Chapter 16:
FISCAL POLICY

FISCAL POLICY AND ITS EFFECT ON AGGREGATE DEMAND & AGGREGATE SUPPLY

What is GOVERNMENT BUDGET?

- The **government *budget*** is an **annual** statement of the *revenues*, the *outlays*, and *surplus* or deficit of the government.

What is FISCAL POLICY?

- ***Fiscal Policy:*** The ***use*** of the government budget to **achieve** the macroeconomic objectives of high and sustained economic growth and full employment.

Fiscal Policy & Aggregate Demand

- ***Fiscal Policy*** can take the **<u>form</u>** of a change in the government ***outlays*** or a change in the ***tax revenues***.
- ***And a change*** in government outlays can take the **<u>form</u>** of a change in ***expenditure*** on goods and services or a change in ***transfer payment***.

Fiscal Policy & Aggregate Demand

- ***Other things remaining the same*** a change in <u>**any of the items**</u> in the government budget <u>**changes**</u> aggregate demand and has a multiplier effect.
- ***Aggregate Demand*** changes by a <u>**greater**</u> amount than the <u>**initial**</u> change in the item in the government budget

A Successful Fiscal Stimulus

- ✓ If real GDP ***is below*** potential GDP, the government might practice a fiscal stimulus by:

I. **Increasing** its expenditure on goods & services

II. **Increasing** transfer of payments

III. **Cutting** taxes (*reducing taxes*)

Or a combination of ***all*** three.

Fiscal Stimulus: When Real GDP is low:

