Fiscal Policy

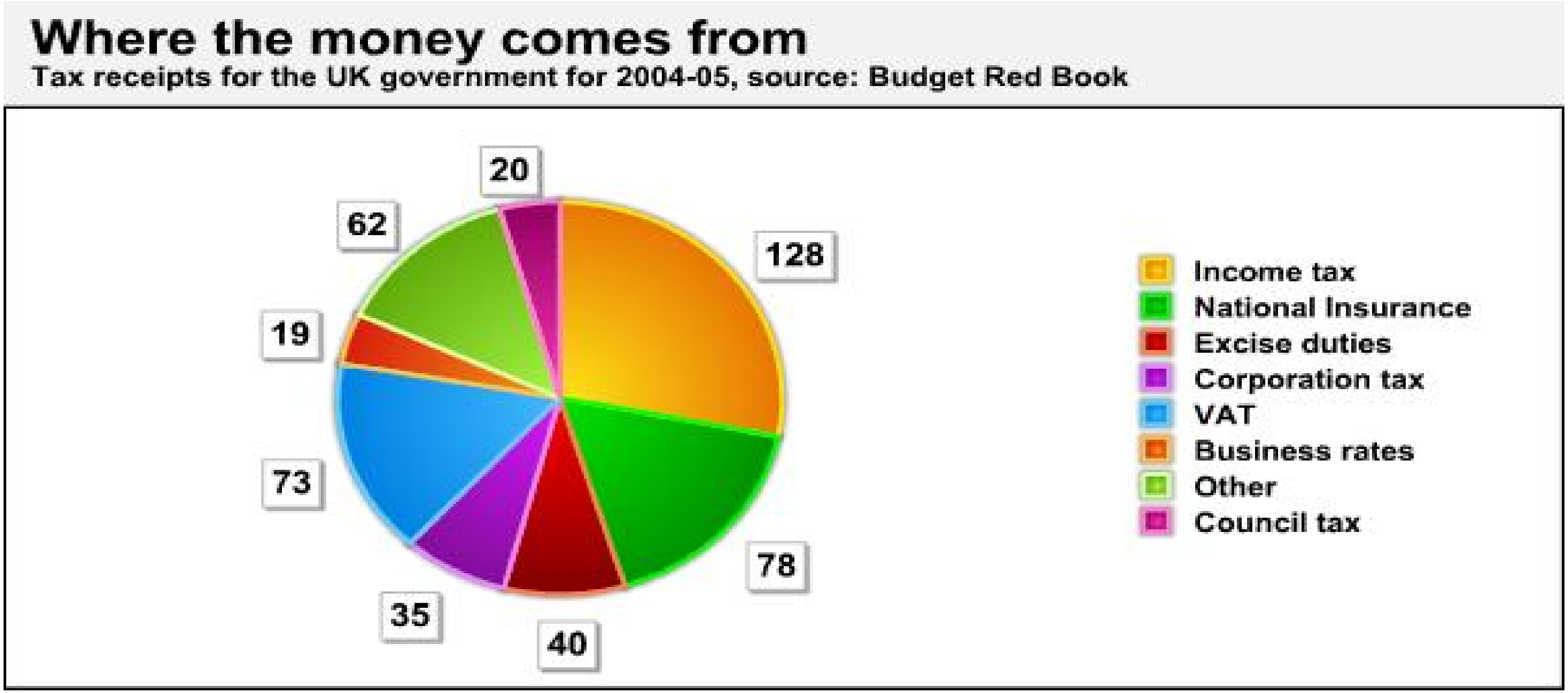
AS Economics Presentation

2005

What is Fiscal Policy?

