Chapter : Fiscal Policy

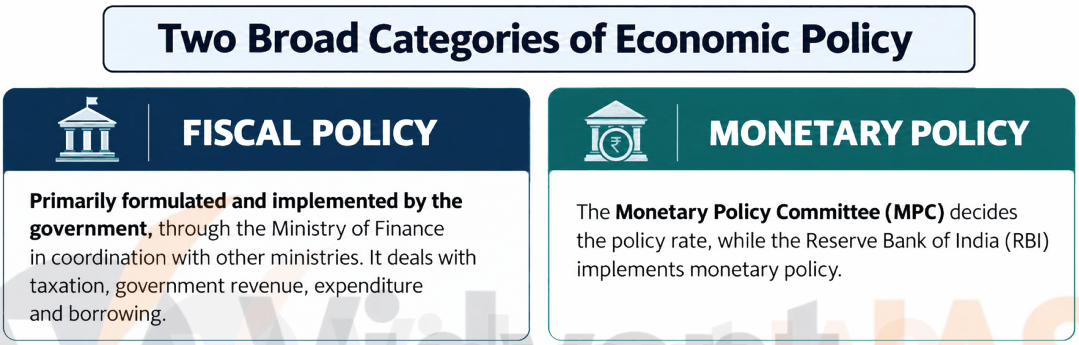
A. UNDERSTANDING FISCAL POLICY

Introduction:

Why Are We Studying Fiscal Policy?

The government collects money through taxes, spends it on public services and development activities, and may also borrow money to meet its financial requirements. These decisions influence various aspects of the economy, such as inflation, employment and economic growth. **Fiscal policy helps us understand how the government uses taxation, public expenditure and borrowing to manage and influence the economy.**

Two Broad Categories of Economic Policy



What Is Fiscal Policy?

DEFINITION

Fiscal policy refers to the government's use of **taxation, public expenditure and borrowing** to influence economic activities and achieve economic objectives.

The three key instruments of fiscal policy are:

- **Taxation** — Revenue collected by the government from individuals and businesses. Example: income tax and GST.
- **Public Expenditure** — Money spent by the government on public services and development. Example: building roads, railways and hospitals.
- **Borrowing** — Money raised by the government when receipts are insufficient to meet expenditure. Example: borrowing from the market to finance infrastructure.

Illustration:

How Does Fiscal Policy Work?

An economy may face challenges such as slow economic growth, unemployment and high inflation. The government can use fiscal policy to respond to these challenges.

CASE 1 | SLOW ECONOMIC GROWTH & HIGH UNEMPLOYMENT

The government increases spending on highways, railways and infrastructure projects and reduces income tax rates. This generates construction jobs, increases people's purchasing power and encourages private investment.

CASE 2 | HIGH INFLATION

The government increases taxes on certain goods and reduces expenditure on non-essential projects. This reduces people's purchasing power and overall demand, helping to ease inflationary pressure.

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Key Takeaways

OBJECTIVE	To achieve economic growth, generate employment and maintain price stability.
HOW IT WORKS	Fiscal policy influences economic activities like production, consumption, trade, investment, etc. in the economy.
KEY TOOLS	Fiscal policy tools like taxation, public expenditure etc. help achieve the above objectives.

UPSC Prelims Practice

With reference to fiscal policy, consider the following statements:

1. It involves the use of government taxation, expenditure and borrowing to influence economic activity.
2. It is primarily formulated and implemented by the central bank to regulate money supply and credit conditions.
3. It can influence aggregate demand, resource allocation and income distribution in an economy.

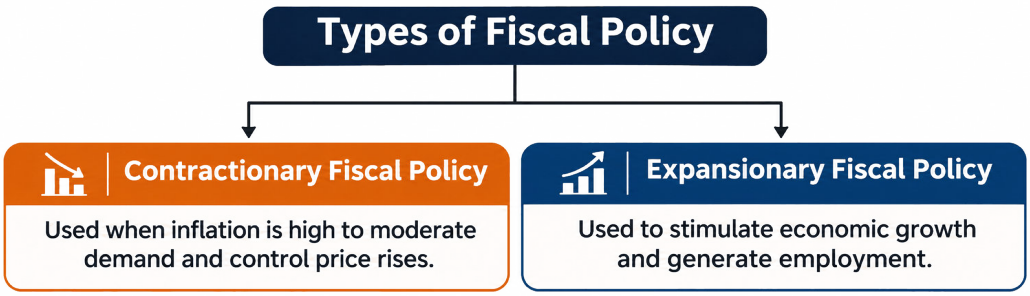
Which of the statements given above are correct?

