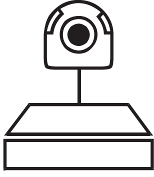
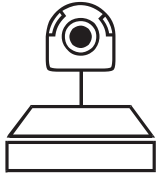


Unit 6, Lesson 35
Visual 1

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.
- ***Supply-Side Fiscal Policy:***
  The idea that fiscal policy may directly affect aggregate supply and not only aggregate demand. For example, a tax cut may give businesses incentives to expand or invest in capital goods, since they have more after-tax income to spend as they choose.



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Visual 2

DEBATES ABOUT FISCAL POLICY

Fiscal policy is controversial. Economists cite several possible problems relating to how effective fiscal policy is in stabilizing the economy. Here are some of the controversies:

1. How large are the multiplier effects?

It is important to know this in order to decide, for example, how large a change in taxes or government spending is necessary to fight recession or inflation. Too large a change could cause more problems, and too small a change would not solve anything. However, economists do not know precisely how large multiplier effects are.

2. How fast does fiscal policy work?

There are time lags that frequently occur with fiscal policy:

- The time it takes to realize that there is a problem in the economy.
- The time it takes to get a change in taxes or spending passed by Congress.
- The time it takes for the fiscal policy to help the recession or inflation.

Economists cannot predict how long these lags will be, and therefore cannot predict how long it will take fiscal policy to help the economy.

3. How is fiscal policy affected by international events?

The U.S. economy is part of the world economy, and is greatly affected by world events that it does not control. Actions in other countries may affect how or whether U.S. fiscal policy achieves its goals. For example, the U.S. government may try to fight a recession by increasing aggregate demand. But people in other countries may offset this if they decide to buy fewer U.S. exports, thereby decreasing aggregate demand for U.S. goods and services.

4. How does fiscal policy affect the national debt and interest rates?

Since expansionary fiscal policy means that government spending goes up or tax revenues go down, this will most likely increase the current national deficit or reduce the current surplus. This may lead to increased interest rates in the economy. When interest rates increase, private businesses may borrow less and decrease their investment in capital goods. This “crowding out” of private investment may offset the expansionary effects of fiscal policy.