

Fiscal Policy

Lesson Objectives

- To understand what is meant by the term fiscal policy
- To identify the sources of government revenue
- To differentiate between different types of government expenditure.
- To distinguish between a budget surplus and a budget deficit.
- To look at the difference between expansionary and contractionary fiscal policy and illustrate both with a diagram.

1) What do you understand by the term “**Fiscal Policy**”?



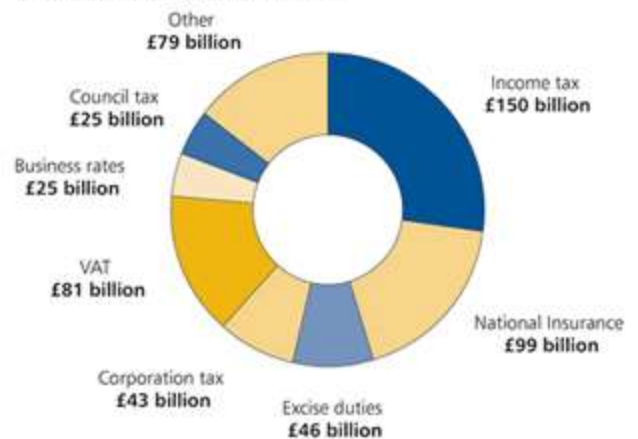
2) Using the graphic below, identify the main sources of government revenue.

Source of government revenue

1
2
3
4
5
6
7
8

Government receipts 2010-11

Total receipts – £548 billion

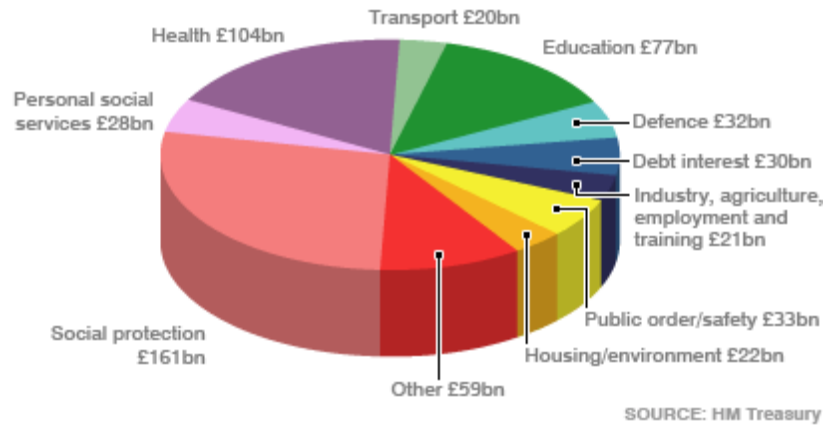


3) Identify what might be included in the ‘other’ category.

4) What are the main items of government expenditure?





	Item of expenditure
1	
2	
3	
4	
5	
6	
7	






5. As well as the above areas of government expenditure (the names of which can vary from country to country, we can also classify government expenditure as either:-

