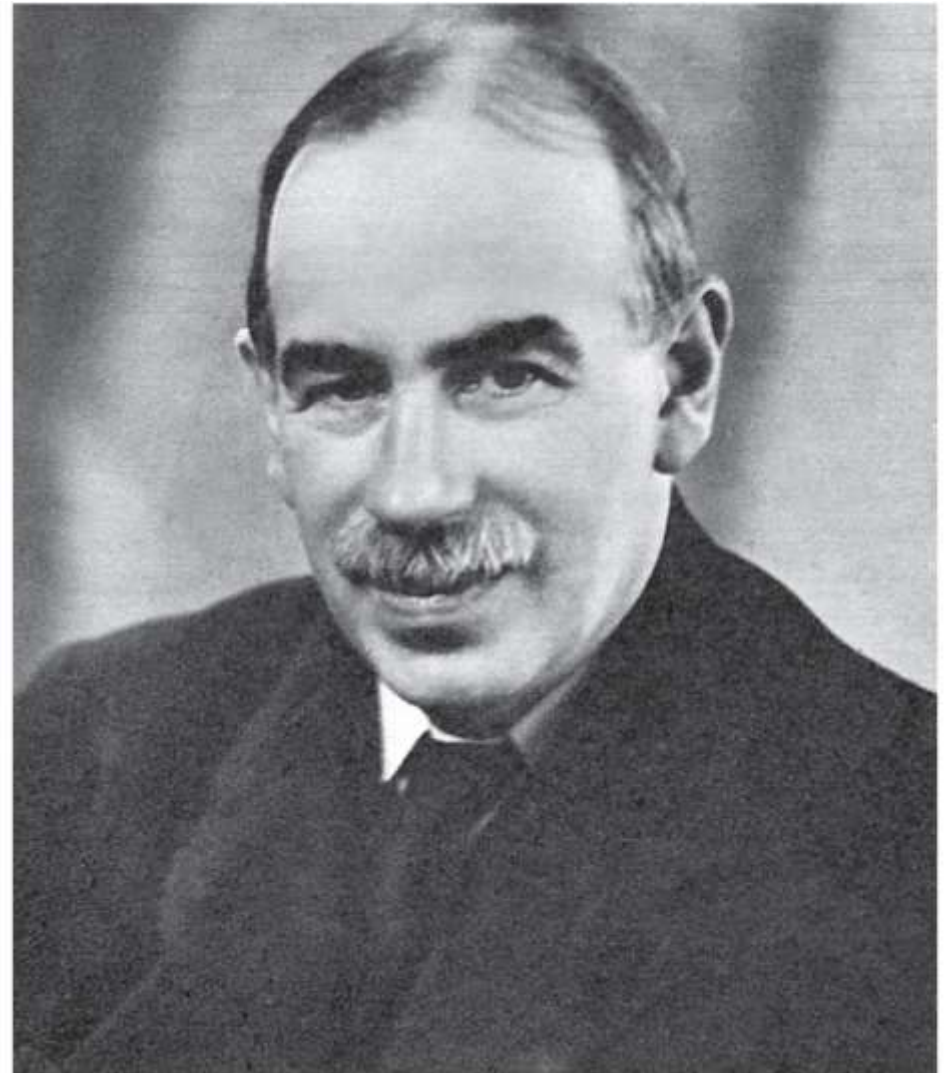


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Classical economist Adam Smith

KEYNESIAN THEORY

- **Keynesian theory**—economic theory centered on the idea that government involvement is sometimes needed to stabilize an economy.



Illustrated London News/Mary Evans/The Image Works

Father of Keynesian theory John
Maynard Keynes

MONETARIST THEORY

- **Monetarist theory**—economic theory that emphasizes limited growth in the money supply as a means of controlling inflation.
- **Stagflation**—a combination of stagnating real GDP and inflation in an economy.



Left: Bachrach/Getty Images; Right: TERESA ZABALA/The New York Times

Monetarists Milton Friedman and Anna Schwartz

SURPRISING CONSENSUS AND SOME LINGERING DISAGREEMENT

- Today, most economists agree that expansionary fiscal policy shifts the aggregate demand curve to the right.
- Problems with lags and politics make fiscal policy undesirable as the primary tool for stabilizing the economy.
- When market forces and monetary policy can't resolve an economic crisis, most economists support the use of fiscal policy.
- Most economist now agree that fiscal and monetary policy can affect the unemployment rate in the short run but cannot keep unemployment below the natural rate in the long run.

