SL IB Economics

Your notes

3.6 Demand Management: Fiscal Policy

Contents

3.6.1 An Overview of Fiscal Policy

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An Introduction to Fiscal Policy

- Fiscal Policy involves the use of **government spending and taxation** (revenue) to influence **aggregate demand** in the economy

- Fiscal policy can be expansionary in order to generate further economic growth
  - Expansionary policies include reducing taxes or increasing government spending

- Fiscal policy can be contractionary in order to slow down economic growth or reduce inflation
  - Contractionary policies include increasing taxes or decreasing government spending

- Fiscal Policy is usually presented annually by the Government through the Government Budget
  - A **balanced budget** means that **government revenue = government expenditure**
  - A **budget deficit** means that **government revenue < government expenditure**
  - A **budget surplus** means that **government revenue > government expenditure**

- A budget deficit has to be financed through **public sector borrowing**
  - This borrowing gets added to the public debt

Sources of Government Revenue

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- The main sources of government revenue include **taxation,** the sale of goods/services by government owned firms, and the sale of government owned assets (privatisation)

1. Taxation

- **Direct taxes** are taxes imposed on **income and profits**
  - They are **paid directly** to the government by the individual or firm
    - E.g. Income tax, corporation tax, capital gains tax, national insurance contributions, inheritance tax

- **Indirect taxes** are imposed on **spending**
  - The **supplier** is responsible for sending the payment to the government
    - Depending on the PED and PES producers are able to pass on a proportion of the indirect tax to the consumer
    - The **less** a consumer spends the **less indirect tax** they pay
    - E.g Value Added Tax (20% VAT rate in the UK in 2022), taxes on demerit goods, excise duties on fuel etc.

2. Sale of goods/services

- Government owned firms sometimes **charge for the goods/services** that they provide
  - E.g. Charges on public transport and fees paid to access some medical services

3. The sale of government owned assets

- Privatisation can generate significant **government revenue** during the year in which the government sells the asset
  - Most assets can only be sold once e.g. national airlines or railways
  - Some assets, such as the right for **mobile phone operators** to use the airwaves, can be sold every few years (the airway license is for a defined period of time)

Government Expenditure

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- **Government expenditure** represents a significant portion of the aggregate demand in many economies. The expenditure can be broken down into three categories

1. **Current expenditures:** These include the **daily payments** required to run the government and public sector. E.g. The wages and salaries of public employees such as teachers, police, members of parliament, military personnel, judges, dentists etc. It also includes payments for goods/services such as medicines for government hospitals

2. **Capital expenditures:** These are investments in infrastructure and capital equipment. E.g. High speed rail projects; new hospitals and schools; new aircraft carriers

3. **Transfer payments:** These are payments made by the government for which **no goods/services are exchanged.** E.g. Unemployment benefits, disability payments, subsidies to producers and consumers etc. This type of government spending does not **contribute to aggregate demand** as income is only transferred from one group of people to another

The Goals of Fiscal Policy

- **Fiscal policy** is used to help the government achieve their **macroeconomic objectives**
- Specifically, the use of fiscal policy aims to
  - Maintain a low and stable rate of inflation
  - Maintain low unemployment
  - Reduce the business cycle fluctuations
  - Create a stable economic environment for long-term economic growth
  - Redistribute income so as to ensure more equity
  - Control the level of exports and imports (net external balance)

- When a policy decision is made, it creates a **ripple effect through the economy** impacting the macroeconomic objectives of the government
- **Changes to fiscal policy** can influence several of the components of AD
  - A change to any component of AD helps to achieve at least one of the **goals of fiscal policy**

