

Fiscal Policy (Congress)

Government Intervention in the Free Market?:

How Congress can try to

speed up

or slow down

the economy

Review Quiz

#1: TRUE or FALSE

John Maynard Keynes was one of the classical economists.

FALSE.

Review Quiz

#2: What did the classical economists believe about the economy?

Economy is self-regulating

Recessions are temporary

Government intervention in the economy is unnecessary & undesirable.

Review Quiz

#3: What are the four types of unemployment?

Structural
Cyclical
Frictional
Seasonal

Review Quiz

#4: What is full employment?

Between 4 and 5 percent unemployment

Review Quiz

#5: What are the three stages of the Aggregate Supply Curve?

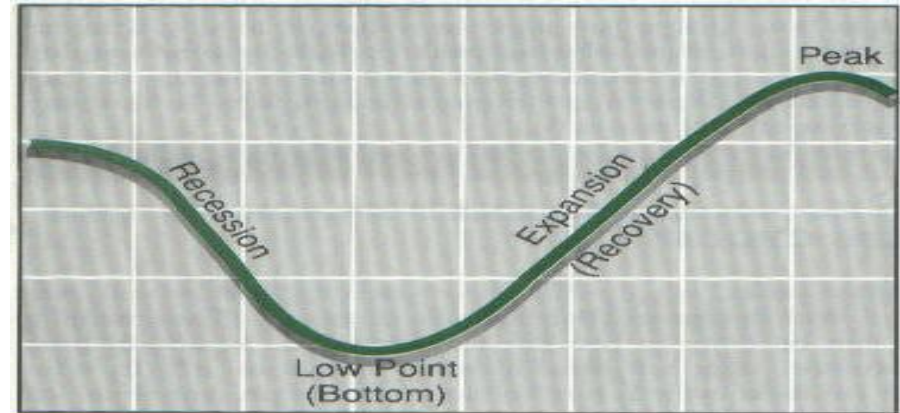
Recession
Sweet Spot
Vertical—inflation too high

Fiscal Policy

Fiscal Policy is the CONGRESS's attempt to influence GDP growth through TAX and SPENDING policy

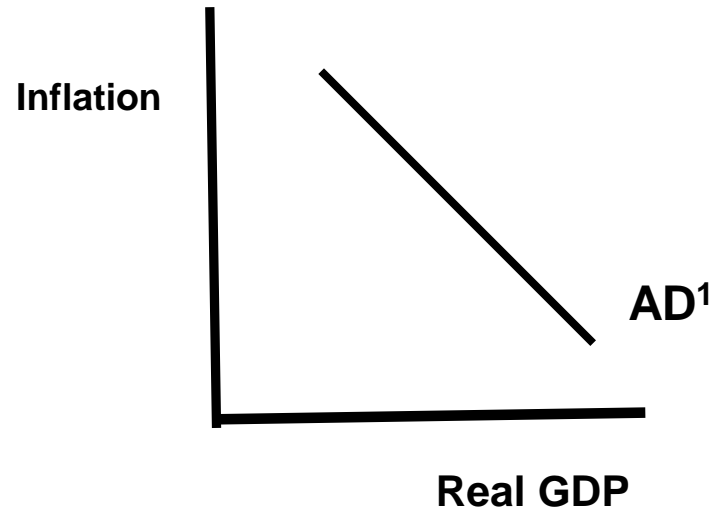


- Keynes believed recessions could be permanent
- Argued investment by Government can moderate the “ups & downs” of **business cycle**



Phases of the Business Cycle

Review: Aggregate Demand (AD)