TYPES OF FISCAL POLICY

- **Expansionary fiscal policy**—government policy that shifts the aggregate demand curve to the right.
- **Contractionary fiscal policy**—government policy that shifts the aggregate demand curve to the left.

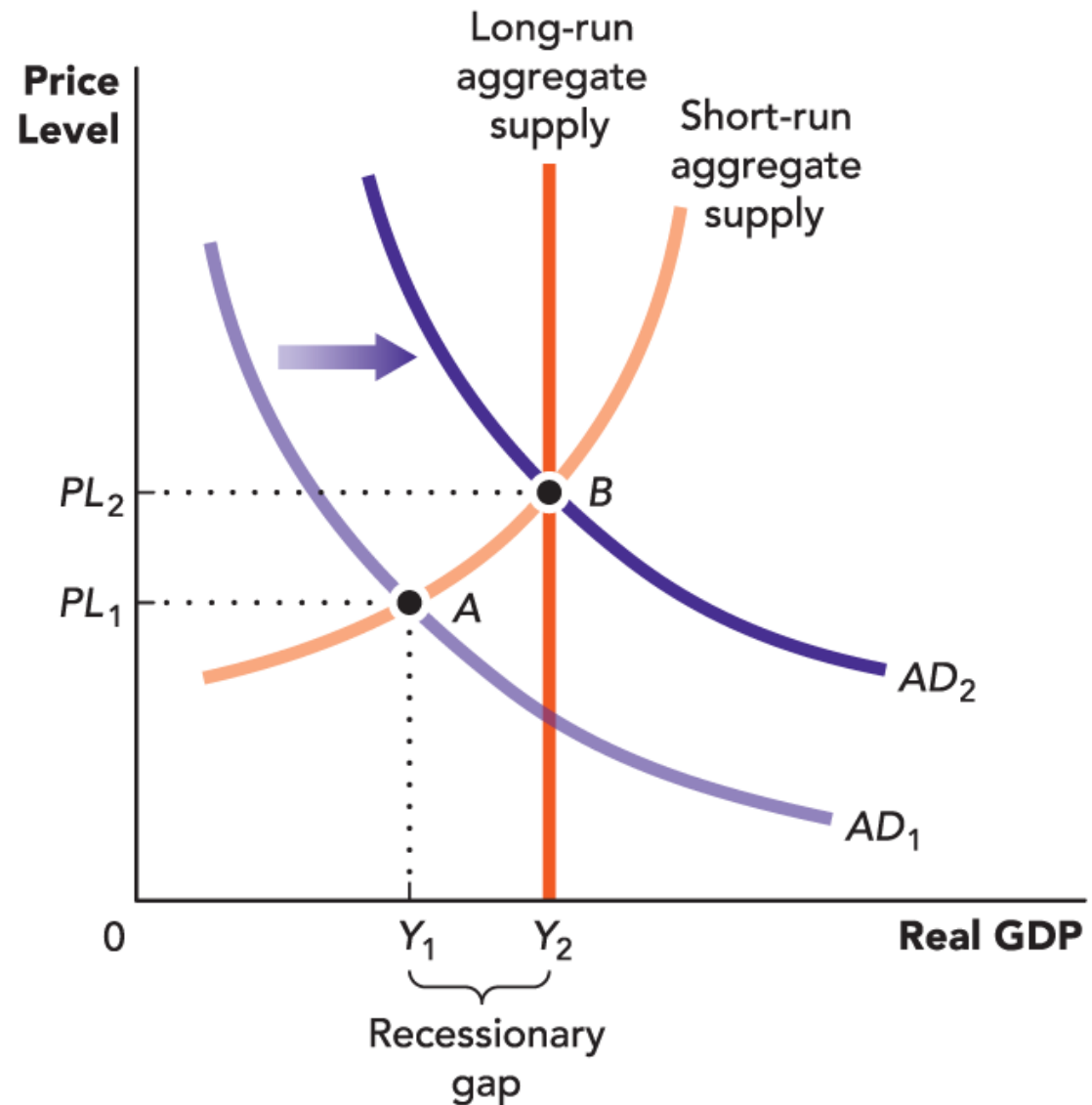
EXPANSIONARY FISCAL POLICY

- **Recessionary gap**—the gap between the actual output level and the full-employment output level when an economy produces less than its full-employment level of output.
- **Transfer payments**—government payments to individuals or firms for which no good or service is provided in return.
- The tools of expansionary fiscal policy are government spending, taxes, and transfer payments.

