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Economics Revision Focus: 2004

AS Economics

Fiscal Policy

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Revision Focus on Fiscal Policy

AS Syllabus Requirements

Candidates should understand how fiscal policy can be used to **influence aggregate demand** and **aggregate supply**. They should also understand that government expenditure and taxation can affect the **pattern of economic activity.**

Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and also the level and growth of aggregate demand, output and employment. It is important to realise that changes in fiscal policy affect both aggregate demand (AD) and aggregate supply (AS). The impact on aggregate supply tends to occur in the medium and longer term whereas fiscal policy can have an impact on AD in a much shorter time period.

Fiscal Policy and Aggregate Demand

Traditionally fiscal policy has been seen as an **instrument of demand management**. Changes in government spending, direct and indirect taxation and the budget balance can be used **"counter-cyclically"** to help smooth out some of the volatility of real national output particularly when the economy has experienced an external shock. From 2001-2004 there has been a huge **fiscal stimulus to the UK economy** through substantial increases in government spending on transport, health and education. This has helped to maintain our economic growth in the short term at a time when some of the other components of AD have been weak.

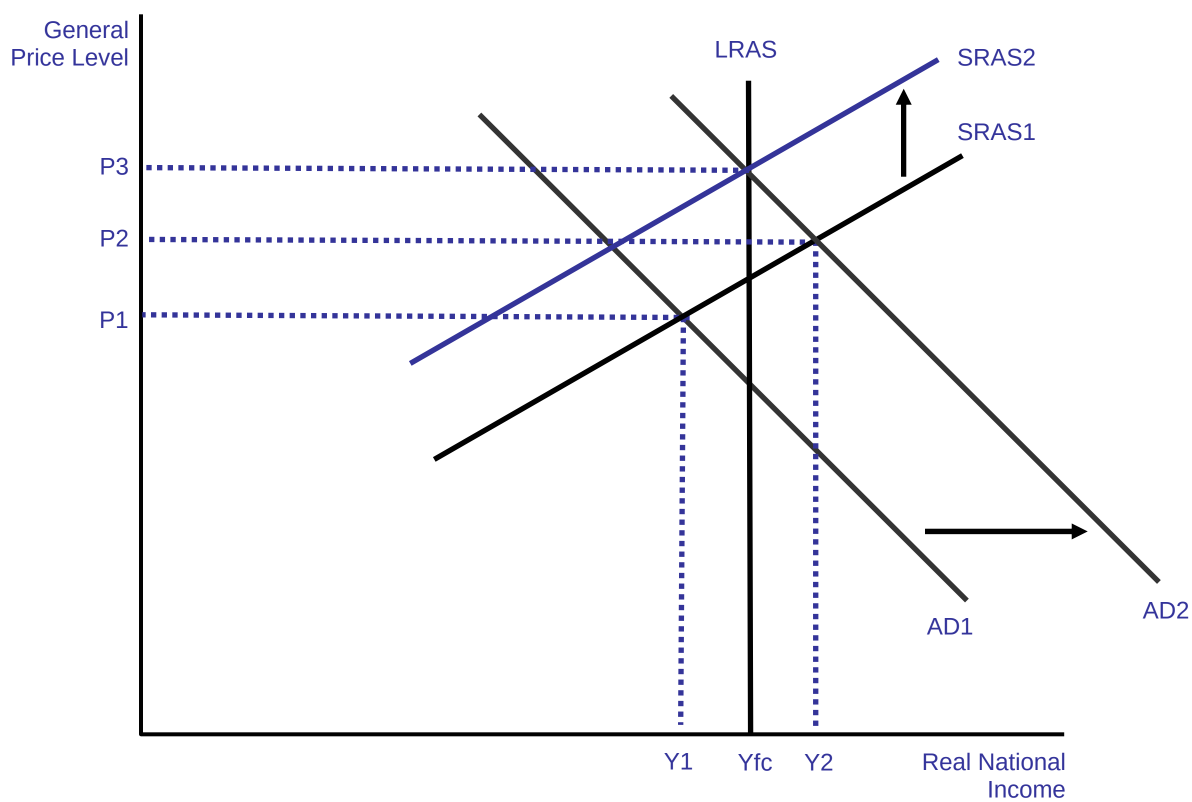
The **Keynesian school** argues that fiscal policy can have powerful effects on aggregate demand, output and employment, particularly when the economy is operating well below full capacity national output, and where there is a need to provide a demand-stimulus to the economy. **Monetarist economists** believe that government spending and tax changes can only have a temporary effect on aggregate demand, output and jobs.

