UNIT – 4: FISCAL POLICY

LEARNING OUTCOMES

After studying this Chapter, you will be able to –

- define fiscal policy and list out its objectives
- explain the various instruments of fiscal policy
- describe the expansionary and contractionary fiscal policies
- elucidate the limitations fiscal policy

CHAPTER OVERVIEW

4.1 INTRODUCTION

The governments of all countries pursue numerous policies to accomplish their economic goals such as rapid economic growth, equitable distribution of wealth and income, reduction of poverty, price stability, exchange rate stability, full-employment, balanced regional development etc. Government budget is one among the most powerful instruments of economic policy. The important tools in the budgetary policy could be broadly classified into public revenue including taxation, public expenditure, public debt and finally deficit financing to bridge the gap between public receipts and payments. When all these tools are used for achieving certain goals of economic policy, public finance is transformed into what is called fiscal policy. In other words, through the use of these instruments governments intend to favourably influence the level of economic activity of a country. These, in fact, form the subject matter of fiscal policy.

Fiscal policy is the deliberate policy of the government under which it uses the instruments of taxation, public expenditure and public borrowing to influence both the pattern of economic activity and level of aggregate demand, output and employment. Fiscal policy is in the nature of a demand-side policy. An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

The classical economists held the belief that the government should not intervene in the economy because the market mechanism makes the economy self-adjusting and keeps the economy at or near the natural level of real GDP at all times. Since the economy always tends to have stable prices and operates at full employment where the resources are utilized at their full capacity, and there will be no unemployment. The government should have a balanced budget and any deliberate fiscal policies are unnecessary.

The significance of fiscal policy as a strategy for achieving certain socio economic objectives was not recognized or widely acknowledged before 1930 due to the faith in the limited role of government advocated by the then prevailing laissez-faire approach. The depression resulted in very low aggregate demand along with high levels of unemployment. The classical economics could not provide any solution to this problem. In 1936, the British economist John Maynard Keynes in his book 'The General Theory of Employment, Interest, and Money' advocated increase in government spending to combat the recessionary forces in the economy and to solve the problem of unemployment. In recent times, especially after being threatened by the global financial crisis and recession, many countries have preferred to have a more active fiscal policy.

4.2 OBJECTIVES OF FISCAL POLICY

The objectives of fiscal policy, like those of other economic policies of the government, are derived from the aspirations and goals of the society. We have seen in our previous unit on market failure that it is the responsibility of the government to provide various goods and services like, highways, primary education healthcare etc to ensure social welfare.

Since nations differ in numerous aspects, the objectives of fiscal policy also may vary from country to country. However, the most common objectives of fiscal policy are:

- Achievement and maintenance of full employment,
- maintenance of price stability,
- acceleration of the rate of economic development, and
- equitable distribution of income and wealth,

The importance as well as order of priority of these objectives may vary from country to country and from time to time. For instance, while stability and equality may be the priorities of developed nations, economic growth, employment and equity may get higher priority in developing countries.

Governments may directly as well as indirectly influence the way resources are used in an economy. Fiscal policy is a powerful tool for managing the economy because of its ability to influence the total amount of output produced viz. gross domestic product. The ability of fiscal policy to influence output by affecting aggregate demand makes it a potential instrument for stabilization of the economy. We shall now see how this happens by investigating into the fundamental equation of national income accounting that measures gross domestic product (GDP) according to expenditures.

$$GDP = C + I + G + NX$$

The right side of the equation shows the different sources of aggregate spending or demand. We know that the market demand is influenced by government actions such as tax rates and government expenditure. The governments can influence the level of economic activity (GDP) by directly controlling G (government expenditure i.e purchases of goods and services by the government) and indirectly influencing C (private consumption), I (investment), and NX (net exports or exports minus imports), through changes in taxes, transfer payments and public expenditure.

