

# Fiscal policy simulation



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Running Head: [short [institute of affiliation] a. There are various decisions that the government should consider in relation to its objective. As the government's main objective for 2006 is to raise real GDP in order to raise real income, the policy changes that have taken place in the economy includes an increase in government spending in infrastructure of 300 million, 100 million in spending for educational programs, and additional income tax rate of 0.50%. These changes affect the economy in the following manner: an increase in real gross domestic product from 39.70 billion to 41.27 billion, a decrease in unemployment rate from 6.32% to 4.41%, and an increase in inflation from 5.00% to 5.19%.

In 2008, however, as the economy continues to expand, inflation has surged up to 10.05%. A very high figure from the previous years, to address the inflation is the major aim of the government. In order to address the inflation, the government has adopted a contractionary fiscal policy, which entails decrease in expenditure for infrastructure of 600 million, decrease in spending in the educational programs, and decrease in the income tax rate. The effects of these changes include a taming of the inflation rate, down to 5.30%. However, as what economics is about, there is always a tradeoff—because of the decrease spending, unemployment rate increases from 3.53% to 4.35%. Lastly, real GDP decreases from 42.00 billion to 41.32 billion in 2008.

In 2009, as the economy continues to approach its potential output, inflation continues to be beyond the acceptable level. In order to curb down inflation and bring it down, the government has to adopt contractionary policy by decreasing spending in educational programs by 400 million. This change lowers real GDP from 42.00 billion to 41.35 billion. This aims to curb down

inflation rate from 42.00 billion to 41.35 billion. However, due to decrease in spending, unemployment is expected to increase from 3.53% to 4.32%.

b. Erehwon's marginal propensity to consume is 0.8, which means that for every dollar the consumers receive, 0.8 cents are spent. Given this, the multiplier of the economy is computed by using the formula  $1/1-mpc$ . With a computed multiplier of five, for every change in the components of aggregate demand, the overall economy expands five times. Let us examine the first situation.

In the first situation, the government spending for infrastructure is 300 million, and 100 million for educational program. This increases the aggregate demand not by 400 million, but by the increase multiplied by the multiplier—therefore aggregate demand increases by 2000. As tax rates are increased, this fiscal policy has an impact on the economy by lowering down the disposable income of the people—therefore, there is a decrease in the economy. This decrease is not directly by the increase in tax rate, but the increase multiplied by a tax multiplier which is lower than the expenditure multiplier. Given all these, aggregate demand is affected.

As aggregate demand is pushed by the increase in government expenditure, and slightly offset by the increase in taxation, with a relatively fixed aggregate supply, the interaction between the two determines the overall level of prices in the economy, or the inflation. As inflation decreases, as the Philip's curve suggests due to a decrease in spending, unemployment rate increases.

In the next two situations where inflation continues to surge and remain at a high level, fiscal policy suggests a shift in aggregate demand in order to slow down the economy. In order to do this, some of the components of the

aggregate demand has to be changed by fiscal policy. This is done either by cutting down on expenditures, or increasing taxes. Therefore, by cutting down on these parts, the aggregate demand will decrease by the effect of the multiplier. As the aggregate demand curve shifts inward, it goes to the overall level of prices is lower, but unemployment rate is higher.

#### Reference List

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