- ✚ Current expenditure
- ✚ Capital expenditure
- ✚ Transfer payment

Type	Definition	Example
Current Expenditure		

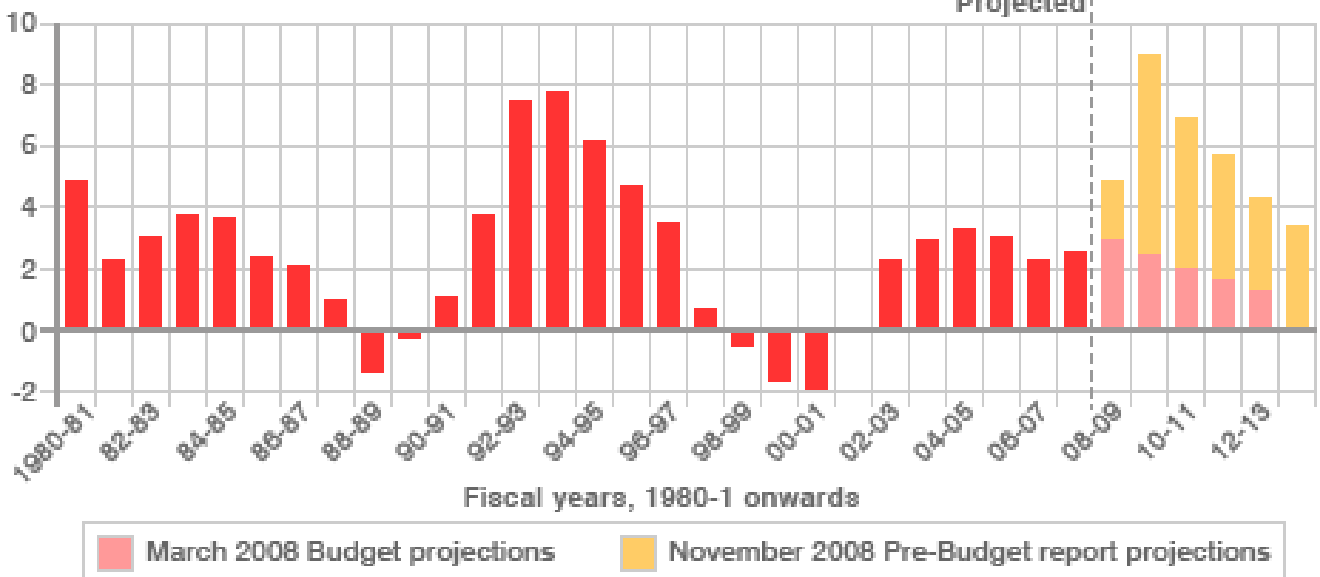
Capital Expenditure	
Transfer payments	

6. Each year the government prepares their **budget** for the next year. They have one of three options.

-  **Balanced budget** _____
-  **Budget surplus** _____
-  **Budget deficit** _____

UK BUDGET DEFICITS

Net borrowing, as % of GDP (scale +/- 6%)



SOURCE: HM Treasury

7. What do you notice about the U.K. government’s budget from the diagram above?

8. What is the national debt?

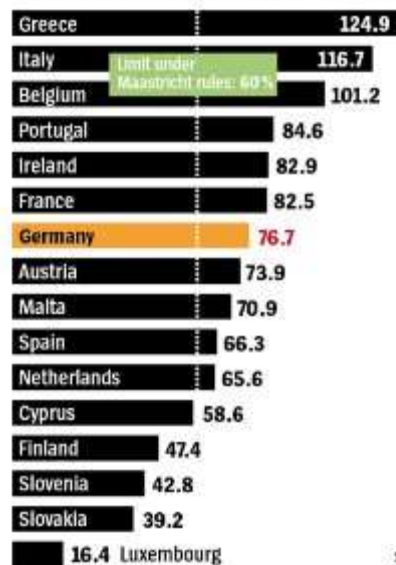
9. What is the relationship between the government's yearly budget deficit/surplus and the national debt?

10. Outline some of the advantages and disadvantages of the government having a large national debt.

Advantages	Disadvantages

National Debts of Euro Zone Members in 2010

as percentage of gross domestic product (forecasts)



