**Introduction to Policy**

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| **Fiscal Policy** | “use of government spending, taxation and borrowing to influence the level of aggregate demand and aggregate supply” |
| **Monetary Policy** | “the use of interest rates and the money supply to influence the level of aggregate demand in the economy” |
| **Supply-Side Policy** | “policies undertaken by the government designed to increase the productive potential of the economy.” |

Policy makers will attempt to use macroeconomic policy in order to meet their various macro-objectives.

What are these objectives?

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**MONETARY POLICY**

**FISCAL POLICY**

**SUPPLY-SIDE POLICIES**

**DEMAND-SIDE POLICIES**

The Bank of England has the power to set interest rates *each month* to **target inflation**

Interest Rates

Shifts AD

The Chancellor sets the Budget *every year* to help improve the economy

The Budget
(G and T)

Shifts AD
e.g. cuts in income tax boosts consumption

Shifts AS
e.g. cuts in income tax boost incentive to work

via C, I and (X – M)

**SUPPLY-SIDE POLICIES**

# Fiscal Policy (Demand-side)

**What is Fiscal Policy?**

The use of government spending, taxation and borrowing to influence the level of aggregate demand and aggregate supply.

What is a budget surplus? This occurs when the government revenue exceeds government spending.

What is a budget deficit?

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**Note**: A balanced budget is where the total government expenditure is equal to total government revenues.

**Types of Government spending**

**Current spending** on the day to day running of the public sector, including raw materials and wages of public sector workers.

**Capital spending** looks to improve the productive capacity of the nation. This includes spending on infrastructure, healthcare and education.

**Transfer payments** are government payments to individuals for which no service is given in return e.g. state benefits

Activity 1

Decide which type of Government spending is described by:-

1. A decrease in spending on incapacity benefits
2. Building a new High speed train line between London and Birmingham
3. The government decides to award a higher than inflation award to Army officers
4. The Chancellor of the Exchequer agrees to pay an extra £20m towards the up keep of the Indian ocean fleet.

What effect might your policy have on the Government finances? (Hint: think short term and long term effects)

Extension activity for Activity 2

Activity 2

Economic growth in the economy is stagnating at around 0.2% and is threatening to become negative in the next quarter. You are an adviser to George Osborne, who as Chancellor of the Exchequer, has asked for your opinion on what to do. He is particularly keen to hear what type of fiscal policy you might use to ‘kick start’ the economy.

1. In the space provided below draw a Keynesian and classical AD-AS diagram that shows unemployment (i.e. negative output gap).
2. Explain (using connectives) how this policy would work. Write your answer in the space below.
3. In the space beneath the diagram explain what a possible consequence of your policy might be for the UK Economy (Hint: think how your actions might affect the other macro-economic objectives.

1. Keynesian Classical

2. How would your policy work? Build up your answer using connectives (therefore, this leads to, etc)

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3. In the table below describe the effects that your policies may have on

|  |  |
| --- | --- |
| Economic Growth |  |
| The Balance of Payments on current account |  |
| The rate of inflation |  |

Activity 3

The Government can change the level of taxes and the amount it spends to affect the level of Aggregate Demand in the economy.

Using Fiscal Policy what should the Government do in each of the scenarios below to achieve its macro-economic objectives? In all cases, be specific about the type of tax and type of Government spending that you are suggesting. For both questions, illustrate the impact of your policy with an AD-AS diagram.

1. Inflation is at 5% which is above the inflation target of 2%. What should the Government do?

**Explanation of government response**

 **Diagram**

1. Unemployment is at a 5 year high, and inflation is low. What should the Government do?

**Explanation of the government response**

 **Diagram**

 T3H4RWZ

# Fiscal Policy (Supply-side)

Activity 1

Re-write the following text and correct the mistakes.

*A Government might wish to run a budget surplus in order to reduce the level of unemployment in the Economy. In order to increase economic activity the Government might wish to increase current spending on things like building new schools, whilst at the same time increasing income tax.*

The combined effect of this contractionary fiscal policy will active to expand the economy.

Reading

Whilst Fiscal Policy can affect Aggregate Demand, there may also be an impact on Aggregate Supply. Changes to Fiscal Policy can affect the supply side capacity of an economy and thereby contribute to long term economic growth.

**Supply-side Fiscal Policy:** Changes in the level or structure of government spending and taxation designed to improve the supply side of the economy through influencing incentives to save, to supply labour, to be entrepreneurial, and to promote investment.

