Fiscal Policy - the basics:

1) Introduction

Fiscal policy is the use of government expenditure (G) and taxation (T) to control the economy. It can be operated in two basic ways, demand side and supply side.

The aim of demand side fiscal policy is to influence the overall level of aggregate demand in the economy in an attempt to stabilise the economy as a whole. When used in this fashion, fiscal policy is sometimes known as stabilisation policy.

Supply side fiscal policy aims to improve the supply side of the economy, thereby making UK firms more competitive on world markets. The supply side means the conditions of supply, and therefore includes both labour markets, where the problems are generally lack of skills, and product markets where the problems are generally lack of investment by firms.

In the UK, the fundamental supply side problem is productivity: The UK is on average 20% less productive (output per worker) than Germany, and 40% less than the US.

There are three fundamental reasons for this supply side weakness:

1) **Basic skills levels**: eg 22% of adults in the UK have poor literacy, 50% more than in Germany. This reduces productivity and increases training costs.

2) **Investment in new capital equipment**: This is 40% higher in Germany than in the UK, reducing unit costs and boosting output per worker.

3) **R&D**: The US invests 50% more as a proportion of GDP than UK firms on R&D. This means fewer new innovative products, and fewer new techniques, again damaging productivity.

These two policies (supply side and demand side) are not mutually exclusive, and can in general be used at the same time. In the UK economy at present however, fiscal policy is generally aimed at the supply side, with demand management being left to the control of the Bank of England through the manipulation of interest rates.

Fiscal Policy - the basics (continued):