(a) 1 and 2 only
(b) 1 and 3 only
(c) 2 and 3 only
(d) 1, 2 and 3

B. TYPES OF FISCAL POLICY

Introduction:

Fiscal policy can be broadly classified into two types based on the economic conditions prevailing in the country. The government uses taxation and public expenditure to influence the level of economic activity. Depending on whether the government aims to stimulate economic activity or moderate excessive demand, **fiscal policy is classified into Expansionary Fiscal Policy and Contractionary Fiscal Policy.**



(i) Contractionary Fiscal Policy

Contractionary Fiscal Policy refers to a government policy aimed at reducing aggregate demand in the economy to control inflationary pressures. It involves reducing government expenditure and/or increasing taxes, thereby lowering overall spending and moderating economic activity.

Illustration:

How Can Fiscal Policy Control Inflation?

Imagine people across the country start buying more cars, smartphones and other electronic goods. Demand rises, and prices begin to increase rapidly.

To control inflation, the government reduces spending on public projects or increases taxes. This reduces overall spending in the economy, moderates aggregate demand and helps stabilize prices.

KEY IDEA: Lower public expenditure or higher taxes can help control demand-driven inflation.

Key Takeaways

OBJECTIVE	To reduce aggregate demand and control inflation.
WHEN USED	When excessive demand leads to a rapid rise in prices.
TOOLS	1. Reduction in government expenditure (G ↓) 2. Increase in taxes (T ↑)

(ii) Expansionary Fiscal Policy

Expansionary Fiscal Policy refers to a government policy aimed at increasing aggregate demand to promote economic growth and generate employment. It involves increasing government expenditure and/or reducing taxes to encourage consumption, investment and overall economic activity.

Illustration:

How Does Expansionary Fiscal Policy Work?

Imagine businesses are receiving fewer orders, production is slowing, and unemployment is rising.

To revive the economy, the government increases spending on public projects or reduces taxes. This creates jobs and leaves people with more money to spend, boosting demand for goods and services.

EXPECTED OUTCOME: Higher demand → More production and jobs → Economic recovery

Key Takeaways

OBJECTIVE	To increase aggregate demand, promote economic growth and generate employment.
WHEN USED	When economic activity is weak, demand is low and unemployment is high.
TOOLS	1. Increase in government expenditure (G ↑) 2. Reduction in taxes (T ↓)

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UPSC Prelims Practice

Consider the following statements regarding contractionary and expansionary fiscal policies:

Assertion (A): An increase in government expenditure accompanied by a reduction in taxes is likely to increase aggregate demand in the economy.

Reason (R): Expansionary fiscal policy increases aggregate demand by increasing the disposable income of households and directly increasing demand through government spending.

Select the correct answer using the code given below:

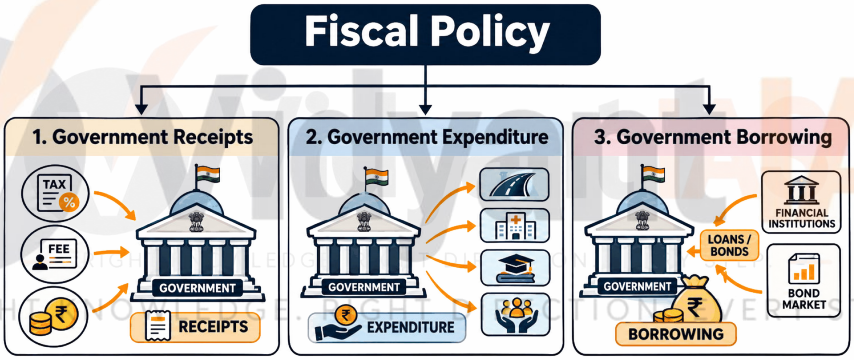
(A) Both A and R are correct, and R is the correct explanation of A.
(B) Both A and R are correct, but R is not the correct explanation of A.
(C) A is correct, but R is incorrect.
(D) A is incorrect, but R is correct.

C. THREE MAJOR COMPONENTS OF FISCAL POLICY

Introduction:

Fiscal policy has three major components:

Fiscal policy has three major components through which the government **manages the economy: government receipts, government expenditure, and government borrowing.** These components determine how the government mobilizes financial resources, allocates them for public welfare and development, and finances any shortfall in its expenditure.