- Fiscal policy involves the use of government spending, taxation and borrowing to
  - (i) influence the pattern of economic activity
  - (ii) affect the level and growth of aggregate demand, output and employment
- Fiscal policy can be used to influence aggregate supply too
- The term ‘public sector’ refers to the government sector (i.e. including central government and local government spending and taxation)

Tax revenues in 2002-03 (£ billion)



Income tax and national insurance

Income Tax and Corporation Tax in the UK		Data is for the tax year 2003-04
Income tax		
Personal tax-free allowance:	under age 65	£4,615 p.a.
Lower rate		10%
Basic rate		22%
Higher rate		40%
Lower-rate limit	(income above personal	£1,960 p.a.
Basic-rate limit	allowance)	£30,500 p.a.
Corporation tax		
Rates:	lower rate	0%
	small companies' rate	19%
	standard rate	30%

Examples of indirect taxation

Vehicle excise duty		
Standard rate		£155 p.a.
Small cars rate		£100 p.a.
Heavy goods vehicles (varies according to vehicle type and weight)		£155-£9,250 p.a.
Landfill levy		
Standard rate		£11 per tonne
Low rate (inactive waste only)		£2 per tonne
Climate change levy (Came into effect on 1 April 2001)		
Electricity		0.43p/kWh
Coal		0.15p/kWh
Natural gas		0.15p/kWh

Why does the government tax?

- Revenue
  - To raise revenue to finance government spending (e.g. on public and merit goods and services)
- Managing aggregate demand
  - To help meet the government's macroeconomic objectives such as stable inflation and economic growth
- Changing the distribution of income and wealth
  - A progressive system of taxation can help bring greater equality in income & wealth between households
  - The government may intervene directly through fiscal policy to on grounds of equity
- Market failure and environmental targets
  - Taxes can correct for externalities – a source of market failure