EXPANSIONARY FISCAL POLICY PART II

To give the economy a boost, the government can:

- increase government spending
- increase transfer payments
- decrease taxes

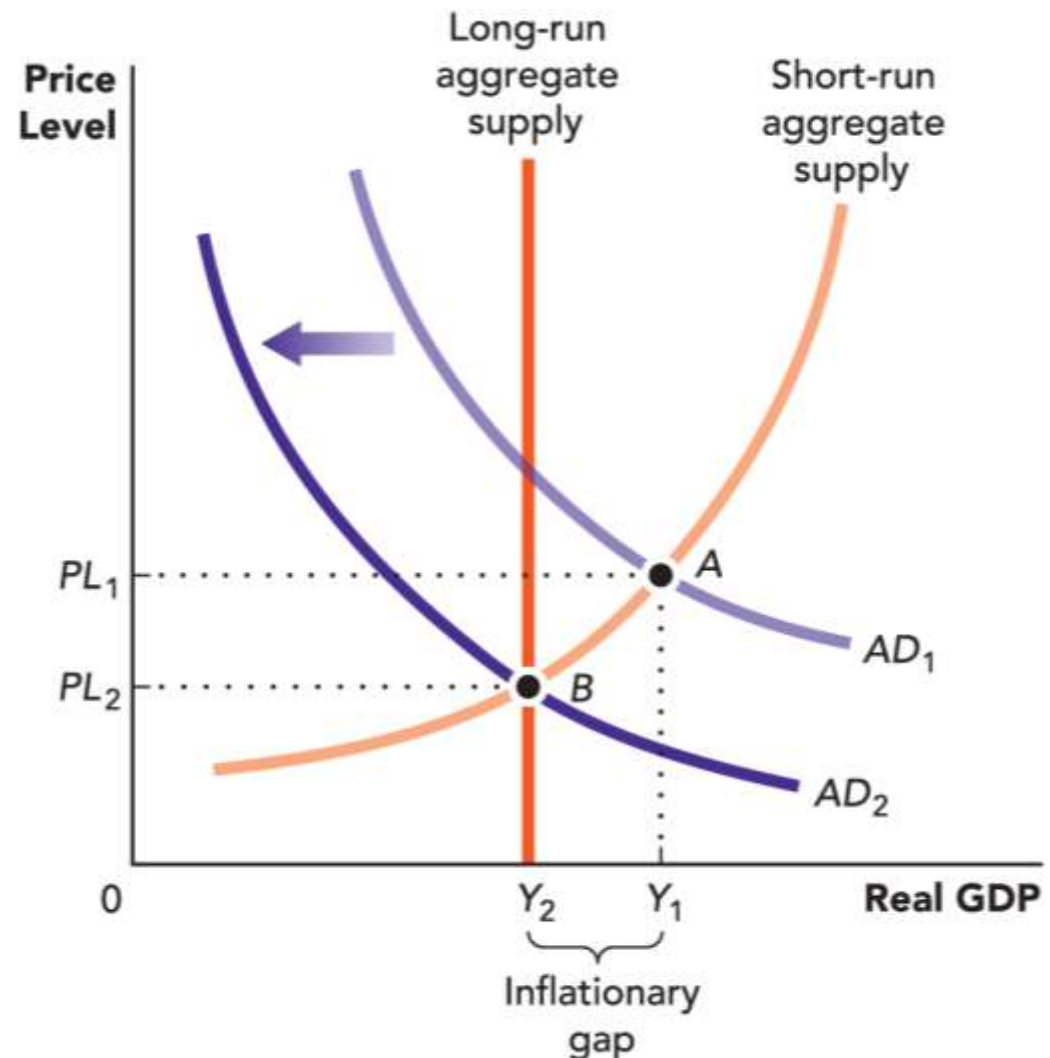


CONTRACTIONARY FISCAL POLICY

Inflationary gap—the gap between the actual output level and the full-employment output level when an economy produces more than its full-employment level of output.

To cool down the economy, the government can:

- decrease government spending
- decrease transfer payments
- increase taxes



AUTOMATIC STABILIZERS

- **Automatic stabilizers**—tax and transfer-payment policies that automatically dampen fluctuations in economic activity.



LEARN BY DOING: PRACTICE QUESTION 1

Lately, the U.S. economy has been disheveled. Jitesh believes that in order to correct this, the government should enact a hands-off approach and should focus on making sure the money supply has limited growth. What school of economic thought does Jitesh most likely belong to?