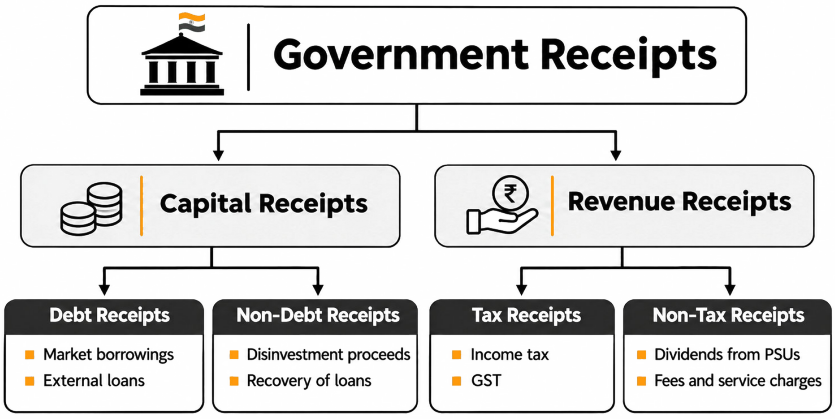
1. **Government Receipts:** Money received by the government through taxes, fees, fines, dividends, and other sources. These receipts help the government meet its expenditure.
2. **Government Expenditure:** Money spent by the government on public services, infrastructure, defense, education, healthcare, and welfare schemes.
3. **Government Borrowing:** Money borrowed by the government when its receipts are insufficient to meet its expenditure. Borrowing helps the government finance its fiscal deficit.

In simple words: Government receipts are the money received, government expenditure is the money spent, and government borrowing is the money raised to meet the shortfall.

1. Government Receipts

Understanding Government Receipts

Government Receipts refer to the money received by the government from various sources to finance its expenditure and carry out its activities. **These receipts are broadly classified into two categories: Revenue Receipts and Capital Receipts.**



(i) Capital Receipts

Capital Receipts are those **receipts that either create a repayment obligation (liability) for the government** or **lead to a reduction in its financial assets.** In simple terms, these include money raised through borrowings and money received by selling assets or recovering loans given earlier.

a. Debt-Creating Receipts

These receipts create a liability for the government because the borrowed money has to be repaid in the future. The examples include market borrowings (government bonds), loans from the World Bank and Asian Development Bank (ADB), and other external loans.

Illustration:

How Does Government Borrowing Create a Liability?

Suppose the government borrows ₹1,000 crore from the market to build highways. It can use this money to improve transport and support economic activity. However, the borrowed amount must be repaid along with interest.

KEY IDEA: Government borrowing provides funds today but creates a repayment obligation for the future.

b. Non-Debt-Creating Receipts

These receipts do not create any liability for the government but reduce its existing financial assets. The examples include proceeds from disinvestment (sale of government shares in PSUs) and recovery of loans previously given by the government to states, public sector enterprises and other institutions.

Illustration:

How Does Disinvestment Work?

Suppose the government sells its shares in a public sector enterprise for ₹500 crore. It receives money from the sale, but its ownership in the company decreases. Thus, the government raises funds by selling part of an asset it owns.

KEY IDEA: Disinvestment generates funds by reducing the government's ownership of an asset.

(ii) Revenue Receipts

Revenue Receipts are the regular income received by the government through sources such as taxes, fees, fines, penalties, dividends and interest. These receipts neither create any repayment obligation for the government nor lead to a reduction in its existing assets.

a. Tax Revenue

Money received by the government through taxes imposed on individuals and businesses. The examples include Income Tax, Corporate Tax, Goods and Services Tax (GST), Customs Duty and Excise Duty.

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Illustration:

Tax Payments as Government Revenue

Suppose a person pays ₹20,000 as income tax and a company pays GST on its taxable sales. The government receives this money to fund public services such as education, healthcare, defense, and infrastructure. **These tax payments do not create a repayment obligation for the government or reduce its assets.**

b. Non-Tax Revenue

Money received by the government from sources other than taxes. The examples include dividends and profits from Public Sector Undertakings (PSUs), fees, licence charges, fines, penalties and interest receipts.

