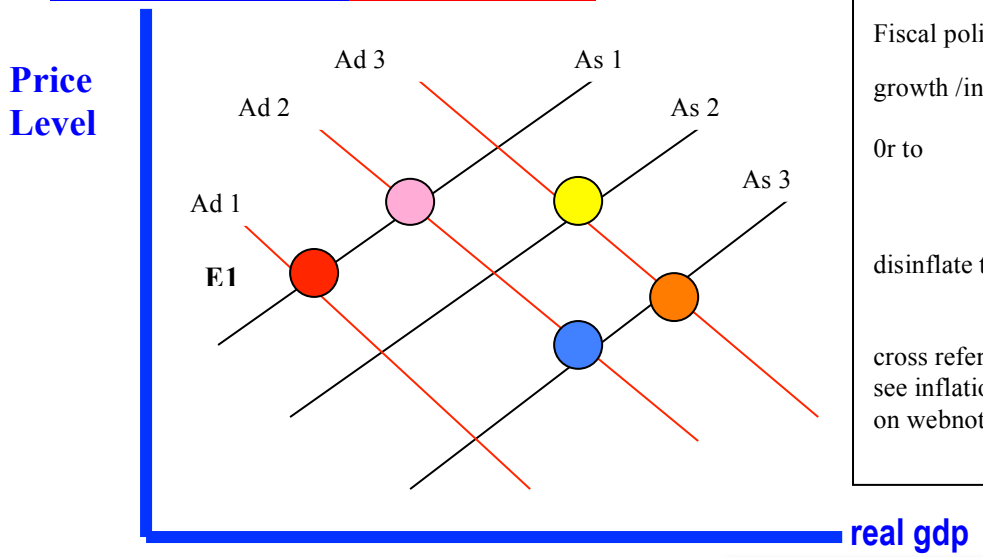
Syllabus Reference 2.4: Fiscal policy

Cross Reference: see webnote 300 re circular flow of income for a macroeconomy syllabus 2.1

Fiscal policy

- Spending and revenue plan for government
- Allows government to control essential injections and leakages into the macroecomomy
- Main components of fiscal policy are incomes and expenditures
- Forms the key macro management tool for government (the other key policy is monetary policy)

As /Ad model



As /ad model

Fiscal policy can be used to promote growth /inflate to

0r to

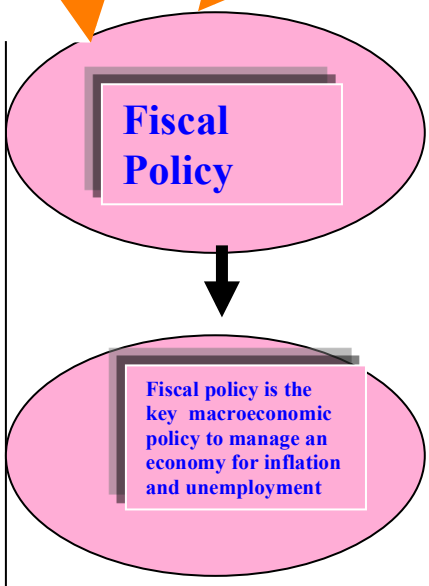
disinflate the economy to

cross reference:
see inflationary and deflationary gaps on webnote 328 (syllabus **2.2**)

Government macro Management e.g fiscal

e.g. Taxation:

1. raise taxes to contract economy
2. reduce taxes to inflate/expand the economy
3. borrowing/ indebtedness if the government want to run a deficit on the current account- see webnote 211 for current account



Governments can use Fiscal policy to manage the economy according to the economic objectives / priorities: see web 301 for a list of objectives

- **Expenditure switching policies where G attempts to make M (imports) more expensive in order to reduce this leakage (see webnote 408)**
- **Expenditure reducing policies. G deflates the economy using a range of policy alternatives e.g. increase direct taxes (see webnote 408) or reducing spending i.e. government cutbacks in educationa and healthcare**
- **Time lags are important here as it takes time for tax changes to affect the real economy in terms of spending**
- **Deficit or suplus fiscal policy? Most governments run deficits and the EU target is to control deficits by allowing a max deficit of 3 % of the value of GDP**

Fiscal Policy: fiscal options for macromanagment

4 Key Macro Problems:

1. **Inflation**
2. **Growth**
3. **Unemployment**
4. **Development/welfare/transfer payments**

Fiscal Policy: 2 major spending components:

1) current account (SR impact)

2) capital account (LR impact)

A) Problem: recession
Deficit fiscal policy to improve growth + employment
(note: government could try to spend their way out of a recession and in the case.
G could rise and/or T fall but ND will increase further)

Expansionary Fiscal Policy:
(T falls, G rises)

Deficit Fiscal policies

ND: National Debt rises

Outcomes:
Growth

- **Growth Rise**
- Debt Repayment through growth (increased tax revenue) or higher taxes in longer term

Problem: Growth / inflation

1) scarcity in factor markets leading to cost push inflation
-2) confidence high leading to demand pull inflation

Contractionary Fiscal policy:
(T-taxes rise, G falls)

Surplus Fiscal policies

ND: National Debt falls

Outomes:
Poverty Rise

- Poverty to rise as government reduce spending on services (public and merit)
- Economy (inflation) stabilised

Note: Review webnote 211 in section 2.1

Reading:

- McGee 377