

## *Discretionary and Automatic Fiscal Policy*

One of the goals of economic policy is to stabilize the economy. This means trying to keep employment high and the price level stable. To accomplish this, the amount of aggregate demand in the economy must be near the full-employment level of output. If aggregate demand is too low, there will be unemployment. If aggregate demand is too high, there will be inflation.

If aggregate demand is too low, government may be able to stimulate spending in the economy by increasing its spending or by cutting taxes. These policies are examples of *expansionary fiscal policy*. If government wants to slow down aggregate demand, it would pursue a *contractionary fiscal policy*. To do this, it could cut government spending or raise taxes.

If government has to pass a law or take some other specific action to change its tax and/or spending policies, then government is stabilizing the economy through *discretionary policy*. If the effect happens by itself as the economic situation changes, then it is known as an *automatic stabilizer*. An example of an automatic stabilizer is unemployment compensation: If the economy goes into a recession and people are laid off, they may be eligible to receive unemployment compensation. This payment helps them buy necessities and helps keep aggregate demand from falling as much as it might otherwise. The payments help stabilize the economy but occur without any additional legislation.

---

Activity written by David Nelson, Western Washington University, Bellingham, Wash.


**UNIT 3** **Macroeconomics** **LESSON 8** ■ **ACTIVITY 31** (continued)

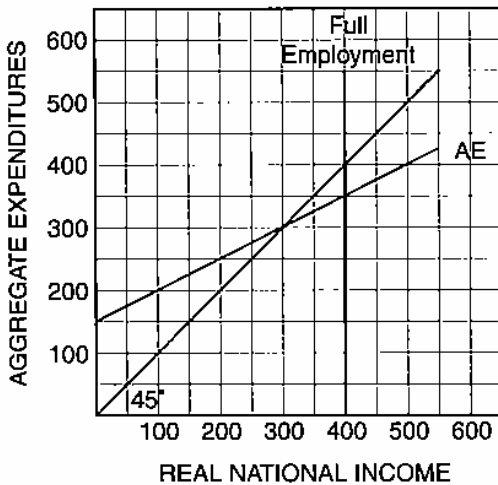
Listed below are several economic scenarios. For each scenario, indicate whether it represents an automatic (A) or discretionary (D) stabilizer and whether it is an example of expansionary (E) or contractionary (C) fiscal policy. A sample has been completed for you.

Economic Scenarios	Automatic (A) or Discretionary (D)	Expansionary (E) or Contractionary (C)
<i>Sample:</i> Recession raises amount of unemployment compensation.	A	E
1. The government cuts personal income-tax rates.	_____	_____
2. The government eliminates favorable tax treatment on long-term capital gains.	_____	_____
3. Incomes rise; as a result, people pay a larger fraction of their income in taxes.	_____	_____
4. As a result of a recession, more families qualify for food stamps and welfare benefits.	_____	_____
5. The government eliminates the deductibility of interest expense for tax purposes.	_____	_____
6. The government launches a major new space program to explore Mars.	_____	_____
7. The government raises Social Security taxes.	_____	_____
8. Corporate profits increase; as a result, government collects more corporate income taxes.	_____	_____
9. The government raises corporate income tax rates.	_____	_____
10. The government gives all its employees a large pay raise.	_____	_____

## Two Ways to Analyze Fiscal Policy

In Figure 32.1, assume an estimated full-employment national income of \$400 billion for the economy and a horizontal SRAS.

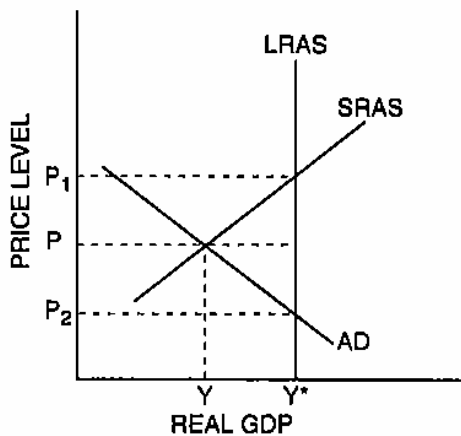
 Figure 32.1  
Aggregate Expenditure Function  
for a Hypothetical Economy



1. What will be the actual national income level in equilibrium? \_\_\_\_\_
2. Given a marginal propensity to consume of 0.50, how much of an increase in aggregate expenditure would be needed to move the economy to full employment? (Hint: Calculate the MPC from the diagram using the rise divided by the run. Then calculate the multiplier that will operate on any change in AE.) \_\_\_\_\_
3. How much will GDP increase if aggregate expenditure increases by \$50 billion? Why?
4. What fiscal policy measures are available to deal with this situation?
5. Draw in a new AE curve showing the elimination of the gap between the current equilibrium income and the full-employment level of income through the use of fiscal policy. Explain completely the policy you employed.

