**Topic 4: Fiscal Policy**

**LVL 1: As you read, answer the following questions**

1. What does the government try to achieve with fiscal policies?

2. What is the goal of lowering taxes and increasing government spending? (Expansionary Fiscal Policy)

3. What is the goal of increasing taxes and lowering government spending? (Contractionary Fiscal Policy)

4. How does the government add money to their budget?

5. What are some of the expenses the government has to pay for?

6. What is a budget surplus?

7. What is a budget deficit?

8. What is the difference between debt and deficit?

9. What happens to the debt if interest rates rise?

10. If you own a U.S. bond, then you own a piece of the U.S. \_\_\_\_\_\_\_\_\_\_\_\_.

11. Draw an aggregate demand graph after the government uses contractionary fiscal policy.

**SSEMA3 Explain how the government uses fiscal policy to promote price stability, full employment, and economic growth.**

1. **Define fiscal policy.**

The term fiscal policy at the federal level refers to legislation, passed by Congress and signed into law by the President, changing levels of taxation and/or government spending to stabilize the economy. By changing the amount of taxes people pay or the amount of spending by the government, fiscal policy influences economic activity in the circular flow of the economy. State and local governments also use changes in taxes or spending to influence economic activity.

1. **Explain the effect on the economy of the government’s taxing and spending decisions in promoting price stability, full employment, and economic growth.**

Changes in taxation and spending may promote price stability, full employment, and economic growth. During a time of increasing price level, the government may decide to pursue contractionary fiscal policy to curb inflation. The fiscal policy tools used to combat inflation include lowering government spending or increasing taxes. Reducing government spending, fewer firms and workers are earning money from government contracts and jobs. This lowers consumption and investment spending in the economy putting downward pressure on prices and eventually reducing inflation.

When the government wishes to promote full employment and economic growth at a time when price level is not a concern, it will use fiscal policy tools designed to increase consumption and investment spending in the economy. By lowering taxes, government allows people to keep more of their income for spending on goods and services. By increasing government spending, more firms and workers can earn money from government contracts and jobs. Households spend some of this additional income on goods and services, increasing other economic activity.

The chart below illustrates how changes in government spending and taxes should affect the economy.

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| --- | --- | --- | --- | --- |
| **Tool**  | **Action**  | **When is the government most likely to use it?**  | **Effect on Economic Activity**  | **Effect on Price** **Level, Real GDP, & Unemployment**  |
| **Change in Taxes**  | Increase taxes  | When concerned about inflation (Price Stability)  | Economic activity would fall  | Price Level falls Real GDP falls Unemployment rises  |
|  | Decrease taxes  | When concerned about contraction or recession (Full Employment)  | Economic activity would increase  | Price Level rises Real GDP rises Unemployment decreases  |
| **Change in** **Government** **Spending**  | Decrease spending  | When concerned about inflation (Price Stability)  | Economic activity would fall  | Price Level falls Real GDP falls Unemployment rises  |
|  | Increase Spending  | When concerned about contraction or recession (Full Employment)  | Economic activity would increase  | Price Level rises Real GDP rises Unemployment decreases  |

1. **Explain how government budget deficits or surpluses impact national debt.**

All **budgets** include sources of income and a list of expenses. Income for a government usually comes from two sources: taxes and fees. Expenses include all the public goods and services provided by the government as well as the interest payments the government pay on its debt. The total amount of income the government receives minus the total amount of expenses it pays determines whether a **government’s budget** runs a surplus or a deficit. A **surplus** exists when the amount of income received exceeds the amount of expenses paid. A **deficit** exists when the amount of income received falls short of the amount of expenses paid. Governments running a deficit must borrow funds to pay expenses. Anyone who owns a government bond is a lender to that government and is paid interest by the government for the use of their money. Each year, any deficit in the federal government’s budget adds to the country’s **national debt**. If interest rates remain the same or increase as the **national debt** increases, it costs the federal government more each year to pay the interest payments on the debt. If a government runs a surplus in its budget, it can pay down its debt with the surplus funds to reduce the national debt.

**LVL II Consider the following questions**

1. What impact will tax cuts and maintaining spending levels have on the federal budget?
2. What should Congress do to stimulate economic growth?