What is Fiscal Policy?

Worksheet

Fiscal policy is the use of government taxes and spending to influence aggregate demand and economic growth. Expansionary fiscal policy increases spending or cuts taxes; contractionary policy does the opposite.

Questions

1. Fiscal policy operates through…

A) Interest rates
B) Aggregate demand
C) Money supply
D) Exchange rates

2. If government increases spending by $80B with a multiplier of 2, GDP will increase by:

A) $80B
B) $160B
C) $40B
D) $320B

3. A recession requires which fiscal policy?

A) Raising taxes
B) Cutting spending
C) Expansionary (higher G or lower T)
D) Contractionary

4. The fiscal multiplier is typically greater than 1 because…

A) Government never changes taxes
B) Increased spending creates more jobs and incomes
C) Money loses value
D) Output is always constant

5. Government increases spending on infrastructure by $100B. If the multiplier is 2, what is the total GDP effect?

6. During a recession with 8% unemployment, should fiscal policy be expansionary or contractionary?

7. The government cuts taxes by $50B. If the tax multiplier is 1.5, what is the GDP impact?

8. Define: What is fiscal policy?

9. Define: What are the main tools of fiscal policy?

10. Define: What is the fiscal multiplier?

Answer Key

1. B) Aggregate demand — Fiscal policy changes government spending and taxes, shifting aggregate demand.

2. B) $160B — Total = 80B × 2 =160B.

3. C) Expansionary (higher G or lower T) — Higher spending or lower taxes boost AD during recessions.

4. B) Increased spending creates more jobs and incomes — Spending ripples through the economy as workers and businesses spend their incomes.

5. ΔG = 100B (spending increase) Multiplier = 2 Total impact = ΔG × Multiplier =100B × 2 = 200B GDP increases by200B

6. Recession → need to boost AD and employment Expansionary fiscal policy Increase G or cut T (taxes) AD shifts right, output and employment rise

7. ΔT = −50B (tax cut) Tax multiplier = 1.5 Total GDP effect = ΔT × Tax Multiplier = −50B × 1.5 = −75B But the sign: lower taxes increase income, so GDP ↑75B

8. Government use of taxes and spending to influence aggregate demand and economic growth.

9. Tax changes and government spending adjustments.

10. The ratio of change in GDP to an initial change in spending or taxes — typically 1.5–2.5.