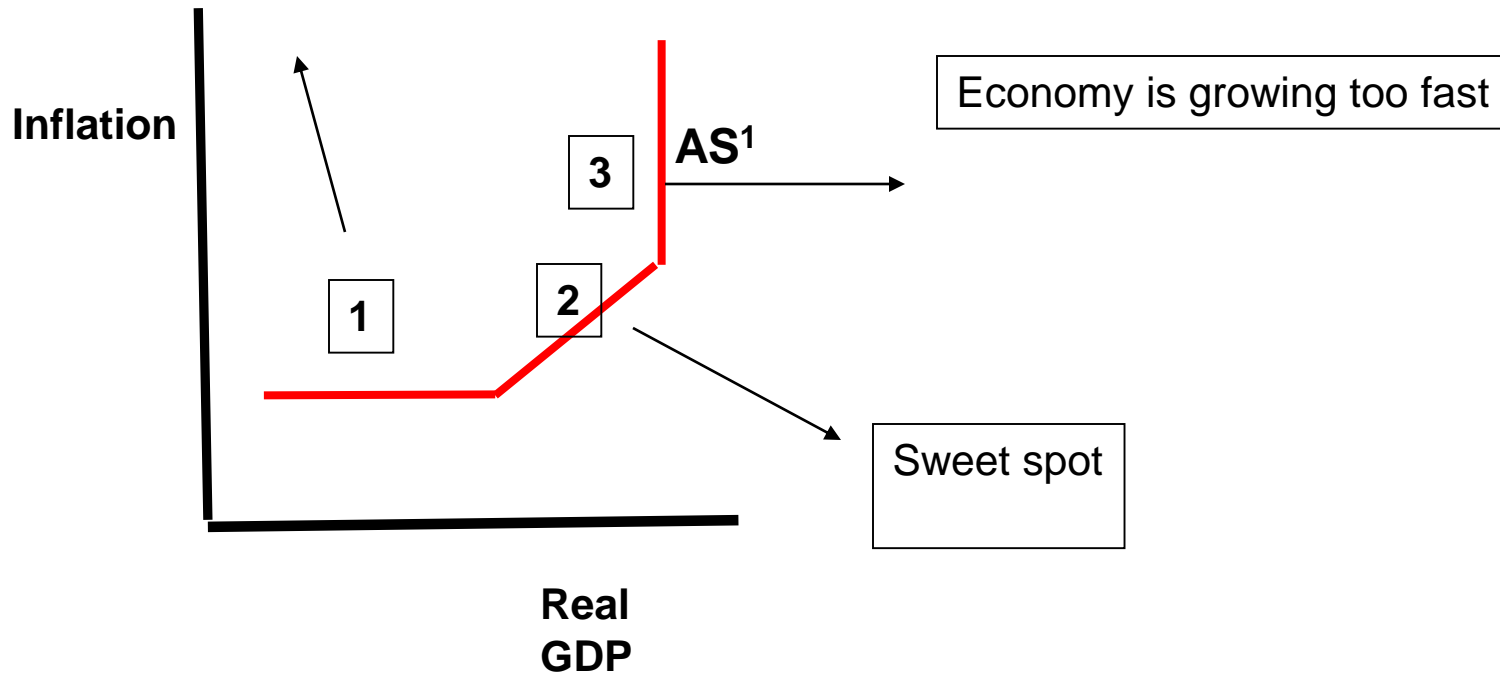


Aggregate-demand curve (AD)- the demand curve for the entire economy

Review: 3 Phases of **AS Curve**

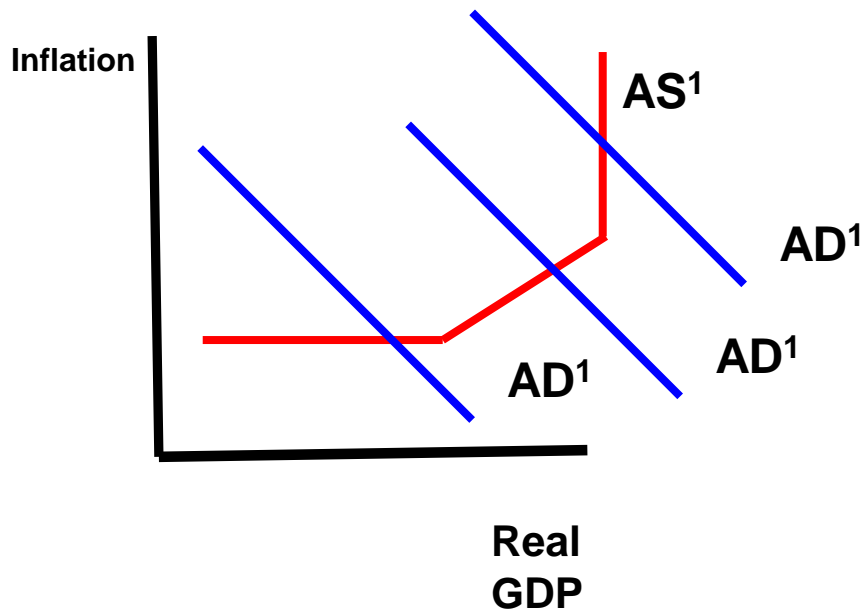
- **Aggregate-supply curve** (AS)- the supply curve for the entire economy