Adapted from Dascomb R. Forbush and Fredric G. Menz, *Study Guide and Problems to Accompany Lipsey, Steiner and Purvis, Economics*, 8th ed. (New York: HarperCollins Publishing Co., 1987), p. 369.

**\*** Figure 32.2  
Diagram of a Persistent Gap



6. Assume a persistent gap between current equilibrium income,  $Y$ , and full-employment income,  $Y^*$ , as shown in Figure 32.2.
  - (A) If the government decided not to implement any fiscal policy, the unemployment of resources would eventually lead to a decrease in factor prices. Show diagrammatically that this could eliminate the gap. Label the new curve  $SRAS_1$ . The new price level would be \_\_\_\_\_.
  - (B) A second possibility would be to depend on a smaller shift of aggregate supply and have a modest shift in aggregate demand by a discretionary fiscal stimulus so that the price level was maintained at  $P$ . Show these two changes in the graph. Label the curves  $SRAS_2$  and  $AD_1$ .
  - (C) A third possibility is that government would seek changes in taxes and/or expenditures that would rapidly bring the economy to full employment. Show this diagrammatically. Label the curve  $AD_2$ .
  
7. Assume that a hypothetical economy is currently at an equilibrium national income level of \$1 trillion, but the full-employment national income is \$1.2 trillion. Assume the government's budget is currently in balance at \$200 billion and the marginal propensity to consume is 0.75. Fill in the answer blanks or underline the correct words in parentheses.
  - (A) The gap between the equilibrium income and full employment is \_\_\_\_\_.
  - (B) The value of the multiplier is \_\_\_\_\_.
  - (C) Aggregate expenditures would have to be (*increased / decreased*) by \_\_\_\_\_ billion to eliminate the gap.
  - (D) The government could attempt to eliminate the gap by holding taxes constant and (*increasing / decreasing*) expenditures by \_\_\_\_\_ billion.
  - (E) Alternatively, the government could attempt to eliminate the gap by holding expenditures constant and (*increasing / decreasing*) its tax receipts by \_\_\_\_\_ billion.

## *Analyzing the Macroeconomy*

Answer the following questions. In some cases, you may also want to include a graph to show your analysis.

1. True, false or uncertain, and explain why? “Regardless of our current economic situation, an increase in aggregate demand will always create new jobs.”
2. True, false or uncertain, and explain why? “In the long run, when nominal wages increase, everyone has more money to spend; therefore, the economy as a whole benefits.”
3. True, false or uncertain, and explain why? “When unemployment rises, the price level falls. When unemployment falls, the price level rises. It is impossible to have a rising price level with rising unemployment.”
4. True, false or uncertain, and explain why? “Our economy is able to adjust to a long-run equilibrium after a decrease in aggregate demand because prices and wages are sticky.”
5. True, false or uncertain, and explain why? “If we are in a recession, as long as we continue to increase aggregate demand, we can achieve full employment without driving up the inflation rate.”

---

Activity written by James Stanley, Choate Rosemary Hall, Wallingford, Conn., and John Morton, National Council on Economic Education, New York, N.Y.

6. True, false or uncertain, and explain why? "When the economy experiences an increase in aggregate demand, it will discover that its production possibilities curve has shifted outward."
7. Use short-run AD and AS analysis to illustrate the results of the following events. Then explain why these changes have taken place. Each answer should be accompanied by a clearly labeled diagram.
- (A) There is a 25 percent decrease in the price of crude oil.
- (B) Price levels in Germany, Japan and Great Britain rise considerably, while price levels in the United States remain unchanged.
- (C) The federal government launches a major new highway-construction program.

(D) An insidious computer virus causes all IBM computers in the United States to crash.

(E) There is an increase in worker productivity.

8. Illustrate the following fiscal policy using both the AD and AS model and the Keynesian aggregate expenditure model. In other words, draw two graphs for the fiscal policy change and give a brief explanation of each graph. In your explanation, be sure to emphasize the line of reasoning that generated your results; it is not enough to list the results of your analysis.

**Fiscal Policy:** At less than full employment, the federal government decreases taxes while holding government spending constant.