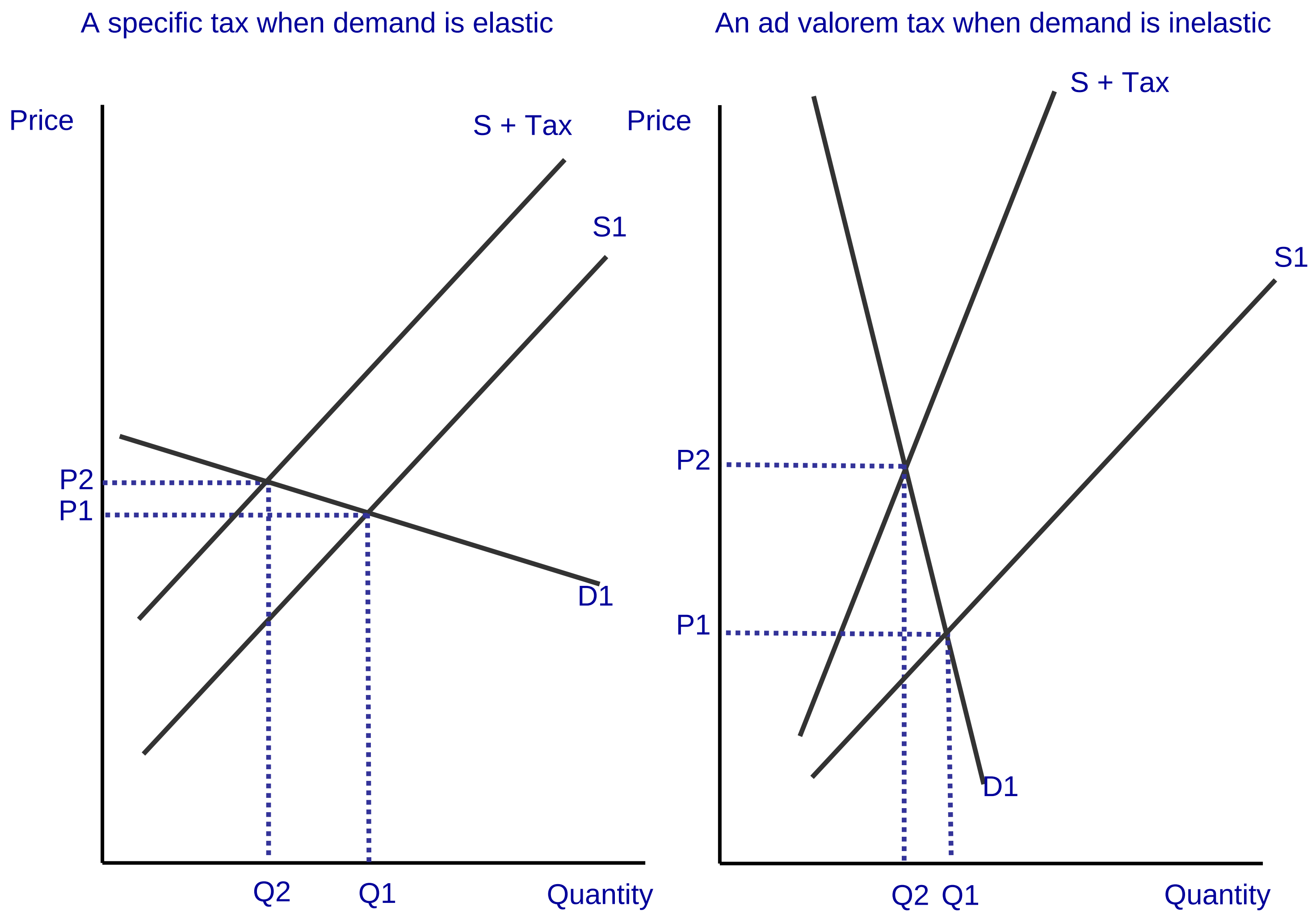
Direct taxes

- Direct taxation
  - Direct taxation is levied on income, wealth and profit
  - Direct taxes include
    - income tax
    - national insurance contributions
    - capital gains tax
    - corporation tax
  - The burden of a direct tax cannot be shifted
  - Over the last twenty years in the British economy, there has been a shift towards indirect taxes

Indirect taxes

- Indirect taxation
  - Indirect taxes is levied on spending by consumers on goods and services
  - Indirect taxes include VAT; excise duties on fuel and alcohol, car tax, betting tax and the TV licence
  - VAT: An indirect tax at the rate of 17.5%, although domestic fuel is taxed at 5%
  - Excise duties are specific duties. The main duties are placed on cigarettes, alcohol, and fuel
  - The burden of an indirect tax might be passed onto the consumer by the producer
    - This depends on the price elasticity of demand and supply for the product