The **multiplier effects of an expansionary fiscal policy** depend on how much spare productive capacity the economy has; how much of any increase in disposable income is spent rather than saved or spent on imports. And also the effects of fiscal policy on variables such as interest rates

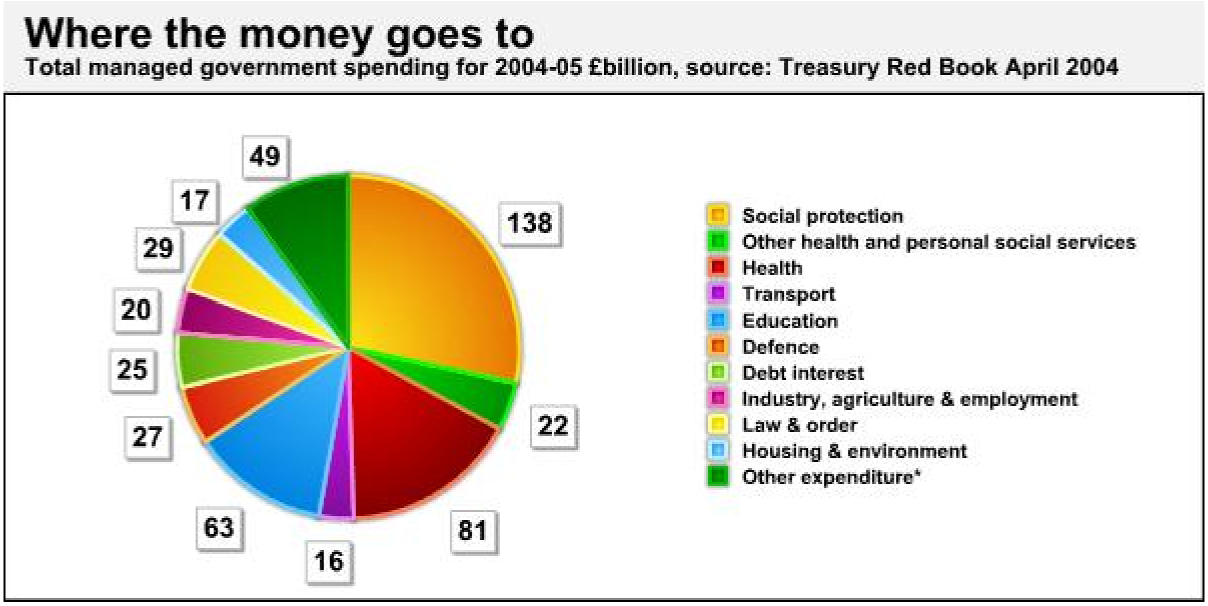
Expansionary Fiscal Policy

- Cut in personal income tax → Boost to disposable income → Adds to consumer demand
- Cut in indirect taxes → Lower prices – leads to higher real incomes → Adds to consumer demand
- Cut in corporation tax → Higher "post tax" profits for businesses → Adds to business capital spending
- Cut in tax on interest from saving → Boost to disposable income of people with net savings → Adds to consumer demand

> Fiscal policy can be used to stimulate aggregate demand – either through tax cuts or a rise in planned government spending. The government needs to be careful not to boost AD too much – otherwise there is a risk that an inflationary gap will emerge.
> In the diagram below, AD shifts out beyond potential output (shown by the



Government spending



Automatic stabilisers and discretionary changes in fiscal policy

Discretionary fiscal changes are **deliberate changes** in direct and indirect taxation and govt spending – for example a decision by the government to increase total capital spending on the road building budget or increase the allocation of resources going direct into the NHS.