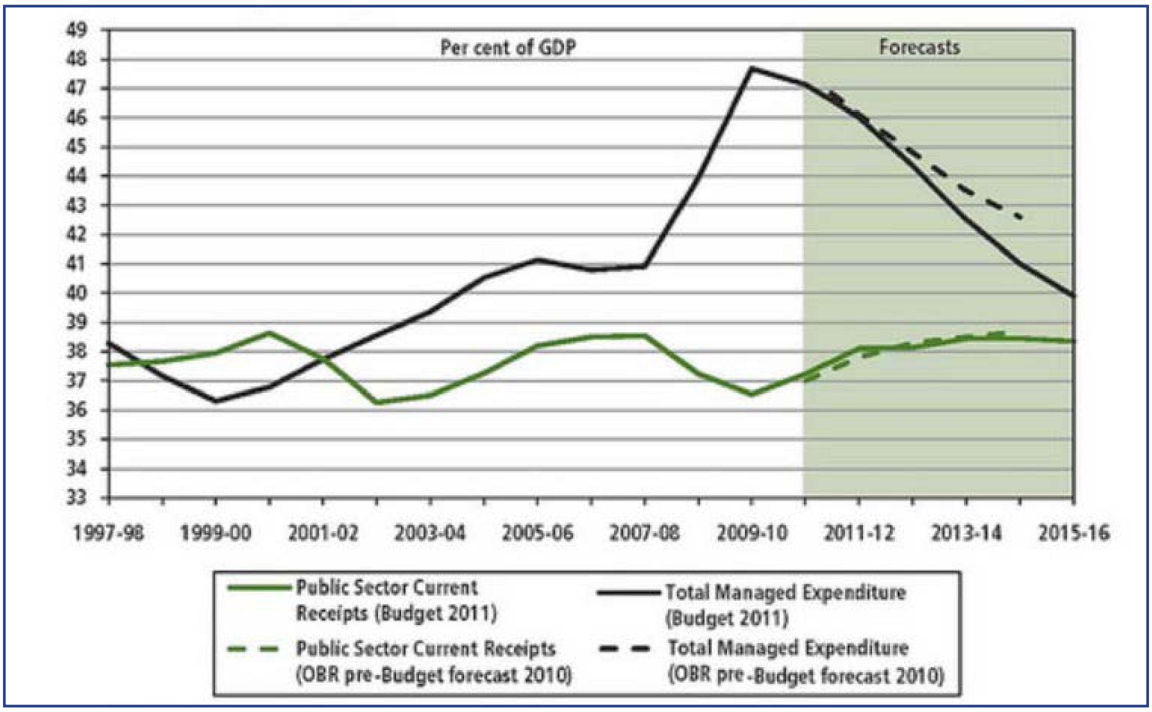
2) The budget

The budget is the annual statement of the government's tax and spending plans. In recent years it has generally been the case that the government's expenditure has been greater than its tax revenue. This situation is described as a budget deficit.

In principle the budget can be in one of 3 states:

1) Budget surplus, where T > G
2) Budget balance where G = T
3) Budget Deficit where G > T

Budget 2011: Receipts and expenditure:



Source: Office for Budget Responsibility and Office for National Statistics

In the graph above, there was a budget surplus between 1998 and 2001 meaning that the government is reducing the size of the national debt (total of all money borrowed by the government) but in all other years there was a deficit, meaning that each year the government is adding to its total amount of debt.

Fiscal Policy - the basics (continued):

Does debt matter?

In short, it can do, for three main reasons:

Firstly, the government has to pay interest on the debt. In 2011-12, this interest was £50 billion. There is obviously a significant opportunity cost of simply using taxpayers' money to pay interest on past debt. £50bn, for example is the same as the amount of money spent on both the police force and transport.

Secondly, the larger the debt, the riskier the government is perceived to be – and this can cause its credit rating to be reduced, making the cost of borrowing more expensive. In 2011, for example, the Greek government had to pay 16% interest for its debt, whereas the Germans were paying only 3% because Germany was seen as a far safer country to lend to.

Thirdly, if the Government is borrowing significant amounts of money, this can cause a shortage of liquidity in the banking system, driving up interest rates for other borrowers, such as firms. This may then damage investment, which as we noted above is the last thing the government is likely to want to do.

It is possible to categorise both government spending and tax.

Government spending

Government spending can be split into Current spending and Capital spending:

Current spending involves the day to day running expenses of the public sector – nurses', soldiers' police wages, medicines for the NHS and so on.

Capital spending is expenditure on infrastructure projects – where something tangible will remain after the expenditure has taken place: New schools and hospitals, the high speed rail link from London to Birmingham and so on.

Taxation

Taxation can be split into Direct and Indirect taxes:

Direct taxes are taxes in income and wealth: Income tax, Corporation tax, National insurance contributions.

Indirect taxes are indirect. They are on spending. You pay the shop, the shop pays the government. Examples are VAT and excise duty (extra taxes generally on goods with negative externalities like alcohol, tobacco and petrol).

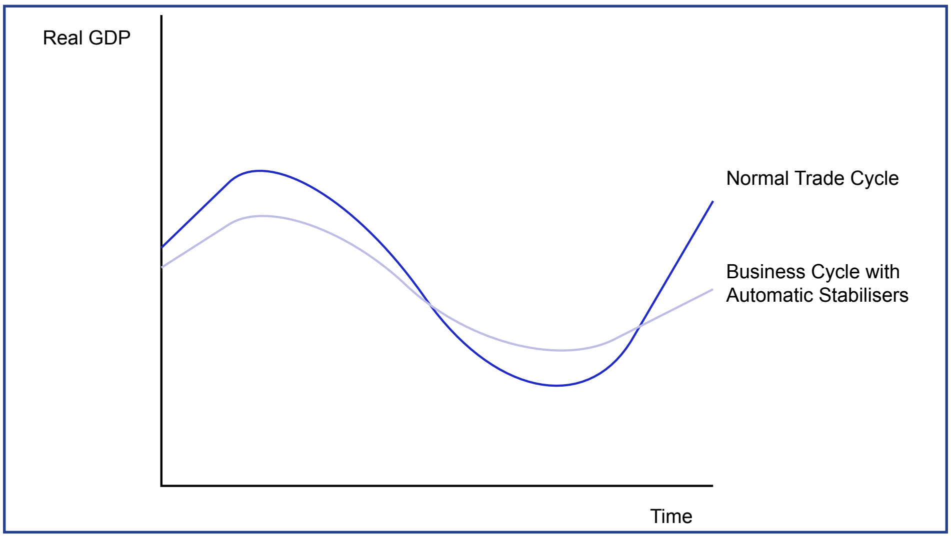
Fiscal Policy - the basics (continued):