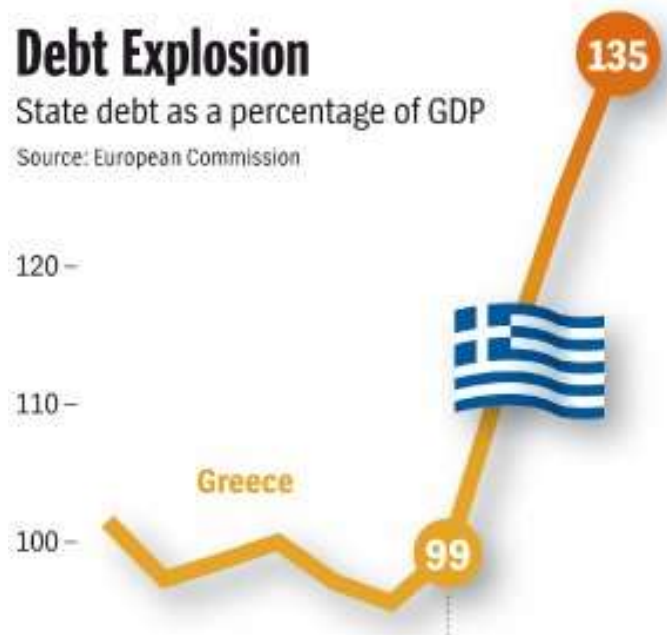
Euro zone average: 84 percent

Source: European Commission

Debt Explosion

State debt as a percentage of GDP

Source: European Commission



11. How do the government borrow money?

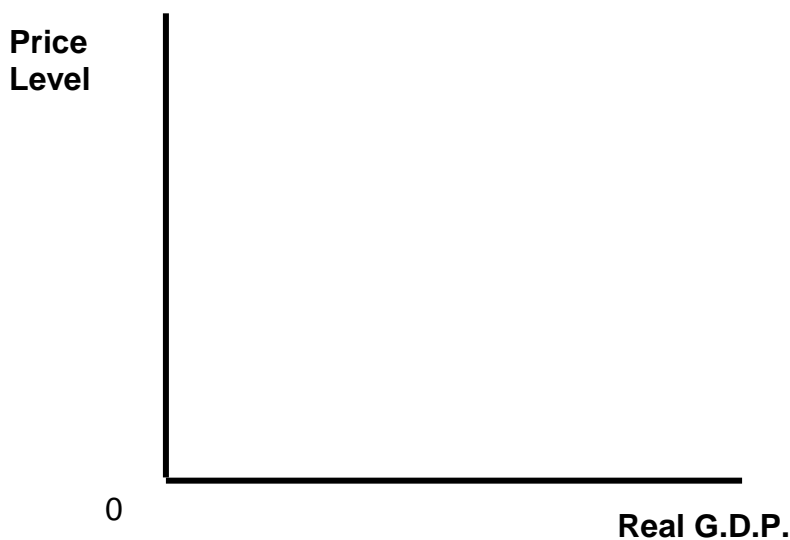


12. Using the table below illustrate the difference between a contractionary fiscal policy and an expansionary fiscal policy.

Type of Fiscal Policy	Taxation ↑ ↓	Government Spending ↑ ↓
✚ Contractionary		
✚ Expansionary		

13. Why might the government pursue an expansionary fiscal policy?

14. On the diagram below illustrate the impact of such a policy on the economy. (closing a deflationary gap)



15. What are the potential disadvantages of an expansionary fiscal policy?

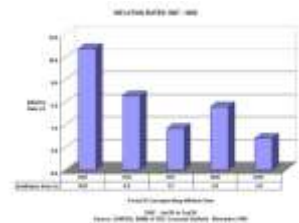
✚ _____

✚ _____

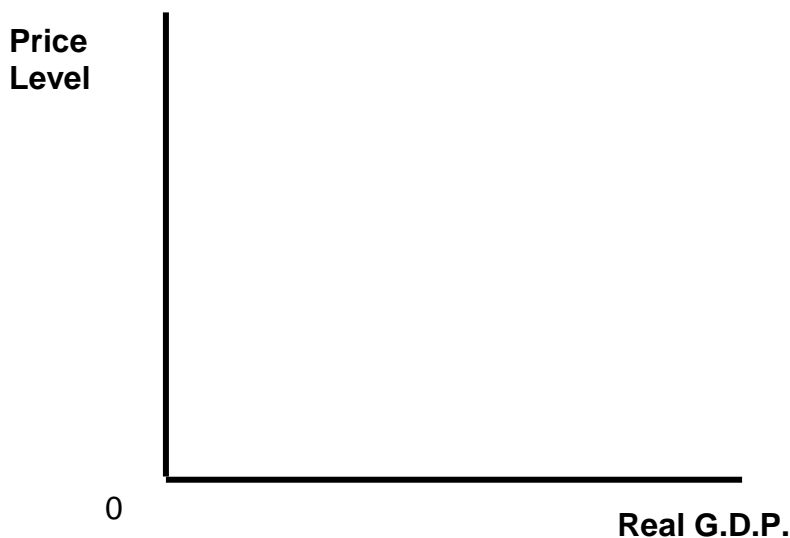
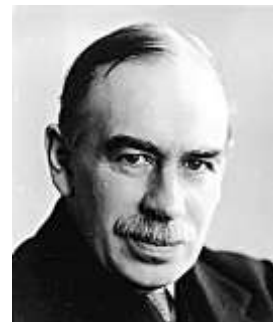
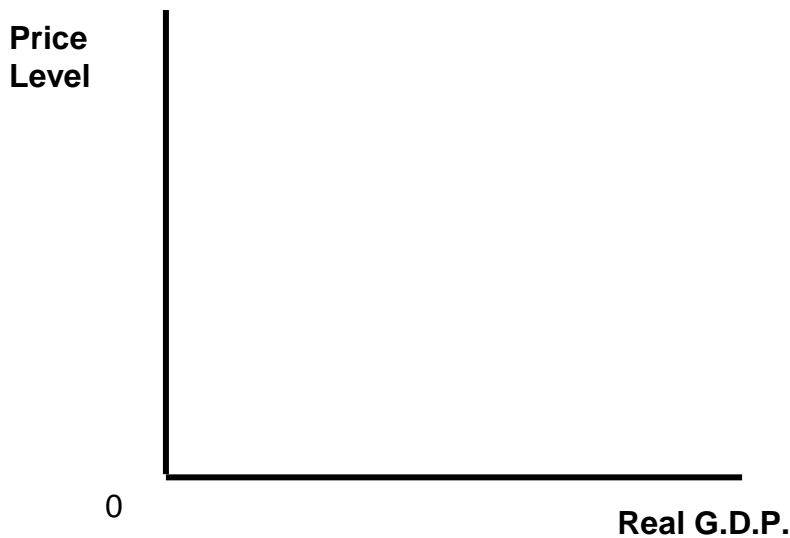
✚ _____