4.3 TYPES OF FISCAL POLICY

As we are aware, while pursuing fiscal policy, the government makes deliberate attempts to adjust revenues, expenditures and public debt to eliminate unemployment during recession and to achieve price stability during in inflation. Contra cyclical fiscal policy or fiscal policy measures to correct different problems created by business-cycle instability are of two basic types namely, expansionary fiscal policy and contractionary fiscal policy.

a) Expansionary Fiscal Policy

Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of a business cycle or when there is an anticipation of a business cycle contraction. A recession is said to occur when the overall economic activity declines, or in other words, when the economy 'contracts'. A 'demand-deficient' recession sets in with a period of falling real GDP, low aggregate demand and reduced consumer spending and rising unemployment. To combat such a slump in overall economic activity, the government can resort to expansionary fiscal policies. We may technically refer to this as a policy measure to close a 'recessionary gap'. How does the government achieve this?

- The government may cut all types of taxes, direct and indirect, leaving the taxpayers with extra money to spend so that there is more purchasing power and more demand for goods and services. Consequently aggregate demand, output and employment increase.
- An increase in government expenditure (discussed in detail below) will pump money into the economy and increase aggregate demand. This in turn will increase output and employment.

- A combination of increase in government spending and decrease in personal income taxes and/or business taxes

While resorting to expansionary fiscal policy, the government may run into budget deficits because tax cuts reduce government income and the government expenditures exceed tax revenues in a given year.

b) Contractionary fiscal policy

Contractionary fiscal policy is basically the opposite of expansionary fiscal policy. Contractionary fiscal policy is designed to restrain the levels of economic activity of the economy during an inflationary phase or when there is anticipation of a business-cycle expansion which is likely to induce inflation. Contractionary fiscal policy refers to the deliberate policy of government applied to curtail aggregate demand and consequently the level of economic activity. In other words, it is fiscal policy aimed at eliminating an 'inflationary gap'. In other words, if the state of the economy is such that its growth rate is extraordinarily high causing inflation and asset bubbles, contractionary fiscal policy can be used to confine it into sustainable levels.

Contractionary fiscal policy works through:

- Decrease in government spending: With decrease in government spending, the total amount of money available in the economy is reduced which in turn has the effect of reducing the aggregate demand.
- Increase in personal income taxes and/or business taxes**:** An increase in personal income taxes reduces disposable incomes leading to fall in consumption spending and aggregate demand. An increase in taxes on business profits reduces the surpluses available to businesses, and as a result, firms' investments shrink causing aggregate demand to fall. Increased taxes also dampen the prospects of profits of potential entrants who will respond by holding back fresh investments.
- A combination of decrease in government spending and increase in personal income taxes and/or business taxes**.**

Contractionary fiscal policy should ideally lead to a smaller government budget deficit or a larger budget surplus.

We have understood in general that governments influence the economy through their policies in respect of taxation, expenditure and borrowing. To sum up:

- during inflation or when there is excessive levels of utilization of resources, fiscal policy aims at controlling excessive aggregate spending, and

- during deflation or during a period of sluggish economic activity when the rate of utilization of resources is less, fiscal policy aims to compensate the deficiency in effective demand by boosting aggregate spending.

We shall now describe the application of each of the fiscal policy tools.

4.4 THE INSTRUMENTS OF FISCAL POLICY

The tools of fiscal policy are taxes, government expenditure, public debt and the government budget. We shall discuss each of them in the following paragraphs.

4.4.1 Government Expenditure as an Instrument of Fiscal Policy

Government expenditure is an important instrument of fiscal policy. Public expenditure includes governments' expenditure towards consumption, investment, and transfer payments. Government expenditure constitutes a considerable part of the total expenditure in the economy. Fiscal policy relates to decisions that determine whether the government's expenditure is more or less than what it receives. A reduction or increase in it may result in significant variations in the country's total income. As such, public expenditure can be instrumental in adjusting consumption and investment to achieve full employment.