(1) **Flat:** Recession



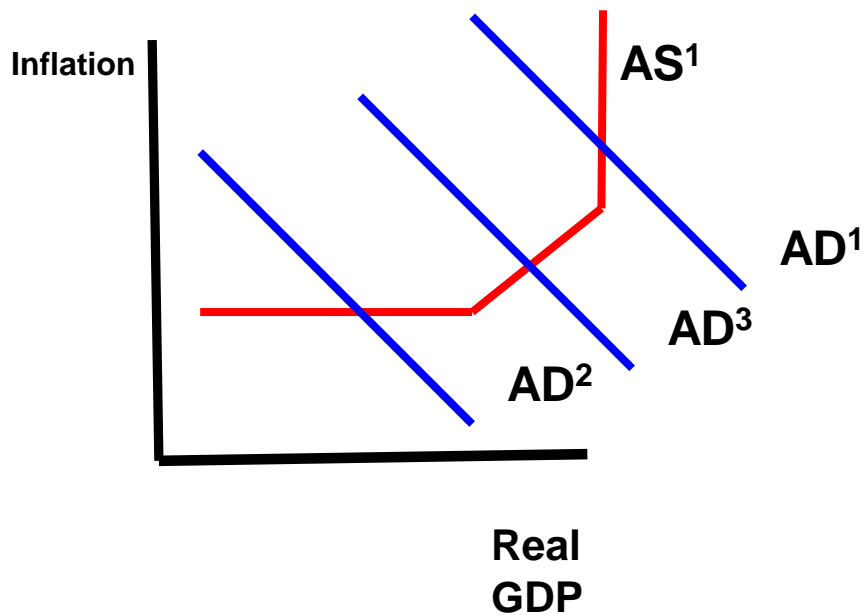
AD/AS Model

Draw the AD curve on the appropriate section of the AS curve based on the economic situation



AD/AS Model

Draw the AD curve on the appropriate section of the AS curve based on the economic situation



1. UNEMPLOYMENT 3%
GDP GROWTH TOO FAST

2. RECESSION

3. UNEMPLOYMENT 5%
GDP GROWTH MODERATE

2 Types of Fiscal Policy

•Expansionary Policy

Goal:

AD↑

•Contractionary Policy

Goal:

AD↓

Expansionary Fiscal Policy

- ***Goal: to increase AD (speed up circular flow)***

How:

1. Increase Gov't Spending

--Job training programs

--Infrastructure projects (building schools, fixing bridges/roads/levees, etc.)

--Unemployment benefits

2. Decrease Taxes (especially personal income taxes)

Restrictive/Contractionary Fiscal Policy

- ***Goal: to decrease AD (slow down circular flow)***

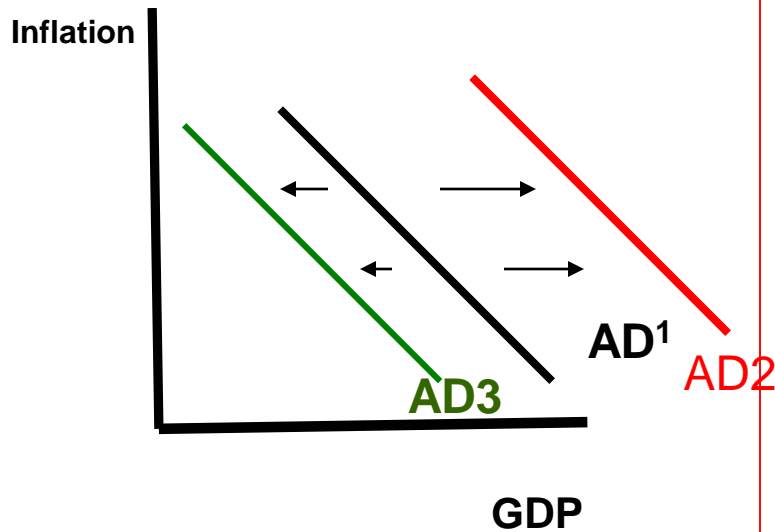
How:

1. Decrease Gov't Spending

- Cut spending by various Cabinet Departments**
- Cut Infrastructure projects (building schools, fixing bridges, etc.)**
- Cut research and development funding**

