

5 With the use of fiscal policy to reduce cyclical fluctuations, some economies like the USA, have been improving steadily despite facing fiscal drag.

(a) Explain why governments aim to reduce cyclical fluctuations. [10]

(b) Discuss the extent to which fiscal drag limits the effectiveness of using fiscal policy in managing cyclical fluctuations in an economy. [15]

Reasons:

1. Better for governments to predict economic outcomes and come up with/formulate suitable economic policies.
2. Be attractive to foreign firms (FDI) and they can make better investment and output decisions.
3. Consumer confidence level on the economy (during boom may have over-stated confidence on the economy, bust need to restore confidence ,, people are not rational and relies too much on animal spirit)
4. Consumers and producers may face unanticipated inflation during boom time incur negative consequences.
5. Consequences of high unemployment when there is a bust.
6. Smooth out cyclical fluctuations to achieve stable and sustainable economic growth otherwise might have negative consequences.

Level	Descriptor	Marks
3	For an answer that has well developed and detailed analysis of at least 3 reasons why different governments aim to reduce cyclical fluctuations.	7-10
2	For an under developed answer that contains brief explanation why governments aim to reduce cyclical fluctuations.	5-6
1	For an answer that contains conceptual errors or just smattering of some valid points.	1-4

## Part b

Introduction:

State the stand or consider other factors that will limit the use of fiscal policies besides fiscal drag (such as crowding out effect, size of multiplier, current govt/public debt issue faced) which will limit the effectiveness of FP.

Body:

Explain that government may use expansionary FP (increase G, reduce T) to smooth out the cyclical fluctuations → AD increases to reduce the negative impact of recession.

Explain how non-discretionary FP (automatic stabilizers) will result in fiscal drag and reduce the effectiveness of FP (eg fall into higher income tax bracket thus pay more tax and do not receive unemployment benefits, resulting in disposable household Y lesser, impact of the expansionary FP is limited)

- Provide judgment on the extent to which limiting the effectiveness depends on the amount of tax. Eg some countries have high taxes and high unemployment benefits.

Explain and discuss how other factors and the extent to which it will limit the effectiveness of FP.

1. Size of multiplier (big and relatively closed economy vs small and open economy)
2. Financial crowding out effect (availability of funds of the government whether it is in high public debt and has past reserves to tap on) High debt countries vs countries with accumulated past reserves.

Conclusion: Give a valid judgment

Level	Descriptor	Marks
3	For an answer that is well developed on the extent of fiscal drag and other factors that may result in limiting the effectiveness of using fiscal policies to reduce cyclical fluctuations.	9-11
2	For an answer that is under developed but contains some analysis and discussion on the extent of how fiscal drag and other factors that will limit effectiveness of using fiscal policy to reduce cyclical fluctuations.	6-8
1	For an answer that contains conceptual errors and smattering of valid points.	1-5

Evaluation:

Allow up to 4 additional marks for Evaluation		
E2	For a valid evaluation and judgement that are well justified.	3-4
E1	For an unexplained judgment or one that is not supported by analysis.	1-2