AP Macroeconomics

Mechanics of Fiscal Policy

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↑)

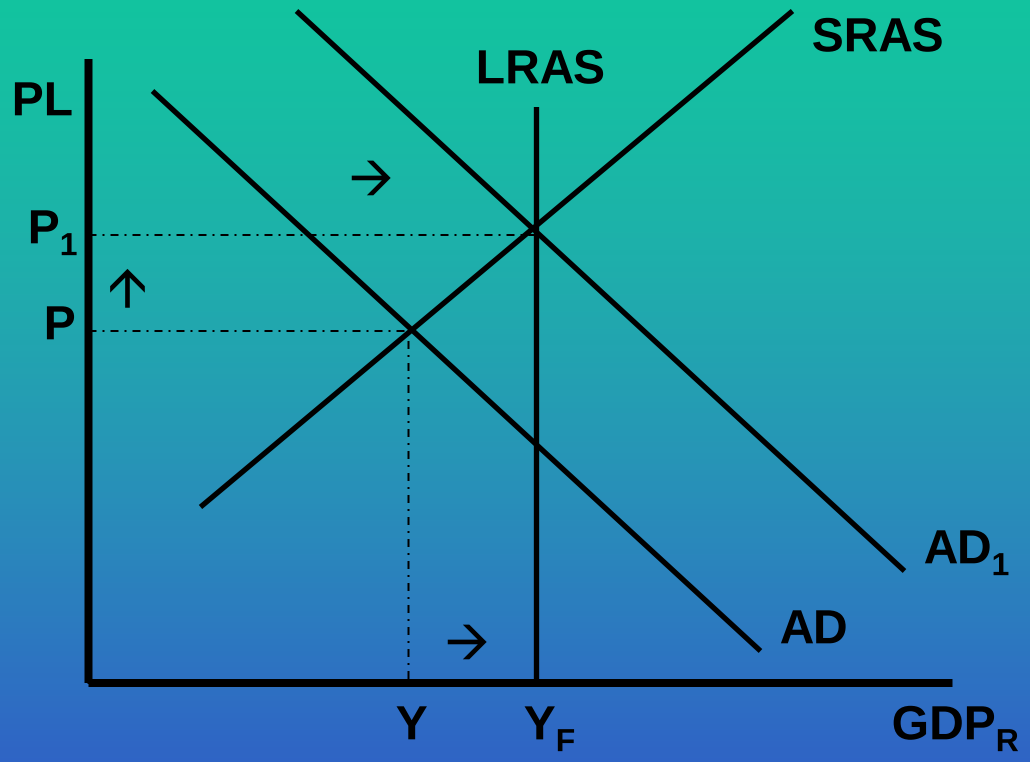
Expansionary Fiscal Policy

In order to combat recession, the government engages in expansionary policy.

If G ↑ or T↓ ,then AD shifts → causing PL↑and GDP ↑,which causes u% ↓

Notice that the PL increased: this means expansionary fiscal policy creates some inflation.

Expansionary Fiscal Policy



IF RECESSION, THEN G↑.: AD → .: GDP_R↑ & PL↑ .: u%↓ & π% ↑

OR T↓ .: DI↑ .: C↑.: AD → .: GDPR↑ & PL↑ .: u%↓ & π% ↑

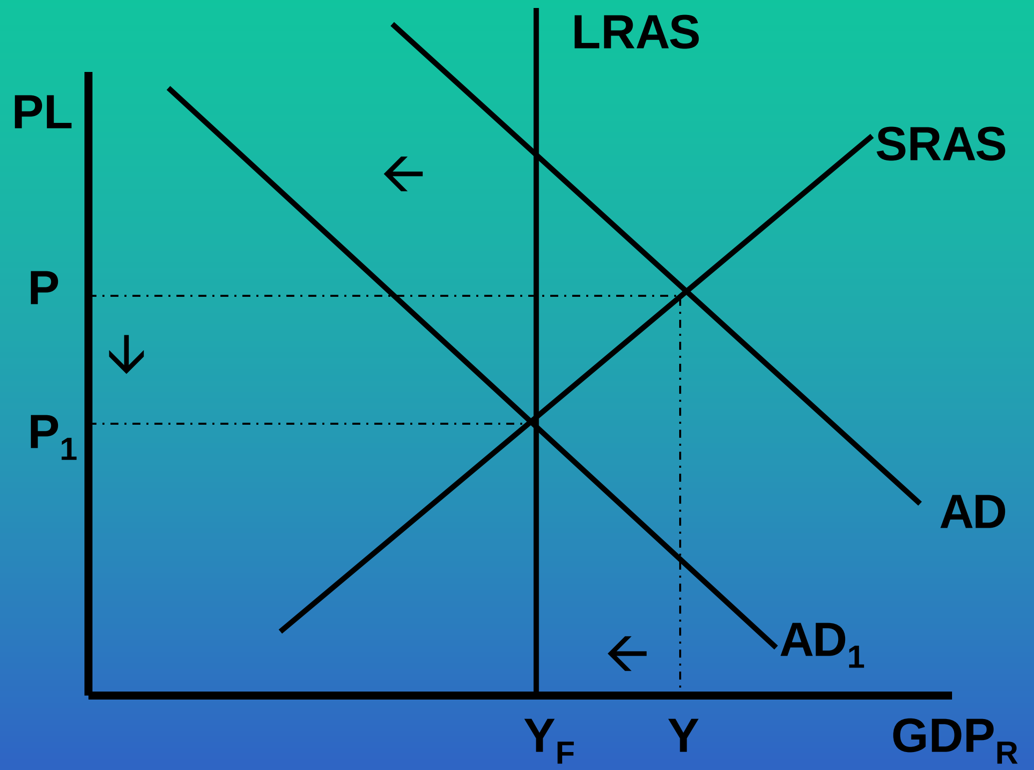
Contractionary Fiscal Policy

In order to combat inflation, the government engages in contractionary policy.

