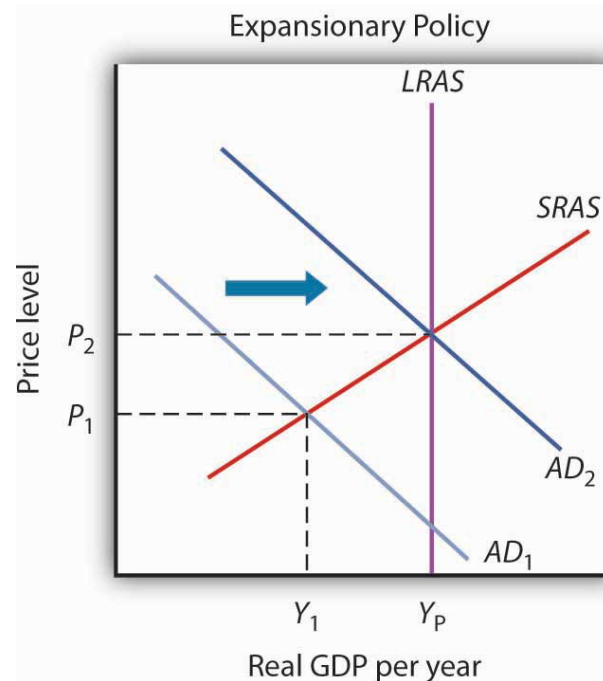


1. Discuss the reasons why the government would use an expansionary fiscal policy stance and with the aid of an appropriate diagram, explain the impact of this stance on the level of economic activity. (12)

Fiscal policy refers to any measures taken by the government to change government expenditure and taxation to achieve the macroeconomic objectives which include; economic growth, price stability and full employment. An expansionary fiscal policy stance is taken up the government to stimulate an economy performing below it's potential level of economic activity. An economy performing below its potential level would have high cyclical unemployment with unemployment levels being above the desired rate of 5%. Inflation rates would be below the target of 2-3%. These factors influence economic activity and prevent the government from being able to reach its macroeconomic objectives.

It is ideal for the government to run an expansionary budget in order to stimulate spending when in a period of low economic activity. Ways for the government to stimulate household and business spending include; reducing income tax to increase household purchasing power, cutting business tax to stimulate business business spending on inputs, employment and investment and increasing government spending on infrastructure such as transport. An expansionary policy stance is usually associated with a budget deficit where planned government expenditure is higher then expected revenue.

The impacts of an expansionary fiscal stance can be seen on the following diagram.



The impacts of an expansionary stance on economic activity would cause Y_1 to shift to Y_p , moving the economy towards its potential level of economic growth. This is due to the government increasing its discretionary spending in different sectors of the economy such as the manufacturing industry. An expansionary policy stance would cause the AD curve to shift to the right from AD_1 to AD_2 . An expansionary Fiscal Policy Stance would increase the government's ability to reach its macroeconomic objectives such as full employment. With the government increasing spending on infrastructure and cutting corporate tax it allows businesses more funds to spend on employment as well as creating employment opportunities through investment on infrastructure. This causes cyclical unemployment to decrease and the unemployment rate to fall to around 5%. The increased number of employed individuals also increases the cash flow of an economy and stimulates it as consumer confidence will increase, causing consumption levels to increase.

An expansionary stance encourages the achievement of the macroeconomic objective of price stability as it causes inflation to go between the targeted range of 2-3%. When the economy is in a contractionary gap despite inflation being low (P1) households are more inclined to save than spend due to the low economic activity. Controlling inflation is an extremely important economic objective as sustained price increases reduce the purchasing power of households and firms. The impact of an expansionary fiscal policy stance on inflation can be seen in the diagram with price levels shifting from P1 to P2.

An expansionary fiscal policy stance boosts aggregate demand, which as a result increases output and employment in the economy. The government increases spending and/or reduces taxes. Government spending is one of the components of aggregate demand, an increase in government spending will shift the demand curve to the right (AD1 to AD2). Aggregate demand is made up of consumption, investment, government spending, and net exports. The aggregate demand curve will shift as a result of changes in any of these components. A reduction in taxes will leave more disposable income and cause consumption and savings to increase. The extent of the shift in the AD curve due to government spending depends on the size of the spending multiplier, while the shift in the AD curve in response to tax cuts depends on the size of the tax multiplier. There is a multiplier effect that boosts the impact of government expenditure.

An expansionary fiscal policy stance can potentially impact aggregate supply as the stance is expected to increase total output because of an increase in aggregate demand. If the government reduces taxes individuals and businesses will use their tax savings to buy more goods and services.

2. Compare and contrast three time lags that occur with fiscal policy and monetary policy. (8)

There are three time lags that occur within both Fiscal and Monetary Policy. These three time lags are recognition, decision and impact. Both the recognition and decision time lag are considered to be inside time lags with the impact lag being considered an outside lag. These three lags interact differently with both Fiscal Policy (the use of government revenue collection and expenditure to influence the economy) and Monetary Policy (involves using interest rates to influence aggregate demand, employment and inflation in the economy. It is one of the main economic **policies** used to stabilise business cycles.). Fiscal policy has an overall long inside lag and a short outside lag while monetary policy has a short inside lag and long outside lag,

Recognition lag is the time lag between when an economic shock, such as sudden boom or trough occurs, and when it is recognised by economists, the RBA and the government. The recognition lag occurs because the economic indicators that provide data about economic performance often lag the current trends, this causes policy makers to be unaware of an event till after it happens and be unsure about where the economy lies in relation to the business cycle. Both Monetary and Fiscal Policy suffer a long recognition lag due to the time it takes to collect economic data from the indicators.

The decision lag refers to the time that passes whilst an appropriate policy/response is created to combat any economic problems. Monetary policy has a short decision lag as the Reserve Bank of Australia (RBA) conducts monthly meetings and are able to implement changes without government interference. Through monetary policy the RBA is able to make changes they deem necessary to the cash rate in response to the state of the economy. Since 2016 the RBA has kept the cash rate at 1.5%. Fiscal Policy however, has a long decision time lag as the government budget is prepared/released annually. Fiscal policy budget proposals also have to be agreed on by both houses of parliament which predominantly is an extremely long process. Fiscal policy has a long decision lag as the government can only release the budget annually, in contrast monetary policy has a short decision lag as they are able to change the cash rate on a monthly basis.

The time it takes for the policies/measures implemented by both Monetary and Fiscal Policy to have an effect on households and businesses/economic activity is known as the impact lag. The length of the impact lag is affected by the speed of the multiplier process. For example if taxes

were cut households would have more disposable income if households/firms chose to spend their increase in income consumption spending would rise, resulting in further increases in income which causes further change in consumption and rises in output/production levels as firms react to higher orders. The impact lag for monetary policy is longer than fiscal policy as monetary policy works indirectly through interest rates to affect the level of aggregate demand. It is estimated that changes in interest can take up to more than 18 months to take effect. This is because even though rates would be reduced it would take time for banks to pass these rates onto customers. In contrast fiscal policy has a short impact lag as it is direct and revenue and spending measures announced in the annual budget can be implemented immediately and they unlike monetary policy they don't need to wait for households or firms to respond to the change.