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# **MACROECONOMICS - Fiscal policies**

By Kru P'Da and Kru P'Eve Knockout.Economics

# Overviews

1. Understanding policies : demand-side and supply-side policies
2. The effect of expansionary fiscal policy
3. The effect of contractionary fiscal policy
4. Summary of fiscal policy to achieve government aims



# 1. Understanding policies

## Policies to achieve economic aims

### Demand-side policy (Policies to influence AD)

#### Fiscal policy

- By government
- Changes in government spending and tax rate to influence AD

**Expansionary fiscal policies: Gov. spending  $\uparrow$ , Tax rate  $\downarrow$  to increase AD**

**Contractionary fiscal policies: Gov. spending  $\downarrow$ , Tax rate  $\uparrow$  to reduce AD**

#### Monetary policy

- By central bank
- Policies to influence AD and to control inflation by changing interest rate

### Supply-side policy (Policies to influence AS)

#### Supply-side policy

- Policies to increase productive potential of an economy
- e.g. education

## 2. The effect of expansionary fiscal policy

Expansionary fiscal policy : A rise in government spending or cut in tax to increase AD

To increase economic growth and employment by expansionary fiscal policy

<b>1. Increasing government spending</b>	<ul style="list-style-type: none"><li>➔ Higher government spending <b>increases AD</b> (<math>AD=C+I+G+NX</math>).</li><li>➔ <b>More output are created and more workers are employed</b> resulting in higher economic growth and employment.</li></ul>
<b>2. Reducing income tax</b>	<ul style="list-style-type: none"><li>➔ Lower income tax increases disposable income and <b>consumption</b>.</li><li>➔ <b>Firms increase production</b> to respond higher spending, resulting in higher economic growth and employment.</li></ul>

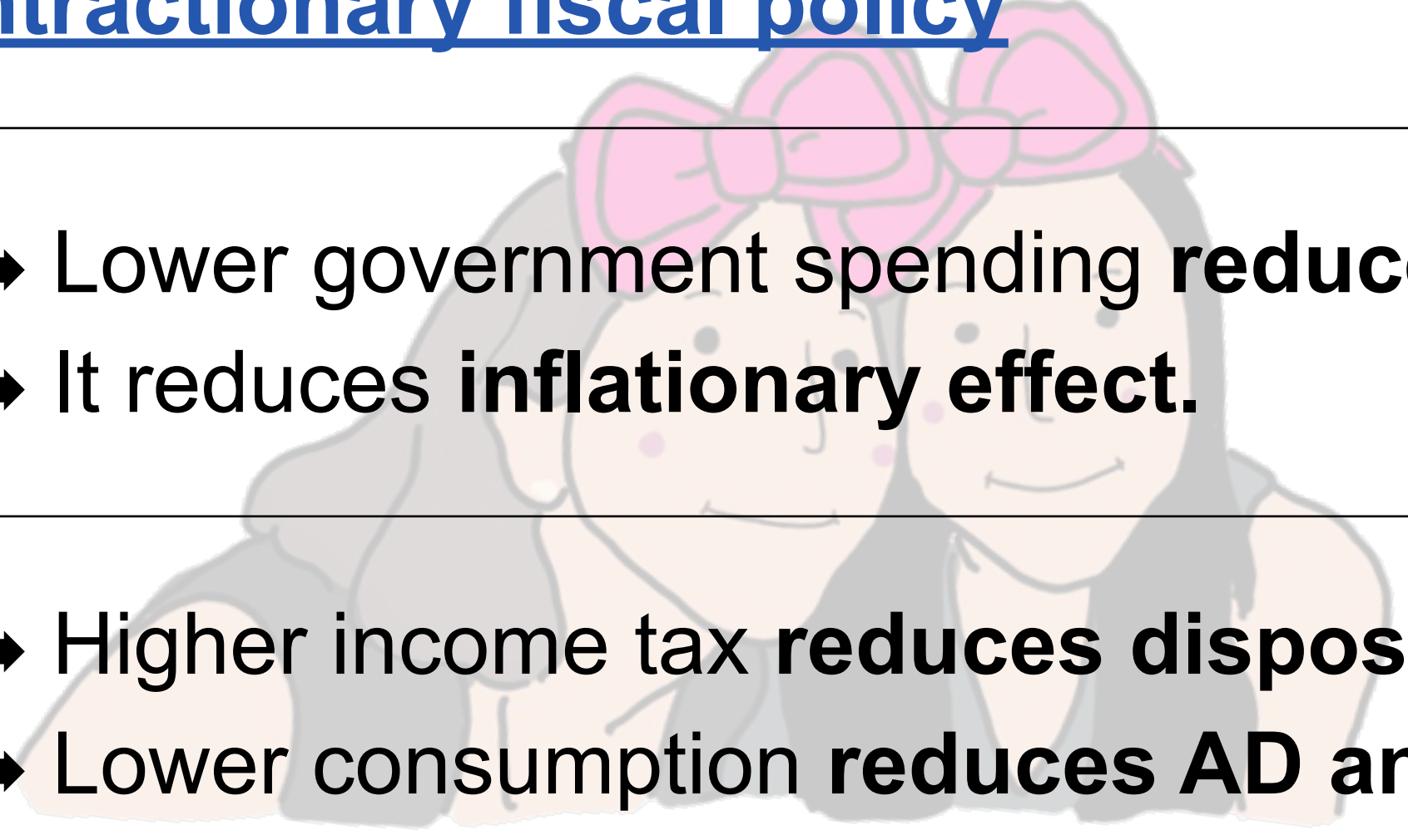
Disadvantages of expansionary fiscal policy

