AQA Economics A-level

Macroeconomics

Topic 5: Fiscal and Supply Side Policies

5.1 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.

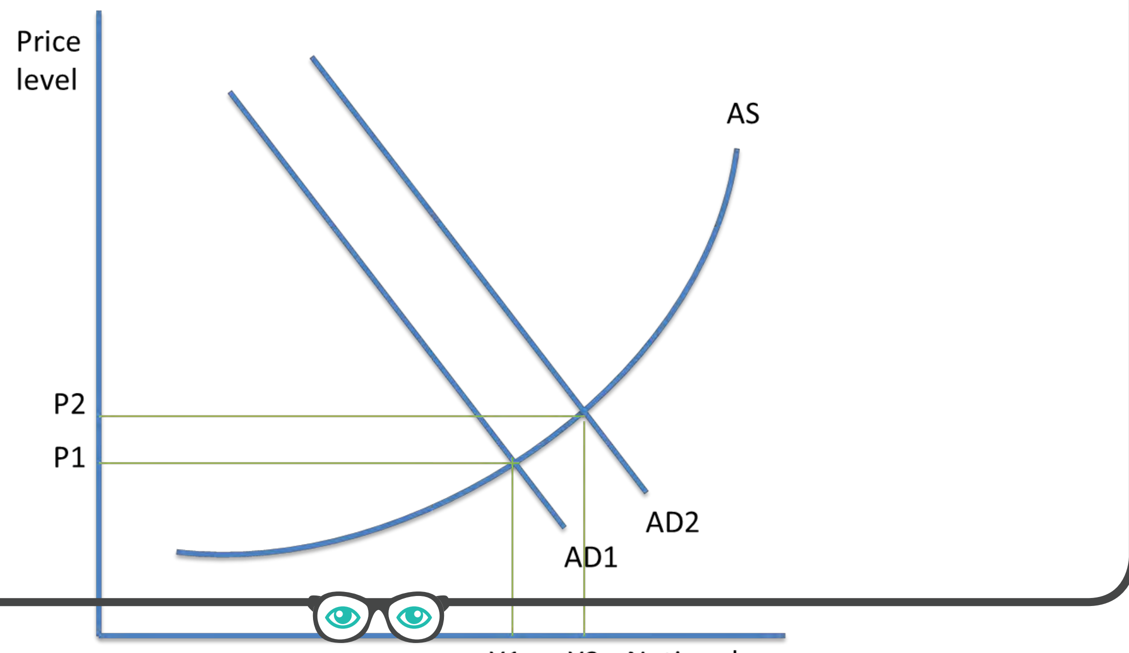
  Fiscal policy aims to stimulate economic growth and stabilise the economy.

  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:

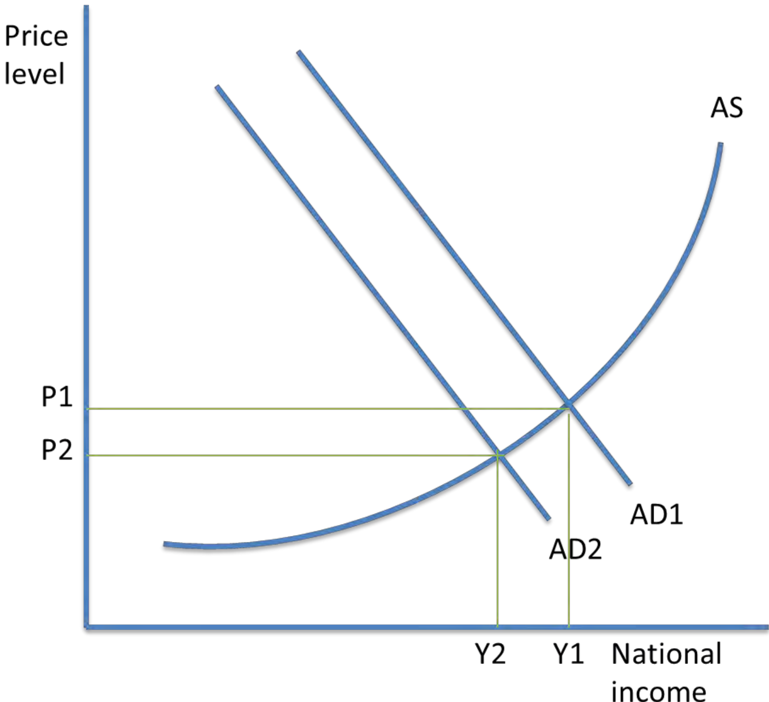
Expansionary fiscal policy

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.

