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Demand Side Policies - Fiscal Policy

GCE A-LEVEL & IB ECONOMICS

What is Fiscal Policy?

Fiscal policy is when the government changes the amount they spend or the amount they tax to affect the level of aggregate demand (AD) in the economy. This will hence affect inflation and real GDP.

Therefore, like monetary policy, fiscal policy is also a type of "Demand-side policy".

Fiscal Policy and Gov. Spending

Equation of Aggregate Demand (AD) = C + I + G + (X - M)

If the government increases government spending (G), it will trigger an injection into the circular flow of income. This will increase AD and shift the AD curve towards the right. It may also lead to a positive multiplier effect for the economy, enlarging the initial government spending; vice versa.

e.g. via construction projects, healthcare/education spending

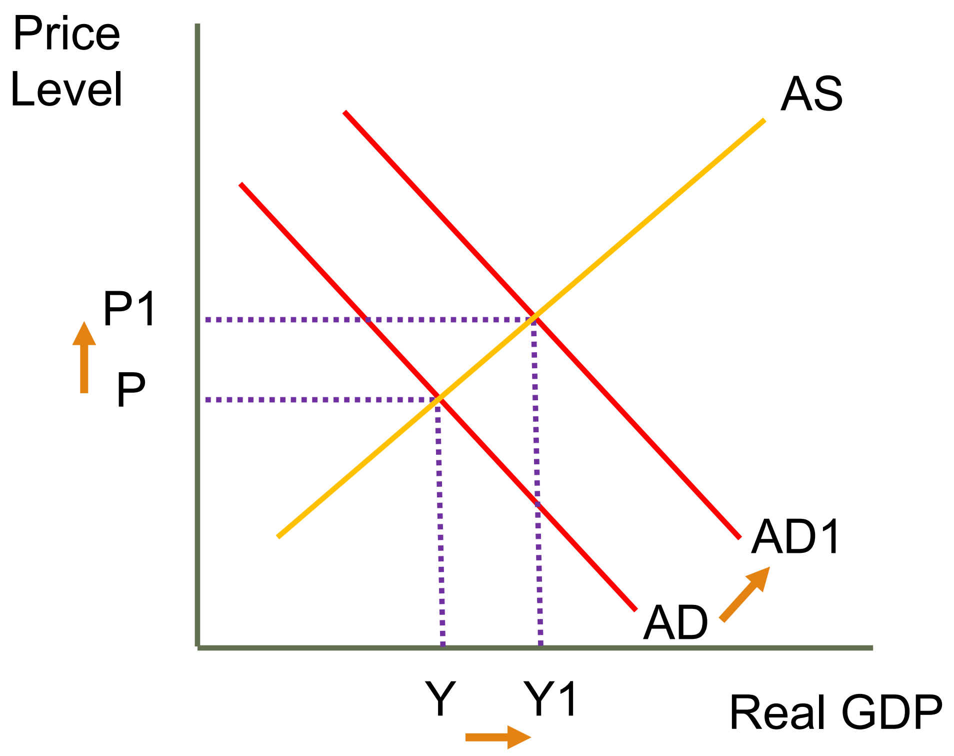
Fiscal Policy and Taxes

If the government increases taxation (T), it will trigger a withdrawal from the circular flow of income. This will decrease AD and shift the AD curve towards the left. It may also lead to a negative multiplier effect for the economy, enlarging the initial government taxation; vice versa.