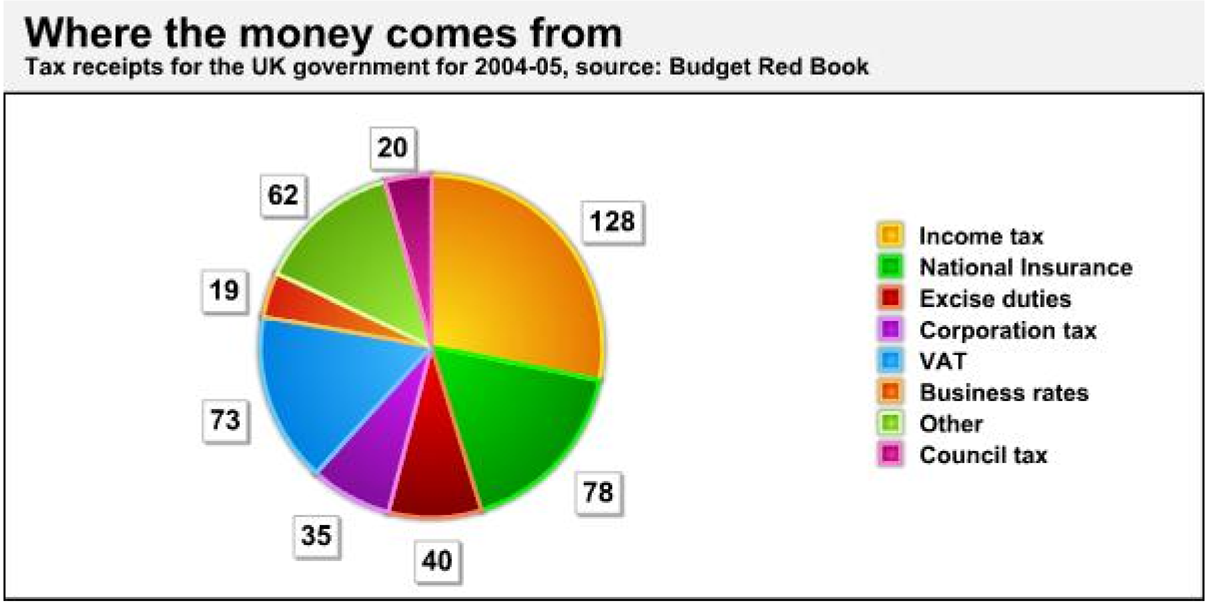
Automatic fiscal changes are changes in tax revenues and government spending arising automatically as the economy moves through different stages of the business cycle

1. **Tax revenues:** When the economy is expanding rapidly the amount of tax revenue increases which takes money out of the circular flow of income and spending
2. **Welfare spending:** A growing economy means that the government does not have to spend as much on means-tested welfare benefits such as income support and unemployment benefits
3. **Budget balance and the circular flow:** A fast-growing economy tends to lead to a net outflow of money from the circular flow. Conversely during a slowdown or a recession, the government normally ends up running a larger budget deficit.

Tax revenues

Direct taxation is levied on income, wealth and profit while indirect taxation is levied on expenditure. Direct taxes include income tax, national insurance contributions, capital gains tax, and corporation tax. Indirect taxes include VAT; excise duties on fuel and alcohol, car tax, betting tax and the TV licence

