Macroeconomics: Fiscal Policy

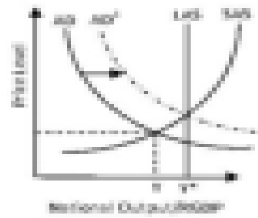
While the central bank can use monetary policy to influence the state of the economy, the government can influence the economy by using fiscal policy. **Fiscal policy** is the use of government expenditure and taxation to affect the level of aggregate demand and the economy's performance.

There are two types of fiscal policy: automatic fiscal policy and discretionary fiscal policy. **Automatic fiscal policy** (or automatic stabilizers) includes the progressive income tax and government transfer payments (e.g., EI, disability, pension payments). These stabilizing mechanisms are set up to automatically reduce inflationary and deflationary gaps that would occur from significant changes in income levels. As income increases or decreases, there is a parallel change in consumer spending and AD. Through the multiplier effect this would change GDP by an even larger amount.

Example: as your income increases, so does your disposable income and level of consumption expenditure. But the progressive income tax increases the amount of tax you pay at a higher income and somewhat reduces your disposable income. This is called reducing the MPC out of the national income. Conversely, when your income level falls, you pay less tax which increases the amount of disposable income available.

Discretionary fiscal policy requires legislative or administrative action by the government to change government expenditure levels or taxes. This is used to "fine tune" fluctuations in RGDP. The government may believe that the amount of time it would take the economy to adjust on its own (shifts in SAS) is too long to wait (from a political or economical perspective) and so will use fiscal policies to shift AD and minimize inflationary or recessionary gaps.

Example: If the economy is experiencing a recession, what fiscal policy actions would be appropriate?



Solution: The government can stimulate the economy by increasing government expenditure and/or decreasing tax rates. Decreased tax rates give people more disposable income and therefore increase levels of consumption expenditure. Both changes increase AD (curve shifts to the right) and real GDP increases, bringing the actual output closer to, or at, potential RGDP.

The government enacts fiscal policy that runs "counter" to business cycle of the economy- encouraging spending in a recession and discouraging spending in a boom. A government will incur a budget deficit in a recession (expenditures > revenue) to stimulate the economy and should incur a budget surplus in an economic boom to dampen inflationary pressures (revenues > expenditures). The government saves

Authored by Emily Simpson