1. High government spending can cause **budget deficit and national debt**.
2. It has **inflationary effect**. Government spending increases aggregate demand and price level.
3. It may **worsen balance of trade**. A cut in income tax may increase spending on imports.

# 3. The effect of contractionary fiscal policy

Contractionary fiscal policy : A cut in government spending or a rise in tax to reduce AD

To reduce inflation by contractionary fiscal policy

<b>1. Reducing government spending</b>	 <ul style="list-style-type: none"><li>➔ Lower government spending <b>reduces AD</b> (<math>AD=C+I+G+NX</math>).</li><li>➔ It reduces <b>inflationary effect</b>.</li></ul>
<b>2. Increasing income tax</b>	<ul style="list-style-type: none"><li>➔ Higher income tax <b>reduces disposable income and spending</b>.</li><li>➔ Lower consumption <b>reduces AD and inflation</b>.</li></ul>

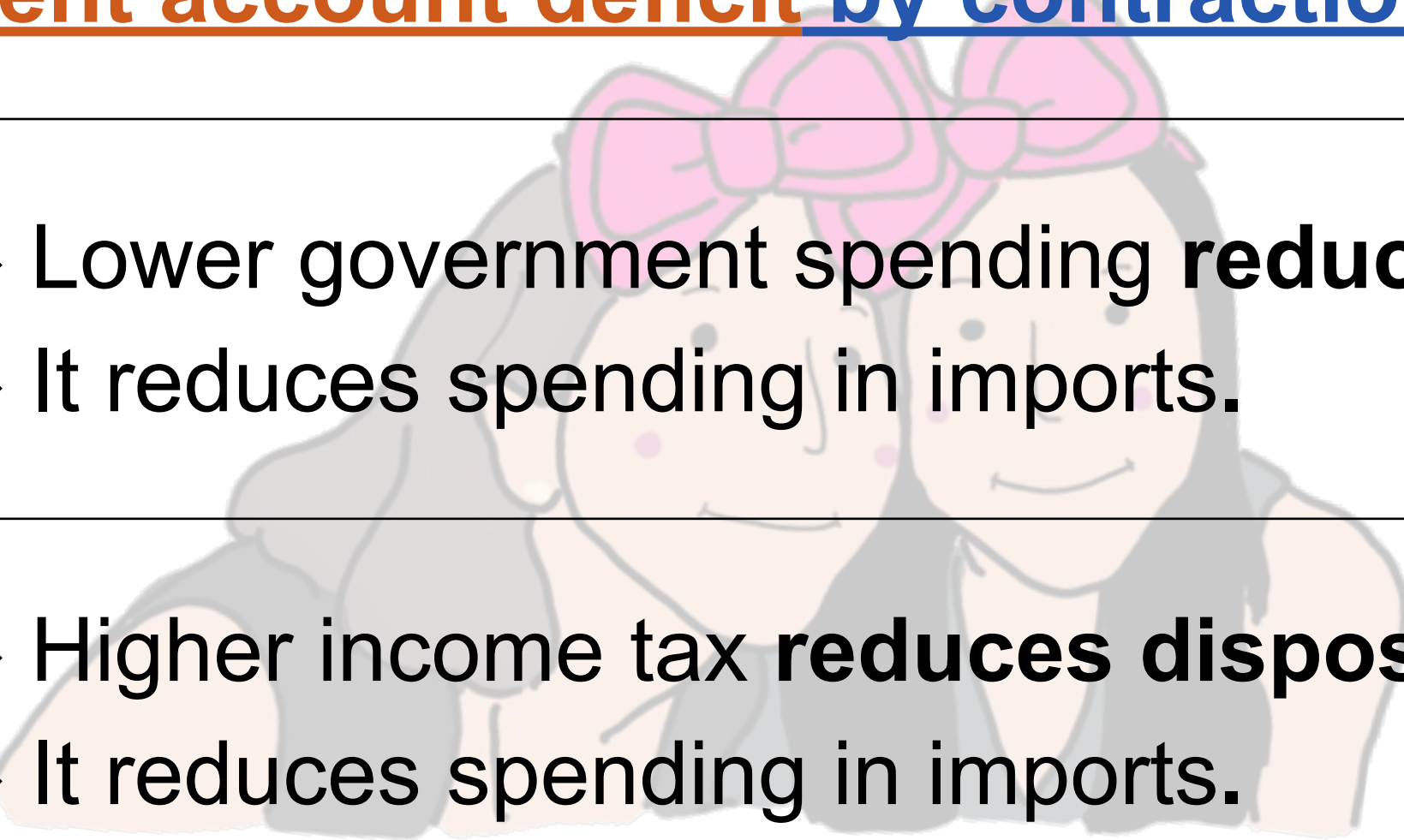
Disadvantages of contractionary fiscal policy

