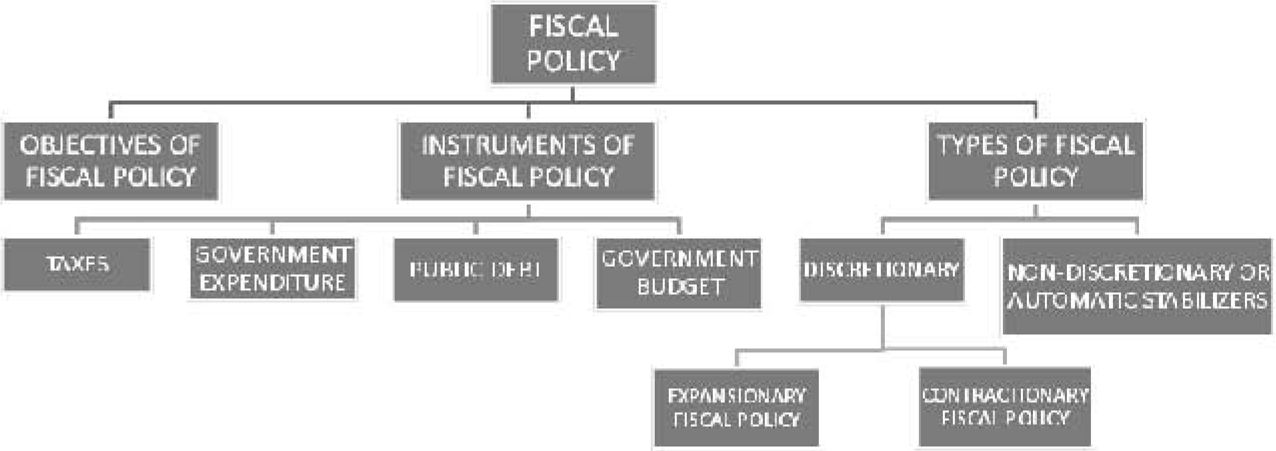
2. FISCAL POLICY



Q.No.1. Define Fiscal policy. What are the objectives of Fiscal policy? (A) (SM, M18 - 3M)

Fiscal policy: Fiscal policy involves the 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.

Fiscal policy is in the nature of a demand-side policy.

Note: An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

OBJECTIVES OF FISCAL POLICY: The objectives of fiscal policy are derived from the aspirations and goals of the society. Since nations differ in numerous aspects, the objectives of fiscal policy also may vary from country to country.

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.

Note: These objectives are not always compatible; for instance the objective of achieving equitable distribution of income may conflict with the objective of economic growth and efficiency.

Q.No.2. Explain about the different instruments of fiscal policy. (B) (SM)

Instruments of Fiscal Policy: The tools of fiscal policy are **Taxes, Government Expenditure, Public Debt** and **Government Budget.**

Q.No.3. How does the government expenditure acts as an instrument of fiscal policy? (A)

Government Expenditure (GE): It is an important instrument of fiscal policy. It includes:

1. Current expenditures to meet the day to day running of the government (i.e. consumption expenditure),
2. Capital expenditures which are in the form of investments made by the government in capital equipment 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. (Ex.: Pensions, unemployment allowances etc.)

Role of Government Expenditure as an Instrument of Fiscal Policy to bring stabilisation:

a) **Direct impact of Government expenditure:** GE 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.

b) **Indirect impact of Government expenditure:** The indirect effect will be in the form of working of multiplier. The incomes generated are spent on purchase of consumer goods.

c) **Government expenditure in rectifying Inflation:** GE will be reduced. It reduces incomes of the people and thus the decreased public spending helps to eliminate excess aggregate demand.

d) **Government expenditure in rectifying economic recession:**

i) During a recession, it may initiate a fresh wave of public works, such as construction of roads, ports, irrigation facilities, electrification of new areas etc.

ii) Primary employment in public works programmes will induce secondary and tertiary employment.

iii) It generates surplus capacity in consumer goods industries and an increase in demand for various goods leads to expansion in production.

iv) It will strengthen the general confidence of businessmen and their willingness to invest.

e) **Government expenditure in rectifying economic depression:**

i) During depression GE may use the concepts of either 'pump priming' or 'compensatory spending'.

ii) **Pump priming:** When private spending becomes deficient, certain volumes of public spending will help to revive the economy. It is termed as Pump priming

iii) **Compensatory spending:** When the government spending is carried out with the intention to compensate for the deficiency in private investment, It is termed as Compensatory spending.

