<u>Fiscal Policy: A Brief Guide</u>

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What is fiscal policy?

Fiscal policy is how the government manipulates taxation and its own spending to control the economy accordingly. The government's main goals in doing so are to establish steady prices for goods and services, achieve high employment, and encourage economic growth. This is controlled by the **central government**, meaning Congress and the President. Essentially, they decide how much money they need, and what it is they plan doing with it. Fiscal policy is used when the government feels outside intervention is necessary because it doesn't seem as though the economy will correct itself. Contrary to popular belief, **it's not enacted only when the economy is performing extremely poor, but also when it's growing at an extremely unstable rate**. Fiscal policy is used to control the **aggregate demand** of the economy. Aggregate demand is the total demand for goods and services in the economy. First, a notice: much of this guide will be understood without too much prior knowledge about the economy, but you'll much better understand this guide and connect it to other concepts if you read the other guides, ""How the Economy Works: A (Kind of) Brief Guide" and "Monetary Policy: A Brief Guide," first.

Where does this money to do this come from?

The government has two sources of income: **taxes and the debt market**. Using the debt market essentially means that the government is borrowing money through the sales of bonds.

What kind of stuff do they do with this money?

Well, that depends on what their goals are. Like monetary policy, there are two types of fiscal policy: **expansionary policy** and **contractionary policy**. Expansionary policy increases the amount of money in an economy, whereas contractionary policy decreases the amount of money in circulation. These are both examples of **discretionary fiscal policy**, because the government is taking an active role in the economy. **Nondiscretionary fiscal policy**, the other hand, is when the government doesn't really do much and let's nature take its course. The policies that are automatically enacted without government legislation when aggregate demand increases or decreases are called **automatic stabilizers**. One common example of an automatic stabilizer is that when aggregate demand decreases, more people become eligible for unemployment compensation. Likewise, when aggregate demand increases, less people become eligible for unemployment compensation. Another example is that when aggregate demand decreases, households pay lower income tax rates. The converse is also true; when aggregate demand increases, households pay higher income tax rates. The purpose of these stabilizers is to **reduce fluctuations in GDP**, or gross domestic product, which is the monetary value of all finished goods and services produced inside a country in a specific time period.

Expansionary fiscal policy: This type of policy is **generally used in the time of a recession**, such as the one faced in 2008. The **largest problem in such an instance is significantly lowered aggregate demand**. Common solutions include **increased government expenditure and lowered taxes**. By increasing expenditure and lowering taxes, the government is increasing aggregate demand by increasing the amount of money people have in their pockets. Remember, the **government is the biggest source of money for the economy**; it pays more than anyone for goods and services. By increasing how much it's paying while increasing how much money have in their pockets (lower taxes means you get to keep more money), the government increases aggregate demand accordingly. **This type of policy is extremely well regarded by the general public** because everyone likes having to pay less taxes. For the most part, fiscal policy is regarded as expansionary when the budget exceeds the revenue.

To summarize:

1. Government spending increases → Aggregate demand increases
2. Taxes decrease → Consumption increases → Aggregate demand increases

Contractionary fiscal policy: This type of policy is used in situations when the economy is growing too fast. You're probably wondering, what kind of problem is having your economy growing too quickly? Well, uncontrollable levels of economic growth often **result in the creation of asset bubbles and high levels of inflation**, which are explained in my other guide, "How the Economy Works: A (Kind of) Brief Guide." **Common solutions include decreased government expenditure and increased taxes**. With less government spending, the aggregate demand will decrease, because of how central the government's spending is to economic growth. With such a significant source of revenue for many businesses taken out of the equation, a large portion of the aggregate demand has been lost. Increasing taxes will also hinder this unstable growth by leaving people with less money to buy things and invest with. **The general public isn't really the biggest fan of contractionary fiscal policy** because many of them understand nothing but the fact that their taxes are being raised, and often don't have enough knowledge regarding economics to see why doing so is necessary. For the most part, fiscal policy is regarded as contractionary when the revenue exceeds how much is spent.

To summarize:

1. Government spending decreases → Aggregate demand decreases
2. Taxes increase → Consumption decreases → Aggregate demand decreases