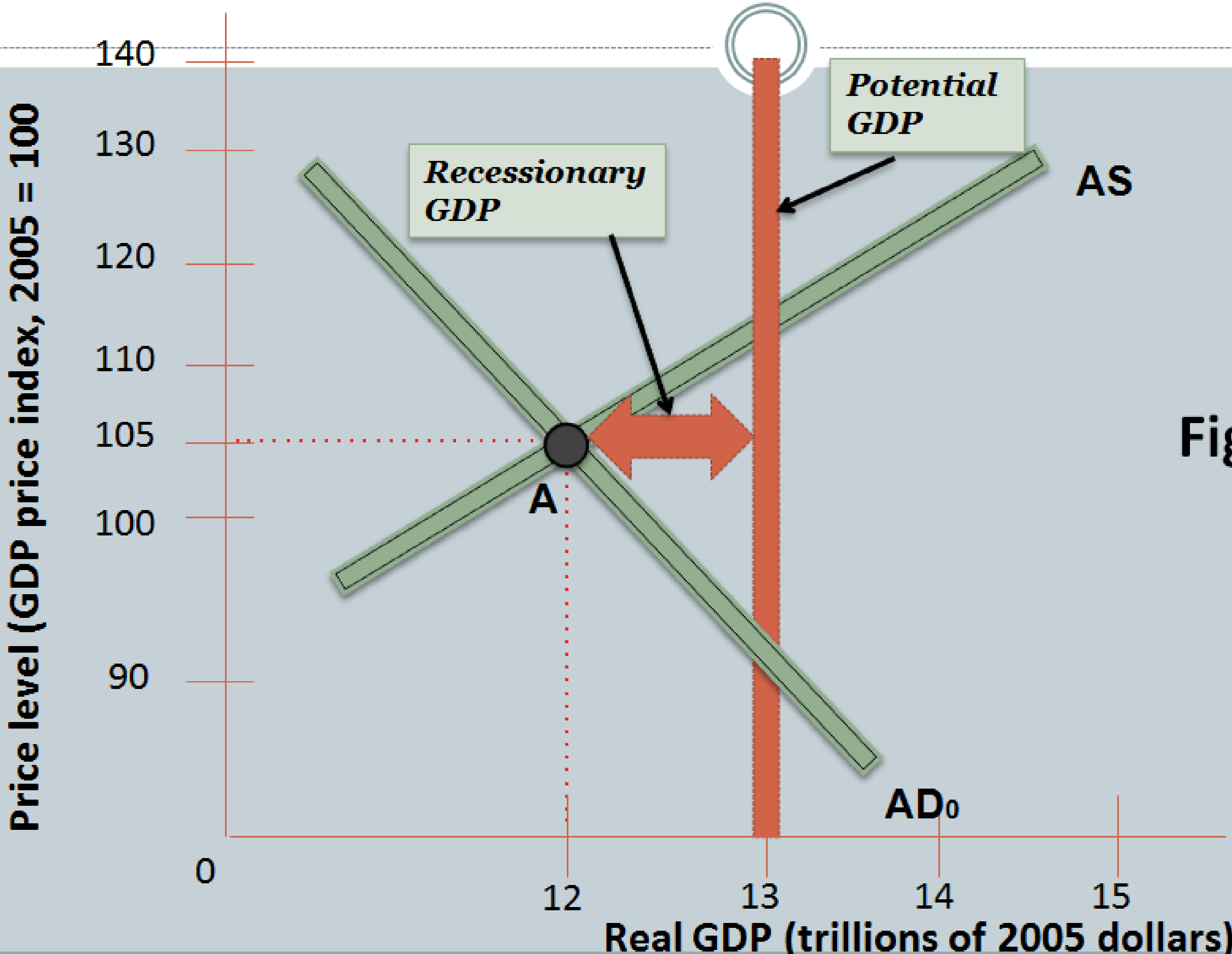


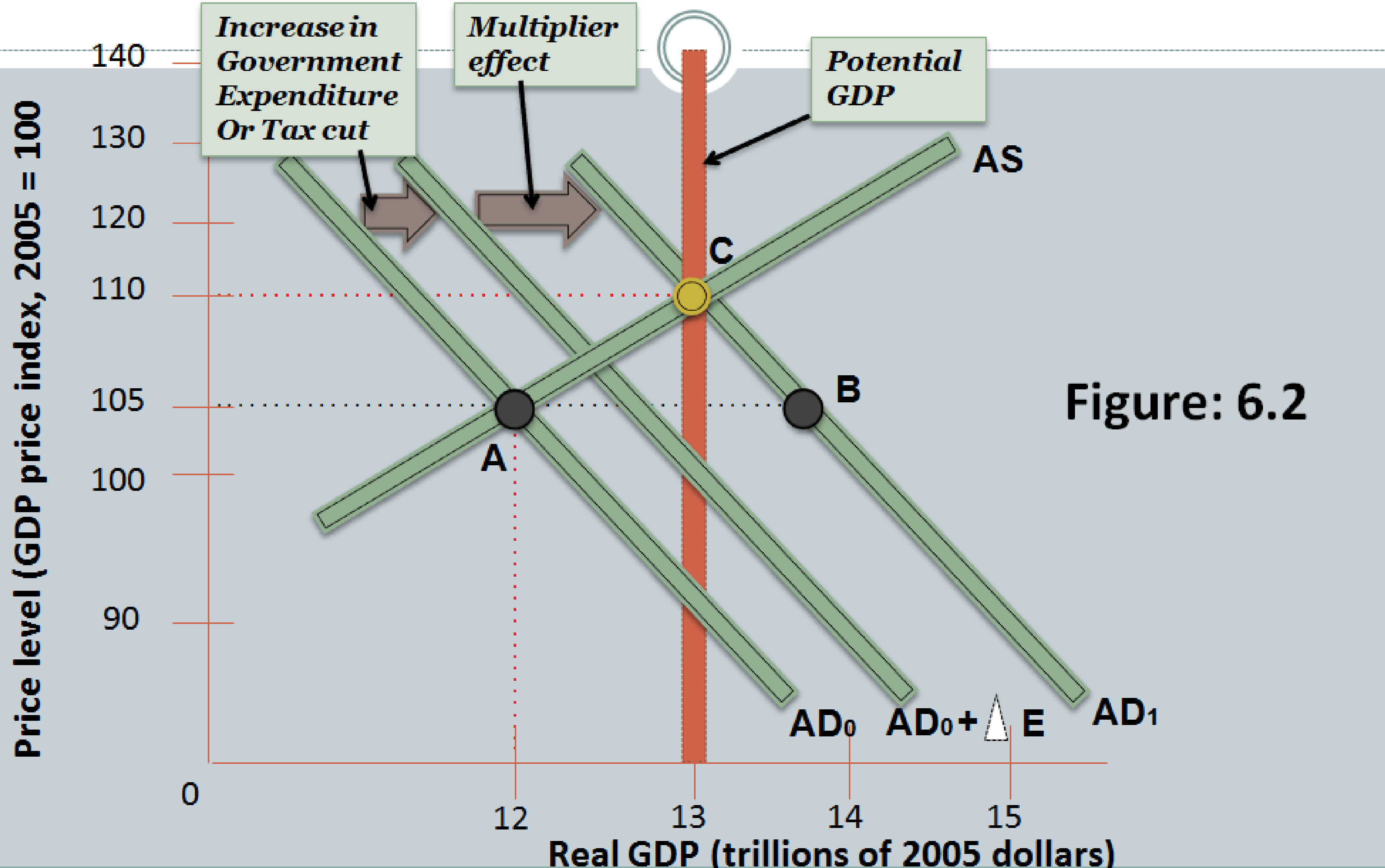
Figure: 6.1

Below full-employment equilibrium

Figure 6.1: Illustration

- ✓ In the figure, potential GDP is $ 13 trillion but real GDP is $ 12 trillion.
- ✓ The ***economy*** is at point **{A}**.
- ✓ The ***red-arrow*** shows the "**recessionary gap**".
- ○ To ***eliminate*** the recessionary gap and restore full employment, the government ***increases*** expenditure or ***cuts*** taxes, to ***increase*** aggregate expenditure by Δ**E**.
- ○ This ***increase*** is illustrated in **figure 6.2**, where full employment is ***achieved***.

Fiscal Stimulus: When Real GDP is low



Full Employment Restored

A Successful Contractionary Fiscal Policy

If real GDP is greater than the potential GDP, the government practices a contractionary fiscal policy.

- ✓ ***The Contractionary Fiscal Policy:*** A **decrease** in the government expenditure on goods and services, **decrease** in the transfer payments, or ***raise*** in taxes designed to ***decrease aggregate demand***.