The principles of taxation

- These 'Canons of Taxation' were first developed by Adam Smith. They are essentially the criteria taxes are judged by. They are:

  1) The cost of collecting the tax must be low relative to the yield
  2) The timing and quantity paid must be obvious to the tax payer
  3) The timing and way of paying should be convenient for the tax payer
  4) Taxes should be imposed depending on the ability to pay. Taxes should also be equitable.

- These have been updated to include:

  5) The tax should not limit efficiency, and there should only be a minimum loss of efficiency.
  6) Tax should be compatible with tax systems of other countries. For the UK, taxes should be compatible with the rest of Europe.
  7) Taxes should adjust with inflation.

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

The types of and reasons for public expenditure and why governments levy taxes

Difference between capital expenditure, current expenditure and transfer payments

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.

Transfer payments are welfare payments from the government. They aim to provide a minimum standard of living for those on low incomes. No goods or services are exchanged for transfer payments.

Examples of transfer payments in the UK include:

- Job Seeker's Allowance
- Income Support
- Child benefit
- The state pension

These are in place to ensure people have a basic standard of living and to help reduce the level of inequality in society. Transfer payments are a means for the government to redistribute income from the rich to the poor.

- **Reasons for the changing size and composition of public expenditure in a global context**

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.

Education spending in the UK has remained relatively constant. This is because it is protected so it does not fall, but it also does not increase much either.

Social security payments are payments from the government to assist those who have low incomes. After the war, people saw this as necessary, so there has been a general increase in spending.

Defence spending in the UK is falling. This is the area the government spends least on.

- **The significance of differing levels of public expenditure as a proportion of GDP on:**
    - **Productivity and growth**

      Governments can spend money on supply-side policies to improve human capital and boost long run growth. Human capital is important for competitiveness. The government could invest in youth apprentice schemes, for example, to make people more employable and productive from a young age.

      Education and training can mean higher value products can be made and productivity can be improved.

      Fiscal policy aims to stimulate economic growth and stabilise 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.

    - **Crowding out**

      Governments might have to fund its spending using taxes or running a budget deficit. This leaves fewer funds in the private sector for firms to use, since the government is borrowing money, which crowds them out of the market.

When the government borrows a lot of money, interest rates might increase. This discourages spending and investment among the private sector.

This reduction in private sector investment is the 'crowding out' of investment.

Sometimes, crowding out refers to the government provision of a good or service, which would otherwise be provided by the private sector.

- **Level of taxation**

  The tax rate might increase if government debts get too high. 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.

  In the UK, the size of government spending is about 40% of GDP. This means that citizens in the UK have a lower tax burden than in a country such as Switzerland, where government spending is 60% of GDP.

- **Equality and living standards**

  Progressive taxes could be used to reduce inequality, since the poorest in society pay the smallest proportion of their income as tax. Redistributive policies and welfare payments, such as Income Support, could be used to help those on the lowest incomes.

  Also, government spending on housing and the provision of public services, such as education and healthcare, helps provide equal opportunities for people from all income backgrounds. This ensures that even those on low incomes can afford a good standard of healthcare and education.

  By providing these services, the government ensures that all members of society can achieve a minimum standard of living.

The relationship between the budget balance and the national debt.

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

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

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

The government has a **balanced budget** when expenditure is equal to revenue.

It is important to distinguish between the government **debt** and the government **deficit.** The national 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 accumulation of the government deficit over time. It is the total amount the government owes.

If the government is continuously running a deficit, the size of the debt increases.

If the government reduces the size of their deficit, the rate of increase of the total debt is slower, but the debt is still increasing.

It is only when the government runs a budget surplus that the size of the national debt decreases. Currently, the UK government is trying to reduce the size of the deficit and eventually run a budget surplus by 2019-2020, at which point they will start paying off the debt.

Cyclical and structural deficits (and surpluses)

Cyclical deficit

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

Structural deficit

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

The consequences of budget deficits and surpluses for macroeconomic performance.

- A fiscal deficit could be inflationary if it increases AD.
- More government spending could lead to crowding out of the private sector. This leaves fewer funds in the private sector for firms to use, since the government is borrowing money, which crowds them out of the market.
- It could lead to increased interest rates. This is because the government has to offer investors an attractive rate in order to encourage them to buy the debt.

The significance of the size of the national 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.

The role of the Office for Budget Responsibility

- The OBR provides analysis of the UK's finances.
- They produce 5-year forecasts for the economy, including the impact of tax and spending changes announced in the Budget.
- They judge the government's performance against its fiscal targets. These are to balance the budget 5 years ahead and have net public sector debt falling in 2015-16. They assess the likelihood of the government meeting the targets.
- They scrutinise tax and welfare spending measures.
- They also assess how sustainable public sector finances are in the long run.