16. Explain what is meant by a **contractionary fiscal policy** and explain why the government may wish to pursue this objective.



17. Illustrate on the diagram below the potential impact of a **contractionary fiscal policy** on the macroeconomy (**closing an inflationary gap – Keynesian AD/AS, then New Classical**).



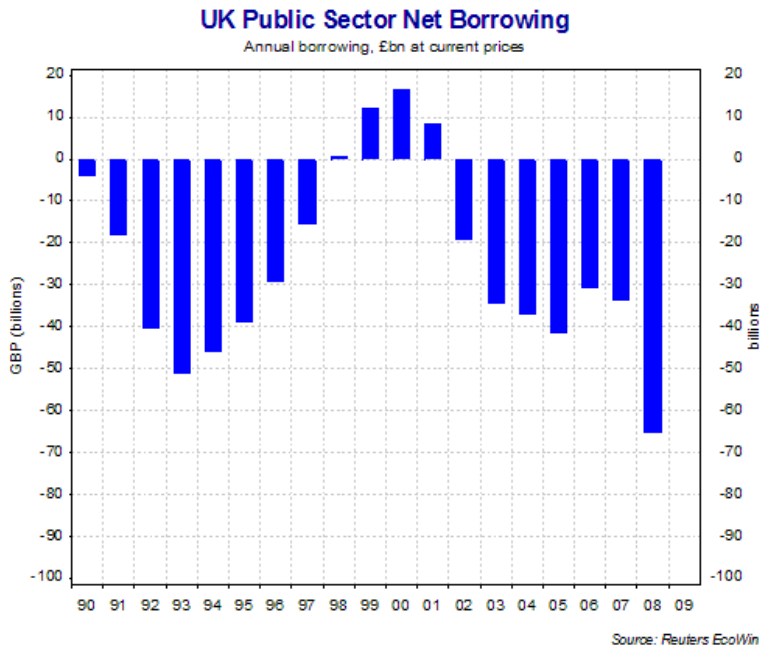
18. What are the drawbacks of a contractionary fiscal policy?

- ✚ _____
- ✚ _____
- ✚ _____



19. Fiscal policy can be used, through the use of **automatic stabilizers**, to smooth fluctuations in the business cycle of an economy.

- ✚ Look at the graphic below and identify when government borrowing was at its peak in terms of the nation's economic cycle.



20.

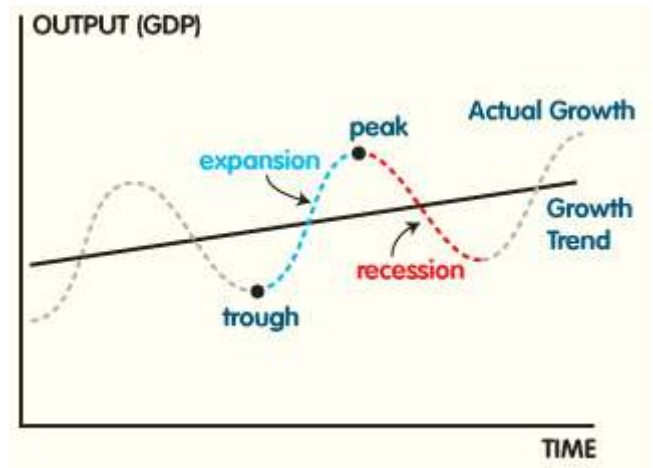
Period of the business cycle	Government Spending	Income Tax	Government Revenue	Deficit/Surplus
Recession				
Boom				

21. What will be the impact on the business cycle of **automatic stabilizers**?

Recession

Boom

22. As well as helping to smooth fluctuations in the business cycle of an economy, explain how fiscal policy **might** be effective in raising the potential output/growth trend of an economy.