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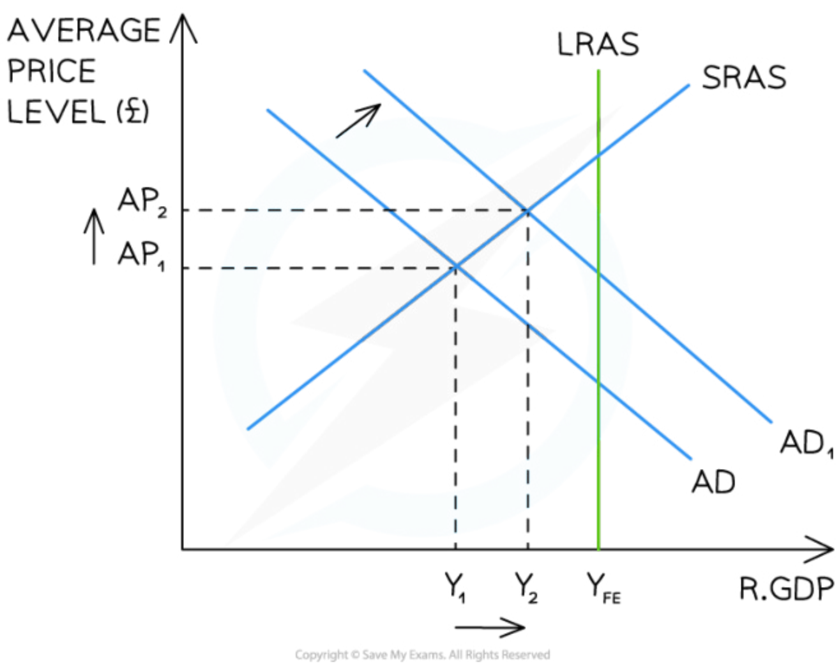
Expansionary & Contractionary Fiscal Policy

1. Expansionary Fiscal Policy

- Expansionary fiscal policies include reducing taxes or increasing government spending with the aim of increasing AD

- AD= household consumption (C) + firms investment (I) + government spending (G) + exports (X) - imports (M)
  - AD = C + I + G + (X - M)

- **Expansionary fiscal** policy aims to shift aggregate demand (AD) to the right



Classical diagram illustrating expansionary fiscal policy which increase real GDP ($Y_1 \rightarrow Y_2$) and average price levels ($AP_1 \rightarrow AP_2$)

Diagram Analysis

- The economy is initially in **macroeconomic equilibrium** AP_1Y_1 - there is a recessionary gap
- The Government is wanting to **boost economic growth** and lowers the rate of income and corporation taxes
- Lower taxes cause investment and consumption to increase which are components of AD
- Aggregate demand increases from AD→ AD_1

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- The economy reaches a new equilibrium at AP_2Y_2 - a higher average price level and a greater level of national output

Examples of the Impact of Expansionary Fiscal Policy

Example 1: The Government decreases corporation tax	
Effect on the economy	Firms net profits increase → investment by firms increases → AD increases
Impact on macroeconomic aims	▪ **Economic growth** increases ▪ **Inflation** rises ▪ **Unemployment** may decrease as output is rising which requires more workers ▪ **Net external demand** - unsure - exports may rise due to new investments in the economy, but imports may rise due to higher income generated by the investment

Example 2: The Government increases unemployment benefits	
Effect on the economy	Household income increases → consumption increases → AD increases
Impact on macroeconomic aims	▪ **Economic growth** increases ▪ **Inflation** rises ▪ **Unemployment** may decrease as output is rising which requires more workers (although increased unemployment benefits may discourage some people from entering the labour market) ▪ **Net external demand** is unlikely to change as this policy helps the poorest and imports are unlikely to increase ▪ **Redistribution of income** has increased and there is more equity in society