Contractionary Fiscal Policy: Above Full Employment

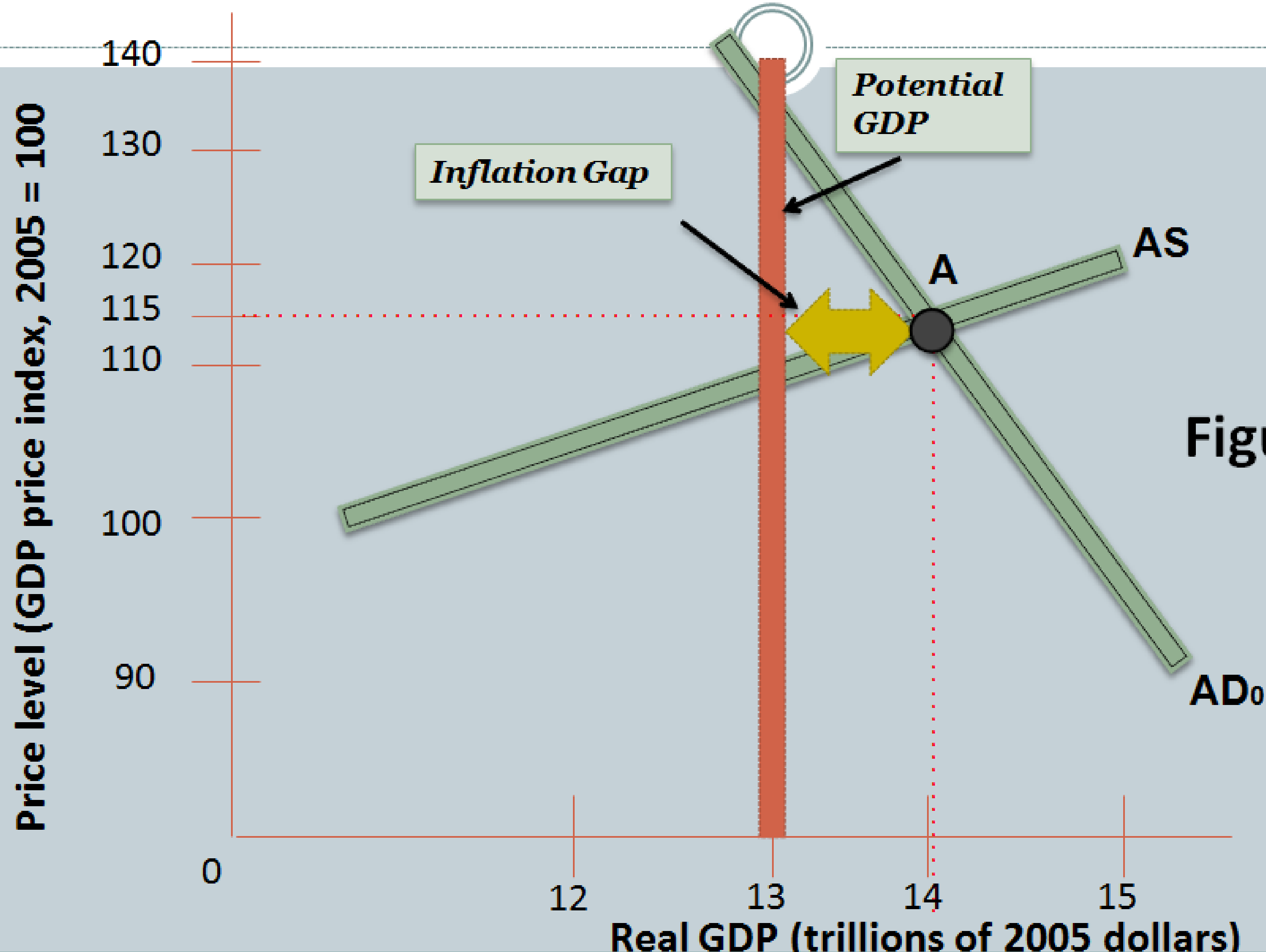


Figure: 6.3

Above full-employment equilibrium

Figure 6.3: Illustration

- In the figure, potential GDP is $ 13 trillion but real GDP is $ 14 trillion.
- The economy is at point **{A}**.
- The ***yellow-arrow*** shows the ***inflation gap***.
- To **eliminate** the recessionary gap and restore full employment, the government ***decreases*** expenditure or ***rises*** taxes, to ***decrease*** aggregate expenditure by ΔE.
- This ***increase*** is illustrated in figure 6.4, where full employment is achieved.