Public expenditures are income generating and include all types of government expenditure such as capital expenditure on public works, relief expenditures, subsidy payments of various types, transfer payments and other social security benefits. Government expenditures include:

1. current expenditures to meet the day to day running of the government,
2. capital expenditures which are in the form of investments made by the government in capital equipments and infrastructure, and
3. transfer payments i.e. government spending which does not contribute to GDP because income is only transferred from one group of people to another without any direct contribution from the receivers.

Government may spend money on performance of its large and ever-growing functions and also for deliberately bringing in stabilization.

During a recession, it may initiate a fresh wave of public works, such as construction of roads, irrigation facilities, sanitary works, ports, electrification of new areas etc. Government expenditure involves employment of labour as well as purchase of multitude of goods and services. These expenditures directly generate incomes to labour and suppliers of materials and services. Apart from the direct effect, there is also indirect effect in the form of working of multiplier. The incomes generated are spent on purchase of consumer goods. The extent of spending by people depends on their marginal propensity to consume (MPC). There is generally surplus capacity in consumer goods industries during recession and an increase in demand for various goods leads to expansion in production in those industries as well.

A relevant question here is; from where will the government find resources to increase its expenditure? We know that if government resorts to increase in taxes, it is self- defeating as increased taxes will reduce the disposable incomes and therefore aggregate demand. The government should in such cases go for a deficit budget which may be financed either through borrowing or through monetization (creation of additional money to finance expenditure). The former runs the risk of crowding out private spending.

Additionally, a programme of public investment will strengthen the general confidence of businessmen and consequently their willingness to invest. Primary employment in public works programmes will induce secondary and tertiary employment, and before long the economy is put on an expansion track.

Public expenditure is also used as a policy instrument to reduce the severity of inflation and to bring down the prices. This is done by reducing government expenditure when there is a fear of inflationary rise in prices. Reduced incomes on account of decreased public spending help eliminate excess aggregate demand.

4.4.2 Taxes as an Instrument of Fiscal Policy

Taxes form the most important source of revenue for governments. Taxation policies are effectively used for establishing stability in an economy. Tax as an instrument of fiscal policy consists of changes in government revenues or in rates of taxes aimed at encouraging or restricting private expenditures on consumption and investment. Taxes determine the size of disposable income in the hands of the general public which in turn determines aggregate demand and possible inflationary and deflationary gaps. The structure of tax rates is varied in the context of the overall economic conditions prevailing in an economy.

During recession and depression, the tax policy is framed to encourage private consumption and investment. A general reduction in income taxes leaves higher disposable incomes with people inducing higher consumption. Low corporate taxes increase the prospects of profits for business and promote further investment. The extent of tax reduction and /or increase in government spending required depends on the size of the recessionary gap and the magnitude of the multiplier.

During inflation, new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes and to wipe off the surplus purchasing power. However, excessive taxation usually stifles new investments and therefore the government has to be cautious about a policy of tax increase.

4.4.3 Public Debt as an Instrument of Fiscal Policy

A rational policy of public borrowing and debt repayment is a potent weapon to fight inflation and deflation. Public debt may be internal or external; when the government borrows from its own people in the country, it is called internal debt. On the other hand, when the government borrows from outside sources, the debt is called external debt. Public debt takes two forms namely, market loans and small savings.

In the case of market loans, the government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets. For financing capital projects, long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued.

The small savings represent public borrowings, which are not negotiable and are not bought and sold in the market. In India, various types of schemes are introduced for mobilising small savings e.g., National Savings Certificates, National Development Certificates, etc. Borrowing from the public through the sale of bonds and securities curtails the aggregate demand in the economy. Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

4.4.4 Budget as an Instrument of Fiscal Policy

Government's budget is widely used as a policy tool to stimulate or contract aggregate demand as required. The budget is simply a statement of revenues earned from taxes and other sources and expenditures made by a nation's government in a year. The net effect of a budget on aggregate demand depends on the government's budget balance.

A government's budget can either be balanced, surplus or deficit.