SIMILAR QUESTIONS:

1. What will be the direct impact of government expenditure under fiscal policy?

A. Refer point "a"

2. What will be the indirect impact of government expenditure under fiscal policy?

A. Refer point "b"

3. What is the role of Government expenditure in rectifying Inflation?

A. Refer point "c"

4. What is the role of Government expenditure in rectifying economic recession?

A. Refer point "d"

5. What is the role of Government expenditure in rectifying economic depression?

A. Refer point "e"

6. Define 'pump priming'

A. Refer point ii) in "e"

7. Define Compensatory spending.

A. Refer point iii) in "e"

Q.No.4. How does the taxes levied by the government acts as an instrument of fiscal policy? (A) (SM)

Taxes: Taxes form the most important source of revenue for governments. Taxation policies are effectively used for establishing stability in an economy.

Role of Taxes as an Instrument of Fiscal Policy:

a) 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.

b) Role of taxes during recession and depression:

i) Reduction in income taxes leaves higher disposable incomes with people inducing higher consumption.

ii) Reduction in corporate taxes increases the prospects of profits for business and promotes further investment.

c) Role of taxes during inflation:

i) 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.

ii) But the excessive taxation suppresses new investments and therefore the government has to be cautious about a policy of tax increase.

SIMILAR QUESTIONS:

1. What should be the tax policy during recession and depression?

A. Refer point b

2. What should be the tax policy during inflation?

A. Refer point c

3. Analyse what should be the tax policy during recession and depression? (RTP M18)

A. Refer above answer

4. What is the consequence excessive taxation will have on business?

A. Refer ii) of point c

Q.No.5. How does the public debt acts as an instrument of fiscal policy? (B) (SM)

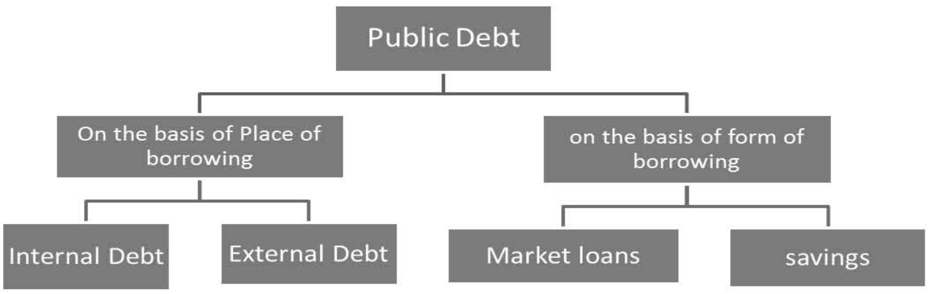
1. **Public Debt or public borrowings:**

a) Public Debt is an amount borrowed by the government.

b) A nation's debt is the difference between its total past deficits and its total past surpluses.

c) If a government has borrowed money over the years to finance its deficits and has not paid it back through accumulated surpluses, then it is said to be in debt.

2. **Forms of public debt:**



a) **Internal Debt:** The government borrows from its own people in the country

b) **External Debt:** The government borrows from outside sources,

c) **Market Loans:** For financing capital projects, long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued.

d) **Small Savings:** They represent public borrowings, which are not negotiable and are not bought and sold in the market. In India, for mobilizing small savings such as National Savings Certificates, National Development Certificates, etc. are introduced

3. **Role of Public Debt as an Instrument of Fiscal Policy:**

a) A rational policy of public borrowing and debt repayment is a potent weapon to fight inflation and deflation.

b) **During Inflation:** Borrowing from the public through the sale of bonds and securities decreases the aggregate demand in the economy.

c) **During Deflation:** Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

SIMILAR QUESTIONS:

1. Define Public debt.
A. Refer side heading 1
2. Define Market loans.
A. Refer point C in side heading 2
3. Define Small savings as a form of public debt.
A. Refer point D in side heading 2
4. Can public debt be used as a potent weapon to combat fluctuations in the economy?
A. Refer side heading 3

Q.No.6. How does budget acts as an instrument of fiscal policy? (B) (SM)

Budget: It is a statement of revenues earned from taxes and other sources; and expenditures made by a nation's government in a year. A government's budget can either be balanced, surplus or deficit.