23. Which politicians/economists believe that this is the primary economic role of the government?

+ _____

+ _____

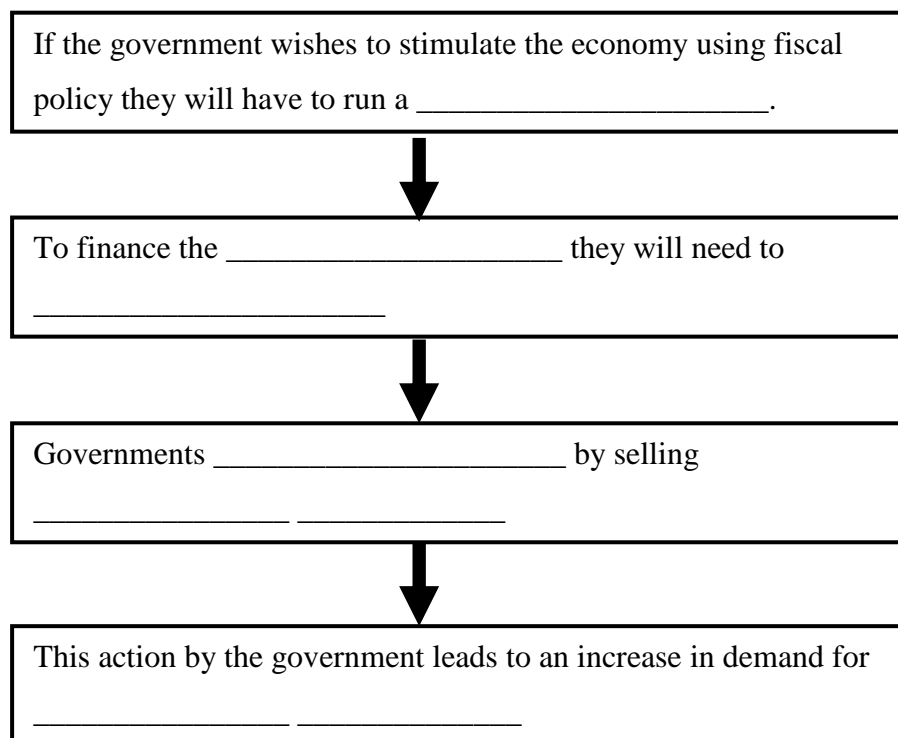


24. The implementation of fiscal policy to achieve macroeconomic objectives may not be effective for several reasons.

<p>Impact on aggregate demand</p>
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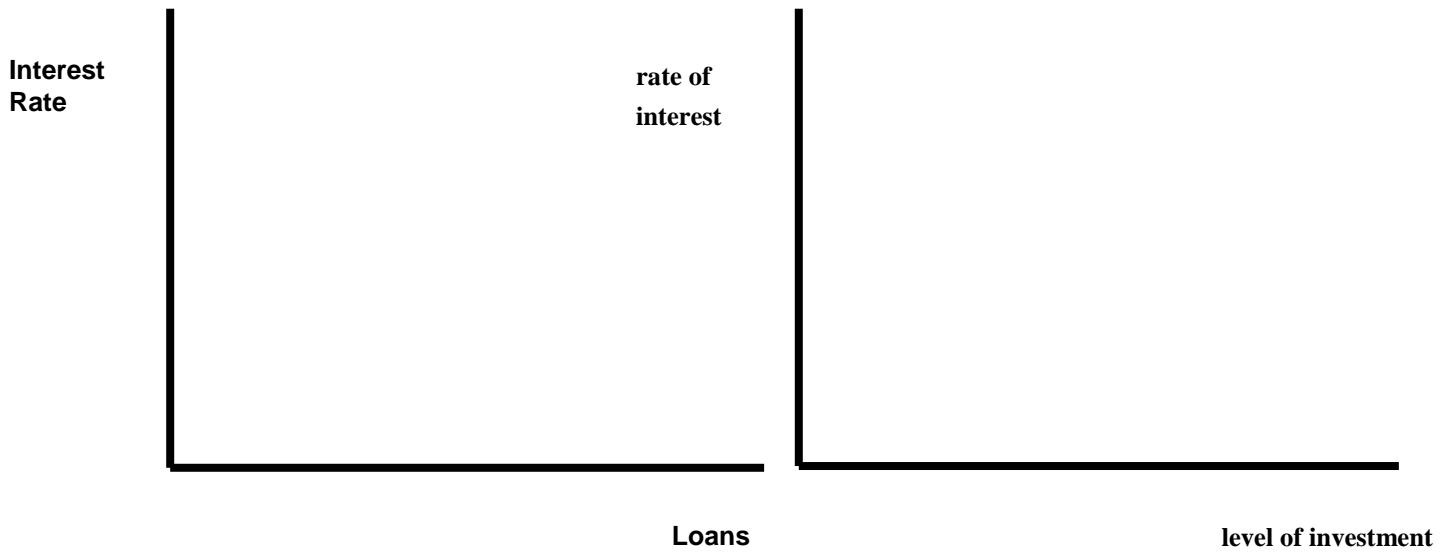
Impact on consumer/firm behaviour
Time lags
Political factors
Supply-side factors