- A balanced budget results when expenditures in a year equal its tax revenues for that year. Such a budget will have no net effect on aggregate demand since the leakages from the system in the form of taxes collected are equal to the injections in the form of expenditures made.
- A budget surplus that occurs when the government collects more than what it spends, though sounds like a highly attractive one, has in fact a negative net effect on aggregate demand since leakages exceed injections.
- A budget deficit wherein the government expenditure in a year is greater than the tax revenue it collects has a positive net effect on aggregate demand since total injections exceed leakages from the system.

While a budget surplus reduces national debt, a budget deficit will add to the national debt. Deliberate changes to the composition of revenue and expenditure components of the budget are extensively used to change macro economic variables such as level of economic growth, inflation, unemployment and external stability.

4.4.5 Fiscal Policy for Long-run Economic Growth

We have been discussing so far about how fiscal policy acts as an effective tool for managing aggregate demand in the short-run to help maintain price stability and employment levels. However, we know that economic growth is indispensable for sustainable development and favourable social outcomes. The demand-side fiscal policies unaccompanied by policies to stimulate aggregate supply cannot produce long-run economic growth.

Fiscal policy influence economic growth through its effects on the incentives faced by individuals and firms. For example;

- Fiscal policies such as those involving infrastructure spending generally have positive supply-side effects. When government supports building a modern infrastructure, the private sector is provided with the requisite overheads it needs.
- Government provision of public goods such as education, healthcare, nutrition, research and development etc. provide momentum for long-run economic growth through human capital formation. Increase in human capital makes physical capital more productive.
- Taxes can have either positive or negative impact on economic growth depending on whether it encourages or discourages saving and investment.
- A well designed tax policy that rewards innovation and entrepreneurship, without discouraging incentives will promote private businesses who wish to invest and thereby help the economy grow. For example, an increase in corporate taxes to raise extra revenue may have adverse consequences on incentives and output.
- Tax and spending policies (e.g. subsidies) can be effectively used to correct market failures resulting from externalities.
- Increase in environment taxes increase the cost of firms and reduce their output
- Subsidies on inputs and support prices to producers (e.g. farmers) generate higher output.

4.4.6 Fiscal Policy for Reduction in Inequalities of Income and Wealth

Many developed and developing economies are facing the challenge of rising inequality in incomes and opportunities. Fiscal policy is a chief instrument available for governments to influence income distribution and plays a significant role in reducing inequality and achieving equity and social justice. Generally, the policy makers in developing countries try to address socioeconomic issues such as illiteracy, poverty, unemployment, and inequality by deliberately changing the tax rates and tax structure and the levels and direction of public spending.

Government revenues and expenditure have traditionally been regarded as important instruments for carrying out desired redistribution of income. The distribution of income in the society is influenced by fiscal policy both directly and indirectly. We shall see a few such measures as to how each of these can be manipulated to achieve desired distributional effects.

- A progressive direct tax system ensures that those who have greater ability to pay contribute more towards defraying the expenses of government and that the tax burden is distributed fairly among the population.
- Indirect taxes can be differential: for example, the commodities which are primarily consumed by the richer income group, such as luxuries, are taxed heavily and the commodities the expenditure on which forms a larger proportion of the income of the lower income group, such as necessities, are taxed light or not taxed at all.
- A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society. This is done through spending programmes targeted at welfare measures for the disadvantaged, such as

  (i) poverty alleviation programmes

  (ii) free or subsidized medical care, education, housing, essential commodities etc. to improve the quality of living of the poor

  (iii) infrastructure provision on a selective basis (e.g. rural roads, water supply for tribal area)

  (iv) various social security schemes under which people are entitled to old-age pensions, unemployment relief, sickness allowance etc.

  (v) subsidized production of products of mass consumption

  (vi) public production and/ or grant of subsidies to ensure sufficient supply of essential goods, and

  (vii) strengthening of human capital for enhancing employability etc.