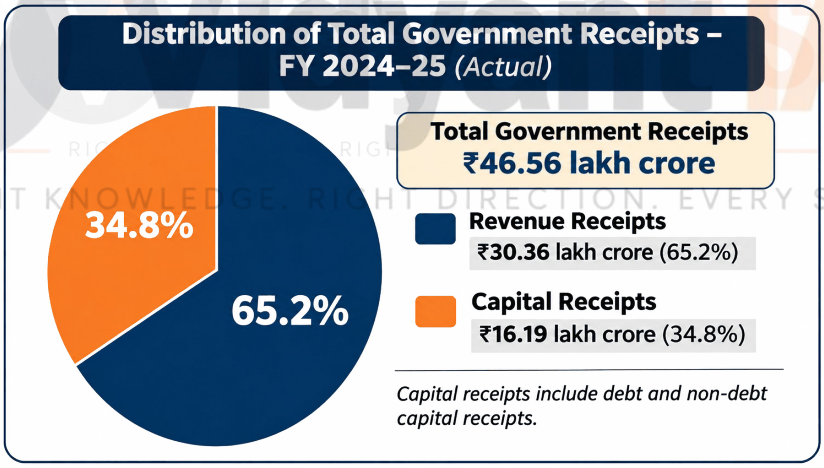
Illustration:

Non-Tax Payments as Government Revenue

Suppose a government department collects ₹5,000 as an application fee or the government receives dividends from a PSU. These amounts become non-tax revenue and can be used to finance public expenditure without requiring the government to return the money or sell its assets.

Key Differences

BASIS	CAPITAL RECEIPTS	REVENUE RECEIPTS
Nature	Create a liability or reduce assets	Neither create a liability nor reduce assets
Types	Debt-creating and non-debt-creating	Tax revenue and non-tax revenue
Examples	Government borrowing, recovery of loans, disinvestment	Income tax, GST, dividends, fees



Key Takeaways

KEY POINT	The main difference between capital receipts and revenue receipts is their effect on the government's liabilities and assets.
CAPITAL RECEIPTS	Capital receipts either **create a liability** or **reduce assets,** whereas revenue receipts do neither.
REVENUE RECEIPTS	Revenue receipts **do neither create a liability nor reduce assets**.

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UPSC Prelims Practice Question: Government Receipts

With reference to capital receipts and revenue receipts of the government, consider the following statements:

1. Recovery of loans given by the government is classified as a capital receipt because it reduces the government's assets.
2. Interest received on loans given by the government is classified as a capital receipt because the original loan was a financial asset.
3. Proceeds from disinvestment are classified as non-debt capital receipts.

Which of the statements given above is/are correct?

(A) 1 and 2 only
(B) 1 and 3 only
(C) 2 and 3 only
(D) 1, 2 and 3

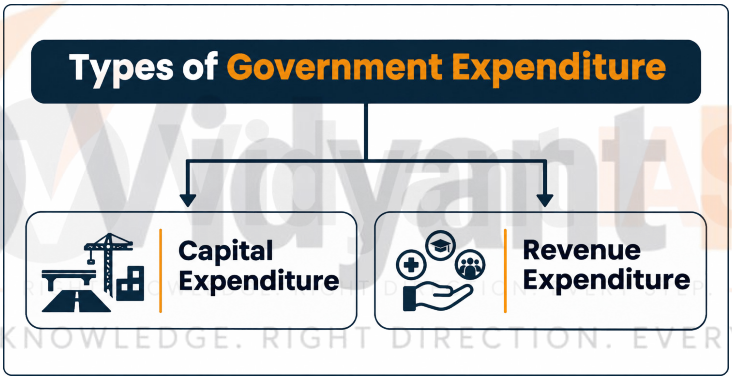
2. Government Expenditure

Understanding Government Expenditure

Government expenditure refers to the spending incurred by the government to carry out its various functions, provide public services, and promote economic development and public welfare.

Types of Government Expenditure

Based on the nature of spending, government expenditure is broadly classified into two categories:



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(i) Capital Expenditure

Capital expenditure is the expenditure that either creates or acquires an asset or reduces the government's liabilities.

Capital expenditure can take place in two ways:

(a) Creation or Acquisition of Assets

The government spends money to create or acquire physical assets and financial assets.

- **Physical assets:** Roads, bridges, buildings, machinery, and infrastructure.
- **Financial assets:** Loans given to states or public sector enterprises, and investments in shares of companies.

(b) Reduction of Liabilities

The government also incurs capital expenditure when it repays the principal amount of its existing loans, thereby reducing its liabilities.

Illustration:

Capital Expenditure

Suppose the Government of India spends ₹500 crore to construct a highway. **Since this expenditure creates a long-term physical asset**, it is classified as Capital Expenditure.

