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FISCAL POLICY

OVERVIEW

1. Stabilization policy is the effort of the government to reduce fluctuations in the business cycle. Fiscal policy, one form of stabilization policy, uses the ability of the government to change taxes or spending or both to alter the level of income and prices. Fiscal policy is administered by the president and Congress.
2. If the level of income is below full employment, the government can reduce taxes, increase spending, or both. If the level of income is above full employment, the government can increase taxes, reduce spending, or both. The government can use the income multiplier to help decide how much to change spending and taxes.
3. A balanced budget occurs when tax collections exactly equal government spending. If more is collected in taxes than is spent, then a surplus occurs. If more is spent than is collected in taxes, then a deficit occurs.
4. Using fiscal policy to achieve and maintain full employment is difficult. We do not know the exact level policy enacted now requires time to affect income. It may be politically difficult to do what is required to achieve full employment. The effects of changes in taxes and spending fall on some individuals and not on others. The choice of who gains and loses will slow down the making of fiscal policy.
5. The national debt is the outstanding debt created when the government deficit spends.
6. Whether the debt is good or bad depends on the weighing of the benefits and costs generated by the debt. The debt has provided larger income and employment. It also provides a form of saving. One cost is that the resources the government uses have other uses. Also, the interest on the debt is a substantial cost. As the deficit rises, the interest rate also rises and crowds out investment.

MATCHING

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|-------|----|-------------------------------|----|--|
| _____ | 1. | stabilization policy | a. | causes an inverse change in income |
| _____ | 2. | fiscal policy | b. | a budget where government spending equals taxes |
| _____ | 3. | change in taxes | c. | when greater deficits cause the interest rate to rise choking off investment |
| _____ | 4. | change in government spending | d. | a budget where taxes are larger than government spending |
| _____ | 5. | balanced budget | e. | the outstanding debt accumulated from when the government runs a deficit |
| _____ | 6. | surplus budget | f. | the policy of the government to smooth out the ups and downs of the economy |
| _____ | 7. | deficit budget | g. | causes a direct change in income |
| _____ | 8. | national debt | h. | a budget when government spends more than it collects in taxes |
| _____ | 9. | crowding-out effect | i. | use of the federal budget, spending or taxes, to stabilize the economy |

TRUE-FALSE

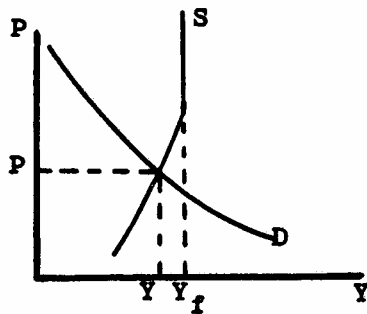
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|-------|----|---|
| _____ | 1. | When the government increases expenditure, we would usually expect the level of income to rise. |
| _____ | 2. | Over the past 30 years, the government has most often run a surplus. |
| _____ | 3. | One problem with the debt is that at some point we have to pay it off. |

- _____ 4. An opportunity cost of the debt is that the interest could be used for an alternative purpose.
- _____ 5. An increase in the deficit will cause no change in business spending.

PROBLEMS

1. a. Suppose that the marginal propensity to save is $1/4$. Find the income multiplier.

 - b. Suppose that we want the level of income to rise by \$400. By how much would government spending have to rise? (Hint: If a \$1 change in G yields a \$4 change in Y , how much change in G is needed to yield a \$400 change in Y ?) _____
 - c. If we want the level of income to fall by \$200, by how much must G change? _____
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2. Suppose that the full employment level of income is shown by Y_f in the graph. Would you increase or decrease G to achieve full employment? _____
Would you increase or decrease T to achieve full employment? _____



IN THE NEWS

1. The Congress and president are spending far more than is collected in taxes. The impact of all the spending is to increase the national debt.
 - a. Is the government running the deficit to make GDP larger? _____
 - b. If G falls (or T rises) what do you expect to happen to the level of income? _____
 - c. Suppose that the MPS is $1/3$. Suppose that the budget were balanced by reducing G by 200 billion. How much would income fall? What would happen to employment? Is this solution to the unbalanced budget politically acceptable? _____