3) Demand Side Fiscal Policy

As noted, the aim here is to stabilise the overall level of aggregate demand, trying to prevent the appearance of inflationary (too much demand) and deflationary (too little demand) gaps. The policy works at two levels, automatic and discretionary.

(i) Automatic stabilisers

These work to damp down the trade cycle without any extra decisions being taken by the government. Therefore, they should operate automatically to hold down demand in a boom and to support it in a recession - they are part of the economic structure. Examples include unemployment benefit, which will support demand automatically during a recession. Instead of unemployed workers having no income to spend, instead they get unemployment benefit. Consequently aggregate demand does not fall as low as it would otherwise have done. A stabiliser working the other way is the UK's progressive income tax structure. During a boom, salaries rise, and as they do, the government takes proportionally more and more tax, therefore reducing demand below the level that it would otherwise have reached.

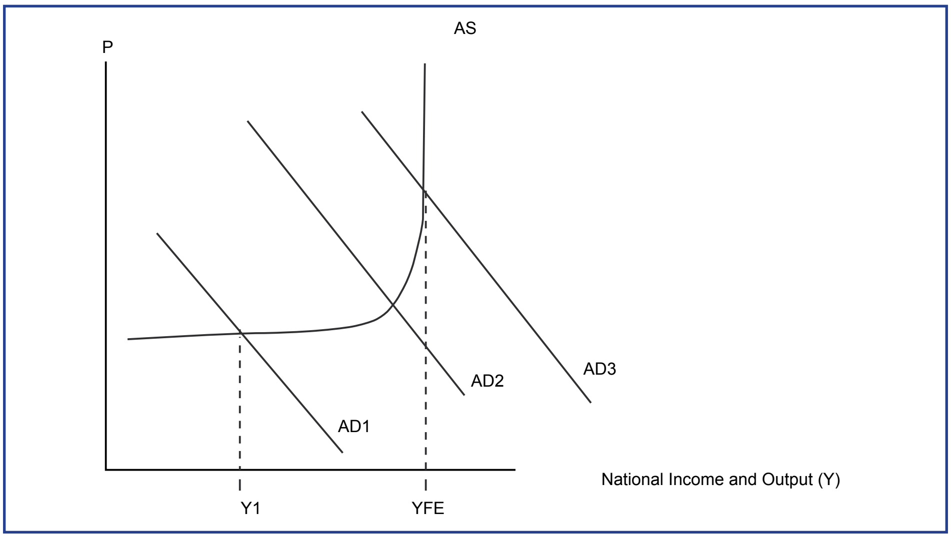


In the diagram, the stabilised cycle is a 'damped' version of the usual cycle. However, the cycle cannot be completely eliminated by automatic stabilisers - before any unemployment benefit can be paid, unemployment has to occur - therefore the stabilisation can only reduce the effects of a recession - not prevent it from occurring.

Fiscal Policy - the basics (continued):

(ii) Discretionary stabilisers

These work to forestall a recession or boom, and allow the economy to grow steadily but not too quickly. In order to work, they require up to date and accurate information, so that when the government anticipates a fall in aggregate demand, it can increase government spending or reduce taxes to compensate. Since this information is basically not available, discretionary policy tends to work as a 'patch-up', to drag the economy out of a recession or boom once it has occurred.