2. Contractionary Fiscal Policy

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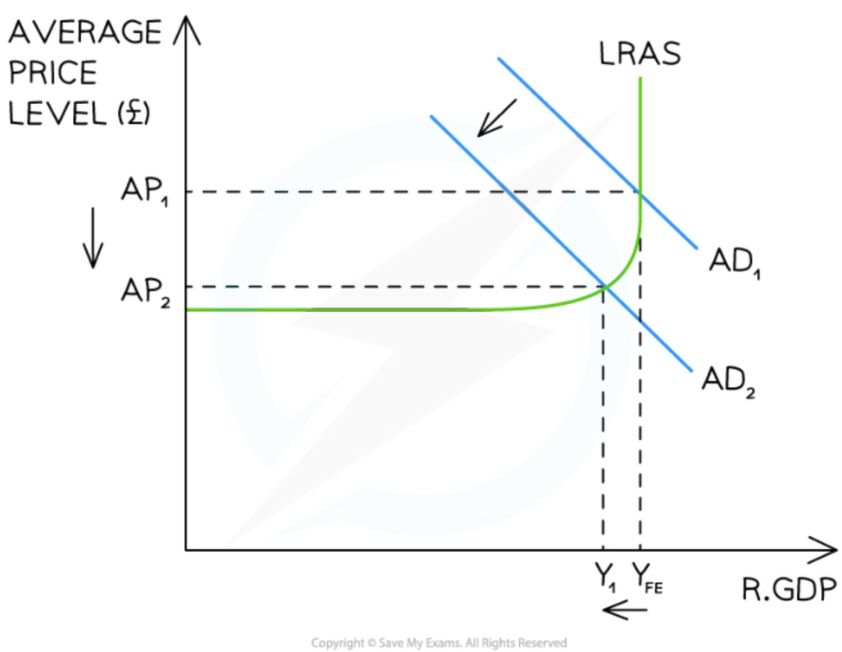
- Contractionary fiscal policies include increasing taxes or decreasing government spending with the aim of decreasing AD
- AD= household consumption (C) + firms investment (I) + government spending (G) + exports (X) - imports (M)
  - AD = C + I + G + (X - M)
- **Changes to fiscal policy** can influence government spending or consumption or investment
  - Changing taxation can influence household consumption and the investment by firms
- **Contractionary fiscal** policies aims to shift aggregate demand (AD) to the left



Keynesian diagram illustrating how a contractionary fiscal policy aims to decrease real GDP ($Y_{FE} \rightarrow Y_1$) and average price levels ($AP_1 \rightarrow AP_2$)

Diagram Analysis

- The economy is initially in **macroeconomic equilibrium** AP_1Y_{FE} - an inflationary output gap is developing
- The economy is booming and the Government is wanting to **lower inflation towards its target of 2%**
- The Government increases the rate of income tax
- Higher tax rates cause households to have less discretionary income causing **consumption** to decrease
- Aggregate demand decreases from $AD_1 \rightarrow AD_2$

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- The economy reaches a new equilibrium at AP_2Y_1 - a lower average price level and a smaller level of national output

Examples of the Impact of Contractionary Fiscal Policy

Example 1: The Government increases the rate of income tax	
Effect on the economy	Households pay more tax → discretionary income reduces → consumption reduces → AD reduces
Impact on macroeconomic aims	▪ **Economic growth** slows down ▪ **Inflation** eases ▪ **Unemployment** may increase as output is falling and fewer workers are required ▪ **Net external demand** Improves (with less income, imports may fall)

Example 2: The Government freezes/reduces public sector workers pay	
Effect on the economy	Wages stagnate or reduce → Consumer confidence falls → consumption decreases → AD decreases
Impact on macroeconomic aims	▪ **Economic growth** slows down ▪ **Inflation** eases ▪ **Unemployment** may increase as output is falling ▪ **Net external demand** improves (with less income, imports may fall)

Example 3: The Government cuts Government Spending in their Budget	
Effect on the economy	Less demand for goods/services → less income for firms → output and profits decrease → AD decreases

Impact on macroeconomic aims	▪ **Economic growth** slows down ▪ **Inflation** eases ▪ **Unemployment** may increase as output is falling ▪ **Net external demand may** Improve (with less income, imports may fall) ▪ Less corporation tax available for **redistribution**

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An Evaluation of Fiscal Policy

Strengths of Fiscal Policy

- Spending can be **targeted** at specific industries
- It can be highly effective in restoring confidence in an economy during a deep recession
- **Redistributes income** through taxation
- Reduces **negative externalities** through taxation
- Increased consumption of merit/public goods
- Short term government spending can lead to an increase in the **aggregate supply** of an economy
  - E.g. Building a new airport **immediately** increases government spending and AD, but when it is built, the potential output will have increased (Production Possibility Curve has shifted outward)

Weaknesses of Fiscal Policy

- **Political pressures:** Policies can fluctuate significantly when **new governments** are elected
  - **Long term** infrastructure projects may lack follow-through

- Unsustainable debt: Increased government spending can create budget deficits which are added to the national debt
  - Repaying this debt may lead to austerity on future generations

- **Conflicts** between objectives
  - E.g. Cutting taxes to increase economic growth may cause inflation

- **Time lags:** It is difficult to predict exactly when the desired effect on the economy will occur. Fiscal policy also takes a longer time to plan and implement than monetary policy
  - Government budgets are usually presented once a year whereas monetary policy adjustments can take place 4-8 times per year