2. Increase Taxes (especially personal income taxes)

Shifts in AD



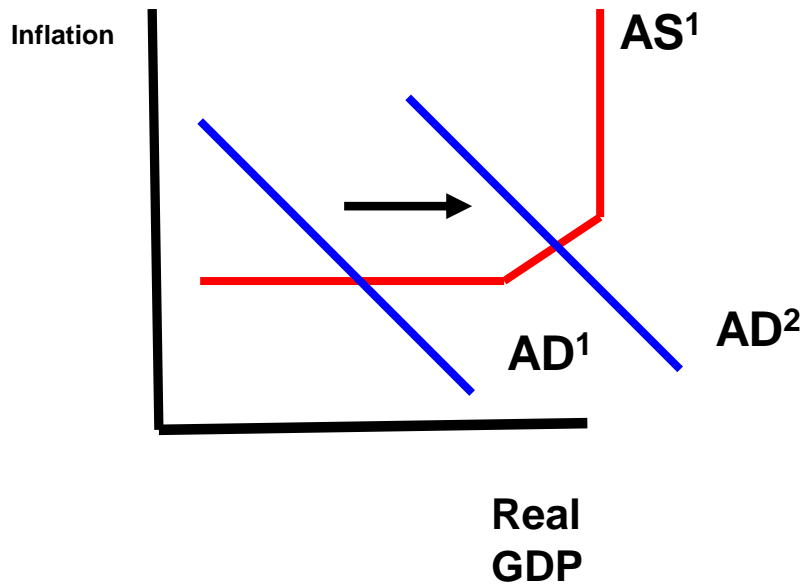
Sample Shifts in AD:

- **Congress increases spending on repairing interstate highways and unemployment benefits**
---AD shifts right
- **Government (Congress) raises taxes**
---AD shifts left

Sample Problem

Type of fiscal policy needed?

What should be done regarding taxes and spending?



Economy in recession

--where does the AD curve cross the AS curve?

Expansionary fiscal policy needed

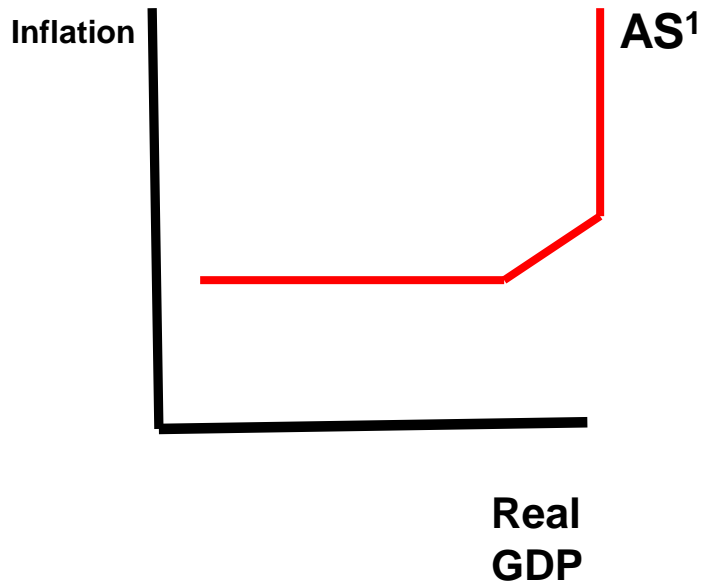
Lower Taxes & ↑ Gov't spending

AD shifts right

End result: higher GDP, more Jobs & slightly higher inflation

Economic Issue	Policy Type (Moderate Expansionary, Aggressive Expansionary, Moderate Contractionary, Aggressive Contractionary Take No Action)	Objective for GDP/ Aggregate Demand	Action on Taxes	Action on Govern- ment Spending	Effect on Deficit
1. Inflation rises to 10%	Aggressive Contractionary	Decrease AD	Raise Taxes	Cut Spending	Decreases Deficit
2. Consumer confidence falling; retail sales very weak; unemployment at 7%	Moderate Expansionary	Increase AD	Cut Taxes	Increase Spending	Increases Deficit
3. GDP growth is at 3.8%; some inflation is feared by economists	Take No Action OR Moderate Contractionary	None OR Decrease AD	No Action OR Raise Taxes	No Action OR Cut Spending	None OR Decrease Deficit
4. GDP growth is a sluggish 1.2%; the inflation rate is 0.6%	Moderate/Aggressive Expansionary	Increase AD	Cut Taxes	Increase Spending	Increases Deficit
5. GDP growth rate is 1.9%; inflation rate is 3.1%	Take No Action OR Moderate Contractionary	None OR Decrease AD	No Action OR Raise Taxes	No Action OR Cut Spending	None OR Decrease Deficit