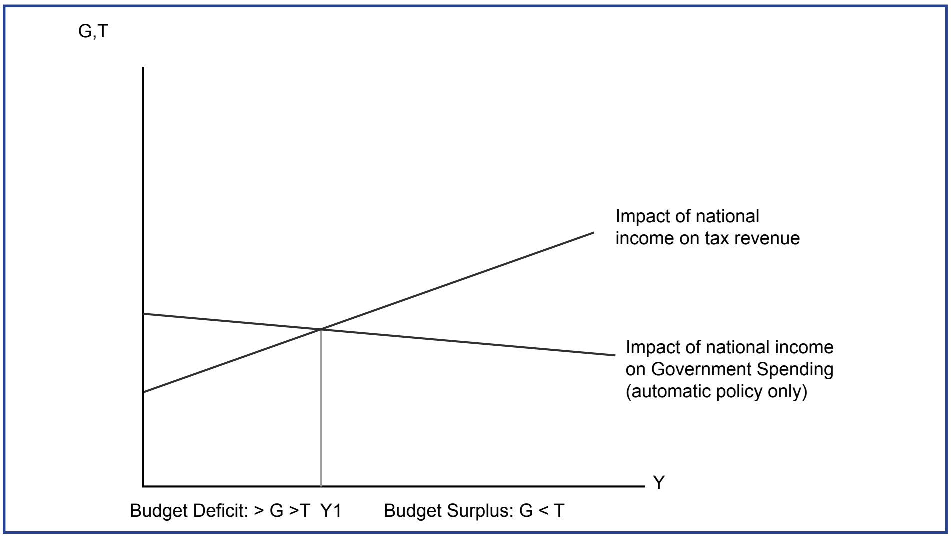
In the diagram, AD1 shows a situation where the economy is in equilibrium far below its full employment capacity (YFE). It will be operating inside its PPF, and will be Pareto inefficient due to high unemployment and lost output. Discretionary policy could be used to increase AD to AD2, via an increase in government spending or a decrease in tax (the government will be borrowing more money to try to increase AD).

If on the other hand, AD was at AD3, this would indicate that the economy was overheating, creating inflationary pressures. Under these circumstances, a government using active policy would cut government spending or increase taxes (reducing the budget deficit), with an aim of easing the inflationary pressures, bringing AD down to AD2.

Therefore, according to classic demand management, the government can ensure that the economy is at full employment without inflation simply by controlling the level of aggregate demand in the economy. This is the classic 'Keynesian' solution to unemployment. In a recession, the government increases G and reduces T, therefore

Fiscal Policy - the basics (continued):

needing to borrow money - there is a Public Sector Borrowing Requirement, or budget deficit. This injection of demand moves the economy out of recession and into boom again. If the economy is overheating, then the government increase taxes and reduces government spending creating a budget surplus or PSDR (Public Sector Debt Repayment). Therefore in theory there is no reason for the National Debt to increase over time. Sometimes the debt increases (during recession) sometimes it falls (during an economic boom), but overall, given the nature of the trade cycle, these two tendencies should cancel out, leaving the government financially sound in the long run.



