

Handout 19-1

THE TOOLS OF FISCAL POLICY

Name _____ Class _____

Changes in federal taxes and federal government spending that are 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 I

Directions: 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. _____

Continued

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