**Economics CSQ – Chapter 5 – Role of Government in an Economy – Aims of Government; Fiscal, Monetary and Supply-side Policies – Q2**

**The Asian Development Bank meets in Indonesia**

In 2009, the Asian Development Bank, representing 67 member countries, held its annual meeting in Bali, Indonesia. It warned that 61 million people in Asia would remain trapped in extreme poverty because of the global downturn and that this figure could double if slow growth continued for the next few years.

It reported that many governments in Asia, especially those in Japan, South Korea and China, were using fiscal policy to try to stimulate economies in the region. The Japanese Finance Minister stated that, ‘the Asian region needs to increase domestic demand to avoid economic downturn.’ Public spending on health care and state benefits, for example, could be a crucial step to boosting confidence and reducing the human cost of such an economic downturn.

Some observers at the meeting, held at an international convention centre surrounded by five star hotels, commented that these luxury hotels provided a clear contrast to the poverty experienced throughout Asia. More than 900 million people in Asia live on US$1.25 or less a day.

1. Define fiscal policy. [2]
2. Explain how fiscal policy could be used to increase domestic demand. [4]
3. Explain how taxation would affect the economy? (8)
4. Explain how indirect tax like GST would affect these Asian Economies (6)

**Suggested Answers**

**(a) Define fiscal policy. [2]**

Fiscal policy is a government policy that involves the variation of government expenditure and taxes to affect the level of economic activity in an economy to achieve certain macroeconomic objectives.

**(b) Explain how fiscal policy could be used to increase domestic demand. [4]**

Identify the type of fiscal policy used to increase domestic demand

The government has to conduct expansionary fiscal policy, which involves an increase in government expenditure and tax reduction, so as to increase domestic demand.

Explain how the increase in government expenditure can raise domestic demand

The increase in government expenditure would raise aggregate expenditure through infrastructural development and the provision of public services, such as the setting up of public hospitals and heathcare services. Consequently, the increase in labour productivity would raise production, resulting in an increase in aggregate demand. Hence, expansionary fiscal policy can increase domestic demand.

Explain how tax reduction can raise domestic demand

Tax reduction would increase disposable income, contributing to higher domestic consumption and return on investment due to lower tax on corporate earnings, such as lower corporate tax. Consequently, higher investment and consumption expenditure will raise aggregate expenditure and domestic demand.