Similarly, when the government lends ₹200 crore to a State Government, **it creates a financial asset because the loan is recoverable**. When the government repays ₹100 crore of its outstanding debt, **it reduces its existing liabilities**. Both are also classified as Capital Expenditure.

KEY IDEA: Capital expenditure either creates assets or reduces existing liabilities.

(ii) Revenue Expenditure

Revenue expenditure is the expenditure incurred by the government on the regular functioning of the government and the delivery of public services. It generally neither creates an asset nor reduces a liability.

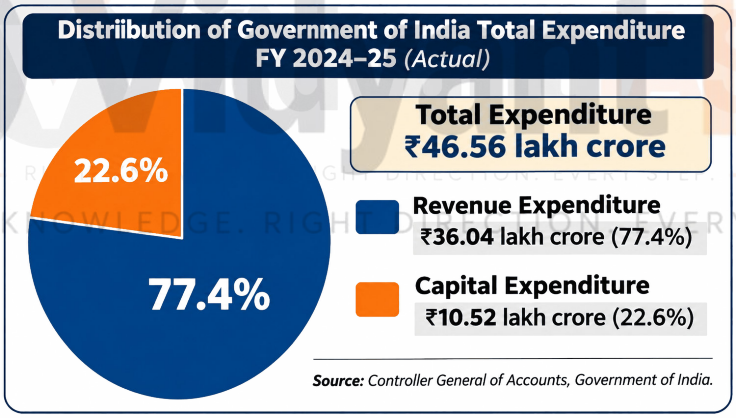
It includes expenditure on salaries, pensions, subsidies, interest payments, and the day-to-day functioning of government departments.

Illustration:

Revenue Expenditure

Just as a family spends money on groceries, electricity bills, children's school fees and loan interest to meet its regular needs, **the government also spends money on salaries of employees, pensions, interest payments, subsidies and maintenance of existing infrastructure.**

These expenses are classified as Revenue Expenditure because they generally do not create new assets or reduce the principal amount of debt.



Key Takeaway

KEY POINT	The main difference between capital expenditure and revenue expenditure lies in their effect on the government's assets and liabilities.
CAPITAL EXPENDITURE	• Creates or acquires assets, or reduces liabilities.
REVENUE EXPENDITURE	• Meets the government's regular expenses and generally does neither.

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UPSC Prelims Practice Question

Which one of the following best distinguishes capital expenditure from revenue expenditure?

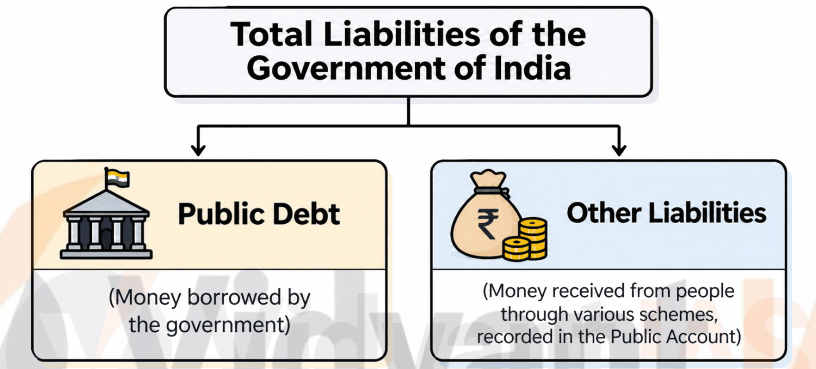
(A) Capital expenditure includes only spending on physical assets, whereas revenue expenditure includes only spending on government salaries.
(B) Capital expenditure creates or acquires assets, or reduces liabilities, whereas revenue expenditure generally does neither.
(C) Capital expenditure includes all non-recurring expenditure, whereas revenue expenditure includes all recurring expenditure.
(D) Capital expenditure reduces government liabilities only, whereas revenue expenditure creates government assets.

3. Total Liabilities of the Government of India

Understanding Total Liabilities

Government liabilities are the amounts that the government owes and is required to repay or settle in the future.

The government's liabilities mainly include Public Debt and Other Liabilities.



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(i) Public Debt

Public debt refers to the money **borrowed by the government that it must repay in the future**.

Public debt is divided into two types:

- **Internal Debt:** Borrowings by the government from domestic sources, such as Indian investors and financial institutions.
- **External Debt:** Borrowings by the government from sources outside India, including foreign governments and international institutions.

