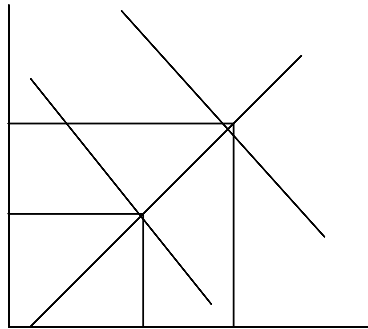
Suppose a government wishes to reduce the level of consumption expenditure in order to reduce inflationary pressure in an economy.Explain how Fiscal Policy might be used to achieve this objective and comment upon how effective such a policy may be in reducing inflation.

Fiscal policy aims to control the economy and manage the level of aggregate demand in he economy by the use of *Taxation* and *Government Spending.*
Inflation is the sustained increase in the general price level.
Fiscal policy might be used to reduce the level of consumption expenditure in order to reduce inflationary pressure in an economy.

Slowing down the economy can lower government spending. As government spending is one of the four elements of AD and a decrease in it will lead to a decrease in the total demand in the economy. This would mean that firms would not have to increase the prices. This would therefore control the inflation rates in the economy.



The diagram above shows how a decrease in government spending affects the AD curve. The AD curve shifts to the left from AD to $AD_{1.}$ The price level would decrease from P to P_1 and the output levels will also decrease from Y to $Y_{1.}$
Governments can also increase Direct Taxes (Income Tax), Indirect Taxes (VAT) and Progressive and Regressive Taxes.

If Direct Taxes increase then people will have less money because they have paid higher taxes. This would mean that consumers will be unable to buy as many goods and services as normal. This would decrease the consumer-

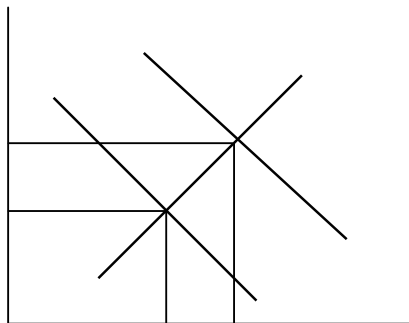
spending element of AD and therefore it would lead to a decrease in AD. This would stop a sustained increase in the general price increase. I.e. Inflation.

If Indirect Taxes increased, then the price of a good will also increases. This means that consumers will be unable to buy the same basket of goods as they normally can because of the increase in price.
If this were to happen, inflation would be stopped because the total demand of goods and services (AD) has decreased.
In addition, as indirect taxes are taxes on spending, there would be an increase in inflation; therefore, it would be better to use supply side policies to reduce inflation in the end.

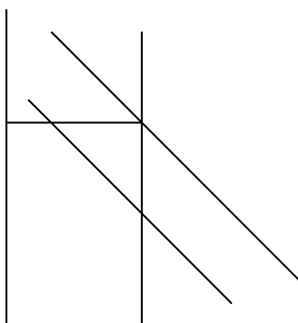
If employees wages were to increase, then a higher percentage of their wage will be taxed, leaving them with a smaller amount to buy goods and services, this would restrict their buying power and therefore would decrease the total demand within the economy.

Above we have discussed that for the government to decrease AD in the economy and inflation they would have to lower government spending and increase taxation.
This in fact increases the budget surplus and reduces the budget deficit.
This is known as **Contractionary Fiscal Policy.**
This would mean that the government would be operating a *deflationary fiscal policy,* and would lead to a tightening of fiscal policy.

This can be shown in a diagram below, by shifting the AD curve to the left, a fall in the price and the levels of output will occur.

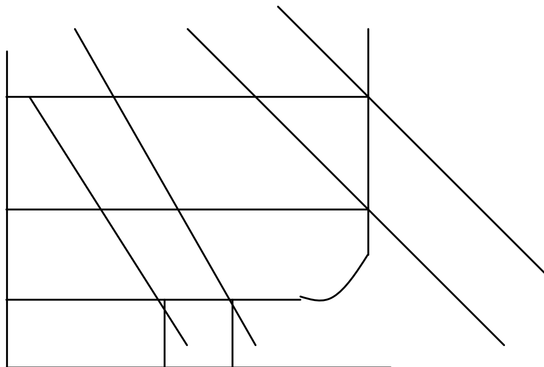


If we consider the classical economists view on contractionary fiscal policy, where there is a tightening of fiscal policy, then output would not be affected due to the vertical LRAS curve, however there will be changes in the price level.



The shift to the left in the AD curve, due to decreased consumer spending shows, according to classical economists that there will be a decrease in inflation in the long run, and the output will remain constant.

The Keynesian economists view of contractionary fiscal policy can be shown below.



The Keynesian view suggests that at, full employment, a decrease in AD, from AD to AD1 will lead to a fall in the price level and hence reduce inflation, however there will be no effect on Real GDP. However if there are unemployed resources within the economy the only effect a reduce in AD would have would be a decrease in output.