AQA Economics AS-level

Macroeconomics

Topic 4: Macroeconomic Policy

4.2 Fiscal policy

Notes

Fiscal policy involves the manipulation of government spending, taxation and the budget balance. It can have both macroeconomic and microeconomic functions.

Fiscal policy instruments:

- **Government spending and taxation**

  Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.

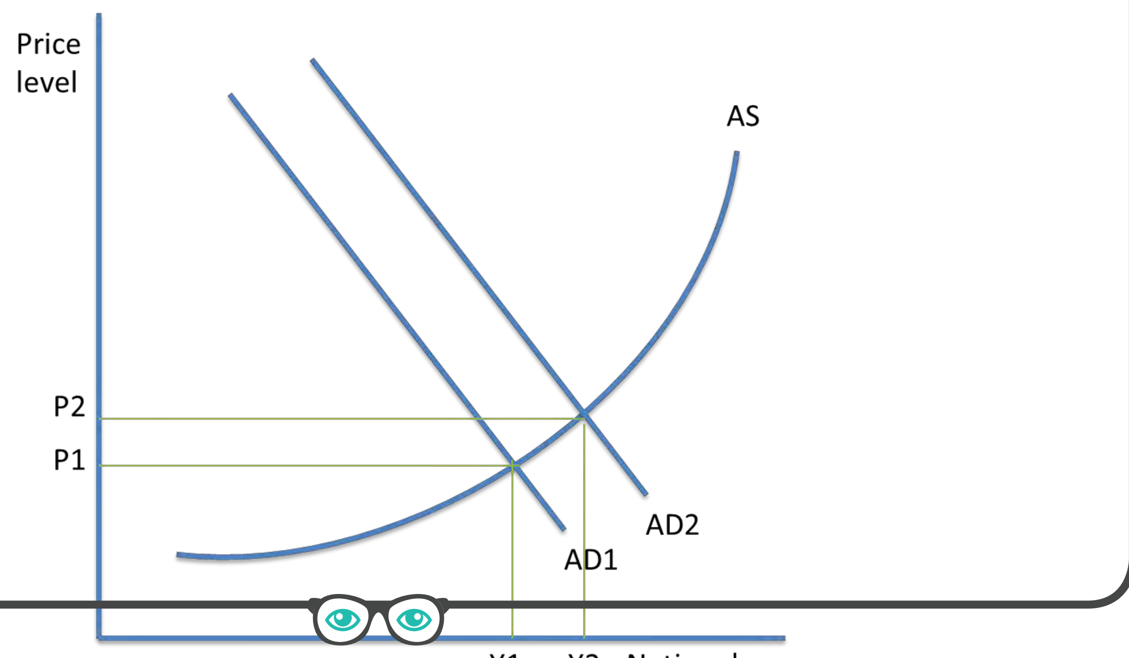
  Fiscal policy aims to stimulate economic growth and stabilise the economy.

  In the UK, the government spends most of their budget on pensions and welfare benefits, followed by health and education. Income tax is the biggest source of tax revenue in the UK.

How fiscal policy can be used to influence AD:

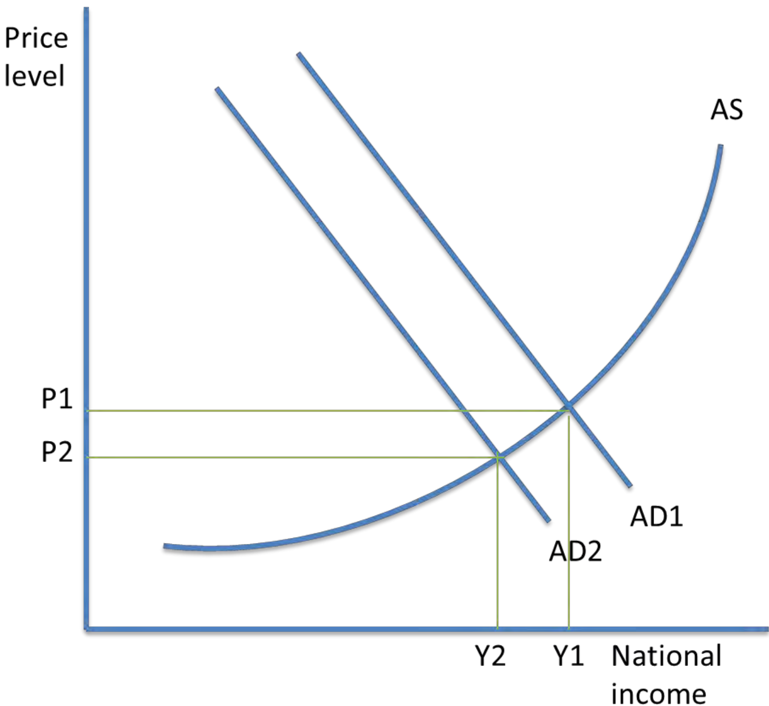
Expansionary fiscal policy

This aims to increase AD. Governments increase spending or reduce taxes to do this. It leads to a worsening of the government budget deficit, and it may mean governments have to borrow more to finance this.



Deflationary fiscal policy

This aims to decrease AD. Governments cut spending or raise taxes, which reduces consumer spending. It leads to an improvement of the government budget deficit.



How fiscal policy can be used to influence AS:

- The government could reduce income and corporation tax to encourage spending and investment.
- The government could subsidise training or spend more on education. This lowers costs for firms, since they will have to train fewer workers. Spending more on healthcare helps improve the quality of the labour force, and contributes towards higher productivity.
- Governments could spend more on infrastructure, such as improving roads and schools.

The government budget (fiscal) surplus and deficit:

A government has a **budget deficit** when expenditure exceeds tax receipts in a financial year.

A government has a **budget surplus** when tax receipts exceed expenditure.

It is important to distinguish between the government **debt** and the government **deficit.** The debt is the accumulation of the government deficit over time. It is the amount the government owes. The deficit (or surplus) is the difference between expenditure and revenue at any one point.

Direct and indirect taxes:

Direct taxes are imposed on income and are paid directly to the government from the tax payer. Examples include income tax, corporation tax, NICs and inheritance tax. Consumers and firms are responsible for paying the whole tax to the government.

Indirect taxes are imposed on expenditure on goods and services, and they increase production costs for producers. This increases market price and demand contracts.

There are two types of indirect taxes:

- **Ad valorem** taxes are percentages, such as VAT, which adds 20% of the unit price. This is the main indirect tax in the UK.
- **Specific taxes** are a set tax per unit, such as the 58p per litre fuel duty on unleaded petrol.

Proportional, progressive and regressive taxes

A proportional tax has a fixed rate for all tax payers, regardless of income. It is also called a flat tax. For example, all tax payers might have to pay 20% income tax rate. The incidence of taxes is equal, regardless of the ability of the taxpayer to pay. It could encourage people to earn higher incomes, because the rate of tax paid does not increase.

A progressive tax has an increase in the average rate of tax as income increases. As income increases, the proportion of income taxed increases. For example, in the UK

income tax is progressive. People have a personal allowance of £10,600 where tax is not paid. For incomes below £31,785, people only pay the basic rate of 20%. For incomes between £31,786 and £150,000, people pay the higher rate of 40%. Above this, a 45% rate is paid. This should help reduce inequality, because those on lower incomes pay less tax. The tax is based on the payer's ability to pay. Higher income households are more able to pay higher rates of tax than lower income households. Generally, direct taxes are more progressive.

A regressive tax does not relate to income, but means those on lowest incomes have a higher average rate of tax. In other words, the proportion of income paid as tax is higher for those on lower incomes than those on higher incomes. For example, as a percentage of income, the London Congestion Charge and Council Taxes are higher for those on lower incomes. This leads to a less equitable distribution of income. Generally, indirect taxes are more regressive.

Limitations of fiscal policy:

- Governments might have imperfect information about the economy. It could lead to inefficient spending.
- There is a significant time lag involved with employing fiscal policy. It could take months or years to have an effect.
- If the government borrows from the private sector, there are fewer funds available for the private sector, which could lead to crowding out.
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy.
- If interest rates are high, fiscal policy might not be effective for increasing demand.
- If the government spends too much, there could be difficulties paying back the debt, which could make it difficult to borrow in the future.