1. A cut in government spending. It can cause a **rise in unemployment**
2. Higher income tax reduces spending and production, resulting in **slowdown economic growth** .

# 3. The effect of contractionary fiscal policy

Contractionary fiscal policy : A cut in government spending or a rise in tax to reduce AD

To reduce import and current account deficit by contractionary fiscal policy

<b>1. Reducing government spending</b>	 <ul style="list-style-type: none"><li>➔ Lower government spending <b>reduces AD</b> (<math>AD=C+I+G+NX</math>).</li><li>➔ It reduces spending in imports.</li></ul>
<b>2. Increasing income tax</b>	<ul style="list-style-type: none"><li>➔ Higher income tax <b>reduces disposable income and spending.</b></li><li>➔ It reduces spending in imports.</li></ul>

## Disadvantages of contractionary fiscal policy

1. A cut in government spending. It can cause a **rise in unemployment**
2. Higher income tax reduces spending and production, resulting in **slowdown economic growth** .

## 4. Summary of fiscal policy to achieve government aims

<b>Fiscal policy to achieve government aims</b>	
<b><u>Expansionary fiscal policies:</u></b> Higher government spending, lower tax rate to increase AD	<b>High economic growth</b>
	<b>High employment</b>
<b><u>Contractionary fiscal policies:</u></b> Lower government spending, higher tax rate to reduce AD	<b>Low inflation</b>
	<b>Balance of payment stability</b>

# Knockout Economics



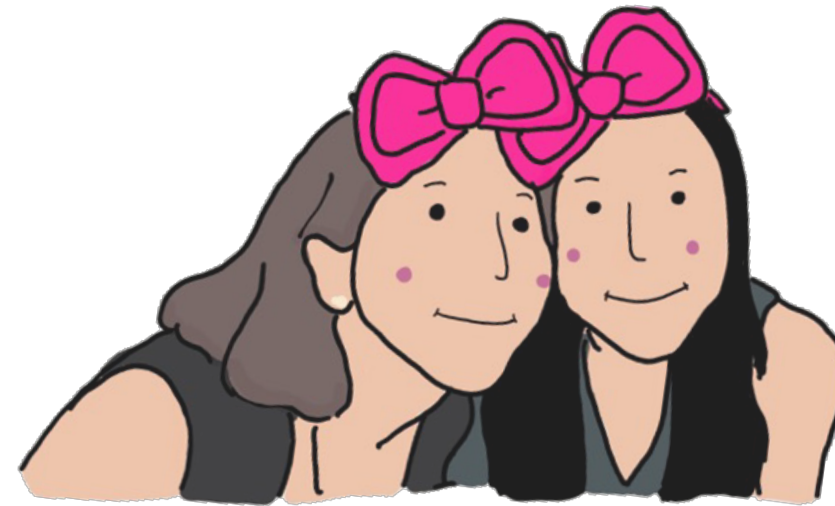
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# **MACROECONOMICS - Exercise : Fiscal policy**

