WJEC (Wales) Economics A-level

Macroeconomics

Topic 3: Policy Instruments

3.1 Fiscal policy

Notes

The government budget:

The government budget is comprised of tax revenues and government expenditure.

Current government expenditure is spending which recurs. This is on goods and services which are consumed and last for a short period of time. For example, it could be on drugs for the health service.

Capital government expenditure is spent on assets, which can be used multiple times. For example, it could be government expenditure on roads or building a school.

The budget position/fiscal stance:

- The fiscal stance is the impact that taxes and government spending has on the future economy.
- The budget position refers to whether the government has a deficit, surplus, or if the budget is balanced.
- A government has a **budget surplus** when tax receipts exceed expenditure.
- The government has a **balanced budget** when expenditure is equal to revenue.
- A government has a **budget deficit** when expenditure exceeds tax receipts in a financial year.
- 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.
- The **national debt** is the amount of money the government has borrowed at one time through issuing securities by the Treasury.

Different budget positions:

Cyclical budget position

This is a temporary budget position, which is related to the business cycle. A deficit might occur during recessions, when governments increase spending to stimulate the economy.

Structural budget position

This is a budget which is either in a deficit or surplus due to an imbalance in the revenue and expenditure of the government, so it exists at every point in the business cycle.

Overall budget position

This is an accumulation of deficits and surpluses over time to give the overall budget.

Budget position on current expenditure

This is the flow of cash at during one period of time.

How budget deficits can be financed:

- Budget deficits are usually financed by borrowing.
- Deficits can be reduced using austerity measures, such as cutting government spending on local authorities.
- Taxes could be increased. For example, the UK government increased the rate of VAT to 20%.
- There could be caps to the amount of welfare benefits someone can claim. In the UK, there is a £26,000 cap per annum.

Policies to correct a budget surplus or deficit:

- Budget deficits could be reduced with less government spending and higher taxes. However, this could lead to lower economic growth, which might cause government finances to worsen since tax revenue falls.

- Moreover, if taxes are too high, people could be discouraged from working, since they are not keeping much of their income.

- Economic growth could be promoted to help reduce a deficit. This would increase revenue from taxes without needing to raise the rate of tax. For example, consumers would spend more, which raises revenue from VAT. However, this is not effective is the government has a structural deficit.

- Governments could choose to default on their debt if it is no longer manageable. However, this can make accessing credit in the future difficult.

Consequences of government debt:

- The cost of borrowing could increase, since by borrowing money, the government is increasing demand for credit in the economy.
- If confidence is lost in the government's ability to repay the debt, governments might have to raise interest rates to encourage investors to buy bonds, so that they can finance the debt.
- It could lead to higher taxes and austerity measures, especially if the debt becomes uncontrollable.

How discretionary fiscal policy could be used to improve macroeconomic performance:

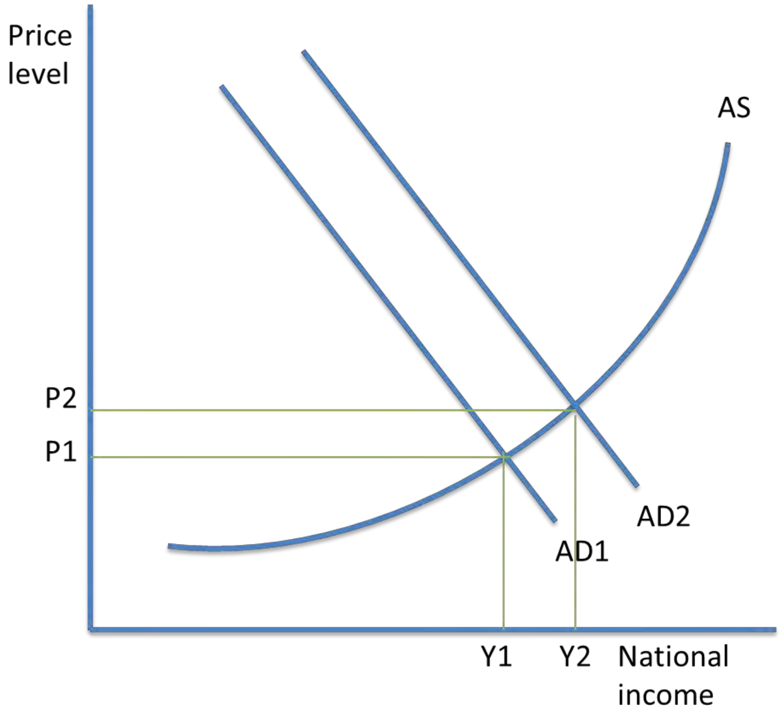
- Discretionary fiscal policy involves deliberate changes in government expenditure and taxes with the intention of influencing aggregate demand.

- 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.

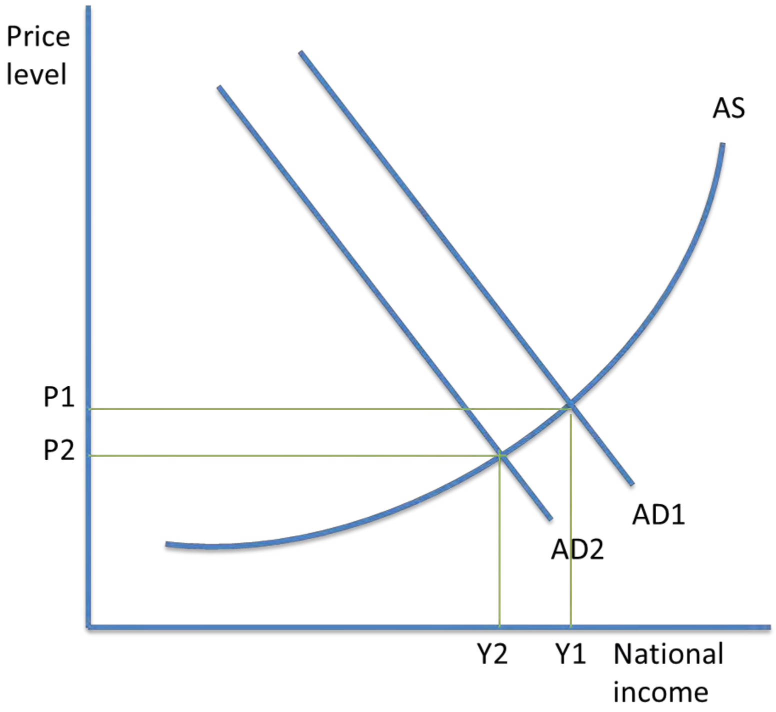
Expansionary fiscal policy

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.



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.