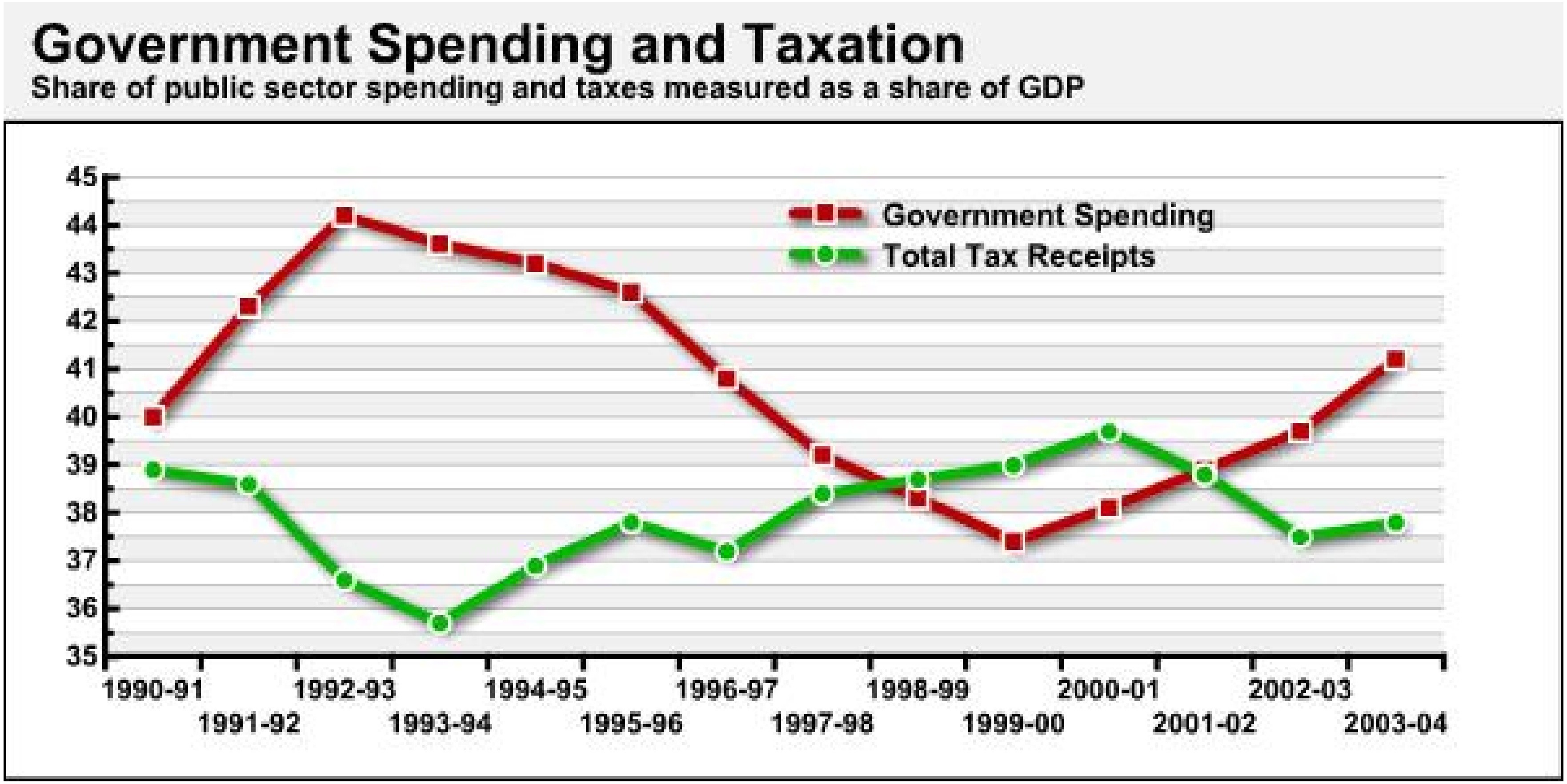
Indirect tax using supply & demand



Progressive and regressive taxation

- Progressive taxes
  - With a progressive tax, the % rate of tax rises as income rises
- Proportional taxes
  - With a proportional tax, the % rate of tax is constant
    - For example, we might have an income tax system that applied a standard rate of tax of 25% across all income levels
- Regressive taxes
  - With a regressive tax, the % rate of tax falls as incomes rise
  - In the UK, most examples of regressive taxes come from excise duties of items of spending such as cigarettes and alcohol and also VAT