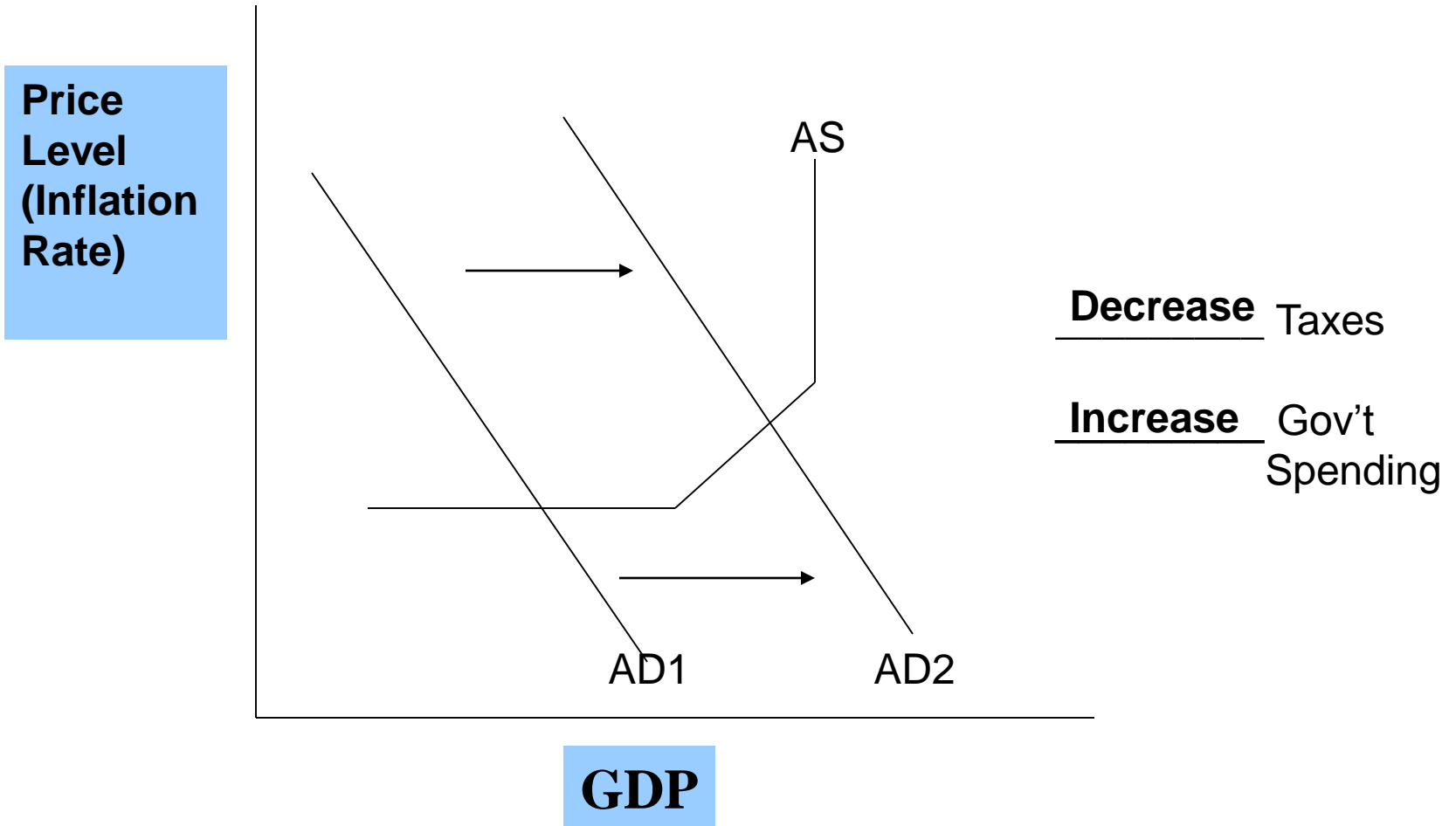
Cautionary Reminder: Economic Speed Limit



Conclusion of vertical AS: The economy has a speed limit. If it grows too fast, you will end up with inflation and no increase in GDP (*section 3 of AS curve*)

