**(a) Explain what could restrict the effectiveness of fiscal policy as a tool to stimulate stagnating economies. [10]**

Fiscal policy is the policy that manipulates government spending and tax rates to achieve various macroeconomics goals. A stagnating economy can be seen from slow growth. To stimulate stagnating economies, expansionary fiscal policy through the use of increased government spending and tax cuts is the policy that most governments would adopt. Yet, there are factors which could limit the effectiveness of the expansionary fiscal policy and we shall examine these factors in this essay.

Fiscal policy is used as a tool to stimulate a stagnating economy as it has the ability to raise actual growth. The most direct method of increasing actual growth is through the increase in aggregate demand (AD) . The increase in government spending in an expansionary fiscal policy will increase AD through the multiplier effect which results in actual growth as seen from the increase in real GDP. The multiplier effect takes place when there is an increase in autonomous spending (in this case government spending) which will create additional rounds of spending in other AD determinants such as consumption, investment and exports until the initial injection is consumed. Similarly, the reduction in taxes, will increase firms’ after-tax profits, making firms more willing and able to invest while consumers will see an increase in purchasing power which will increase their willingness and ability to consume. Hence, both the increase in investment and consumption will result in an increase in AD and real GDP through the multiplier effect.

Furthermore, fiscal policy can also increase the potential growth of the economy. This is done through the infrastructure developments funded by government spending and through increased investments into R&D by firms. Infrastructure developments will increase the efficiency of the flow of the factors of production, while R&D will increase the productive efficiency. Both of which will increase the production capacity and lower the cost of production which is observed from the increase in aggregate supply. This will increase production capacity and address a stagnating economy that is due to the economy reaching full employment.

Yet, there are many factors which inhibit the effectiveness of an expansionary fiscal policy which is crucial for governments to consider.

The first factor would be the size of the multiplier. A small multiplier would limit the increase in AD, as the subsequent injection and rounds of spending from the multiplier process depends on the size of the multiplier to determine the size of the injection and the number of rounds. This will limit the increase in AD which limits the increase in the actual growth. This is prevalent in countries with a high marginal propensity to save such as Singapore as the size of multiplier is inversely related to the extent of the marginal propensity to save. Hence, the small size of multiplier in Singapore would make fiscal policy a poor policy to drive AD growth due to its limited effectiveness.

Second, high public debt or a lack of government budget will limit the extent of fiscal policy that the government can take. Expansionary fiscal policy sees the increase in government spending which increases government expenditure while the reduction in taxes will result in a fall in government revenue. The net result would be an increase in budget deficit in which countries without adequate reserves or budget surplus would incur opportunity cost. Such opportunity costs could be seen from the reduction of government services such as subsidies on education or healthcare. Hence, governments might choose not to implement the best possible fiscal policy but rather a more limited version suited to their financial situations, which would correspondingly limit the effectiveness of the policy.

Third, high government corruption could also limit the effectiveness of the policy as such policies require careful planning and constant implementation. Fiscal policy consists of an increase in government spending and tax cuts, which potentially could be exploited in a corrupted government. Government contracts to companies with dubious links to politicians or tax cuts to companies who politicians have a stake in are some of the potential forms of corruption that could threaten the effectiveness of the policy. Instead of the funds going to investments and improvements in the flow of production, it is instead funneled to support the system of crony capitalism, greatly limiting the fiscal policies ability to increase both actual and potential growth.

Furthermore, the crowding out effect is a serious threat to the effectiveness of the fiscal policy in dealing with a stagnating economy as it may undermine investments as a driver of growth. Crowding out effect takes place since the increase in government spending could reduce the capital available for private investments, which means that the increase in government spending is met with an equal or greater fall in investments. This would not only limit the increase in AD, but also limit the effectiveness in tax cuts as the increased propensity to invest is not followed by the increased availability of funds to invest. Hence, the impacts of fiscal policy could be limited by the crowding out effect.

Also, the phenomenon of fiscal drag would limit the growth of AD through the dampening of consumption due to consumers seeing an increase in taxes because of the fiscal policy. The effects of increase in government spending and the following increase in actual growth could result in consumers seeing an increase in income to the point where they would be placed in a new tax bracket. This could dampen consumption as consumers experience an increase in taxation without the increase in tax rate. As a result, this will lower the consumers purchasing power and reduce their propensity to consume, limiting the increase in AD and real GDP.

The most important factor that limits the effectiveness of fiscal policy would be the factors that prevent the adoption and implementation of the fiscal policy. Even though the policies of crowding out and fiscal drag exist, the overall effects of the shift in AD and AS will result in some potential and actual growth. However, the lack of funds or the presence of corruption will completely negate the implementation of such fiscal policy.

In conclusion, fiscal policy can be a particularly useful tool to address a stagnating economy. However, careful planning is needed as governments should consider the potential factors that would limit the effectiveness of the policy such as the size of multiplier, their budgetary requirements, crowding out effect and fiscal drag. These factors can be mitigated and avoided with proper planning and policies.