Activity 2

Using the table provided below explain how the following measures affect both Aggregate demand and Aggregate Supply. In all cases assume ceteris paribus (all else remains equal)

1. Lowering income tax (example provided)
2. Increasing corporation tax.
3. Government provides the funds (£13bn) to build a new rail line
4. Government cuts the schools budget by £20bn

|  |  |  |
| --- | --- | --- |
| **Fiscal Policy****(expansionary** **or contractionary)** | **Effect on Aggregate Demand****(Identify the component)** | **Effect on Aggregate Supply** |
| Lowering income tax | Increases consumption | Increase in LRAS: Workers willing to work harder (higher productivity) and supply more labour. |
|  |  |  |
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|  |  |  |

Activity 3

Read these comments below and answer questions one and two on the next page.

a) “54 percent of America's workers work in businesses that are taxed not at the corporate tax rate, but at the individual tax rate. And if we lower that rate, they will be able to hire more people. For me, this is about jobs. This is about getting jobs for the American people …….The problem with raising taxes is that it slows down the rate of growth. And you could never quite get the job done. I want to lower spending and encourage economic growth at the same time” Mitt Romney

b) “Do tax cuts for rich people and already-profitable businesses create jobs? Do businesses hire people when they have extra money? When few customers are coming through the door, will tax cuts cause businesses to hire people to sit around reading newspapers or checking Twitter? I think that people with jobs have money to spend and then the businesses that get their business will hire people, and will make money and be happy they have profits to pay taxes on.”

Dave Johnson, Huffington Post

c) David Cameron says tax cuts will restore business confidence. David Cameron used his first outing of 2012 to tell small business owners that tax cuts and low interest rates, rather than government spending, will be key to restoring confidence in the economy.

Telegraph, 5th Jan 2012

1. According to the quotes by Mitt Romney and David Cameron suggest **two** ways in which Tax cuts help improve the productive capacity of the economy?
2. What reason does Dave Johnson believing that some tax cuts may be ineffective?

The Problems with Fiscal Policy

* Contractionary Fiscal Policy to reduce inflation can reduce growth
* Contractionary Fiscal Policy to reduce inflation can cause short run economic growth to fall
* Expansionary Fiscal Policy can increase inflation if the economy is near it’s productive capacity
* Expansionary Fiscal policy can increase the budget deficit
* Expansionary Fiscal Policy can increase a deficit on the current account of the balance of Payments
* Once the need for expansionary fiscal policy has been identifies it could take a long time to implement it, if the focus is on building a new motorway.

**Evaluating Fiscal Policy**

**1. Impact on National Debt (opportunity cost & methods to reduce the deficit)**

* If the Government persistently runs a budget deficit (G > T) then this will increase national debt.

NATIONAL DEBT

Budget Deficit

Budget Deficit

Budget Deficit

* Therefore this means more money spent on interest (which is an opportunity cost)
* There may also be a need for higher taxes and cuts in spending in the longer-term to try and reduce the debt (by running a budget surplus.

**2. Demand-side policies cannot achieve all objectives at once**

By using AD policies alone a Government cannot achieve all its macroeconomic objectives. For example, they cannot increase GDP and control inflation using fiscal policy alone. Remember, it is only supply-side policies that in theory can allow all objectives to be met.

The impact of any AD shift will of course depend on the **elasticity of AS**:

**e.g. When AD is near full employment** (AS is inelastic) the impact of rising AD will be mainly a rising price level rather than increases in real output

The UK is currently operating well below full employment and therefore is more likely to be operating where AS is elastic. Therefore impacts of fiscal policy are more likely to be on growth rather than inflation.

**3. Time lags**

All policies will have time lags associated with them, such as:

* **Lag to recognise problem** (i.e. should we be increasing or decreasing the deficit?)
* **Lag to create right solution** (i.e. combination of tax and spend)
* **Most changes can only be implemented in the Budget** (which is annual)
* **Time taken for policy to have an impact:** (e.g. for consumers to spend tax cuts)

These time lags will be **longer than monetary policy** as interest rate changes can be changed every month by the Bank of England. Although they are much **shorter than some supply-side policies** such as education spending.

The worry therefore with using fiscal policy is that it may make the situation worse. For example, if the economy is in recession and needs to boost AD, by the time the effect of fiscal policy may be too late. It could even make the situation worse as the expansionary fiscal policy may come in at a time when inflation and AD need to be constrained.

