

5. 'Fiscal policy can be used to influence the circular flow of income to achieve economic growth'

- (a) Explain this statement. [10]
- (b) Assess alternative policies that might be more appropriate for the Singapore economy to achieve economic growth. [15]

Synopsis

Answers should explain how expansionary FP can be used to influence the component of the circular flow (C,I,G,X,M,S,T) such that National Income increases. Answer should include the idea of the multiplier.

1. Intro

a. Explain the circular flow of income :

The term **circular flow of income** refers to an economic model which describes the circulation of income between entities in the economy namely Firms, households, government and the external sector. In summary it is a model that depicts how money flows through the economy. Increased Injections raises the circular flow of income and hence Y (national income) whereas Increased withdrawals reduces the circular flow of income and hence reduces Y. The components in the circular flow are : C,I,G,X-M, savings and taxes.

2. Explain How expansionary FP is carried out

FP involves the adjustments of gov't revenue and expenditure to influence economic activities. In order to achieve economic growth, expansionary FP is conducted. Expansionary FP involves the increase in gov't expenditure and the reduction in gov't revenue (e.g Taxes). Hence expansionary FP increases injections as well as reduces withdrawals to raise Y

3. Details of expansionary FP

a. Raising government expenditure and the circular flow

Gov't expenditure consist of expenditure on goods and services as well as transfers.

- i. In raising the gov't expenditure on goods and services, the G component of the circular flow rises and leads to a rise in Y (Draw AS/AD and show). The rise in Y is influenced by the multiplier. {Briefly (very) explain how the multiplier process works.} Do include the formula, $\Delta Y = k \times \Delta AD$
- ii. Increase transfers towards households (e.g unemployment benefits and rebates) raises the disposable income of the households and hence autonomous C. This also raises the C component of the circular flow of income and again via the 'k' process raises Y

b. Lowering gov't revenue and the circular flow

Expansionary FP can also be conducted via reducing tax rates.

- i. Lowering corporate taxes (i.e. reducing withdrawals) increases profits and hence raises the incentive to invest due to the higher returns. This raises the I component of the circular flow of income and hence increases Y via the 'k' process
- i. Similarly, reductions in personal income taxes, raises disposable income and hence raises the C component of the circular flow. This like all other components of AD raises Y via the 'k' process.

4. Conclusion : Expansionary FP and economic growth

Expansionary FP impact on economic growth hinges on the size of the multiplier which is dependent on the mpw in the economy (Give formula). The higher the mpw, the lower the magnitude of k. In countries like Singapore that has high mpw mainly due to its high mps which arises from its compulsory saving scheme (CPF), the impact of expansionary FP on economic growth is limited.

Suggested Marking Scheme

Level	Descriptors	Marks
L3	Clear explanation that links expansionary FP to the circular flow and economic growth with emphasis on <u>both</u> raising gov't expenditure <u>and</u> lowering of gov't revenue.	7-10
L2	Clear Explanation attempting to link expansionary FP to the circular flow and economic growth but deals with <u>either</u> raising gov't expenditure <u>or</u> lowering of gov't revenue.	5-6
L1	Superficial links between expansionary FP and economic growth.	1 – 4

- (b) **Assess alternative policies that might be more appropriate for the Singapore economy to achieve economic growth.** [15]

Synopsis

Answer requires explanation of a policy other than FP that is more appropriate to achieve economic growth in SINGAPORE. The policy chosen should take into account the characteristics of the Singapore economy in terms of its 'openness and its smallness' or even based on its multiplier size. If the latter is considered then supply side policy seems more appropriate. Care should be taken to explain the use of SS side policy without the use of FP. Exchange rate policy should be discussed with reference to Singapore due to the characteristic of a small and open economy.

1. Intro

Explain some characteristics of the Singapore economy.

- Small - small domestic market as well as lacks natural resources hence its reliance on the world
- Open – Trade (X+M) accounts for almost four times of its GDP
- High mpw and hence low size of 'k'

2. Exchange Rate Policy : DD side analysis

- Why is Exchange rate policy appropriate?
Based on Singapore being small and open exchange rate policy would be appropriate. Key function of ERP is to alter prices of X and M. The changes in the price of X and M can influence both AS and AD and hence affect economic growth.
- How is it conducted?

Depreciation of the S\$ and impact on AD

- Selling of S\$ in the exchange rate market lowers the external value of the S\$ in terms of foreign currency. (Draw exchange rate mkt and show depreciation)
- This lowers price of X and raises the price of M.
- Assuming $PED_x > 1$ (justify), X_{rev} will rise. (Draw and show!)
- Assuming $PED_m > 1$ (justify), M_{expd} will fall. (Draw and show!)
- Net X will rise and hence through the 'k' process Y rises (Draw it)
- In addition the depreciation of the S\$ makes it relatively cheaper for foreigners to invest in Spore. This may lead to rising FDI.

➤ **Limitation**

- *The J-curve effect!*

In the SR, PED for X and M is less than 1 (explain). Hence Net X will initially worsens before improving (Draw the J-Curve). Hence the economy contracts initially before expanding

- *Reliance on imported raw material*

Being small, Spore relies heavily on imported raw material. The lower external value of the S\$ raise cost of production due to the more expensive raw material. This causes AS

to fall (Y_f remaining unchanged). Not only does it raises GPL as well as price of X. (Draw AS-AD). There would be a fall in Y. Hence whether or not Y increases would depend on the magnitude of shift of AD and AS (elaborate).

3. Non FP : SS side policy (Chose ONE to TWO and explain; providing limitation)

Due to the low size of 'k', SS side policies can be used to achieve growth. The SS side policy can be used to either reduce the cost of production or raise the productive capacity.

- a. Reducing cost of production.
 - Lowering employer's CPF contribution rates
 - Releasing more land for commercial purposes – lowers rental cost
 - Relaxing immigration policies lowers wage cost due to the ability to obtain relatively cheaper labour.
 - Appreciating the S\$. (reduces the cost of imported raw material)
- b. Raising productive capacity
 - Relaxing immigration policies
 - Reducing barriers to entry in industries such as telco and banking will attract FDI.

4. Conclusion : Which is MORE appropriate?

i) FP has supply side implication and hence it is by no means limited by the size of the multiplier.

Examples of FP with SS side implications :

- Lowering of corporate tax
This raises I and hence in the long term productive capacity is improved. This allows for sustainable growth. (Draw and show)
- Gov't expenditure on Infrastructure
Development of infrastructure such as road networks as well as R and D facilities raises both productivity and attract investments.
- Gov't subsidy on training and education
Helps to improve the quality of labour and hence productive capacity

ii) FP has its limitation too (e.g crowding out effect, strain on government budget etc)

Singapore gov't has employed FP mainly to ensure sustainable growth while maintaining its use of ERP to adjust the economy from external shocks. No one policy is superior and the role they play is crucial in achieving a stable and sustainable growth.

Level	Descriptors	Marks
L3	Detailed and well explained answers that explain alternate policies in the context of Singapore. Answers should also deals with the term 'more appropriate' and makes valid comparison between the alternate policy and FP.	9-11
L2	Clear explanation of alternate policies in achieving growth but does not consider the context of Singapore.	6-8
L1	Answers that superficially deals with policies other than FP to achieve growth.	1-5
E2	Clear explanation on the effectiveness of policies discussed with reference to its ability to achieve econ growth or other economic repercussion.	3-4
E1	Superficial evaluation on the limitation of policies.	1-2