(ii) Other Liabilities

Other liabilities are amounts owed by the government that are not classified as public debt in the narrow sense. **They include certain funds and deposits held by the government.**

Major examples include:

- Small Savings
- Provident Funds
- Deposits and Advances
- Reserve Funds

Illustration:

Public Debt vs Other Liabilities

PUBLIC DEBT

The government raises ₹800 crore by issuing government bonds to investors. This is a direct borrowing by the government and is classified as Public Debt.

Example: Money borrowed through government securities or loans from foreign institutions.

OTHER LIABILITIES

The government raises ₹200 crore through PPF deposits. Such deposits are repayable but are classified as Other Liabilities rather than Public Debt.

Example: PPF deposits or refundable security deposits received from construction companies for government projects.

Key Takeaway

GOVERNMENT LIABILITIES	Government liabilities are **financial obligations** that must be repaid or settled in the future.
PUBLIC DEBT	**Government borrowings** through loans and securities.
OTHER LIABILITIES	Include **savings funds, provident funds, deposits**, and similar obligations.

UPSC Prelims Practice Question

Consider the following statements regarding Public Debt and Other Liabilities of the Government of India:

1. Borrowings through the issuance of government securities form part of Public Debt.
2. Deposits under small-savings schemes such as PPF are classified as Other Liabilities.
3. Money received as a refundable security deposit by the government is treated as Revenue Receipt.
4. Both Public Debt and Other Liabilities create repayment obligations for the government.

Which of the statements given above are correct?

(a) 1 and 2 only
(b) 1, 2 and 4 only
(c) 2, 3 and 4 only
(d) 1, 2, 3 and 4

D. DEFICIT INDICATORS

Introduction:

The government uses various deficit indicators to assess its financial position, borrowing needs, and expenditure management. These include **Fiscal Deficit, Revenue Deficit, Primary Deficit, and Effective Revenue Deficit.**

(i) Revenue Deficit

Understanding Revenue Deficit

Revenue Deficit occurs when the government's revenue expenditure exceeds its revenue receipts during a financial year. It represents a shortfall in the government's regular income to meet its routine expenses, such as salaries, pensions, subsidies and interest payments.

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What does it indicate?

It indicates that the government's regular income is insufficient to meet its regular expenses, such as salaries, pensions, subsidies, and interest payments.

Illustration:

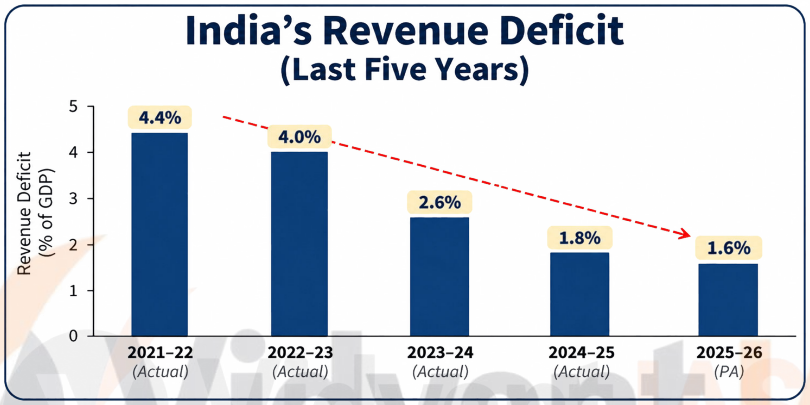
Revenue Deficit Calculation

Suppose a family earns ₹50,000 per month but spends ₹60,000 on regular expenses such as food, electricity, school fees and medical bills.

Revenue Deficit = ₹60,000 − ₹50,000 = ₹10,000

The family has a monthly shortfall of ₹10,000. To cover it, the family may borrow money. Continued borrowing can create interest costs and increase future financial pressure.

Similarly, when the government's revenue expenditure exceeds its revenue receipts, it faces a revenue deficit. Borrowing to cover the shortfall can increase public debt and future interest payments.



Key Takeaway

DEFINITION / FORMULA	**Revenue Deficit** = Revenue Expenditure − Revenue Receipts.
MEANING	It means the government's **regular receipts are insufficient** to meet its regular expenses.
IMPLICATION	A persistent revenue deficit may **increase government borrowing and interest payments**, leaving fewer resources available for development expenditure.

(ii) Fiscal Deficit

Understanding Fiscal Deficit

Fiscal deficit occurs when the government's total expenditure exceeds its total receipts, excluding borrowings.

Fiscal Deficit = Total Expenditure − Total Receipts (excluding borrowings)

What does it indicate?