Budget as an Instrument of Fiscal Policy:

a) **Effect of Balanced budget: (Public Revenue (PR) = Public Expenditure (PE))**

It 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).

b) **Action during Inflation: Effect of Budget Surplus: (PR > PE)**

- It has a negative net effect on aggregate demand (*since leakages exceed injections).*
- It reduces national debt and interest rates.
- It increases savings of government

c) **Action during Recession: Effect of Budget Deficit: (PR < PE)**

- It has a positive net effect on aggregate demand (since total injections exceed leakages from the government sector).
- It will add to the national debt.

Higher levels of domestic savings decrease international borrowings and lessen the current account deficit.

SIMILAR QUESTIONS:

1. What is the effect of balanced budget on aggregate demand?
A. Refer point a
2. What is the effect of Surplus budget on aggregate demand, national debt, interest rates and savings?
A. Refer point b
3. What is the effect of Deficit budget on aggregate demand and national debt?
A. Refer point c

Q.No.7. How does the fiscal policy helps in reducing inequalities of income and wealth in an economy? (B) (SM)

1. **Role of Fiscal Policy in reduction of inequalities of Income and Wealth:** Many developed and developing economies are facing high inequalities in incomes and opportunities. Based on this issue, the fiscal policy is applicable as follows:

a) Fiscal policy is a chief instrument available for governments to influence income distribution both directly and indirectly

b) Fiscal policy plays a significant role in reducing inequality and achieving equity and social justice.

c) Government revenues and expenditure are important instruments for carrying out desired redistribution of income.

2. **Fiscal measures to reduce inequalities of income and wealth:**

a) **Through public revenue:**

i) A progressive direct tax system ensures that those who have greater ability to pay, contribute more and thus the tax burden is distributed fairly among the population.

ii) Indirect taxes can be differential. (EX: luxuries consumed by the richer income group are taxed heavily and the necessities consumed by the lower income group are taxed lower.)

b) **Through public Expenditure:** A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society in the form of welfare measures for the disadvantages, such as

i) Poverty alleviation programmes

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

iii) Infrastructure provision on a selective basis

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.

Inference: *But progressive tax system with high marginal taxes may discourage to work, save and invest. Therefore, the tax structure has to be carefully framed to mitigate possible adverse impacts on production and efficiency.*

Hence the redistributive fiscal policy and the extent of spending on redistribution should be consistent with the macroeconomic policy objectives of the nation.

SIMILAR QUESTIONS:

1. What types of fiscal policy measures are useful for redistribution of income in an economy?

A. Refer 2nd Side heading

2. Fiscal policy plays a significant role in reducing inequality and achieving equity and social justice. Do you agree? Substantiate your answer with examples. (RTP N18)

A. Refer point 'b' in 2nd side heading

3. How the fiscal measures can be manipulated to achieve desired distributional effects to reduce inequalities of income and wealth?

A. Refer 2nd side heading

Q.No.8. What are the two primary types of fiscal policy used by the government to influence the economic activities in an economy? (B) (SM) (RTP-M19)

The two primary types of fiscal policy used by the government are discretionary fiscal policy and non-discretionary fiscal policy (or) automatic stabilizers.

Discretionary Fiscal Policy: Discretionary fiscal policy is a change in government spending or taxes. Its purpose is to expand or shrink the economy as needed. It includes Expansionary fiscal policy and Contractionary fiscal policy.

Non-Discretionary Fiscal Policy (Or) Automatic Stabilizers: Automatic stabilizers are part of the structure of the economy and are 'built-in' fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle.

Q.No.9. Explain non-discretionary fiscal policy (or) automatic stabilizers? (A) (SM)

Changes in fiscal policy do not always require explicit action by government. In most economies, changes in the level of taxation and level of government spending tend to occur automatically.

Non-Discretionary Fiscal Policy (Or) Automatic Stabilizers:

a) Automatic stabilizers are part of the structure of the economy and are 'built-in' fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle without any need for discretionary policy action.

b) Any government programme that automatically tends to reduce fluctuations in GDP is called an automatic stabilizer.

c) Personal income taxes, corporate income taxes and transfer payments (unemployment compensation, welfare benefits) are prominent automatic stabilizers.