- a) Classical
- b) Keynesian
- c) Monetarist
- d) Absolutist

LEARN BY DOING: PRACTICE QUESTION 1

(Answer)

Lately, the U.S. economy has been disheveled. Jitesh believes that in order to correct this, the government should enact a hands-off approach and should focus on making sure the money supply has limited growth. What school of economic thought does Jitesh most likely belong to?

- a) Classical
- b) Keynesian
- c) Monetarist (correct answer)**
- d) Absolutist

POTENTIAL PROBLEMS WITH FISCAL POLICY

- Timing
- Politics
- Crowding out

TIMING

- **Recognition lag**—the delay between the onset of a problem and the realization that it actually exists.
- **Leading indicators**—early warnings signs used by economists to assess a mild downswing and the beginning of an economic calamity.
- **Implementation lag**—the delay between the recognition and implementation of a solution.
- **Outside lag**—the delay between a policy change and its resulting effect on the economy.

POLITICS

All of the following can create pressure and complicate fiscal policy decisions:

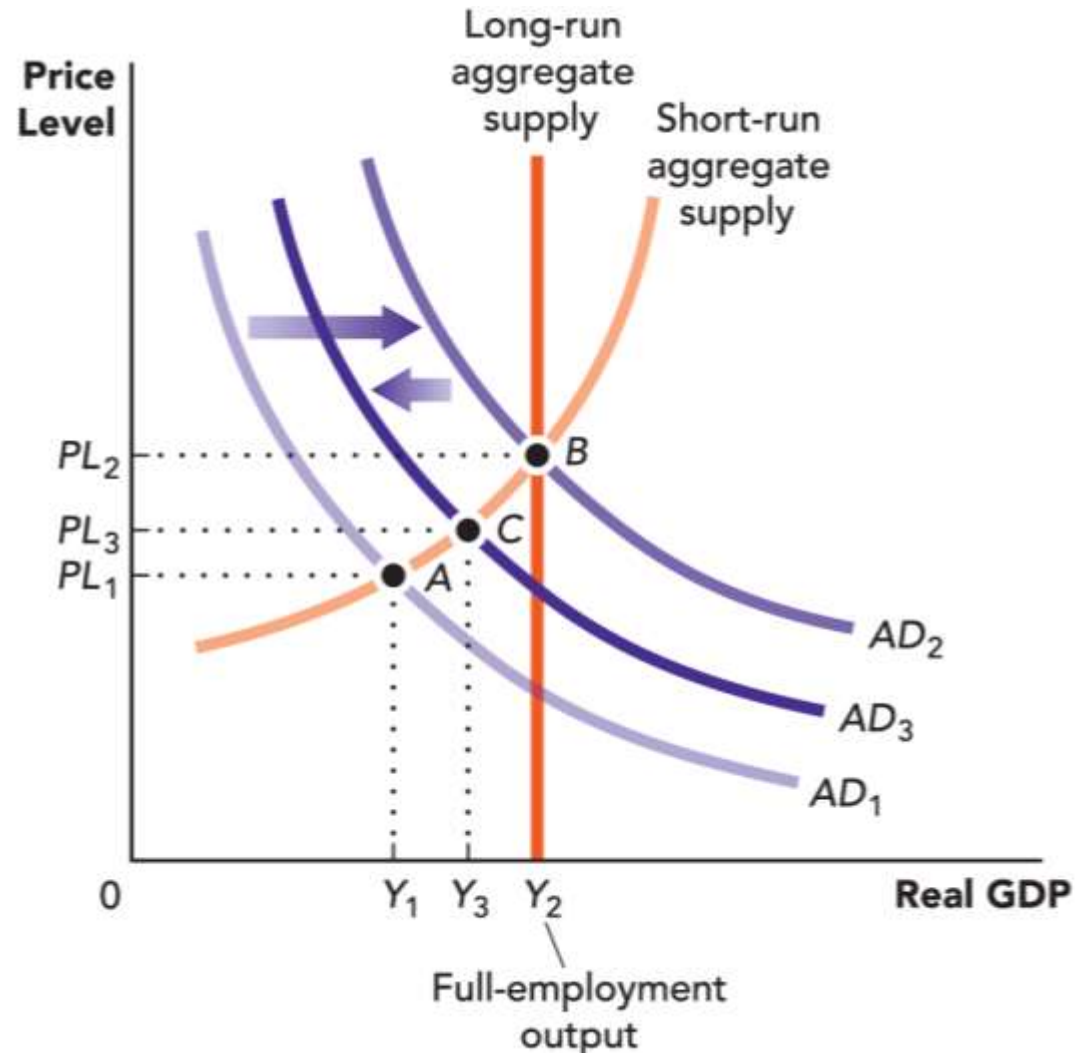
- Voters
- Firms
- Special-interest groups
- Policy makers' own opinions



Left: TASOS KATOPODIS/Getty Images; Right: Bloomberg/Getty Images

CROWDING OUT

- **Crowding out**—the effect of more government spending causing less private investment.