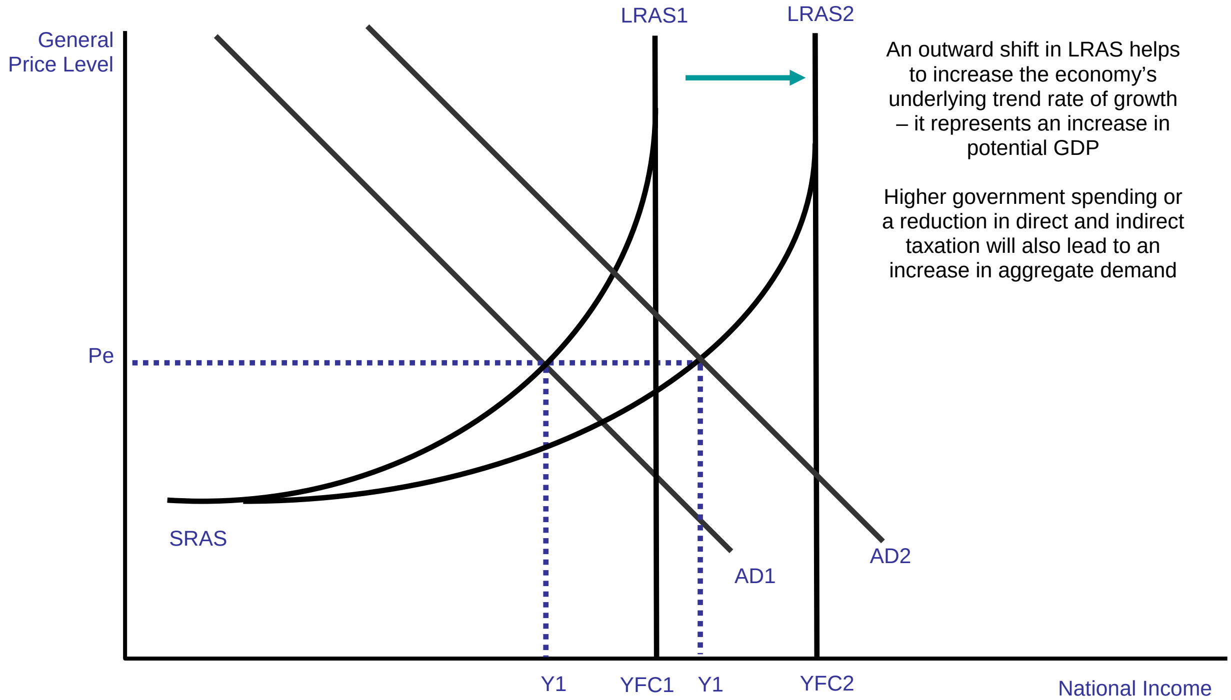
Indirect taxes are taxes on spending – such as excise duties on fuel, cigarettes and alcohol and Value Added Tax (VAT) on many different goods and services



Fiscal Policy and Aggregate Supply

Changes to fiscal policy can affect the supply-side capacity of the economy and therefore contribute to long term economic growth. The effects tend to be longer term in nature.

1. **Labour market incentives:** Cuts in income tax might be used to improve incentives for people to seek work and also as a strategy to boost labour productivity. Some economists argue that **welfare benefit reforms** are more important than tax cuts in improving incentives – in particular to create a "wedge" or gap between the incomes of those people in work and those who are in voluntary unemployment.
2. **Capital spending**. Government capital spending on the national infrastructure (e.g. improvements to our motorway network or an increase in the building programme for new schools and hospitals) contributes to an increase in investment across the whole economy. Lower rates of corporation tax and other business taxes might also be used as a policy to stimulate a higher level of business investment and attract inward investment from overseas
3. **Entrepreneurship and new business creation**: Government spending might be used to fund an expansion in the rate of new small business start-ups
4. **Research and development and innovation**: Government spending, tax credits and other tax allowances could be used to encourage an increase in private business sector research and development – designed to improve the international competitiveness of domestic businesses and contribute to a faster pace of innovation and invention
5. **Human capital of the workforce**: Higher government spending on education and training (designed to boost the human capital of the workforce) and increased investment in health and transport can also have important supply-side economic effects in the long run. An enhanced transport infrastructure is seen by many business organisations as absolutely essential if the UK is to remain competitive within the European and global economy



Free market economists are normally sceptical of the effects of government spending in improving the supply-side of the economy. They argue that lower taxation and tight control of government spending and borrowing is required to allow the private sector of the economy to flourish.

However targeted government spending and tax decisions can have a positive impact even though fiscal policy reforms take a long time to feed through. The key is to help provide the right incentives for individuals and businesses – for example the incentives to find work and incentives for businesses to increase employment and investment.