Discretionary and Automatic Fiscal Policy

One of the goals of economic policy is to stabilize the economy. This means trying to keep employment high and the price level stable. To accomplish this, the amount of aggregate demand in the economy must be near the full-employment level of output. If aggregate demand is too low, there will be unemployment. If aggregate demand is too high, there will be inflation.

If aggregate demand is too low, government may be able to stimulate spending in the economy by increasing its spending or by cutting taxes. These policies are examples of *expansionary fiscal policy*. If government wants to slow down aggregate demand, it would pursue a *contractionary fiscal policy*. To do this, it could cut government spending or raise taxes.

If government has to pass a law or take some other specific action to change its tax and/or spending policies, then government is stabilizing the economy through *discretionary policy.* If the effect happens by itself as the economic situation changes, then it is known as an *automatic stabilizer*. An example of an automatic stabilizer is unemployment compensation: If the economy goes into a recession and people are laid off, they may be eligible to receive unemployment compensation. This payment helps them buy necessities and helps keep aggregate demand from falling as much as it might otherwise. The payments help stabilize the economy but occur without any additional legislation.

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Listed below are several economic scenarios. For each scenario, indicate whether it represents an automatic (A) or discretionary (D) stabilizer and whether it is an example of expansionary (E) or contractionary (C) fiscal policy. A sample has been completed for you.

Economic Scenarios	Automatic (A) or Discretionary (D)	Expansionary (E) or Contractionary (C)
Sample: Recession raises amount of unemployment compensation.	A	E
1. The government cuts personal income-tax rates.		
2. The government eliminates favorable tax treatment on long-term capital gains.		
3. Incomes rise; as a result, people pay a larger fraction of their income in taxes.		
4. As a result of a recession, more families qualify for food stamps and welfare benefits.		
5. The government eliminates the deductibility of interest expense for tax purposes.		
6. The government launches a major new space program to explore Mars.		
7. The government raises Social Security taxes.		
8. Corporate profits increase; as a result, government collects more corporate income taxes.		
9. The government raises corporate income tax rates.		
10. The government gives all its employees a large pay raise.		