e.g. via VAT, income/corporation tax

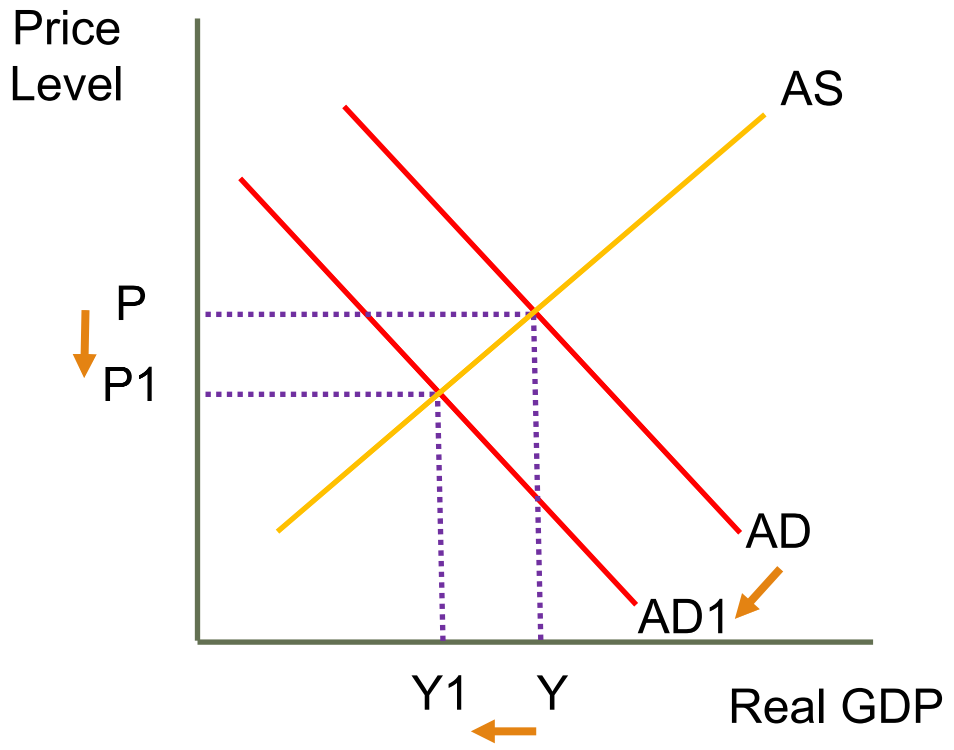
Expansionary Fiscal Policy

An expansionary fiscal policy happens when the government aims for an increase in AD and GDP. This is done when the government increases government spending (G) or decreases taxes (T). The government may adopt this policy in a recession to compensate for the loss in Economic activity due to the business/economic cycle, in order to achieve stable economic growth.



Contractionary Fiscal Policy

An contractionary fiscal policy happens when the government aims for a decrease in AD and GDP. This is done when the government decreases government spending (G) or increases taxes (T). The government may adopt this policy in a boom to decrease above target inflation/economic activity due to the business/economic cycle, in order to achieve stable level of inflation.



Fiscal Policy and Gov. Budget

The government runs a budget deficit when government spending/expenditure is higher than tax revenue/income (G > T). This would mean that overall, the government is injecting money into the economy, and can be described as operating an expansionary fiscal policy.

This tends to be the case in a recession when business profits and household incomes are low, leading to lower tax revenue. At the same time, welfare payments will be higher, increasing government spending.

The opposite happens when the government runs a budget surplus (G < T).

Fiscal Policy and Gov. Budget

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Hence, a cyclical fiscal deficit is a budget deficit caused by the business/economic cycle, particularly when the economy is in recession. It is expected to be balanced out by the additional tax income received in a boom.

E.g. Unemployment/welfare benefits, Covid-19 government aid

However, a structural fiscal deficit is a budget deficit unrelated to the business/economic cycle. It is expected to continue to exist despite the economy recovers. This tends to indicate a more fundamental problem in the economy which required government funding.

E.g. [UK Pension crisis]

Implementing Fiscal Policy (Spending)