Trends in the government tax burden

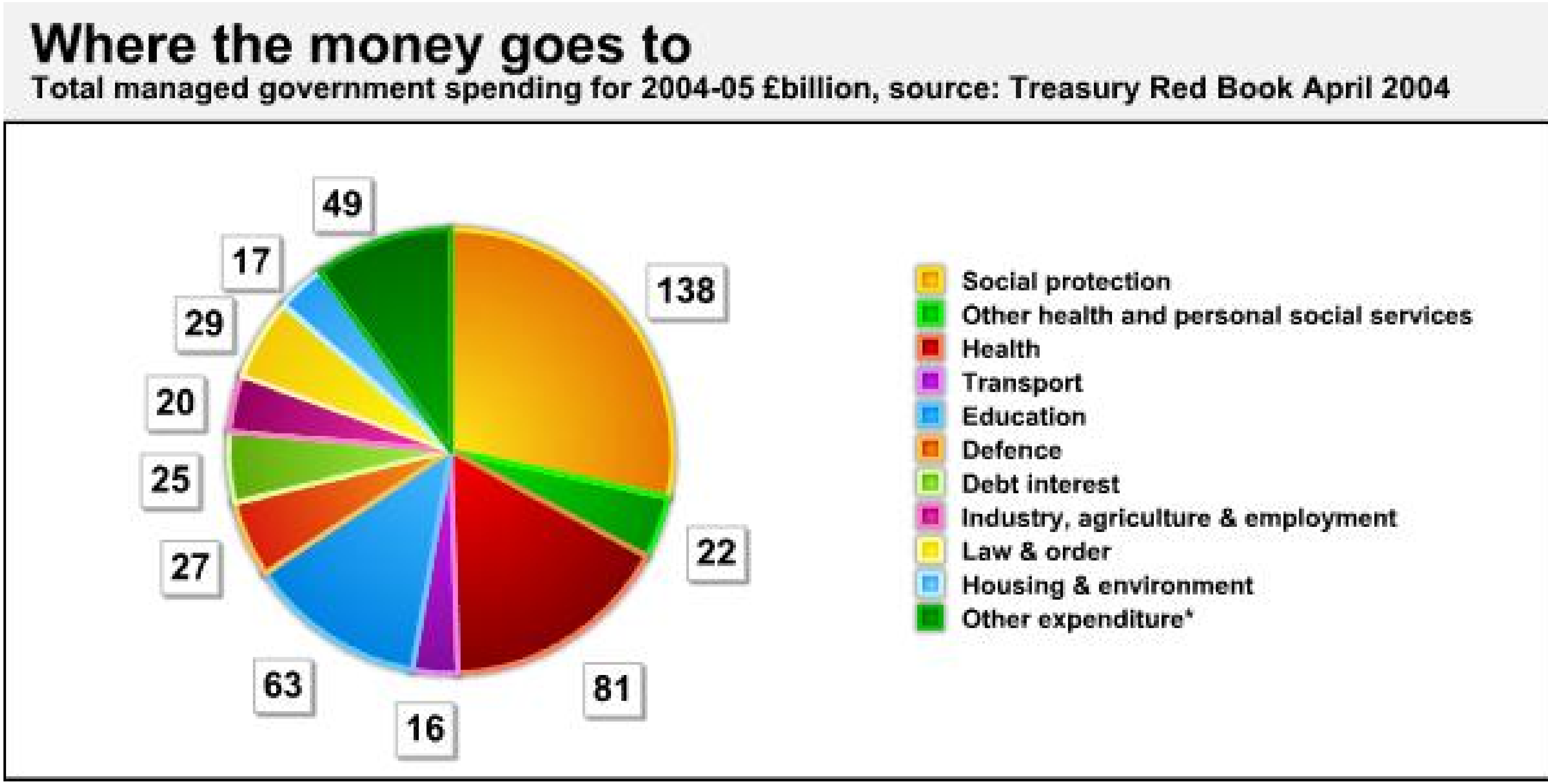


Government spending (G)

- Government (or public) spending each years takes up over 40% of gross domestic product
- Spending by the public sector can be broken down into three main areas:
  - (1) Transfer Payments: i.e. welfare payments made to benefit recipients such as the state pension and the Jobseeker's Allowance
  - (2) Current Government Spending: i.e. spending on state-provided goods & services such as education and health
  - (3) Capital Spending: i.e. infrastructural spending such as spending on new roads, hospitals, motorways and prisons

Public Sector Spending

Distribution of Public Spending



Composition of Government Spending

- Transfer Payments (i.e. welfare payments)
  - Social security payments
  - Over £110 billion including
    - Income support
    - Jobseekers' Allowance
    - State Pensions
    - Housing benefit / Council Tax Benefit
  - Some benefits are means tested
  - Others are universal or are based on national insurance contributions
- Benefits help to even out the distribution of income
- So too does the effect of a progressive tax system
- But no welfare system ever seeks a huge redistribution of income