If G↓ or T↑ ,then AD shifts ← causing PL↓ and GDP↓, which causes u% ↑

Notice that the u% increased: this means contractionary fiscal policy creates some unemployment.

Contractionary Fiscal Policy



IF INFLATION, THEN G↓ .: AD ← .: GDP_R↓ & PL↓ .: u%↑ & π%↓

OR T↑ .: DI↓ .: C↓ .: AD ← .: GDP_R↓ & PL↓ .: u%↑ & π%↓

Discretionary v. Automatic Fiscal Policies

- **Discretionary**
  - 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
- **Automatic**
  - 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.

Weaknesses of Fiscal Policy

- Lags
  - Inside lag – it takes time to recognize economic problems and to promote solutions to those problems
  - Outside lag – 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.

Expansionary Fiscal Policy Side-effect: 'Crowding-out' of Investment and Net Exports

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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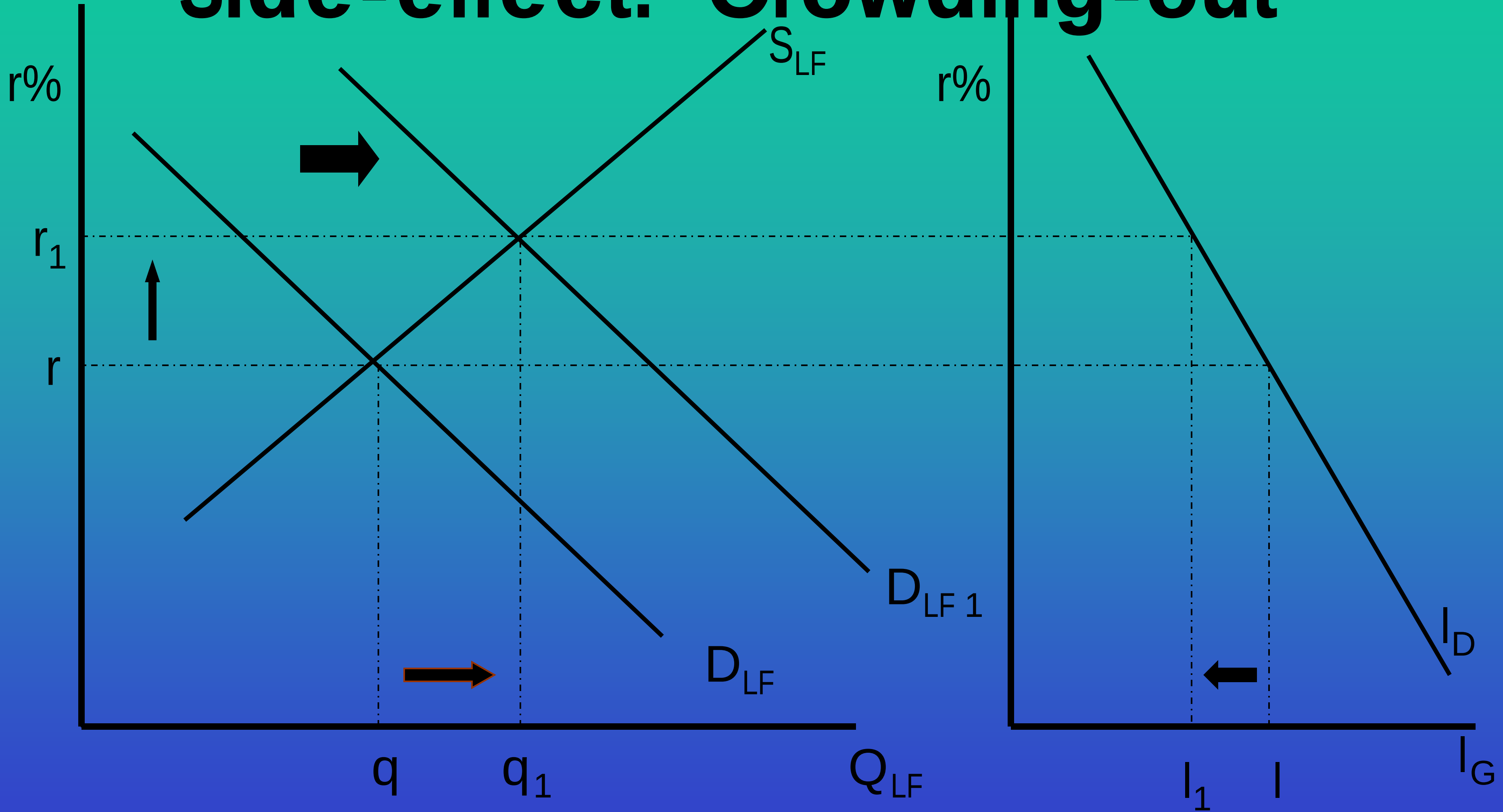
Expansionary Fiscal Policy
Side-effect: 'Crowding-out'



G↑ and/or T↓ .: Government deficit spends .: D_{LF} → .: r%↑ .: I_G↓

(Crowding-Out Effect)

Contractionary Fiscal Policy Side-effect: 'Crowding-in' of Investment and Net Exports

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 $\$_{\downarrow}$ 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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