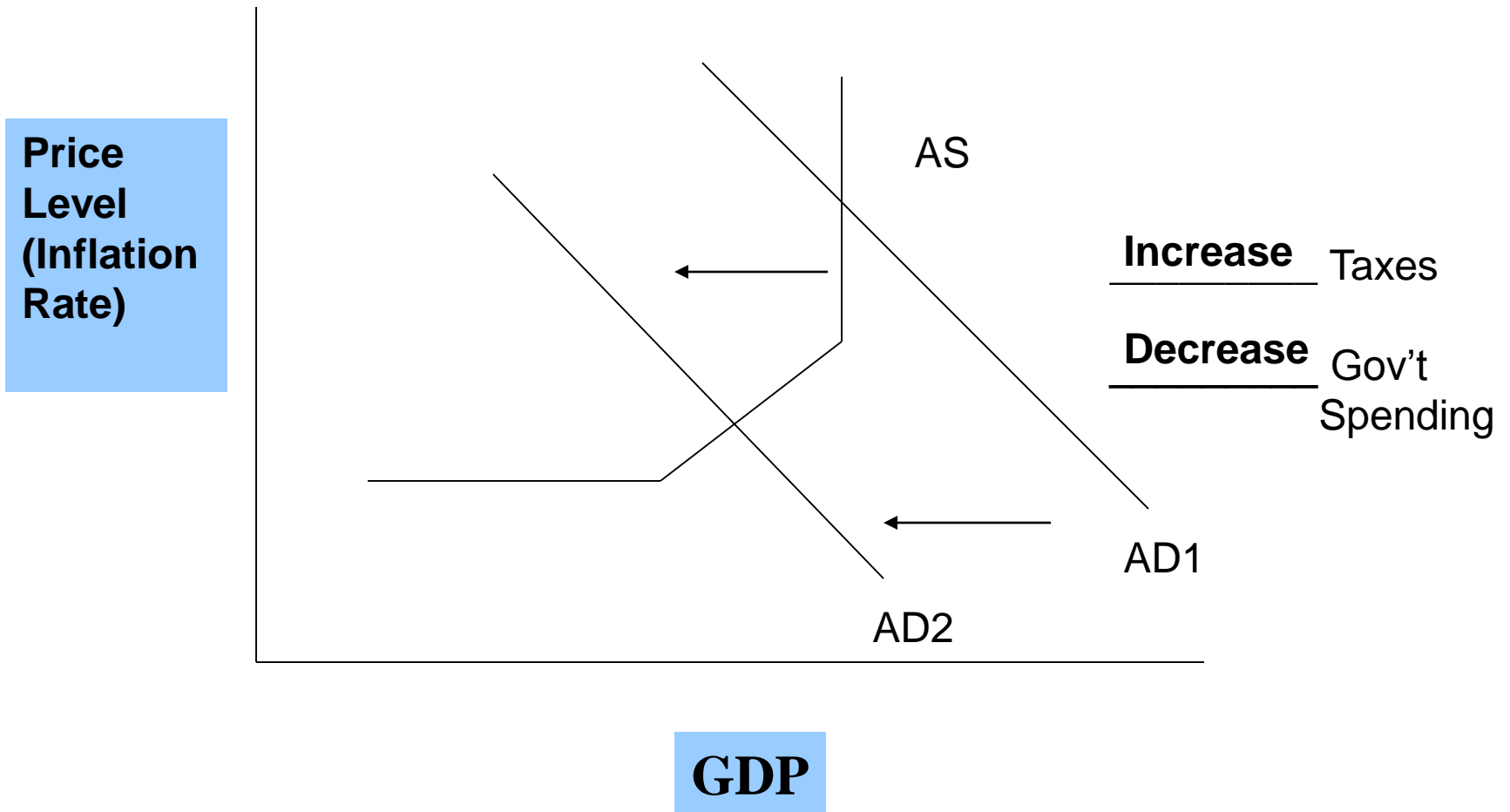
More Practice

Inflation at 0.5%, Unemployment at 8.2%



Still More Practice

Inflation at 9%, Unemployment at 3%



4-Types of Unemployment

- **Structural**
 - Skills do not match demand for labor
- **Cyclical**
 - Too low a level of aggregate demand
- **Frictional**
 - Temporarily between Jobs
- **Seasonal**
 - Out of work based on time of year