Role of Automatic Stabilizers:

a) They automatically increases aggregate demand when there is recession and reduces aggregate demand when there is inflation in the economy.

b) They have a tendency for increasing GDP when it is falling and reducing GDP when it is rising.

c) Since they affect disposable personal income directly, they act rapidly to reduce the extent of changes in real GDP.

d) Automatic stabilizers work through limiting the increase in disposable income during an expansionary phase and limiting the decrease in disposable income during the contraction phase of the business cycle.

However, automatic stabilizers alone would not be sufficient to correct instabilities. The government needs to resort to discretionary fiscal policies.

SIMILAR QUESTIONS:

1. Explain how automatic stabilizers bring stability in an economy.

A. Refer above answer.

2. What would be the effect of automatic stabilizers on multiplier? (MTP1 M18 - 2M)

A. Refer 2nd Side heading

3. What is non- discretionary fiscal policy and how it occurs? (MTP-N19)

A. Refer above answer.

Q.No.10. What is the impact of non-discretionary fiscal policy (or) automatic stabilizers during contractionary phase of business cycle (or) recession in an economy? (A) (SM)

Consequences during recession:

1. Incomes are reduced

2. With progressive taxation the proportion of income that is taxed will be reduced.

3. It results in lower tax payments.

4. Simultaneously, government expenditures increase due to increased transfer payments like unemployment benefits.

Role of automatic stabilizers:

Thus fall in tax revenue and rise in government expenditure provide more disposable income available for consumption spending to households.

Conclusion:

In brief, automatic stabilizers work through limiting the decrease in disposable income during the contraction phase of the business cycle.

In the absence of automatic responses, the economy would probably fall into a deeper recession.

SIMILAR QUESTION:

1. Justify the sentence "The automatic stabilizers work through limiting the decrease in disposable income during the contraction phase of the business cycle".

A. Refer above answer.

Q.No.11. What is the impact of non-discretionary fiscal policy (or) automatic stabilizers during expansionary phase of business cycle (or) inflation in an economy? (A) (SM)

Consequences during expansionary phase:

1. When an economy expands, employment increases.
2. With progressive system of taxes people have to pay higher taxes as their income rises.
3. It reduces disposable income and also aggregate demand.
4. Corporate profits tend to be higher attracting higher corporate tax payments.
5. It results in lower surplus causing a decline in their consumption and investments.

Role of automatic stabilizers:

During expansion unemployment falls, therefore government expenditure by way of transfer payments falls and with lower government expenditure inflation gets controlled to a certain extent.

The built-in stabilisers automatically remove spending from the economy to reduce demand-pull inflationary pressures and further expansionary stimulation.

Conclusion: In brief, automatic stabilizers work through limiting the increase in disposable income during an expansionary phase of the business cycle.

SIMILAR QUESTIONS:

1. Justify the sentence "The automatic stabilizers work through limiting the increase in disposable income during an expansionary phase of the business cycle".

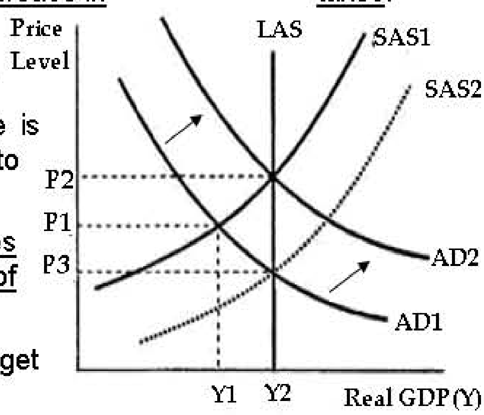
A. Refer above answer.

Q.No.12. Explain the types of Discretionary fiscal policies to correct business cycle instability in the economy? (B) (SM)

The Discretionary fiscal policy measures to correct different problems created by business-cycle instability are of two basic types namely, expansionary and contractionary.

1. **Expansionary fiscal policy**:
   a) It is designed to stimulate the economy during the contractionary phase of business cycle or when there is an anticipation of a business cycle contraction.
   b) This is carried out by increasing aggregate expenditures and aggregate demand through an increase in all types of government spending and / or a decrease in taxes.

2. **Contractionary fiscal policy:**



   a) It 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.
   b) This is carried out by decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/ or an increase in taxes.
   c) It should ideally lead to a smaller government budget deficit or a larger budget surplus.

SIMILAR QUESTIONS:

1. Describe the term expansionary fiscal policy. (RTP-M19)

A. Refer 1st point

2. What is meant by expansionary fiscal policy? Under what circumstances do government pursue expansionary policy? (M19-2M)

A. Refer 1st point

3. Describe the term contractionary fiscal policy.

A. Refer 2nd point

Q.No.13. Explain graphically the role of expansionary fiscal policy to eliminate recessionary gap. (A) (SM)

Recessionary Gap:

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 full employment of resources.

This gap occurs during the contractionary phase of business-cycle and results in higher rates of unemployment. (or)

This gap occurs when the aggregate demand is not sufficient to create conditions of full employment.

Role of expansionary fiscal policy to eliminate a recessionary gap:

According to Keynes when the aggregate demand falls short of aggregate supply, it results in unemployment of resources, especially labour. In that case, the government intervenes through an expansionary fiscal policy.

Expansionary Fiscal policy for Combating Recession

a) Real GDP at Y_1 level lies below the natural level, Y_2. This represents a situation where the economy is initially in a recession. There is less than full employment of the resources in the economy.

b) **According to Classical economist with the assumption of flexibility of wages.**

This would cause wages to fall resulting in reduction in costs. Consequently, suppliers would increase supply and the short run aggregate supply curve SAS_1 will shift to the right SAS_2 and bring the economy back to the level of full employment at Y_2.

c) **According to Keynes with the assumption of wages will not adjust rapidly to accommodate the unemployed i.e. wages are 'sticky downward'.**

When once recession set in, it would persist for a long time. The government responds by increasing government expenditures (adopts deficit budget) in adequate quantities as to cause a rightward shift in the aggregate demand curve from AD_1 to AD_2. Now the firms respond to increase their output in the short- run. Hence firms must hire more workers. This has the effect of reducing unemployment in the economy.

d) The increase in level of government expenditure depends upon the GNP gap created due to recession and also on the size of multiplier (Multiplier depends upon MPC).

e) The increase in government expenditures need not be equal to Y_2 - Y_1, it can be much less.

f) The concept of 'fiscal multiplier,' suggests that a lesser government expenditure is sufficient to achieve the natural level of real GDP.

g) **Sources of government to raise its expenditure:** Taxes, Public borrowings and monetization (creation of additional money to finance expenditure).

Note: The expansionary fiscal policy will be successful only if there is accommodative monetary policy.

SIMILAR QUESTION:

1. Explain the term 'recessionary gap'.

A. Refer the definition of recessionary gap

2. How do changes in government expenditure (G), and taxes (T) eliminate a recessionary gap?

A. Refer the above answer.

3. Under what circumstances do governments pursue expansionary fiscal policy? What are the instruments for expansionary fiscal policy?

A. Refer the above answer.

Q.No.14. Explain graphically the contractionary fiscal policy for combating inflation. (A) (SM)

When aggregate demand rises beyond what the economy can potentially produce by fully employing it's given resources, it gives rise to inflationary pressures in the economy. Under such circumstances, a contractionary fiscal policy has to be used.

1. **Contractionary Fiscal Policy:** Contractionary fiscal policy is aimed at eliminating an inflationary gap. This is achieved by adopting policy measures that would result in the aggregate demand curve (AD) shift to the left so the equilibrium may be established at the full employment level of real GDP.

   This can be achieved either by:

   a) Decrease in government spending or Increase in personal income taxes and business taxes.

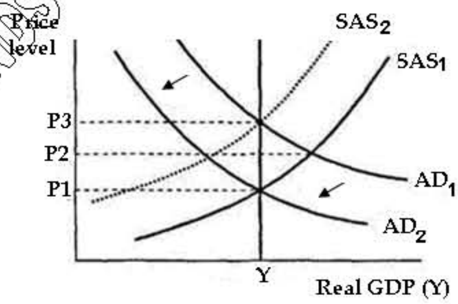
   b) A combination of decrease in government spending and increase in personal income taxes and/or business taxes.

2. **Contractionary Fiscal policy for Combating Inflation:**

   The graph depicts the following:

   a) As real GDP rises above its natural level, 'Y', prices rises from P2 to P3, prompting an increase in wages and other resource prices. This causes the SAS curve to shift to left from SAS1 to SAS2. But the real GDP remains the same at Y.

   b) Now the government intervenes to control inflation through **contractionary** fiscal policy to reduce aggregate demand.



SIMILAR QUESTION:

1. How do changes in government expenditure (G), and taxes (T) eliminate an inflationary gap?

A. Refer above answer.

2. Define the Contractionary Fiscal Policy. What measures under this policy are to be adopted to eliminate the inflationary gap? (N18 - 3M)

A. Refer above answer.

3. Unemployment and recessionary trends can be solved through the use of fiscal policies. Do you agree? Justify your answer.

A. Refer above answer.

Q.No.15. What are the limitations involved in Discretionary fiscal policy? (A) (SM)(MAY19)

Discretionary fiscal policy is the conscious manipulation of government spending and taxes to influence the economy.

Significant limitations in respect of choice and implementation of fiscal policy:

a) The following are some of the significant lags involved in discretionary fiscal-policy to counteract fluctuations:

   Recognition lag: As the economy is a complex phenomenon, the government must first recognize the need for a policy change.

Decision lag: Later the government has to evaluate the possible alternative policies. Delays are likely to occur to decide on the most appropriate policy.

Implementation lag: After appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them.

Impact lag: It occurs when the results of a policy are not visible for some time.

b) It is practically difficult to reduce government spending on various items such as defence, social security and on huge capital projects which are already midway.

c) 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.

d) Urgent public projects cannot be postponed for reasons of expenditure cut to correct fluctuations caused by business cycles.

e) Supply-side economists are of the opinion that certain fiscal measures will cause disincentives.

E.g.: 1 An increase in profits tax may adversely affect the incentives of firms to invest.

E.g.: 2 An increase in social security benefits may adversely affect incentives to work and save.

f) *There are difficulties in instantaneously changing governments' spending and taxation policies.*

g) *Due to uncertainties, there are difficulties of forecasting and determining the accurate policy at the time of inflation or deflation.*

h) *There are possible conflicts between different objectives of fiscal policy such that a policy designed to achieve one goal may adversely affect another. For example, an expansionary fiscal policy may worsen inflation in an economy.*

i) *Deficit financing increases the purchasing power of people. But in under developed countries, the production of goods and services may not be able to meet the increased demand. This will result in inflation.*

j) *Increase in government borrowing creates burden on future generations. External debt burden has been a constant problem for India and many developing countries.*

SIMILAR QUESTION:

1. List out the limitations fiscal policy. (MTP -M19)

A. Refer any six points

2. Describe the limitations of fiscal policy (M19-3M)

A. Refer any six points

3. List out the factors that limit the effectiveness of fiscal policy? Explain the possible impacts on private sector?

A. Refer any six points

Q.No.16. Explain the term "Crowding Out" with suitable example. (Or) Describe the meaning and mechanism of Crowding Out effect of public expenditure. (A) (SM, M18 - 3M)

Crowding out effect: If governments compete with the private sector to borrow money for spending, the 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 situation is termed as crowded out of private sector.

a) Crowding out effect is the negative effect on fiscal policy as money from the private sector is 'crowded out' to the public sector

Ex: If government provides free computers to students, the demand from students for computers may not be forthcoming.

b) Crowding Effect is less during recession.

c) If government increases taxes (i.e. self- defeating) it runs the risk of crowding out private spending.

QUESTIONS FOR ACADEMIC INTEREST – FOR STUDENT SELF STUDY

Q.No.17. 'In its allocation role the government acts as a complement rather than as a substitute to the market system in an economy'. Support the sentence with suitable examples? (C) (SM)

The following government interventions do not imply that markets are replaced by government action:

a) The government can provide us with goods and services that we cannot produce on our own or buy at a price from the market.

b) The government establishes property rights and makes the necessary arrangements for enforcing contracts through provision of law enforcement and courts.

c) Goods which involve externalities that are not met by the market require intervention by the government for corrective measures.

d) Merit goods which are greatly beneficial to the society also fall under the purview of provision by the government.

Q.No.18. Support the sentence "The expansionary fiscal policy will be successful only if there is accommodative monetary policy." (B) (SM)(MAY19)

The expansionary fiscal policy will be successful only if there is accommodative monetary policy.

If interest rates rise as a result of increased demand for money but money supply does not rise concurrently, then private investment will be adversely affected.

If interest rates remain unchanged, private investment will not be affected badly and a rise in government expenditure will have full effect on national income and employment.

Q.No.19. What are the measures undertaken in a contractionary fiscal policy? (B) (SM)(MTP-M19)

Measures undertaken by contractionary fiscal policy:

a) The government needs to reduce expenditures or raise taxes only by a small amount because of the multiplier effects such actions.

b) Even as expenditures are reduced, the government may attempt to enhance public revenues in order to generate a budget surplus.

c) In any economy, on account of political, social and defence considerations government spending cannot be reduced beyond a particular limit.

d) The government can change its expenditure in response to inflationary pressures.

Q.No.20. Explain the role of Discretionary fiscal policy in stabilizing the economy. (B)

Discretionary fiscal policy for stabilization:

It refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment and prices. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the quantity and form of borrowing.

Governments may directly as well as indirectly influence the way resources are used in an economy.

This can be explained with the fundamental equation of Gross Domestic Product (GDP), according to expenditures.

GDP = C + I + G + NX (or) GDP = C + I + G + (X - M)

It is evident from the equation that 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.

DIFFERENCES

Q.No.21. Differences between Inflation and Recession Phases of a business cycle. (C)

Inflation(Boom)	Recession
It is an expansionary phase of business cycle	It is a contractionary phase of business cycle
Level of employment, income and general price level increases. Hence excess aggregate demand exits	Level of employment, income and general price level decreases. Hence lesser aggregate demand exits
High taxes are to be levied by the government	Taxes are to be reduced by the government
Government expenditure will be reduced	Government expenditure will be increased
Surplus budget should be prepared	Deficit budget should be prepared
Contractionary fiscal policy is to be implemented	Expansionary fiscal policy is to be implemented

Q.No.22. Differences between Demand side Fiscal policy and Supply side Fiscal policy. (A)

Basis of difference	Demand side Fiscal policy	Supply side Fiscal policy
Scope	Applicable in the **short-run**, to maintain price stability & employment levels	Applicable for **long-run economic growth.**
Focus on	Managing Aggregate **Demand** - to increase demand in case of recession, and to reduce demand in case of Inflation.	Stimulating Aggregate **Supply** in the long-run, to match with increasing Demand, to ensure effective economic growth.
Examples	Expansionary Fiscal Policy in case of recession and Contractionary Policy in case of inflation	• Government spending on Infrastructure, • Govt. providing public goods (Education, R&D, etc.) • Tax incentives for Innovation, Entrepreneurship etc.

Q.No.23. Differentiate Discretionary Fiscal policy and Non-discretionary Fiscal policy. (B)(SM)

Basis of difference	Discretionary Fiscal policy	Non-discretionary Fiscal policy (or) Automatic stabilizers
Definition	These are **deliberate policy actions** by the Government, to change the levels of expenditure and taxes, in order to influence the level of National Output, Employment and prices	These are **'Built-in'** fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle.
Instruments of policy	Expansionary fiscal policy and Contractionary fiscal policy	Personal Income Taxes, Corporate Income Taxes and Transfer Payments

Q.No.24. Expansionary Fiscal Policy Vs. Contractionary Fiscal Policy (A)

Basis of difference	Expansionary Fiscal policy	Contractionary Fiscal policy
When used?	When there is an anticipation of a business cycle contraction	When there is anticipation of a business-cycle expansion which is likely to induce inflation.

Applies to	**Recession / Deflation situation,** i.e. low growth rate, with fall in Aggregate Demand	**Inflation,** i.e. high growth rate with inflation and asset bubbles.
Scenario	• Decline in overall economic activity, • Decline in Real GDP, • Higher rates of unemployment, • Fall in Aggregate Demand	• Increase in economic activities of Consumption and Investment, due to higher levels of Disposable Incomes with Households and Firms, • Level of employment increases • Increase in Aggregate Demand , • Higher Factor Prices with higher cost of production
Gap to be addressed	Recessionary gap	Inflationary gap
Usage of Policy Tools	Aggregate demand increases due to the following: • Lower Personal and Corporate Taxes, • High Government Spending, • Reduction in Government Borrowing, and • Higher Budget Deficit or Reduced Surplus.	Aggregate demand increases due to the following: • Higher Personal and Corporate Taxes, • Reduced Government Spending, • Increase in Government Borrowing, and • Smaller Budget Deficit or Higher Surplus.
Impact	• Higher levels of Disposable income and more Government spending increases the Consumption levels of Households. • Lower Corporate Taxes gives more Income for Firms to increase investment. New Firms are attracted to invest, due to lower taxes. • Higher Consumption and Investment, simulates the economy, and increases Aggregate Demand	• Higher Taxes, lower levels of Disposable income and less Government spending reduces the Consumption Levels of Households. • Higher Corporate Taxes leads to less Net Incomes for Firms, and consequently lower investment. New Firms do not enter the field, due to higher taxes. • Lower Consumption and Investment, regulates the economy, and moderates the unsustainable increase in Aggregate Demand.

Q.No.25. Balanced Budget Vs. Surplus Budget Vs. Deficit Budget (C)

Basis of difference	Balanced Budget	Surplus Budget	Deficit Budget
Net Revenue	Revenue = Expenditure	Revenue > Expenditure	Revenue < Expenditure
Leakages and injections	Leakages = injections	Leakages > injections	Leakages< injections
Effect on aggregate demand	No	Negative	Positive
Prepared during	-	Inflation	Deflation/recession

Q.No.26. Differentiate between Boom, Recession and Depression (C)

Boom	Recession	Depression
It is an expansionary phase of business cycle	It is a Contractionary phase of business cycle	It is a Contractionary phase of business cycle

A boom refers to a period of increased economic activity within either a business, market, industry or economy as a whole	Recession is typically defined as a decline in gross domestic product for a period of time	Depression is a severe and prolonged downturn in economic activity.

TEST YOUR KNOWLEDGE

1. What should be the public revenue and expenditure policy of the government during recession? **(RTP N18)**
2. Illustrate four cases which provide justification for government intervention in markets.
3. Does the market economy automatically generate full employment and price stability?
4. During inflation
   a) What will be the level of utilization of resources?
   b) What does fiscal policy aims at?
5. During deflation
   a) What will be the level of utilization of resources?
   b) What does fiscal policy aims at?
6. Define Fiscal Multiplier.
7. In the process of self-defeating the recession, if government resorts to increase in taxes, what will be its effect on disposable incomes and on aggregate demand.
8. You are the Finance Minister of India. You find that the country is passing through recession. As Finance Minister what suggestions will you make to the Government of India to bring the country out of recession? Justify your answer. **(MTP M18 - 5M)**
9. What is meant by monetization?
10. As a part of fiscal multiplier, from where will the government find resources to increase its expenditure?
11. Summarize the reasons for the rise in aggregate demand?
12. Does the inflationary gap occur because of rise in Aggregate demand or rise in Aggregate supply?
13. What is the impact on all types of incomes during an expansionary phase?
14. What is the impact on amount of transfer payments during an expansionary phase?
15. What is the impact on disposable income available for consumption expenditure during an expansionary phase?
16. Distinguish between Automatic Stabilizers from Discretionary Fiscal Policy.
17. How do built-in stabilizers combat demand-pull inflationary pressures?
18. What are the symptoms of the beginning of a recession?
19. Distinguish between pump priming and the 'compensatory spending'. **(RTP N18, MTP1 N18 - 3M)**
20. Explain the use of fiscal policy for economic growth.
21. The government of Country X, an underdeveloped country, having a severe problem of unemployment of labour embarks on a massive development programme. It has recognized the imminent need for boosting up investments to take the country to a higher than average growth trajectory. The following steps were taken by the government:
    i) Invited tenders for a huge network of highways, solar energy generation, communication systems ad computerized systems

ii) Large number of schools throughout the country

iii) Research grants for universities and private research institutes

iv) Announced a number of free health care programmes for all

v) All citizens assured of social security

vi) Increase in payments under existing social security schemes

vii) Tax exemption limit raised for individuals, instituted progressive taxes with high marginal rates - increased corporate taxes

Very soon prices started spiraling and there was general unrest among people especially the poor.

i) Analyze each of the above measures from a fiscal policy perspective.

ii) Why did overall prices increase?

iii) What policies do you suggest to solve the problem of price rise?

iv) What are the limitations?

22. List any two statements that are intended to control potential rise in prices?

23. Using aggregate demand and supply diagrams, examine the impact of fiscal policy on national output.

THE END