5.7 Demand management: fiscal policy

Name: _____ Class: _____ Date: _____ **Total: 30 marks**

KEY WORDS fiscal policy • direct tax • capital expenditure • automatic stabilizer • crowding out • budget deficit

Objective

Build the skills to answer exam questions on **fiscal policy** : government revenue and spending, expansionary and contractionary policy, automatic stabilizers, and the strengths and limits of the policy.

You must be able to:

- outline sources of government revenue and types of government spending
- explain expansionary and contractionary fiscal policy using AD/AS
- explain automatic stabilizers and discretionary policy
- evaluate fiscal policy, including crowding out and time lags
- use the multiplier to calculate the effect of a fiscal change

1 Key knowledge and worked examples

■ Fiscal policy

Fiscal policy is the use of **government spending** and **taxation** to influence AD.

revenue	spending
direct taxes on income and profits	**current spending**: wages of public workers, medicines, running costs
indirect taxes on spending (VAT, excise)	**capital spending**: roads, schools, hospitals
sale of goods and services, privatization	**transfer payments**: pensions, benefits (no output in return)

Expansionary fiscal policy: **raise** G **and/or cut taxes** → AD shifts right → higher real GDP and employment, possibly higher inflation; usually a bigger budget deficit. **Contractionary** policy: cut G and/or raise taxes, to cool inflation or reduce the deficit.

Automatic stabilizers work without new decisions: in a recession, tax revenue falls and benefit spending rises, supporting AD; in a boom the opposite happens. **Discretionary** policy is a deliberate change in taxes or spending.

Strengths: it can target sectors or regions; in a **deep recession** government spending adds directly to AD when private spending is weak; spending on infrastructure and education can also shift **LRAS** right; the **multiplier** increases the effect.

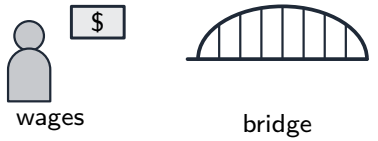
Limits: time lags (deciding, approving and starting projects); political pressure (hard to cut spending or raise taxes); **crowding out**: government borrowing may push up interest rates and reduce private investment; rising **debt**; people may save tax cuts if they expect future tax rises.

AHL – multiplier: change in real GDP $= k\times$ change in G, with $k = \dfrac{1}{1-\text{MPC}}$. A tax cut has a smaller effect than the same rise in G, because part of the tax cut is saved.

Answer shapes: AD/AS diagram → name the fiscal tool → the multiplier and effect on output, jobs, prices and the budget → evaluation.

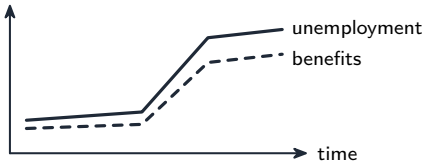
2 Practice

2.1 Distinguish between current and capital government spending, with an example of each. [2]



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2.2 Explain how unemployment benefits act as an automatic stabilizer. [2]

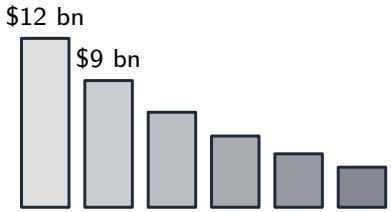


2.3 Using an AD/AS diagram, explain how a cut in income tax could close a recessionary gap. [4]



[[drawlines:4]]

2.4 The MPC is 0.75. The government increases spending on roads by \$12 billion. Calculate the final change in real GDP. [3]



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2.5 Explain why a \$12 billion tax cut would raise real GDP by less than a \$12 billion rise in government spending, when MPC = 0.75. [3]



3 Exam-style questions

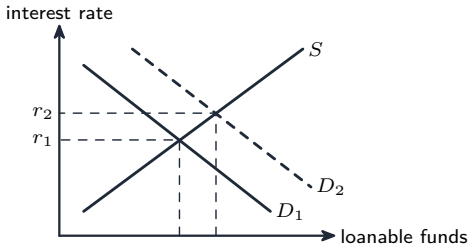
3.1 A government plans to spend \$50 billion on railways during a recession.



(a) Identify **two** groups that would gain. [2]

(b) Evaluate the use of this spending to end the recession. [6]

3.2 Some economists argue that government borrowing to finance higher spending "crowds out" private investment.



Explain crowding out, and evaluate whether it is likely in a deep recession. [8]

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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

current: day-to-day spending on running services, e.g. teachers' wages, medicines; capital: spending on long-lasting assets, e.g. roads, hospitals, schools

2.2

in a recession more people lose jobs and receive benefits, so government spending rises automatically; this supports household income and spending, so AD falls less

2.3

lower income tax raises disposable income; consumption rises, so AD shifts right; real GDP rises towards potential output and unemployment falls; correctly labelled diagram with $AD_1 \rightarrow AD_2$, $Y_1 \rightarrow Y_p$

2.4

$k = 1 \div (1 - 0.75) = 4$; change in GDP $= 4 \times 12 =$ \$**48** bn

2.5

G enters AD in full in the first round; with a tax cut, households save part: only $0.75 \times 12 =$ \$9 bn is spent in the first round; so the total effect is $4 \times 9 =$ \$36 bn, less than \$48 bn

3.1

(a) any two: construction firms and their workers; steel and other suppliers; passengers and businesses using the railway later; the unemployed who find jobs

(b) G adds directly to AD, with a multiplier effect on income and jobs; it also raises long-run capacity (LRAS) by improving transport; but large projects take time to plan and start, so the effect may come after recovery; borrowing raises debt and may crowd out private investment if interest rates rise; judgement: effective if projects are ready and the recession is deep with idle resources

3.2

award up to [8]: to finance a deficit, the government borrows; higher demand for loanable funds raises interest rates; higher rates reduce private investment and consumption on credit; so the net rise in AD is smaller than the rise in G; in a deep recession, private demand for loans is weak and savings are high; so government borrowing may not raise interest rates much: little crowding out; central banks may also keep rates low; judgement: crowding out matters more near full employment than in a deep recession

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