  Choice of a progressive tax system with high marginal taxes may act as a strong deterrent to work save and invest. Therefore, the tax structure has to be carefully framed to mitigate possible adverse impacts on production and efficiency. Additionally, a highly redistributive fiscal policy with excessively generous social programs can reduce incentives to work and save.

4.4.7 Limitations of Fiscal Policy

We have seen above that fiscal policy is the conscious manipulation of government spending and taxes to influence the economy. However, there are some significant limitations in respect of choice and implementation of fiscal policy.

- One of the biggest problems with using planned fiscal policy to counteract fluctuations is the different types of lags involved in fiscal-policy action. There are significant lags namely:
  - Recognition lag: The economy is a complex phenomenon and the state of the macro economic variables is usually not easily comprehensible. There is difficulty in collecting accurate and timely data. There may be delay on the part of the government to recognize the need for a policy change.
  - Decision lag: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to make a decision on the most appropriate policy.
  - Implementation lag: even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them on account of bureaucracy. This is specially so under a democratic set up.
  - Impact lag: impact lag occurs when the outcomes of a policy are not visible for some time.
- Fiscal policy changes may at times be badly timed due to the various lags so that it is highly possible that an expansionary policy is initiated when the economy is already on a path of recovery and vice versa.
- There are difficulties in instantly changing governments' spending and taxation policies.
- It is practically difficult to reduce government spending on various items such as defence and social security as well as on huge capital projects which are already midway.
- Public works cannot be adjusted easily along with movements of the trade cycle because many huge projects such as highways and dams have long gestation period. Besides, some urgent public projects cannot be postponed for reasons of expenditure cut to correct fluctuations caused by business cycles.
- Supply-side economists are of the opinion that certain fiscal measures will cause disincentives. For example, increase in profits tax may adversely affect the incentives of firms to invest and an increase in social security benefits may adversely affect incentives to work and save.

- Deficit financing increases the purchasing power people. The production of goods and services, especially in under developed countries may not catch up simultaneously to meet the increased demand. This will result in prices spiraling beyond control.
- Increase is government borrowing creates perpetual burden on even future generations as debts have to be repaid. If the economy lags behind in productive utilization of borrowed money, sufficient surpluses will not be generated for servicing debts. External debt burden has been a constant problem for India and many developing countries.
- If governments compete with the private sector to borrow money for spending, it is likely that interest rates will go up, and firms' willingness to invest may be reduced. Individuals too may be reluctant to borrow and spend and the desired increase in aggregate demand may not be realized. This phenomenon is described below.

4.4.8 Crowding Out

We shall now discuss the secondary effects that fiscal policy may have on the economy. Some economists are of the opinion that government spending would sometimes substitute private spending and when this happens the impact of government spending on aggregate demand would be smaller than what it should be. In such cases, fiscal policy may become ineffective.

When government aims to solve the problem of recession with an expansionary fiscal policy, it will resort to increase in spending and/or a reduction in taxes. The government runs a budget deficit as income decreases and expenditure increases. The budget deficit, which is the difference between government expenditures and tax revenues, is financed by government borrowing from the credit market. The government adds to national debt by issuing long-term, interest-bearing bonds and uses the proceeds to finance the deficit.

Substantial government borrowing in the credit market tends to reduce the amount of funds available and pushes the interest rates up. Higher interest rates slow down business investment expenditures and consumption expenditures that are sensitive to interest rates. An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy. In other words, when spending by government in an economy replaces private spending, the latter is said to be crowded out. As a result, the effectiveness of expansionary fiscal policy in stimulating aggregate demand will be diminished to a great extent. This may also possibly reduce the economy's prospects of long-run economic growth.

However, during deep recessions, crowding-out is less likely to happen as private sector investment is already minimal and therefore there is only insignificant private spending to crowd out. Moreover, during a recession phase the government would be able to borrow from the market without increasing interest rates.