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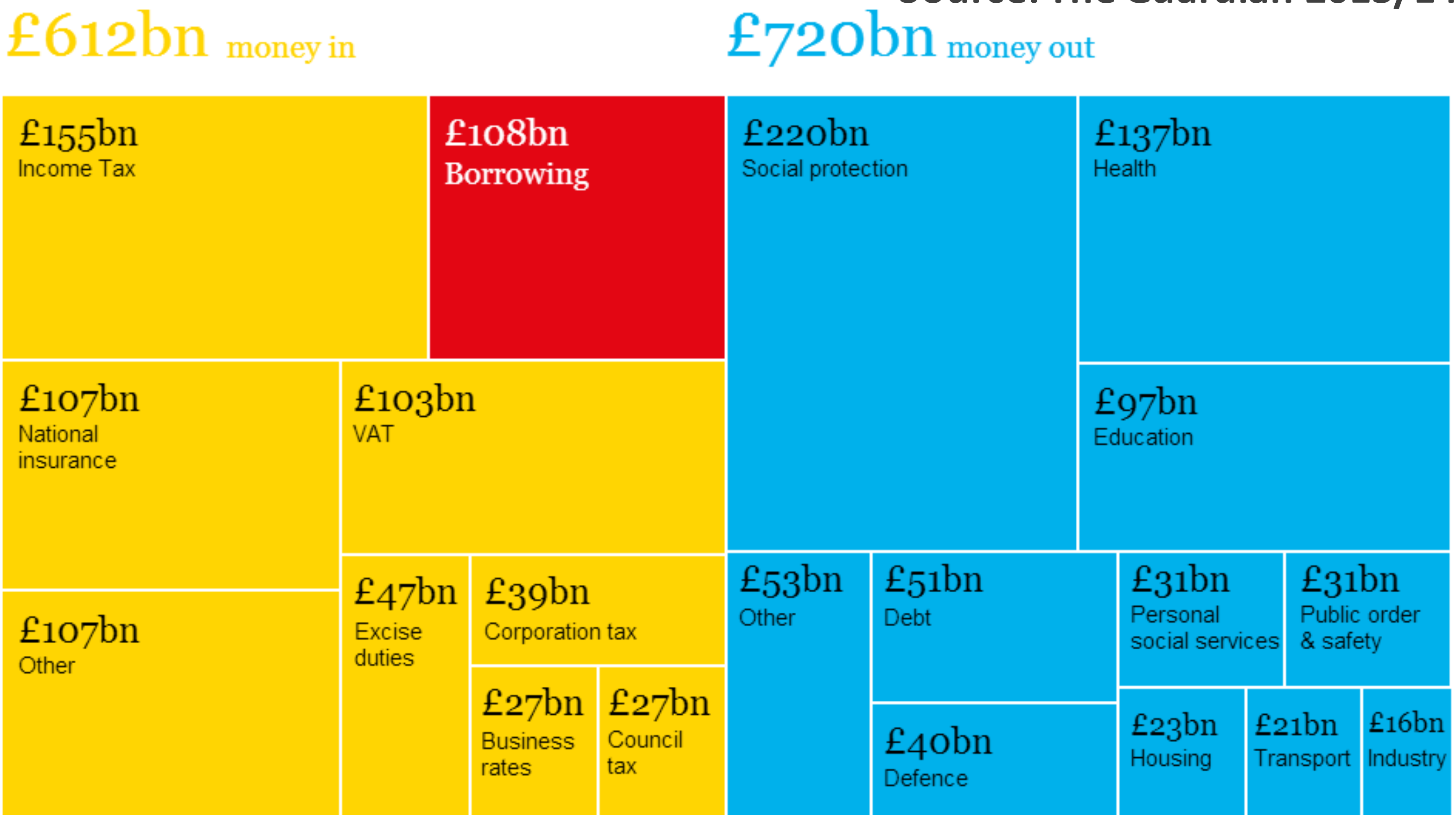
Source: The Guardian 2013/14

The government can increase/decrease major components of government spending to implement fiscal policy.

E.g. building more hospitals, schools; or reduce their available funding.

Even an increase in defense spending during wartime would qualify.



Spending and Supply-Side Policy

Interventionist supply-side policies are undertaken by the government to increase productive potential in the economy by improving factors of production (e.g. labour)

Government spending projects on infrastructure, healthcare and education also tend to have a supply-side element for it to maximize welfare benefit to society.

Examples: HS2, Crossrail (Elizabeth line), 5G Network

Hence, these projects would be an overlap of both fiscal and interventionist supply-side policy, due to the government spending element and the improvement in productive potential, shifting AD and AS to the right.

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Implementing Fiscal Policy (Taxation)

There are two types of government taxation:

Direct Tax – taxes levied on income/profits

E.g. Income tax, Corporation tax, Dividends tax, Inheritance tax

Indirect Tax – taxes levied through production/consumption of goods and services

E.g. VAT, alcohol and tobacco tax, sugar tax, petrol/fuel duties

Direct taxes tend to be progressive (e.g. UK Income tax) which means those with higher incomes will pay a large proportion of tax. The higher tax rates in higher income brackets mean more tax per each dollar/pound earned.

Indirect taxes tend to be regressive (e.g. VAT) as those with higher incomes pay less VAT as a proportion to their total income.

Implementing Fiscal Policy (Taxation)

Examples of how changing taxes achieve an increase/decrease in AD:

1. Decrease in corporation tax

-> Increases profits retained by businesses, which can be used to fund new business projects

-> Increases investment (I) e.g. buying more capital/equipment to expand business

-> As $AD = C + I + G + (X – M)$ and I increases, AD increases

2. An increase in personal income/indirect tax

-> Reduces disposable household income and their purchasing power

-> This decreases consumption (C) as less goods and services can be afforded

-> As $AD = C + I + G + (X – M)$ and C decreases, AD decreases

Taxation and Supply-Side Policy

Market-based supply-side policies reduce government involvement in the free market to increase market efficiency. This is possibly done by providing incentives or encouraging market competition.

This includes reducing income tax to incentivize more workers to join the workforce, or reducing corporation tax to incentivize business investment/inward FDI.

As a result, these expansionary fiscal policies also have a supply-side element, leading to a shift in AD and AS to the right.

Fiscal Policy Evaluation

How can fiscal policy help to achieve key macroeconomic objectives?

1. Economic Growth

-> Expansionary fiscal policy can shift AD to the right as government spending increases demand for goods and services, hence increasing GDP if the economy is under full employment in a recession

-> Non-targeted fiscal policy (e.g. income/corporation tax cuts) that are not supply-side policies does not generate long term economic growth as it is not effective in increasing productive capacity

Fiscal Policy Evaluation

How can fiscal policy help to achieve key macroeconomic objectives?

2. Unemployment

-> An increase in aggregate demand and GDP means a higher output of goods & services. This would cause higher derived demand for labor and hence decrease unemployment in the economy.

-> If the fiscal policy is focused on labor training or to help with frictional unemployment (e.g. unemployment benefits), this can be even more effective as it will help reduce occupational immobility and structural unemployment.

Fiscal Policy Evaluation

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How effective can fiscal policy help to achieve key macroeconomic objectives?

3. Inflation

-> Inflation can be tackled by contractionary fiscal policy and a reduction in AD. This is because lower demand in the economy causes producers to charge less for goods and services, thus reducing the general price level.

-> However, this may not be very effective if the cause of the inflation is due to rising cost of production (cost-push inflation), and may also reduce employment and GDP.

-> Vice versa, expansionary fiscal policy increases inflationary pressure despite raising AD/GDP.

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Fiscal Policy Evaluation

How effective can fiscal policy help to achieve key macroeconomic objectives?

4. Balance of Payments

-> Contractionary fiscal policies such as tax hikes can help to reduce imports by lowering households' disposable income. This is because consumer imports tend to be income elastic normal goods. Lowering total expenditure on imports will help decrease a current account deficit.

-> However, this may not be very effective if a large proportion of the country's imports are on raw materials/commodities that are necessities and are income inelastic (meaning a change in income will only affect quantities purchased minutely).

-> Fundamentally, the effectiveness depends on the marginal propensity of import of citizens. Furthermore, the government can use expansionary fiscal policy on targeted domestic industries to produce needed goods/services locally and replace imports.

Fiscal Policy Evaluation

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What are some general considerations when considering to use fiscal policy?

-> Can quickly maintaining demand/stimulating the economy by increasing AD and GDP in a recession

-> Not effective if economy is already working a full capacity/employment (e.g. at a boom)

-> May lead to “crowding out” where government spending replaces the need for private investment. This may occur if government borrows money for the fiscal spending, leading to higher interest rates and costs for private companies to invest

Fiscal Policy Evaluation

What are some general considerations when considering to use fiscal policy?

-> Depends on the marginal propensity to save/consume of those affected which changes the size of the multiplier effect

-> Impact is more short-term and may not necessarily be recurring/long-lasting

-> Can be targeted at specific regions/industries but may lead to geographical imbalances