Name: ______________________________ Date: ____________________ Block: __________

SSEMA2 The Tools of Fiscal Policy

Changes in federal taxes and federal government spending designed to affect the level of aggregate demand (and in some cases aggregate supply) in the economy are called *fiscal policy*.

Aggregate demand is the total amount of spending on goods and services in the economy during a stated period of time. Aggregate demand consists of consumer spending, government spending, and investment spending.

Aggregate supply consists of the total amount of goods and services available in the economy during a stated period of time.

During a recession, aggregate demand is usually too low to bring about full employment of resources. Government can increase aggregate demand by spending more, cutting taxes, or doing both. These actions often result in budget deficits because the government spends more than it collects in taxes. Increasing government spending without increasing taxes or decreasing taxes without decreasing government expenditures should increase aggregate demand. Such an expansionary fiscal policy should increase employment, inflation, or both.

If the level of aggregate demand is too high, government can reduce its spending, increase taxes, or do both. These actions should result in a larger budget surplus or a smaller budget deficit than existed before. Such a contractionary fiscal policy should lower the level of aggregate demand, and the economy will experience less employment of its resources, less inflation, or both.

Part A.
Decide whether each of the following fiscal policies of the federal government is expansionary or contractionary. Write *expansionary* or *contractionary* and **EXPLAIN THE REASONS FOR YOUR CHOICE**.

1. The government cuts business and personal income taxes and increases its own spending. ________________________

2. The government increases the personal income tax, Social Security tax, and corporate income tax. Government spending stays the same. ________________________

3. Government spending goes up while taxes remain the same. ________________________

4. The government reduces the wages of its employees while raising taxes on consumers and business. Other government spending remains the same. ________________________

Part B.

Test your understanding of fiscal policy by completing the first four questions in the table "Effects of Fiscal Policy." All your choices for each situation must be consistent, that is, you should choose either an expansionary or contractionary fiscal policy. Fill in the spaces as follows:

Column A: Objective for Aggregate Demand
Write *increase* if you wish to increase aggregate demand.
Write *decrease* if you wish to decrease aggregate demand.

Column B: Action on Taxes
Write *increase* if you wish to increase taxes.
Write *decrease* if you wish to decrease taxes.

Column C: Action on Government Spending
Write *increase* if you wish to increase government spending.
Write *decrease* if you wish to decrease government spending.

Column D: Effect on Budget
Write *toward deficit* if you wish to increase the deficit (or reduce the surplus).
Write *toward surplus* if you wish to reduce the deficit (or increase the surplus).

Effects of Fiscal Policy

	(A) Objective for Aggregate Demand	**(B)** Action on Taxes	**(C)** Action on Government Spending	**(D)** Effect on Budget
1. The national unemployment rate rises to 12%.				
2. Inflation is strong and its rate is now 14% per year.				
3. Surveys show consumers are losing confidence in the economy, retail sales are weak, and business inventories are increasing rapidly.				
4. Business sales and investment are expanding rapidly, and economists believe strong inflation lies ahead.				
5. Inflation persists while unemployment stays high.				