4.4.9 Conclusion

Well designed and timely fiscal responses are necessary for an economy which is going through stages of recession or inflation or on a drive to achieve economic growth and/ or equitable distribution of income. During periods of recession when there are idle productive capacity and unemployed workers, an increase in aggregate demand will generally bring about an increase in total output without changing the level of prices. On the contrary, if an economy is functioning at full employment, an expansionary fiscal policy will exert pressure on prices to go up and will have no impact on total output. Fiscal policy is also a potent instrument for bringing in economic growth and equality in distribution of income.

SUMMARY

- Fiscal policy involves the deliberate use of government spending, taxation and borrowing to influence both the pattern of economic activity and level of growth of aggregate demand, output and employment.
- Laissez-faire approach advocated limited role of government resulting in non recognition of the significance of fiscal policy as a strategy for achieving certain socio economic objectives till 1930.
- Through the use budgetary instruments such as public revenue, public expenditure, public debt and deficit financing, governments intend to favourably influence the level of economic activity of a country.
- The objectives of fiscal policy may vary from country to country, but generally they are: achievement and maintenance of full employment, maintenance of price stability, acceleration of the rate of economic development and equitable distribution of income and wealth.
- Since GDP = C + I + G + NX, governments can influence economic activity (GDP), by controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfer payments and expenditure.
- The Keynesian school is of the opinion that fiscal policy can have very powerful effects in altering aggregate demand, employment and output in an economy when the economy is operating at less than full employment levels and when there is a need to offer a stimulus to demand.
- The tools of fiscal policy are taxes, government expenditure, public debt and the budget.
- Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of a business cycle and is accomplished by increasing aggregate

expenditures and aggregate demand through an increase in all types of government spending and / or a decrease in taxes.

- Contractionary fiscal policy is designed to restrain the levels of economic activity of the economy during an inflationary phase by decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/ or an increase in taxes.
- A recession sets in with a period of declining real income, as measured by real GDP and a situation of rising unemployment.
- A recessionary gap, also known as a contractionary gap, is said to exist if the existing levels of aggregate production is less than what would be produced with the full employment of resources.
- Government expenditure, an important instrument of fiscal policy, generates incomes and also has indirect effect in the form of working of multiplier.
- Taxes determine the size of disposable income in the hands of general public which in turn determines aggregate demand and possible inflationary and deflationary gaps.
- During recession and depression, the tax policy is framed to encourage private consumption and investment. A general reduction in income taxes and lower corporate taxes increase aggregate demand and investments respectively.
- During inflation new taxes can be levied and the rates of existing taxes may be raised to reduce disposable incomes and to wipe off the surplus purchasing power.
- Borrowing from the public through the sale of bonds and securities curtails the money available for spending which in turn reduces the aggregate demand in the economy. Repayment of debts increases the availability of money in the economy and increase aggregate demand.
- Budget is widely used as a policy tool to stimulate or to contract aggregate demand as required.
- Fiscal Policy also aims to attain long-run economic growth through policies to stimulate aggregate supply.
- Fiscal policy is a chief instrument available for governments to influence income distribution and plays a significant role in reducing inequality and achieving equity and social justice.
- Contractionary fiscal policy is aimed at eliminating inflationary gaps and to trim down the aggregate demand by decrease in government spending and an increase in

personal income taxes and/or business taxes causing less disposable incomes and lower incentives to invest.

- Fiscal policy suffers from limitations such as limitations in respect of choice of appropriate policy, recognition lag, decision lag, implementation lag, impact lag, inappropriate timing, difficulties of forecasting due to uncertainties, possible conflicts between different objectives, possibility of generating disincentives, practical difficulty to reduce government expenditures and the possibility of certain fiscal measures replacing private spending.
- An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy. In other words, when spending by government in an economy replaces private spending, the latter is said to be crowded out.
- As a result of crowding out, the effectiveness of expansionary fiscal policy in stimulating aggregate demand will be diminished to a great extent. This may also possibly reduce the economy's prospects of long-run economic growth.
- During deep recessions, crowding-out is less likely to happen as private sector investment is already minimal and therefore there is only insignificant private spending to crowd out.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Fiscal policy refers to the*