Recent trends in government spending

	Government spending at current prices	Government spending in real terms	Government spending as a share of GDP
	£ billion	£ billion	(2001-02 prices)
1997-98	323.6	367.5	39.3
1998-99	333.3	368.5	38.4
1999-00	343.6	370.9	37.4
2000-01	366.8	387.2	38.1
2001-02	389.8	401.5	38.8
Projections			
2002-03	419.9	419.9	39.8
2003-04	450.7	438.9	40.7
2004-05	479.6	455.3	40.9
2005-06	511.4	473.6	41.3

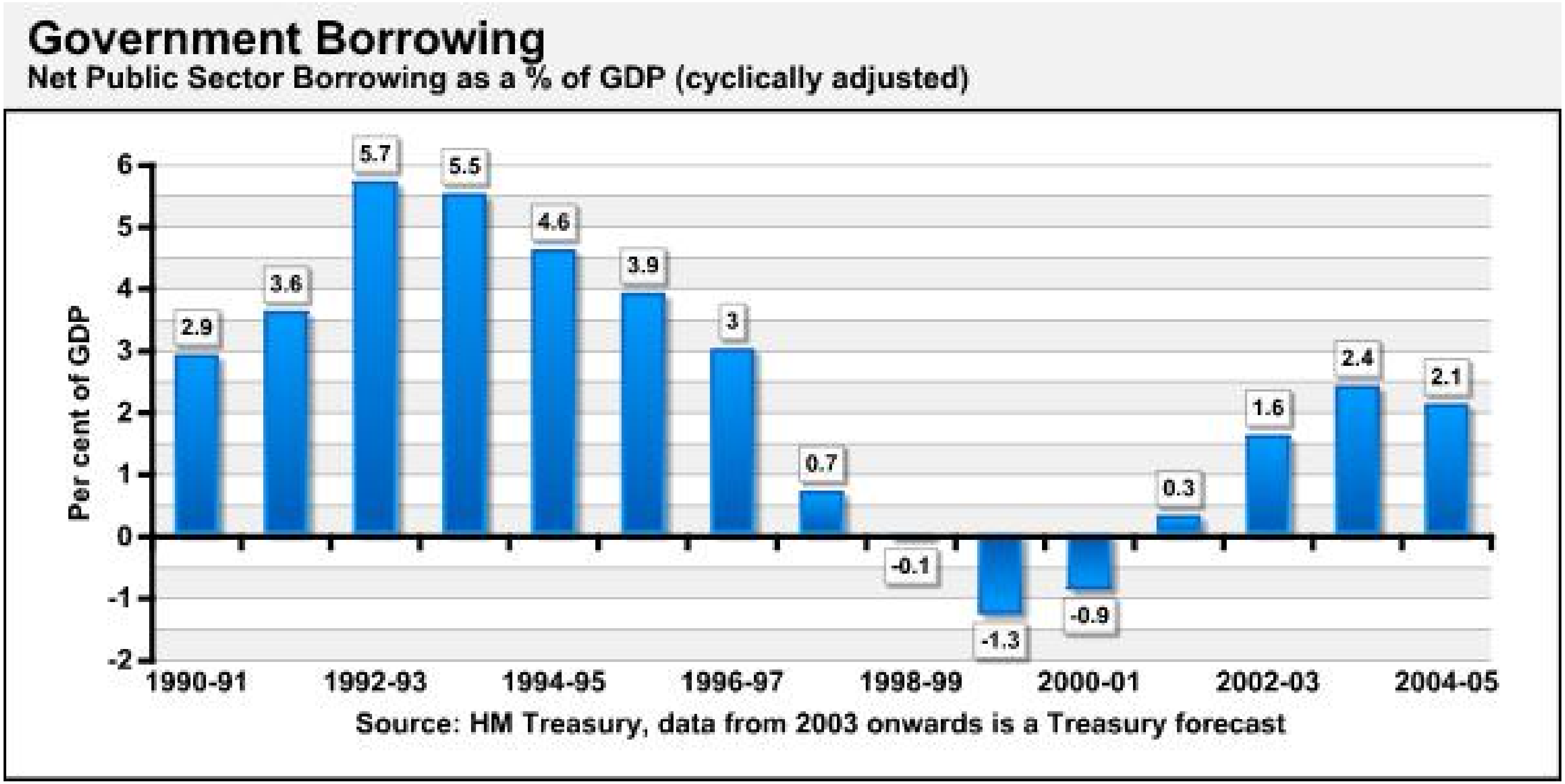
Why Have Government Spending?