It indicates the government's borrowing requirement. The government generally borrows to finance the gap between its total expenditure and its receipts, excluding borrowings.

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Illustration:

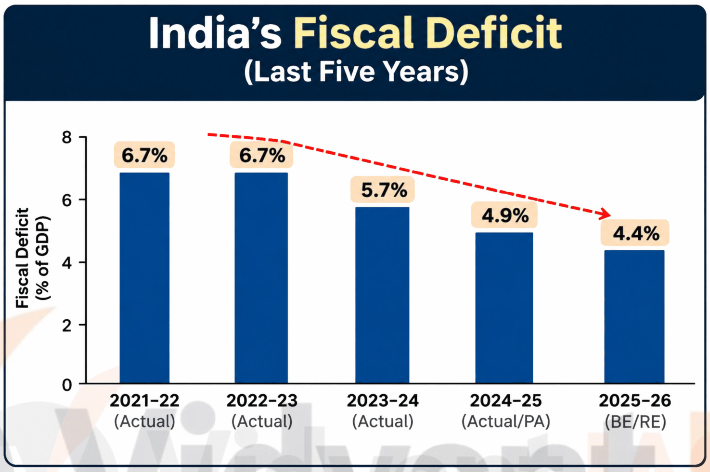
Fiscal Deficit Calculation

Suppose a family has the following finances in a month:

- Total expenditure: ₹80,000
- Total income: ₹60,000
- Shortfall: ₹20,000

Fiscal Deficit = ₹80,000 − ₹60,000 = ₹20,000

The family needs to borrow ₹20,000 to meet its expenses. Similarly, when the government's total expenditure exceeds its receipts (excluding borrowings), the gap is called the fiscal deficit. The government generally borrows to finance this gap.



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Key Questions on Fiscal Deficit

Q1. Why are borrowings excluded from total receipts while calculating fiscal deficit?

Borrowing is excluded because it finances the gap between expenditure and receipts. If borrowings were included as receipts, the deficit would be concealed rather than measured.

Q2. Is fiscal deficit desirable?

A fiscal deficit is not necessarily bad. Borrowing to build roads, railways, and other productive assets can support economic growth. However, a large and persistent fiscal deficit may increase government debt and interest payments.

Key Takeaway

DIMENSION	QUICK REVISION
DEFINITION / FORMULA	**Fiscal Deficit** = Total Expenditure − Total Receipts (excluding borrowings).
MEANING	It indicates the government's **borrowing requirement**.
IMPLICATION	A fiscal deficit can support development, but **excessive borrowing** may increase the **debt and interest burden.**

(iii) Effective Revenue Deficit (ERD)

Understanding Effective Revenue Deficit

Effective Revenue Deficit is the revenue deficit after deducting grants given by the government for the creation of capital assets.

Effective Revenue Deficit = Revenue Deficit − Grants for Creation of Capital Assets

It helps us understand the government's revenue deficit after excluding grants that are used to create assets.

What does it indicate?

It indicates the portion of the revenue deficit that remains after grants used to create capital assets are deducted. These grants are recorded as revenue expenditure in the government's accounts, even though they help create assets.

Illustration:

Effective Revenue Deficit Calculation

Suppose a family has the following monthly finances:

- Monthly income: ₹50,000
- Regular expenditure: ₹60,000
- Amount given to their child to construct a room: ₹4,000

Revenue Deficit = ₹60,000 − ₹50,000 = ₹10,000

Effective Revenue Deficit = ₹10,000 − ₹4,000 = ₹6,000

Although the family records the ₹4,000 as an expense, the money is used to create an asset. Similarly, the government gives grants to states or institutions to create capital assets. These grants are deducted from the revenue deficit to calculate the effective revenue deficit.

Key Takeaway

DEFINITION / FORMULA	**ERD** = Revenue Deficit − Grants for Creation of Capital Assets.
MEANING	It **excludes grants used to create capital assets** from the revenue deficit.
IMPLICATION	A **lower ERD** than the revenue deficit indicates that some of the revenue shortfall is associated with grants used for asset creation.

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(iv) Primary Deficit

Understanding Primary Deficit

Primary deficit is the fiscal deficit remaining after deducting interest payments on previous borrowings.

Primary Deficit = Fiscal Deficit − Interest Payments

It helps us understand the government's current deficit, excluding the burden of interest on past borrowings.

What does it indicate?

It shows how much of the government's fiscal deficit remains after interest payments on earlier borrowings are removed. A lower primary deficit can indicate that the current gap between non-interest expenditure and receipts is smaller.