   (a) *use of government spending, taxation and borrowing to influence the level of economic activity*

   (b) *government activities related to use of government spending for supply of essential goods*

   (c) *use of government spending, taxation and borrowing for reducing the fiscal deficits*

   (d) *and (b) above*

2. *If real GDP is continuously declining and the rate of unemployment in the economy is increasing, the appropriate policy should be to*

   (a) *Increase taxes and decrease government spending*

   (b) *Decrease both taxes and government spending*

(c) *Decrease taxes and increase government spending*

(d) *Either (a) or (c)*

3. *Which of the following are likely to occur when an economy is in an expansionary phase of a business cycle?*

(A) *Rising unemployment rate*

(B) *Falling unemployment rate*

(C) *Rising inflation rate*

(D) *Deflation*

(E) *Falling or stagnant wage for workers*

(F) *Increasing tax revenue*

(G) *Falling tax revenue*

(a) *A, B and F are most likely to occur*

(b) *B, C and F are most likely to occur*

(c) *D, E and F are most likely to occur*

(d) *A, E and G are most likely to occur*

4. *During recession the fiscal policy of the government should be directed towards*

(a) *Increasing the taxes and reducing the aggregate demand*

(b) *Decreasing taxes to ensure higher disposable income*

(c) *Increasing government expenditure and increasing taxes*

(d) *None of the above*

5. *According to Keynesian economics, when we have inflation an effective fiscal policy should not include*

(a) *increase corporate taxes.*

(b) *decrease aggregate demand.*

(c) *Increase government purchases.*

(d) *None of the above is correct*

6. *Keynesian economists believe that*

(a) *fiscal policy can have very powerful effects in altering aggregate demand, employment and output in an economy*

(b) *when the economy is operating at less than full employment levels and when there is a need to offer stimulus to demand fiscal policy is of great use*

(c) *Wages are flexible and therefore business fluctuations would be automatically adjusted*

(d) *(a) and (b) above*

7. *Which of the following may ensure a decrease in aggregate demand during inflation?*

(a) *decrease in all types of government spending and/ or an increase in taxes*

(b) *increase in government spending and/ or a decrease in taxes*

(c) *decrease in government spending and/ or a decrease in taxes*

(d) *All the above*

8. *A recession is characterized by*

(a) *Declining prices and rising employment*

(b) *Declining unemployment and rising prices*

(c) *Declining real income and rising unemployment.*

(d) *Rising real income and rising prices*

9. *Which one of the following is an example of fiscal policy?*

(a) *A tax cut aimed at increasing the disposable income and spending*

(b) *A reduction in government expenditure to contain inflation*

(c) *An increase in taxes and decrease in government expenditure to control inflation*

(d) *All the above*

10. *Which of the following would illustrate a recognition lag?*

(a) *The time required to identify the appropriate policy*

(b) *The time required to identify to pass a legislation*

(c) *The time required to identify the need for a policy change*

(d) *The time required to establish the outcomes of fiscal policy*

11. *An expansionary fiscal policy, taking everything else constant, would in the short-run have the effect of*

(a) *a relative large increase in GDP and a smaller increase in price*

(b) *a relative large increase in price, a relatively smaller increase in GDP*

(c) *both GDP and price will be increasing in the same proportion*

(d) *both GDP and price will be increasing in a smaller proportion*

12. *Which statement (s) is (are) correct about crowding out?*

I. *A decline in private spending may be partially or completely offset by the expansion of demand resulting from an increase in government expenditure.*

II. *Crowding out effect is the negative effect fiscal policy may generate when money from the private sector is 'crowded out' to the public sector.*

III *When spending by government in an economy increases government spending would be crowded out.*

IV. *Private investments, especially the ones which are interest –sensitive, will be reduced if interest rates rise due to increased spending by government*

