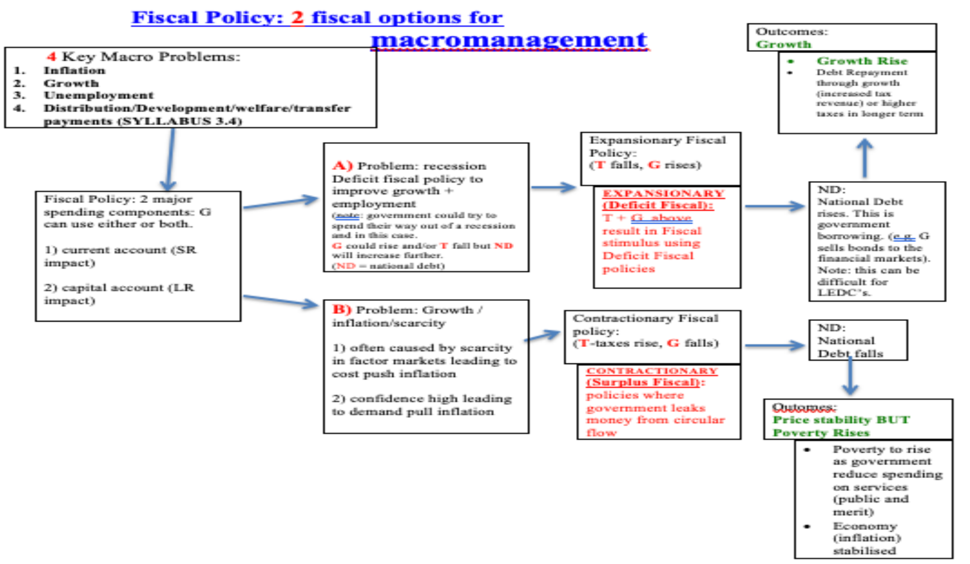
Syllabus Reference 3.6: Fiscal policy

Fiscal policy – strengths of fiscal policy

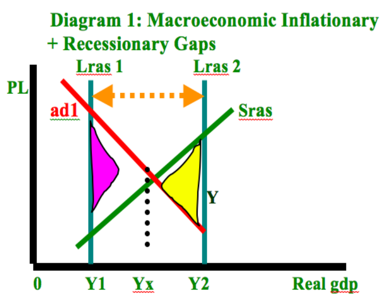
- What is an automatic stabilizer?

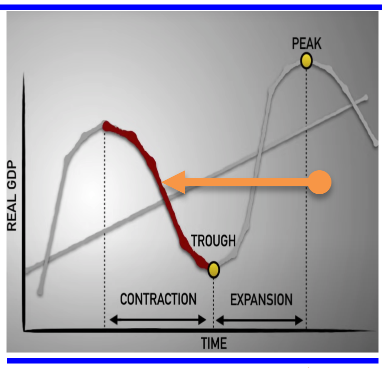
Fiscal Policy: 2 fiscal options for micromanagement

See webnote 361 for details of this chart:



Automatic stabilizers
The features of government fiscal policy (for example, unemployment benefits and direct tax revenues) that automatically counter-balance fluctuations in economic activity.





Fiscal Policy automatically stabilizes the macroeconomy and helps government to achieve its objectives 1-4 above)

Note: you could use the business cycle to show the expansion or contraction or use the neo-classical SRAS/AD with LRAS to show an inflationary or deflationary gap

Example 1: expansionary benefit

Automatic stabilization then is a distinct advantage for fiscal policy whereby (for example) if the economy is expanding too rapidly an inflationary gap could open where the SR economy is exceeding the LR output. In this case the leakages caused by taxation will increase helping to reduce the impact of the inflationary gap (see yellow triangle in Dig 1).

Example 2: contractionary benefit

For example, government spending on unemployment benefits automatically rise and direct tax revenues automatically fall when economy activity is slow. See trough on business cycle.