- Direct government (public sector) provision of
  - Public Goods
  - Merit Goods
- Provide welfare support for low income households / the unemployed
- Government spending is also a means of redistributing income within society e.g. to reduce the scale of relative poverty
- Government spending can also be used as a tool to manage aggregate demand (GDP) as part of macroeconomic policy

The budget deficit / surplus

- The budget deficit measures how much the government sector needs to borrow each year to finance its own spending
- The national debt is the total amount of borrowing undertaken by the government that has not yet been repaid
  - The national debt is the sum of all outstanding central government debt
  - In 2003-04 the British government is running a very large budget deficit
  - In 2004 it is forecast to rise to over 3% of national income
  - There are fears that taxes may have to rise

Government budget balances



Why is Gordon Brown running such a large budget deficit?

- Large increases in government spending in key priority areas – notably the NHS
- A slowdown in tax revenues
  - Global economic weakness
  - Lower company profits
- The result is a sharp rise in government borrowing
- In the short term a budget deficit boosts aggregate demand
- But
  - (i) Eventually taxes may rise to reduce the deficit
  - (ii) The government may have to trim its spending plans
  - (iii) Interest rates might have to rise to persuade people to buy government bonds

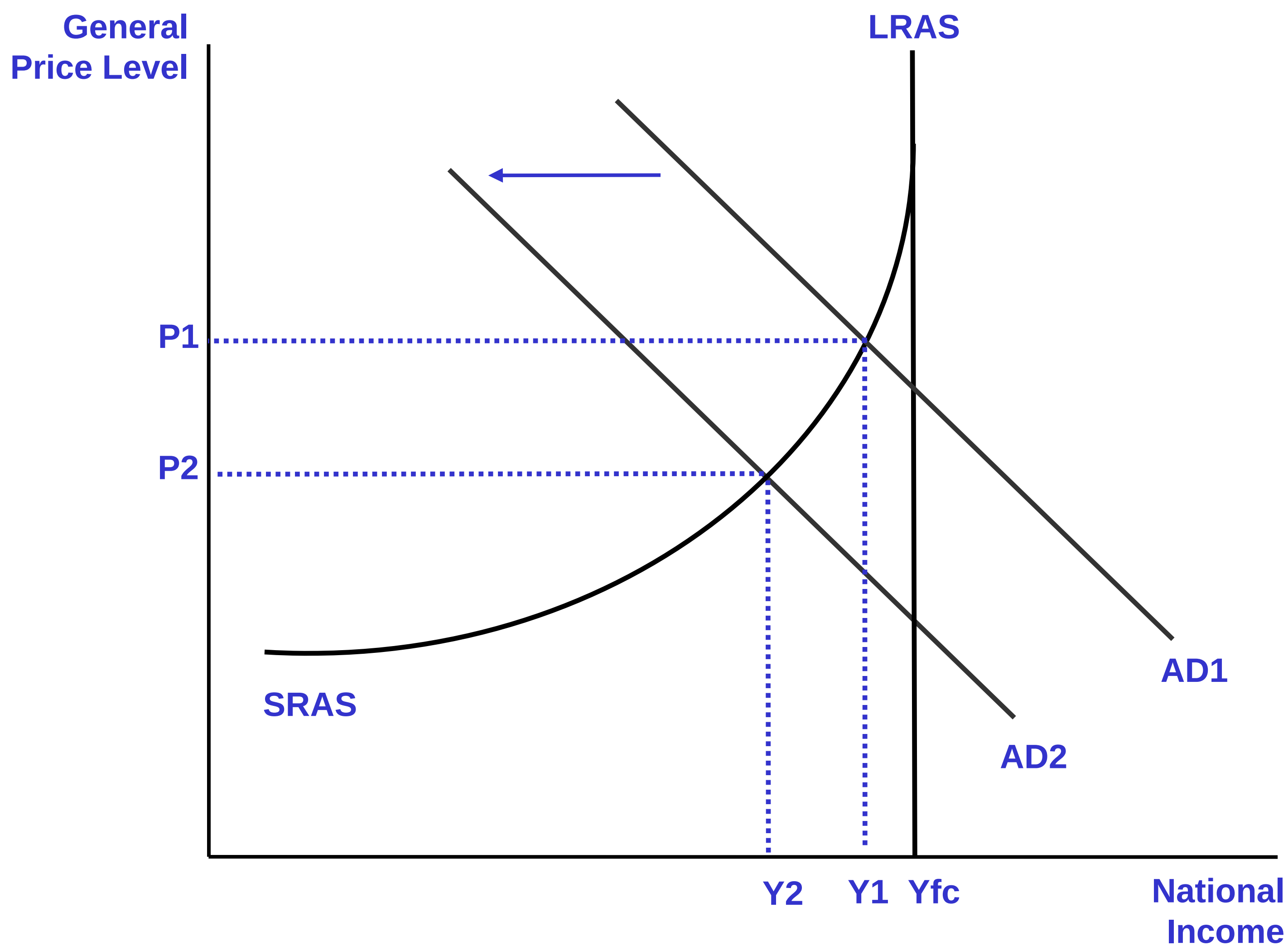
Brown’s Fiscal Rules

- The golden rule
  - Government borrowing finances investment but not current expenditure over the course of the economic cycle
- The sustainable investment rule
  - Requires net government sector debt to be at a “stable and prudent” level over economic cycle – probably around 40% of GDP
- These rules do not have to be met each year - they are designed to provide targets for government borrowing (and hence spending and tax decisions) over the medium term / economic cycle