(a) *I and III only*

(b) *I, II, and III*

(c) *I, II, and IV*

(d) *III only*

13. *Which of the following policies is likely to shift an economy's aggregate demand curve to the right?*

(a) *Increase in government spending*

(b) *Decrease in taxes*

(c) *A tax cut along with increase in public expenditure*

(d) *All the above*

14. *Identify the incorrect statement*

(a) *A progressive direct tax system ensures economic growth with stability because it distributes the burden of taxes unequally*

(b) *A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society.*

(c) *There are possible conflicts between different objectives of fiscal policy such that a policy designed to achieve one goal may adversely affect another*

(d) *An increase in the size of government spending during recessions may possibly 'crowd-out' private spending in an economy.*

15. *Read the following statements*

    I. *Fiscal policy is said to be contractionary when revenue is higher than spending i.e., the government budget is in surplus*

    II. *Other things constant, a fiscal expansion will raise interest rates and "crowd out" some private investment*

    III. *During inflation new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes*

    IV. *Classical economists advocated contractionary fiscal policy to solve the problem of inflation*

    Of the above statements

    (a) *I and II are correct*

    (b) *I, II and III are correct*

    (c) *Only III is correct*

    (d) *All are correct*

16. *While resorting to expansionary fiscal policy*

    (a) *the government may possibly have a budget surplus as increased expenditure will bring more output and more tax revenue*

    (b) *the government may run into budget deficits because tax cuts reduce government income and the government expenditures exceed tax revenues in a given year*

    (c) *it is important to have a balanced budget to avoid inflation and bring in stability*

    (d) *None of the above will happen*

17. *Contractionary fiscal policy*

    (a) *is resorted to when government expenditure is greater than tax revenues of any particular year*

    (b) *increase the aggregate demand to sustain the economy*

    (c) *to increase the disposable income of people through tax cuts and to enable greater demand*

    (d) *is designed to restrain the levels of economic activity of the economy during an inflationary phase*

18. *When government spending is deliberately reduced to bring in stability*

    (a) *the government is resorting to contractionary fiscal policy*

(b) *the government is resorting to expansionary fiscal policy*

(c) *trying to limit aggregate demand to sustainable levels*

(d) *(a) and c) above*

19. *An increase in personal income taxes*

(a) *reduces disposable incomes leading to fall in consumption spending and aggregate demand*

(b) *is desirable during inflation or when there is excessive levels of aggregate demand*

(c) *is to compensate the deficiency in effective demand by boosting aggregate spending*

(d) *both a) and b) are correct*

20. *While the government resorts to deliberate fiscal policy it may not attempt to manipulate*

(a) *Government expenditures on public works*

(b) *The rates of personal income taxes and corporate taxes*

(c) *Government expenditures on goods and services purchased by government*

(d) *The rate of interest prevailing in the economy*

21. *Which of the following fiscal remedy would you advice when an economy is facing recession*

(a) *the government may cut interest rates to encourage consumption and investment*

(b) *the government may cut taxes to increase aggregate demand*

(c) *the government may follow a policy of balanced the budget.*

(d) *None of the above will work*

22. *While if governments compete with the private sector to borrow money for securing resources for expansionary fiscal policy*

(a) *it is likely that interest rates will go up and firms may not be willing to invest*

(b) *it is likely that interest rates will go up and the individuals too may be reluctant to borrow and spend*

(c) *it is likely that interest rates will go up and the desired increase in aggregate demand may not be realized*

(d) *All the above are possible.*

ANSWERS

1.	**(a)**	2	**(c)**	3	**(b)**	4.	**(b)**	5.	**(c)**	6.	**(d)**
7.	**(a)**	8.	**(c)**	9.	**(d)**	10.	**(c)**	11.	**(a)**	12.	**(c)**
13.	**(d)**	14.	**(a)**	15.	**(b)**	16.	**(b)**	17.	**(d)**	18.	**(d)**
19.	**(d)**	20.	**(d)**	21.	**(b)**	22.	**(d)**				