Total demand for all goods and services in the economy

Fiscal Policy

<u>Fiscal Policy</u>: the use of government spending and taxation to influence the aggregate demand curve and therefore the inflation rate, unemployment rate and economic growth of the country.

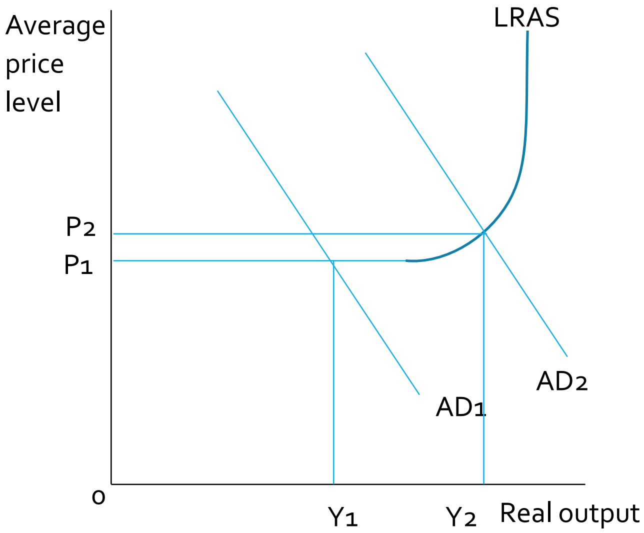
Government spending may involve spending on education, healthcare, defense, agricultural subsidies, transport, infrastructure projects and transfer payments.

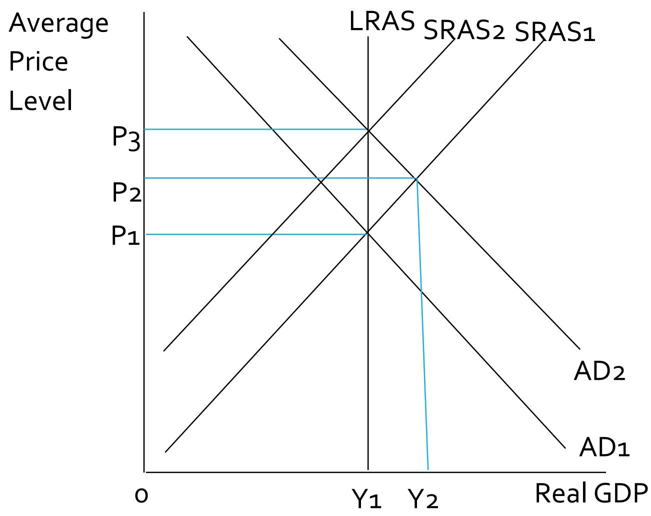
A payment of money from the government without any exchange of goods or services, e.g. state pension, unemployment benefit, child benefit

Government taxation include corporation taxes, payroll taxes, consumption taxes (VAT), income taxes, property taxes, capital gains tax and inheritance tax.

<u>Expansionary/Inflationary fiscal policy</u>: this is used to increase economic growth and decrease unemployment within the economy, however, it may lead to inflation.

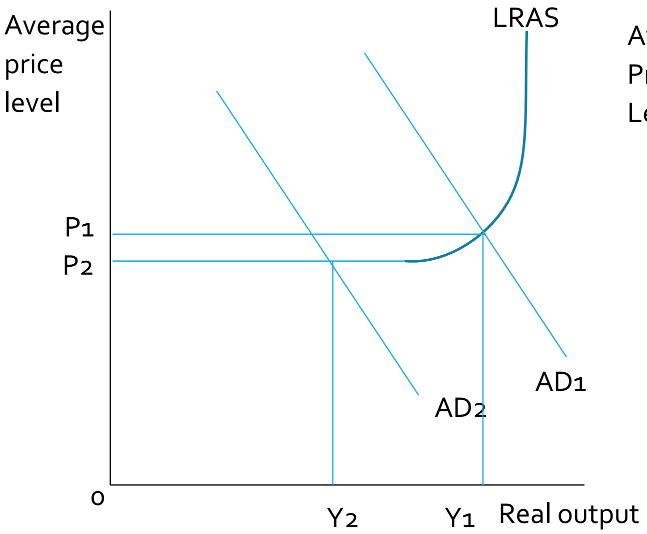
This policy involves an increase in government spending and/or a reduction in taxation in order to increase aggregate demand.

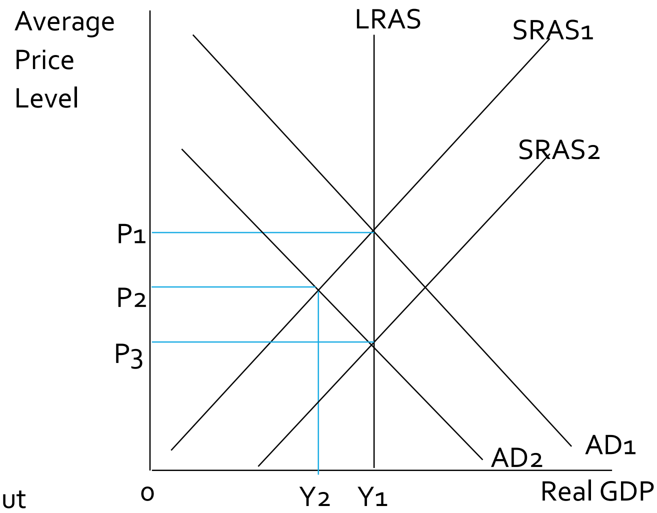




<u>Contractionary/Deflationary fiscal policy</u>: this is used to reduce inflation, however, it may lead to a decrease in the rate of economic growth and an increase in unemployment.

This policy involves a reduction in government spending and/or an increase in taxation in order to decrease aggregate demand.





Evaluation of fiscal policy:

- As government spending is a component of aggregate demand, G will directly influence AD.
- The government can target growth in specific sectors, such as by increasing its spending on subsidies for agriculture
- According to Keynes, the effects of a change in aggregate demand depends on the AD's position on the curve.
- According to Monetarists, any changes in aggregate demand will have purely inflationary/deflationary consequences, without impacting on growth.
- The Keynesian multiplier effect states that the initial spending by the government will have a more than proportional impact on the economy. For example, if the government increases its spending on an infrastructure project then this provides jobs, which increase the average incomes of those employed. These new employees are then able to consume more, which in turn increases aggregate demand and increases the number of employment opportunities. However, a decrease in spending will do the opposite and have a more the proportional effect on the economy.

Multiplier effect

- Crowding out is when an increase in government spending fails to increase aggregate demand because it leads to an equal fall in private spending and investment.

No crowding out	Some crowding out	Complete crowding out

- Government spending may be purely due to political motives, rather than economic ones. For example, in the run up to a general election, governments tend to spend a lot in order to persuade voters to vote for them.
- As the government only meets once a year to establish the budget, it may take a long time to implement such a policy.
- If the lack of economic growth or inflation is due to non-demand side causes, then such a policy will fail to deal with the underlying cause. For instance, if high levels of inflation are due to poor infrastructure then a decrease in government spending could in fact lead to an increase in inflation.