**4. Inadequacy of data, model & knowledge**

The decision that the Chancellor makes are often based on projections, forecasts and economic models. This may lead to the wrong policy being pursued if:

* **The data used to make the decision is wrong**
* **The economic model is not accurate**
* **Policy makers do not have enough knowledge to successfully implement / interpret the suggestions from the economic model.**

**For example:** if the growth for the forecast is -0.5% next year it may decide to boost AD using fiscal policy. If in reality growth turns out to be much higher (e.g. 2%) then this boost to fiscal policy may have not been needed and just caused extra inflation.

**5. Will Fiscal Policy work?**

Although boosting Government spending has a direct impact on AD, tax changes may or may not impact on AD. For example, even if income and corporation tax were lowered currently they may not boost consumption and investment due to low consumer and business confidence. Consumers and businesses may not respond either if they think the change is temporary and will have to pay higher taxes later.

**6. Side-effects on policy objectives (e.g. on the environment)**

The Government in recent years has moved away from taxing income (the highest rate of income tax has fallen from over 80% to 50%) and towards indirect taxes. These indirect taxes (such as specific taxes like excise duties) have been used to target the environment; these are called Green Taxes. Hopefully the Government can now achieve both the raising of tax revenue whilst also helping the environment.

However, say the Government implemented a nationwide road pricing scheme and it was very effective in reducing car usage, then the tax raising ability would be diminished.

Tax Revenue from Green Taxes

**Vs.**

Effective Green Taxes reducing Climate Change

Therefore, the goals of raising revenue and protecting the environment may conflict.

**7. Long-term issues & Magnitude Issues**

**a) Multiplier Effect**

In the long-term the impact on AD from fiscal policy may be increased due to the multiplier (or negative multiplier) effect. It will take time for the full extent of the multiplier to work its way through the economy. It’s impact will depend on the MPC or leakages from the circular flow.

**b) Side-effects on AS**

Certain fiscal policy will also have supply-side impacts in the long-term, for example spending on education and training boosts the quality of labour and aggregate supply. Therefore AS may shift too in the long-term.

This makes the **magnitude of policies** hard to assess, how much will real GDP really change?

**Fiscal Policy & the Multiplier Effect**

If the Government increases the budget deficit (e.g. via Government spending increases), then it will be injecting more money into the circular flow. This injection of money into the circular flow will have a multiplier effect associated with it. This means that AD **will increase by more than the initial injection** from Government spending.

However, the size of the multiplier depends on:

* The magnitude of the injection from the Government
* The amount of money that is withdrawn from the circular flow of income (i.e. if consumers have a low MPC or are importing a significant number of goods then the multiplier will be smaller)

**For example: Government subsidises a firm**

More Government spending 🡪 more firms & employment 🡪 more income for employees 🡪 more consumption 🡪 more profits 🡪 more investment 🡪 expansion & more jobs 🡪 …

**Illustrating the Multiplier Effect**

The Government increasing the budget deficit will increase AD1 to AD2. However, due to the multiplier effect AD will increase by more to AD3:



**Negative Multiplier Effect**

If the Government decides to reduce the budget deficit (as they currently are) then this will reduce AD due to there being less money injected into the economy than last year. However, there will be further knock-on effects again due to the multiplier effect but this time negatively.

For example, if there is less Government spending then there is likely to be fewer public sector jobs. This means these workers will have less income, which will lower their spending. Therefore local businesses will have less profit and may go out of business in the long-term. This would then lead to fewer jobs and further effects on income, consumption and profits.

**MCQs**

1. An increase in imports of consumer goods is most likely to be caused by a

A rise in household saving.

B rise in household income.

C fall in the exchange rate.

D fall in employment.

1. Real incomes rise whenever

A Nominal incomes rise by more than the price level.

B The price level rises by more than nominal incomes.

C Nominal incomes rise.

D The rate of inflation slows down.

1. Which one of the following is an example of fiscal policy having a direct supply-side effect?

A An increase in the money supply leading to greater output

B A reduction in income tax boosting consumption and the supply of consumer credit from banks

C A reduction in interest rates boosting investment and the productive potential of the economy

D Government expenditure on retraining schemes increasing factor mobility

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A rise in household saving.

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C fall in the exchange rate.

D fall in employment.

1. In which one of the following situations is a government most likely to pursue an expansionary fiscal policy in order to increase aggregate demand? When…

**A** there is a positive output gap

**B** the long-run trend rate of economic growth is too low

**C** there is a high level of structural unemployment

**D** cyclical unemployment is increasing

1. Which one of the following is an example of fiscal policy having a direct supply-side effect?

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C. A reduction in interest rates boosting investment and the productive potential of the economy

D. Government expenditure on retraining schemes increasing factor mobility

Additional notes page