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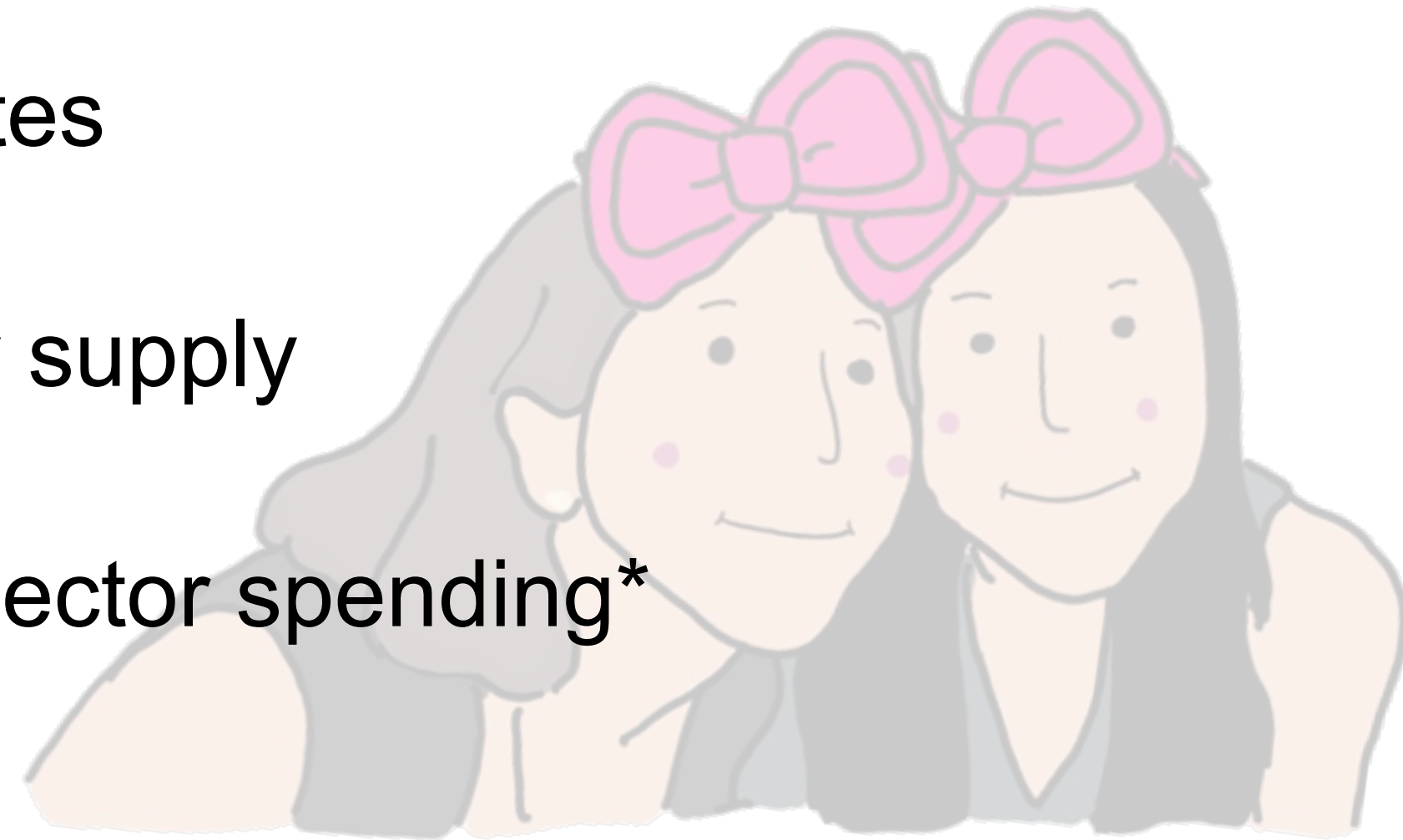
## Exercise: MCQ

1. Which combination of fiscal policy measures will solve the effects of a recession?
- A. A reduction in interest rates and a reduction in income tax
  - B. An increase in corporate rates and a decrease in income tax
  - C. An increase in government spending and a reduction in income tax\*
  - D. A decrease in government spending and an increase in money supply

## Exercise: MCQ

2. Which policy is an example of a contractionary fiscal policy?

- A. Higher interest rates
- B. Increasing money supply
- C. Reducing public sector spending\*
- D. Lower tax rate



# Exercise: Essay

1.) Discuss whether fiscal policy is always the best way to increase employment. [8]

1. Economic growth **KNOCKOUT 1**  
2. Low unemployment  
3. Price stability  
4. Balance of payment stability  
5. Redistribution of income

1. Consumer, worker // producer, MNCS  
2. Government // tax payer  
3. Saver // borrower  
4. Exporter // Importer **KNOCKOUT 2**

**Fiscal policy is always the best way**



**Fiscal policy is **not** the best way**

# Exercise: Essay

1.) Discuss whether fiscal policy is always the best way to increase employment. [8]

1. Economic growth **KNOCKOUT 1**  
2. Low unemployment  
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1. Consumer, worker // producer, MNCS  
2. Government // tax payer  
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4. Exporter // Importer **KNOCKOUT 2**

## Fiscal policy is always the best way

- Increasing government spending on...
- Decreasing income tax

## Fiscal policy is **not** the best way

- High government spending can cause **budget deficit and national debt.**
- It has **inflationary effect.** Government spending increases aggregate demand and price level.
- It may **worsen balance of trade.** A cut in income tax may increase spending on imports.

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