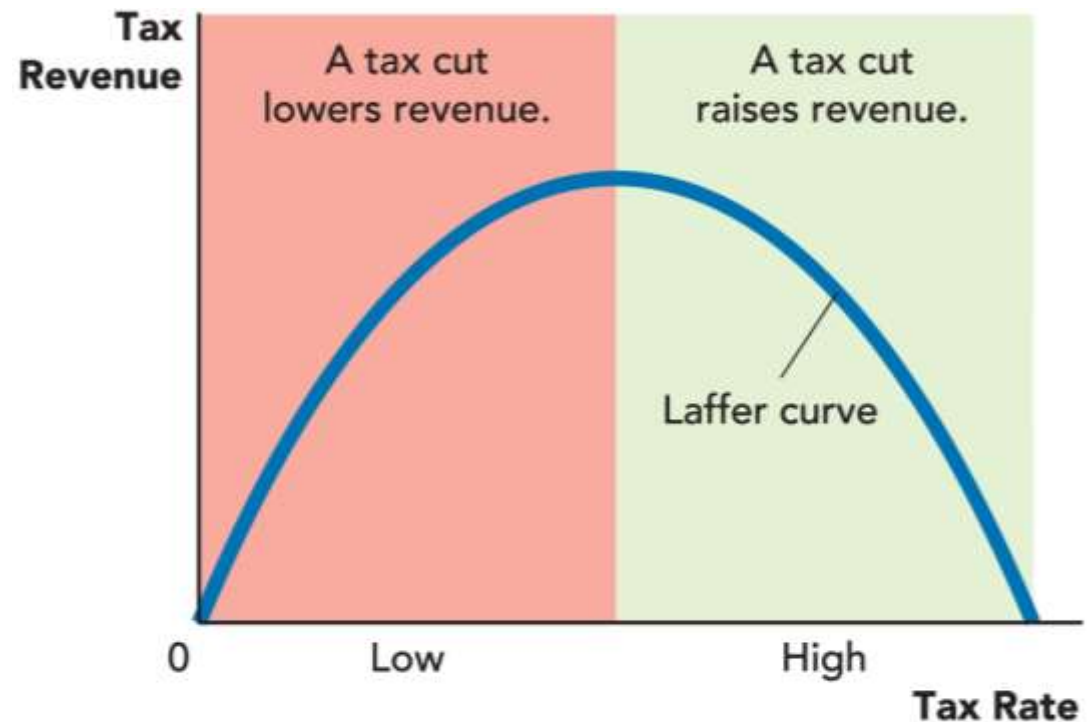
Anderson, *Survey of Economics*, © 2019 Worth Publishers

Partial Crowding Out

SUPPLY-SIDE FISCAL POLICY

Supply-side fiscal policy—fiscal policy that focuses on increasing aggregate supply to increase an economy’s output and decrease the inflation rate.

- Strengths:
 - Lower taxes raise consumers’ disposable income.
 - Higher income encourages workers to work more.
 - Lower taxes encourage firms to increase output.
- Weaknesses:
 - Lower tax revenues hurt government’s operations.



Anderson, *Survey of Economics*, © 2019 Worth Publishers

The Laffer Curve

LEARN BY DOING: PRACTICE QUESTION 2

The economy is experiencing increased bouts of inflation. The government decides to intervene by decreasing government spending. What kind of fiscal policy is this, and what effect will it have on aggregate demand?

- a) Contractionary; aggregate demand will shift to the right.
- b) Contractionary; aggregate demand will shift to the left.
- c) Expansionary; aggregate demand will shift to the left.
- d) Expansionary; aggregate demand will shift to the right.

LEARN BY DOING: PRACTICE QUESTION 2

(Answer)

The economy is experiencing increased bouts of inflation. The government decides to intervene by decreasing government spending. What kind of fiscal policy is this, and what effect will it have on aggregate demand?

- a) Contractionary; aggregate demand will shift to the right.
- b) Contractionary; aggregate demand will shift to the left (correct answer).**
- c) Expansionary; aggregate demand will shift to the left.
- d) Expansionary; aggregate demand will shift to the right.