Fiscal policy and aggregate demand

- Fiscal policy can be used "counter-cyclically" to help smooth out some of the fluctuations in real GDP
  - From 2001-2003 there has been a huge fiscal stimulus to the economy through increases in government spending on transport, health and education
- The Keynesian school argues that fiscal policy can have powerful effects on AD, output and employment, particularly when the economy is operating well below full capacity
- Other economists argue that government borrowing can have negative consequences

Negative output gap



Taxation and Aggregate Demand

The fiscal policy transmission mechanism

Expansionary Fiscal Policy

Cut in personal income tax →	Boost to disposable income →	Adds to consumer demand
Cut in indirect taxes →	Lower prices – higher real incomes →	Adds to consumer demand
Cut in corporation tax →	Higher "post tax" profits for businesses →	Adds to business capital spending
Rise in government spending →	Direct boost to aggregate demand →	Possible multiplier effects on national income

Shaping the supply-side of the economy

Fiscal policy and aggregate supply

- Labour market incentives:
  - Cuts in income tax might improve incentives for people to seek work and boost labour productivity
- Capital spending
  - Lower rates of corporation tax might stimulate a higher level of business investment from domestic and foreign firms
- Entrepreneurship and new business creation:
  - Government spending might be used to fund new small business start-ups

Fiscal policy and aggregate supply

- Research and development and innovation:
  - Tax credits could be used to encourage an increase in business research and development
- Human capital of the workforce:
  - Higher spending on education and training (designed to boost the human capital of the workforce)
  - Increased investment in health and transport can also have very important supply-side effects