Illustration:

Primary Deficit Calculation

Suppose a family has the following monthly finances:

- Monthly financial shortfall: ₹20,000
- Interest paid on an earlier loan: ₹5,000

Primary Deficit = ₹20,000 − ₹5,000 = ₹15,000

The family's primary deficit is ₹15,000. The remaining ₹5,000 of the original shortfall represents interest paid on the earlier loan. Similarly, the government's primary deficit shows its fiscal deficit after excluding interest payments on past borrowings.

Key Takeaway

DEFINITION / FORMULA	**Primary Deficit** = Fiscal Deficit − Interest Payments.
MEANING	It shows the government's **deficit excluding interest payments** on past borrowings.
IMPLICATION	A **zero primary deficit** means the fiscal deficit is just enough to cover interest payments.

UPSC Prelims Practice Questions

Question 1

With reference to capital receipts and revenue receipts of the government, consider the following statements:

1. Recovery of loans given by the government is classified as a capital receipt because it reduces the government's assets.
2. Interest received on loans given by the government is classified as a capital receipt because the original loan was a financial asset.
3. Proceeds from disinvestment are classified as non-debt capital receipts.

Which of the statements given above is/are correct?

(A) 1 and 2 only
(B) 1 and 3 only
(C) 2 and 3 only
(D) 1, 2 and 3

Question 2

With reference to deficit indicators, consider the following statements:

1. A government can have zero primary deficit even when its fiscal deficit is positive.
2. Effective revenue deficit can be zero even when revenue deficit is positive.
3. A reduction in primary deficit necessarily leads to a reduction in fiscal deficit.

Which of the statements given above are correct?

(a) 1 and 2 only
(b) 2 and 3 only
(c) 1 and 3 only

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Question 3

Consider the following information relating to the budget of a hypothetical government for a financial year (₹ lakh crore):

PARTICULARS	AMOUNT
Total Government Expenditure	32.00
Capital Expenditure	9.00
Revenue Receipts	18.50
Non-Debt Capital Receipts	1.50
Capital Grants to States for Asset Creation	2.00
Interest Payments	3.00
Borrowings and Other Liabilities	12.00

Based on the above information, consider the following statements:

1. The Revenue Deficit of the government is ₹4.50 lakh crore, indicating that its revenue receipts are insufficient to meet its revenue expenditure.
2. The Fiscal Deficit is ₹12 lakh crore, which represents the total borrowing requirement of the government during the financial year.
3. The Effective Revenue Deficit is ₹2.50 lakh crore, after excluding grants provided for the creation of capital assets from the Revenue Deficit.
4. The Primary Deficit is ₹9 lakh crore, indicating that the government's borrowing requirement, excluding interest payments on past debt, is ₹9 lakh crore.

How many of the above statements are correct?

(a) Only one
(b) Only two
(c) Only three
(d) All four

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E. IMPORTANT KEYWORDS IN FISCAL POLICY

01 Fiscal Stimulus
An increase in government spending or a reduction in taxes to support aggregate demand, especially during an economic slowdown.

02 Fiscal Consolidation
Measures to improve the government's fiscal position by reducing the deficit and putting public finances on a more sustainable path.

03 Dovish Policy Stance
A stance that gives greater priority to supporting growth and employment, often favouring easier policy. "Dovish" and "hawkish" are used most commonly for monetary policy, but may describe broader policy preferences.

04 Hawkish Policy Stance
A stance that places greater emphasis on controlling inflation and limiting excess demand, potentially favouring tighter policy. The terms are most commonly used in monetary-policy discussions.

05	**Counter-Cyclical Fiscal Policy** Fiscal action that works against the economic cycle: supporting demand during a slowdown and restraining it during an economic boom.
06	**Pro-Cyclical Fiscal Policy** Fiscal action that reinforces the economic cycle — for example, expanding spending during a boom or cutting spending during a downturn.
07	**Crowding-Out Effect** A situation in which higher government borrowing may raise interest rates or absorb available funds, thereby discouraging some private investment.
08	**Fiscal Multiplier** The extent to which a change in government spending or taxation affects national income. A multiplier above one means output changes by more than the initial fiscal change.
09	**Automatic Stabilizers** Built-in features such as progressive taxes and unemployment benefits that help moderate economic fluctuations without requiring new policy decisions.
10	**Fiscal Space** The government's capacity to increase spending or reduce taxes without putting public-debt sustainability or its ability to meet obligations at significant risk.

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