Fiscal Policy: A Two-Act Play

The U.S. Government is often blamed during times of unemployment, decreasing GDP, or inflation. Many economists believe that the federal government can (and should) help to alleviate these problems by traditional, discretionary fiscal policy. Traditional (demand-side) fiscal policy advocates that in times of recession and above-normal unemployment, the government should deliberately increase spending on goods and services and/ or reduce taxes to increase aggregate demand. In theory, this spending has multiplier effects and stimulates other spending, resulting in increased production and more jobs. In times of inflation, traditional fiscal policy calls for reduced government spending and/ or increases in taxes to decrease aggregate demand. Reductions in demand should then lead to decreased inflation.

Traditional fiscal policy has its critics, for several reasons. Economists do not know with certainty how large the multiplier effects are or how long it takes for fiscal policy to work. Therefore, by the time an expansionary fiscal policy takes effect, the economy may no longer be in a recession and the policy may actually lead to inflation. Also, events in other countries can greatly affect the outcome of U.S. fiscal policy measures. Most economists recognize the possibility of crowding out, which occurs if government borrowing (for example, to finance expansionary fiscal policy) causes interest rates to rise and private investment spending to decrease.

Some economists emphasize possible supply-side effects of fiscal policy, particularly with respect to tax cuts. In this scenario, because people and businesses have more after-tax income to spend as they choose, business tax cuts would lead to increased production and investment in capital goods. These outcomes should in turn lead to a direct increase in aggregate supply and to lower unemployment and lower inflation.

Whether fiscal policy is effective or not depends in part on how people respond to incentives. For example, if you are given a tax cut, will you spend the extra money or save it? If you spend it, it becomes someone else's income, and if they spend their income (and their tax cut), this has a stimulative effect on the economy. However, if everyone saves the tax cuts, which may also be rational, the desired effect of the fiscal policy may be much smaller or nonexistent. Issues like these make the effects of fiscal policy difficult to predict.

FISCAL POLICY TERMS

Fiscal Policy:
Changes in federal government spending or tax revenues designed to promote full employment, price stability, and reasonable rates of economic growth.

Expansionary Fiscal Policy:
An increase in government spending and/ or a decrease in taxes designed to increase aggregate demand in the economy. The intent is to increase GDP and decrease unemployment.

Contractionary Fiscal Policy:
A decrease in government spending and/ or an increase in taxes designed to decrease aggregate demand in the economy. The intent is to control inflation.

Multiplier Effects:
Based on the idea that increased spending by consumers, businesses, or government becomes income for someone else. When this person spends the income, it becomes income for someone else, and so on, leading to increased production in an economy. Multiplier effects can also work in reverse when spending decreases.

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<u>QUESTIONS FOR DISCUSSION</u>

1. In your own words … what is Fiscal Policy?

2. What is the purpose of expansionary fiscal policy? Give an example.

3. What is the purpose of contractionary fiscal policy? Give an example.

4. Say that the government, in an effort to fight unemployment, decides to increase its spending by hiring people to repair roads. Explain how hiring one person to repair a road could result in several people having more income to spend (the multiplier effect).