# 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



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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.

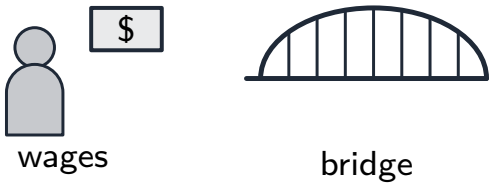
**Limits: time lags** (deciding, approving and starting projects); political pressure (hard to cut spending or raise taxes); **crowding out**: government borrowing may push up interest rates and reduce private investment; rising **debt**; people may save tax cuts if they expect future tax rises.

**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

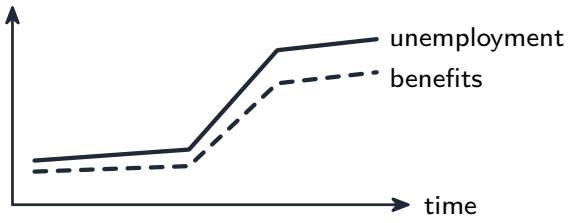
**2.1** Distinguish between current and capital government spending, with an example of each. [2]





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

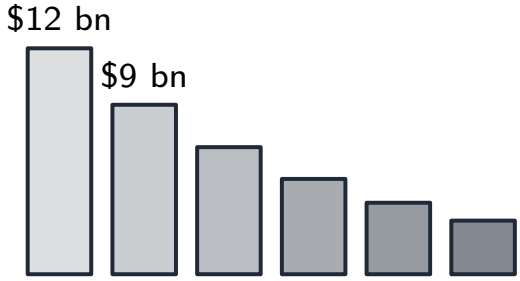



**2.3** Using an AD/AS diagram, explain how a cut in income tax could close a recessionary gap. [4]




[[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.



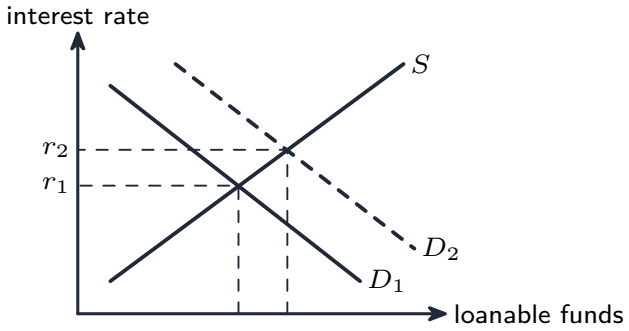
(a) Identify **two** groups that would gain. [2]

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



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**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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