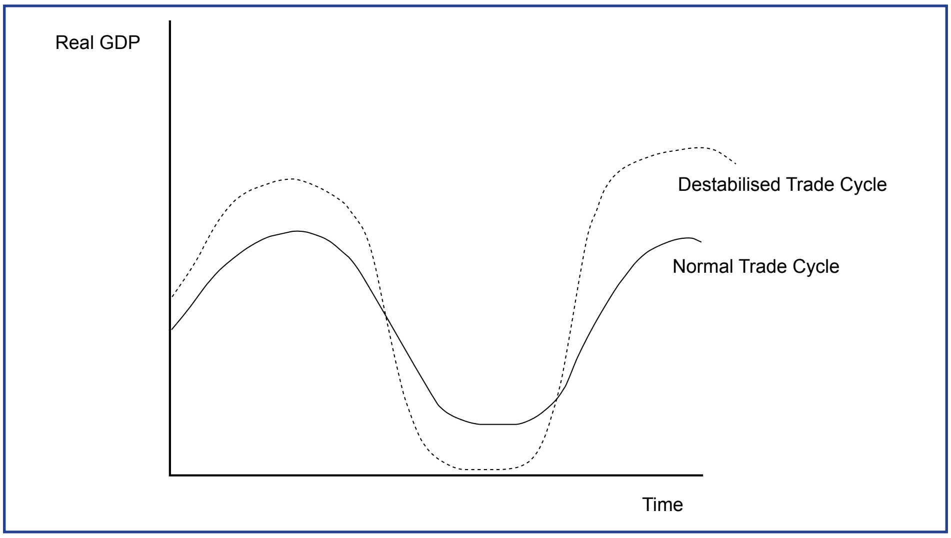
Thus, during a recession the Budget will automatically move into deficit, and in a boom it will automatically move back into surplus, although this will also be influenced by the government's discretionary policy.

Fiscal Policy - the basics (continued):

4) Problems with Demand Side Fiscal Policy

a) Information

Because the government often does not have the information it needs, this can create a situation in which its policies are counterproductive. This is particularly likely when there is a *lead time* before action can be taken, and lags before policies begin to bite. Therefore, the government might feel that the economy is in need of extra demand to forestall a recession, cutting taxes in the next budget. However, the information that the government was acting on is likely to be months out of date. By the time the tax cut begins to have an impact on consumer spending, economic conditions may have changed, meaning that the policy of increasing demand may begin to work when the economy is already in an upswing, therefore exacerbating the trade cycle rather than damping it down.



b) Crowding Out

If the government wishes to expand AD, and finances its Budget deficit through a bond issue, then the total demand for funds in the money market will be higher. The consequence of this is that borrowing rates on medium term debt (loans) will increase. This will be likely to reduce the amount of investment that firms can afford to undertake because of the higher cost of borrowing.

This will have both short and long term effects. In the short term, this reduction in investment will work against the increase in government spending, therefore lessening the impact of the policy. The private sector has been 'crowded out' by the increased role of the government. In the longer term, the reduction in the level of investment may

Fiscal Policy - the basics (continued):

reduce the growth rate of the UK economy. Most studies suggest that there is a strong positive correlation between investment and economic growth. In addition, UK firms will be investing less in R&D and new equipment than international rivals, reducing competitiveness.

c) Precommited spending

In many cases, it may be difficult for the government to alter government spending in a downward direction, due to commitments from previous years. Many major capital investment projects run for more than one fiscal year - if the government has built half of the M40, it would be very difficult to cut spending the next year - half a motorway is of no use to anybody.

d) Increased debt repayments

One consequence of fiscal stabilisation has been the tendency for the National Debt to rise. This has happened because governments are generally much keener to borrow money than they are to increase taxes to pay it back, and precommited spending may make it difficult to reduce government spending quickly. As a result government funds are diverted to the money market rather than being spent on education, health, training and so on, which may undermine the supply side performance of the economy.

e) Poverty/Unemployment trap

As fiscal policy has been used more and more to create 'automatic' stabilisers, there has been an increasing danger that for a substantial proportion of the workforce, accepting a job may not be worthwhile. This is because until recently, accepting a job generally meant losing all benefits (income support etc.) at the same time as becoming liable for tax. This meant that it was possible to end up with less money in a job than you would have received on benefit. This therefore created a major imperfection in the labour market, increasing frictional/voluntary unemployment.

In the 1999 budget, the government has sought to tackle this by guaranteeing all families with a full time employee £200 per week. The previous objection to this is that employers would just use this to pay workers less, but this is more difficult now that the minimum wage has been introduced.