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- d. If a massive cut in G is not possible, how else could we return to a balanced budget? What impact would there be on income? Employment? _____
- e. Given the expected economic impact of a balanced budget, is a balanced budget desirable at this time? _____
- f. What impact do these deficits have on the national debt? _____
- g. There is a belief that the large amount of government spending causes the interest rate to be higher. If government reduces spending and interest rates fall, what would happen to investment? _____
- h. If government does reduce spending and interest rates fall, what would happen to the level of income. _____
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2. Large deficits add to the national debt. The debt is not allowed to increase beyond the limits set by Congress. But Congress raises the debt limit nearly every year. The debt and debt limit have gotten so large that names like billion and trillion seem hardly large enough to keep track of the debt.
- a. Surely this growth in debt must stop somewhere. What costs are there to a debt this size? _____
- b. What benefits have we generated by having this debt? _____
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PRACTICE TEST

Circle the correct answer.

1. Fiscal policy involves:
- a. changing government spending.
 - b. changing taxes.
 - c. changing the federal budget.
 - d. all of the above.
2. In a recession, the appropriate fiscal policy is:
- a. increase government spending and increase taxes.
 - b. increase government spending and decrease taxes.
 - c. decrease government spending and increase taxes.
 - d. decrease government spending and decrease taxes.
3. If GDP is \$5000 and government spending increases by \$200, what is the new level of income when the MPC is $\frac{4}{5}$?
- a. \$5160
 - b. \$5200
 - c. \$5500
 - d. \$6000

4. The national debt is:
 - a. the total outstanding government debt.
 - b. the total outstanding debt of all consumers.
 - c. the total outstanding debt of all business.
 - d. the total outstanding debt of all sectors combined.

5. The budget should be:
 - a. balanced always.
 - b. a surplus when above full employment.
 - c. a deficit when below full employment.
 - d. both band c.

ANSWERS

Matching

1. f
2. i
3. a
4. g
5. b
6. d
7. h
8. e
9. c

True-False

1. T
2. F
3. F
4. T
5. F

Problems

1.
 - a. The income multiplier is the reciprocal *of* the MPS; so the multiplier is 4.
 - b. If we want a \$400 increase in income, we need a \$100 increase in government spending.
 - c. To make the level of income fall by \$200, we need a \$50 decrease in government spending.
2. The economy is at less than full employment so to obtain an increase in aggregate demand and achieve full employment, we would need an increase in government spending or a decrease in taxes.

In the News

1.
 - a. Probably not. The government is aware of the economic impact of the deficit, but its spending program and not the economic impact of the deficit is its primary consideration.
 - b. If government spending falls, or taxes rise, we expect the level of income to fall.
 - c. If MPS is $1/3$ and government spending is reduced by \$200 billion, GDP will fall by \$200 billion times the multiplier of 3, or \$600 billion dollars. Employment will also fall by a large amount. This solution will not seem politically acceptable.
 - d. Taxes could be increased, but the impact will be the same, smaller income and employment.
 - e. It seems that a balanced budget would require a large reduction in output and employment. If these are the true costs, society would have to weigh these costs against the benefits society sees in a balanced budget.
 - f. The larger the deficit, the larger the national debt.
 - g. A reduction in the interest rate would cause investment to rise, and also income and employment.
 - h. If government spends less, the level of income will fall by a multiplied amount. If the interest rate goes down and stimulates investment, the increase in investment will cause income to rise by a multiplied amount. Income will fall after both changes if the decrease in government spending is more than the increase in investment. Income will rise after both changes if the increase in investment is more than the decrease in government spending.
2.
 - a. The costs are the interest payments, and that to finance the debt, the government has to borrow, which drives up interest rates that in turn will reduce business spending. The high interest payments will cause the deficit to be larger next year. That will cause more debt and higher interest rates and so on. b. The benefits are a higher level of employment than would occur otherwise, as well as a safe form of saving. Also there are more public goods and fewer private goods. This is either a cost or a benefit depending on your point of view.

Practice Test

1.d., 2.b., 3.d., 4.a., 5.d.