Contractionary Fiscal Policy: Above Full Employment

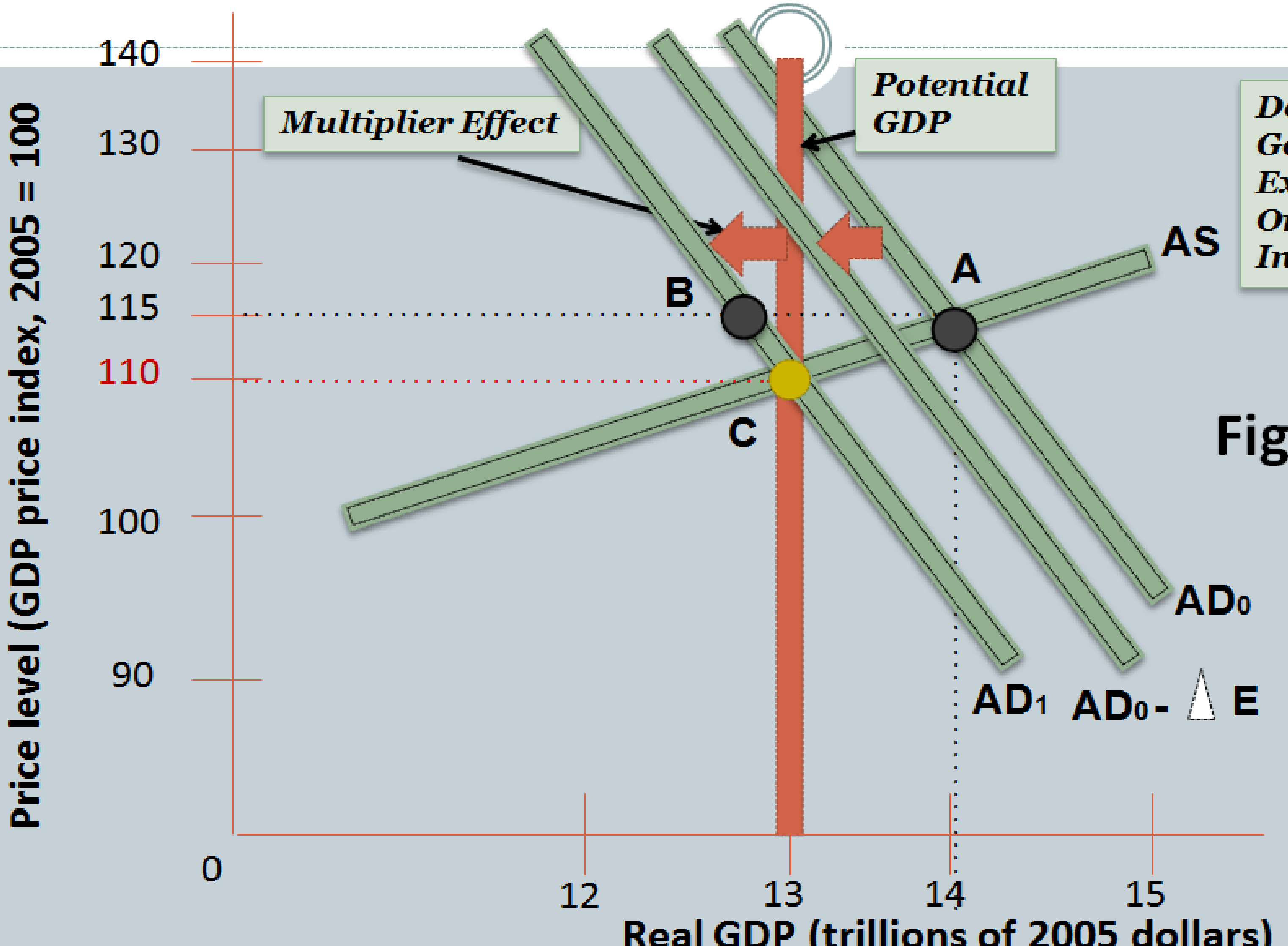


Figure: 6.4

Full Employment Restored

The Supply Side: Potential GDP & Growth

- Fiscal policy can influence the output gap by changing the aggregate demand and the real GDP relative to the potential GDP.
- **But fiscal policy also influences potential GDP and the growth rate of potential GDP.**
- **These influences rises because the government provides public goods and services that increase productivity and because taxes change the incentives that affect people.**
- **These influences are called SUPPLY-side effects, operates more slowly than the DEMAND-side effects.**

The Supply Side: Potential GDP & Growth

- **In recession:** Supply-side effects are <u>ignored</u> as the focus is on *fiscal stimuli* and restoring *full employment*.
- **In the long-run:** Supply-side effects will *dominate* and *determine* **the potential GDP**.

The Supply Side: Full Employment & Potential GDP

With consideration of government services and taxes:

- **Both sides of the government budget influence the potential GDP.**
- The **expenditure side** provides the public goods and services that **increases** productivity.
- This *increase* in productivity **increases the** potential GDP.
- On the **revenue side**, **taxes** modify the *incentives* and change the full-employment quantity of labor as well as the amount of saving and investment.

The Supply Side: Public Goods and Productivity

- The government provides a *legal system* and other *infrastructure services* – which **increase** the nation's productivity.
- *Public goods* and *services* financed by government, increase the real GDP that a given amount of labor can produce.
- This means the **provision** of public goods and services *increases* potential GDP.

The Supply Side: Taxes and Incentives

- **Taxes influence the potential GDP and the aggregate supply.**
- ***For Example* :*Income tax* *lowers the incentive to work , save and invest* and decreases the full-employment quantity of labor. Therefore the potential GDP becomes lower and the aggregate supply curve shifts to the left.**