Fiscal Policy - the basics (continued):

f) Difficulty with control

Whereas monetary policy, under control of the monetary policy committee can be altered every month, fiscal policy is generally set through the budget, which is annual. Therefore it may be very difficult to fine tune the economy using fiscal policy. If a major increase in AD is needed, especially when confidence is low, then fiscal policy may be appropriate (Japan 1998), but otherwise governments have tended to rely increasingly on monetary policy as their primary method of demand management.

Fiscal Policy - the basics (continued):

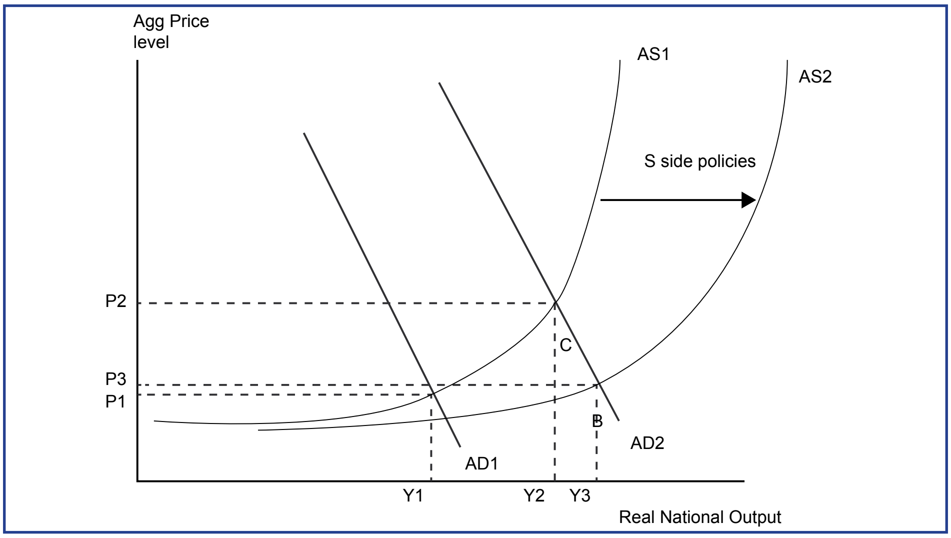
5) Supply Side Fiscal Policy

Since the UK government has controlled demand through monetary policy in recent years (although the financial crisis was an exception), fiscal policy has generally had a different role to play. This has been to enhance the supply side of the economy. As noted previously, this means improving the functioning of labour, capital and product markets to increase the capacity of the UK economy, and to increase the competitiveness of UK firms.

The 1999 budget was a good example of how this has worked. To improve **labour markets**, the government has:

- Introduced individual learning accounts offering big discounts to firms and individuals on training, helping to close the skills/productivity gap with other countries.

In theoretical terms, the impact of these policies will be to shift the AS curve to the right (and probably downwards as productivity improvements reduce unit costs), therefore making it easier for the economy to expand without the build-up of inflationary pressures:



In this case, supply side policies shift the AS curve from AS1 to AS2. Consequently, when AD rises from AD1 to AD2, there is far less upward pressure on prices due to the increase in the capacity/flexibility of the economy. Therefore the main effect of the extra demand is to raise output rather than prices, resulting in a new equilibrium at 'B' rather than 'C'. Hence we get a rise in output to Y3 instead of Y2, whilst prices rise only to P3 instead of P2.

Fiscal Policy - the basics (continued):

The effect of supply side policies on policy objectives

Looking at supply side policies alone, given that their aim is to boost productivity (output per worker), then this should generally be beneficial: Higher productivity should help to reduce firms' unit costs, therefore putting downward pressure on inflation as well as helping UK firms to be more competitive internationally, therefore improving the trade balance.

At the same time, the greater efficiency should also promote growth and hence jobs. These effects can be seen in the diagram below, as inflation is reduced (P1 to P2) and real GDP rises (Y1 to Y2), although these effects may take some time to be felt: