

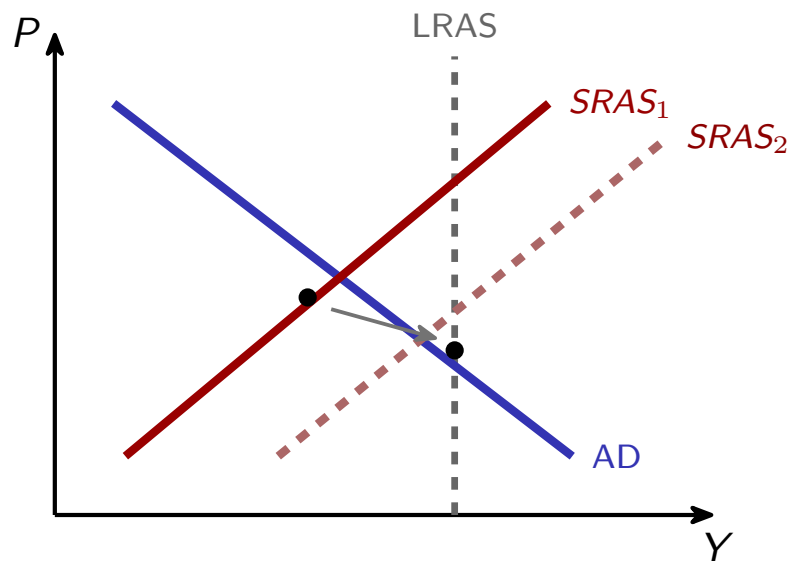
Exercise walk-through

3.8

Fiscal Policy

AP Macroeconomics

Long-run self-adjustment



Left alone, a gap heals by moving
SRAS (not AD):

- recessionary gap: high unemployment $\Rightarrow$ wages fall $\Rightarrow$ SRAS **right**
- inflationary gap: scarce labour $\Rightarrow$ wages rise $\Rightarrow$ SRAS **left**

Output returns to potential; the price level ends **lower** (or higher) – but slowly.

Fiscal policy

Fiscal policy : the government uses **spending and taxes** to steer AD.

Expansionary: raise G / cut T
 $\Rightarrow$ AD right (for a recessionary gap)

Contractionary: cut G / raise T
 $\Rightarrow$ AD left (for an inflationary gap)

Worked example

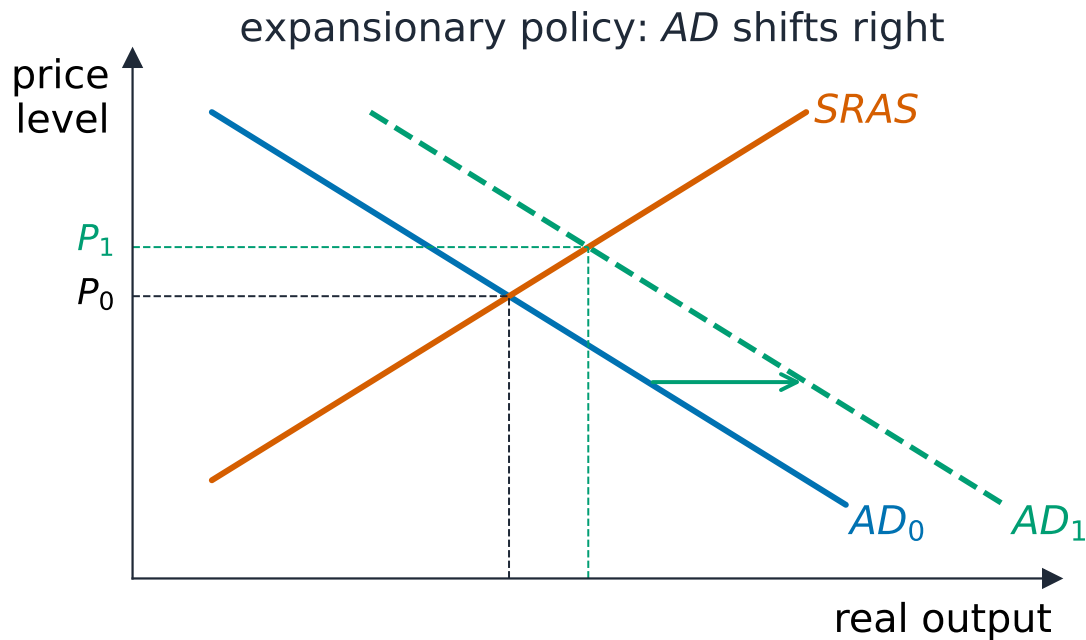
Gap = 200, $MPC = 0.8$ so multiplier = 5.

$$\Delta G = \frac{200}{5} = 40$$



Spending and taxes steer aggregate demand

Expansionary fiscal policy shifts AD right



Expansionary fiscal policy shifts AD right, raising output and prices

Automatic stabilizers

Automatic stabilizers dampen
the business cycle **with no new law**:

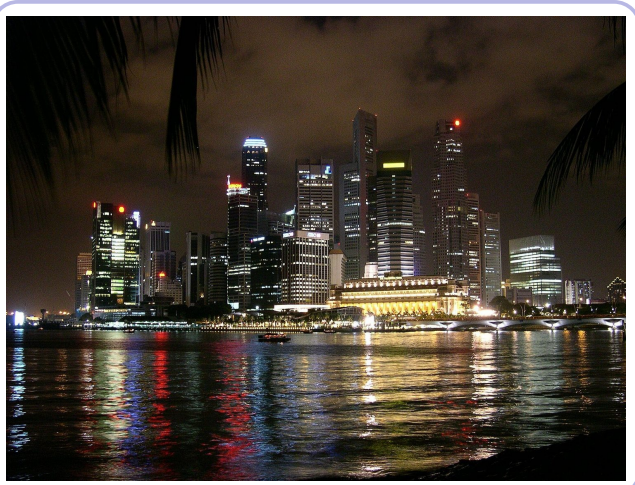
Progressive taxes : collect
more in booms, less in slumps

Transfer payments :
benefits rise automatically in a re-
cession

Automatic: instant, built
into law – no **legislative**
lag .

Discretionary : a new
bill – precise, but slow to pass.

Aggregate Demand



A city skyline: national output and aggregate demand reflect economy-wide spending

Exercises 2.1-2.3

2.1 Define fiscal policy.

[1]

2.2 State the type of fiscal policy used to close a recessionary gap.

[1]

2.3 State the effect of expansionary fiscal policy on AD.

[1]

Exercises 2.1-2.3

2.1 Define fiscal policy. [1]

2.1

- the government's use of spending and taxes to influence the economy
-

2.2 State the type of fiscal policy used to close a recessionary gap. [1]

2.2

- expansionary fiscal policy
-

2.3 State the effect of expansionary fiscal policy on AD. [1]

2.3

- it increases (shifts right) AD

Exercises 3.1-3.2

3.1 Expansionary fiscal policy involves

[1]

☐

A cutting government spending

B raising taxes

C increasing government spending

D raising interest rates

3.2 To fight high inflation, the government should use _____ fiscal policy.

[1]

☐

A expansionary

B contractionary

C monetary

D no

Exercises 3.1-3.2

3.1 Expansionary fiscal policy involves

[1]

☐

- A cutting government spending
- B raising taxes
- C increasing government spending
- D raising interest rates

3.1 C

- increasing government spending.

3.2 To fight high inflation, the government should use _____ fiscal policy.

[1]

☐

- A expansionary
- B contractionary
- C monetary
- D no

3.2 B

- contractionary.

Exercise 3.3 (a)

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(a) Name a fiscal tool that could close it.

[1]

Exercise 3.3 (a)

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(a) Name a fiscal tool that could close it.

[1]

(a)

- increase government spending (or cut taxes)

Exercise 3.3 (b)

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(b) State the effect on AD.

[1]

Exercise 3.3 (b)

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(b) State the effect on AD.

[1]

(b)

- AD shifts right

Exercise 3.3 (c)

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(c) Find the rise in government spending needed.

[1]

Exercise 3.3 (c)

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(c) Find the rise in government spending needed.

[1]

(c)

- multiplier = $\frac{1}{1 - 0.8} = 5$, so spending = $\frac{100}{5} = \$20$ billion