25. However, one of the main criticisms leveled at fiscal policy (expansionary fiscal policy) is that it leads to ‘**crowding out**’.



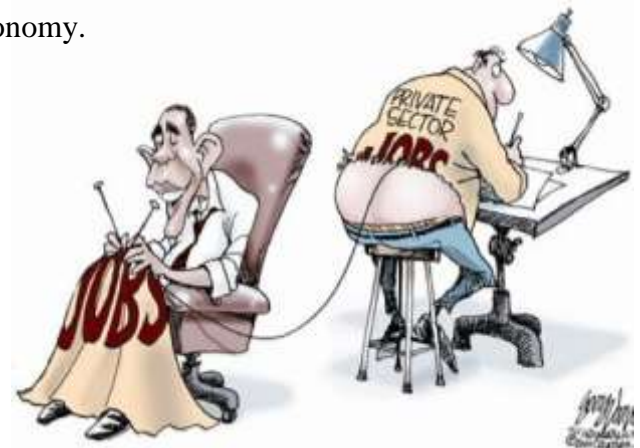
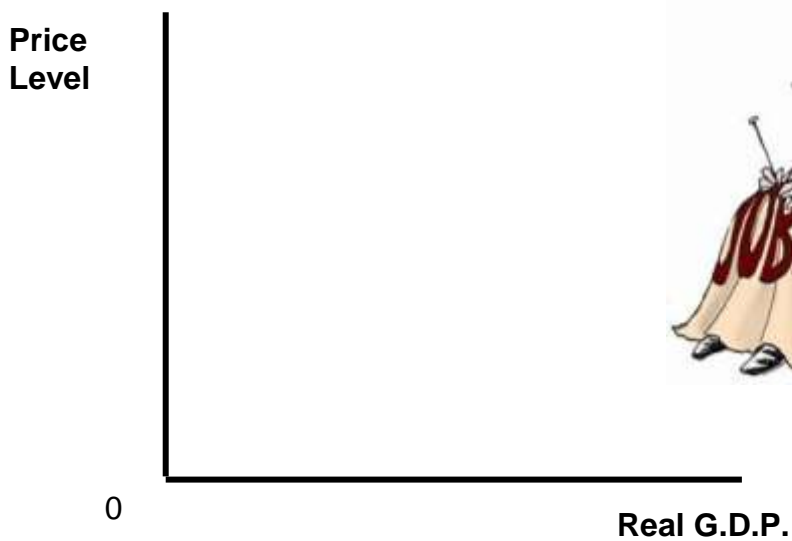
✚ The key to understanding this concept is that ‘savings’, of which there are a finite amount in the economy, are used to purchase **government debt** as opposed to being lent to the private sector (firms) in the form of loans or purchase of company shares/debt.

26. On the diagrams below, identify the impact of an increase in government borrowing



27. What is the possible impact of an increase in government borrowing on the private sector?

28. Illustrate the potential impact on the macro economy.



29. In the table below, summarize the Keynesian and New Classical views about 'crowding-out'.

Keynesian
New Classical