

Chapter 30 Fiscal policy

Answers to Knowledge checks

- 30.1** A project of this kind, designed to improve transport links between the southeast and southwest (and to preserve the nation's heritage) would be part of capital expenditure.
- 30.2** A example of a fiscal measure to increase aggregate demand is public expenditure on infrastructure — or any other item of government expenditure such as social security benefits. A reduction in taxation would also increase aggregate demand through its impact on consumer spending power.
- 30.3** If the marginal propensity to import is high, then the withdrawals from an increase in autonomous expenditure will be diluted. In other words, the successive round of spending that makes up the multiplier effect will be less strong. See Chapter 21 for more detail on this.
- 30.4** This would be a budget deficit.
- 30.5** With a structural deficit, the national debt would grow even when the economy was in the upturn or booming. This would mean that the country was becoming more and more indebted, and at some point this would make it more difficult and more expensive to borrow — and to meet the interest payments on existing debt.
- 30.6** When the economy is in the boom phase of the economic cycle, incomes are rising, so tax revenues will increase. Furthermore, more people will be taking jobs, therefore reducing the government's expenditure on transfer payments. These tend to reduce the government budget deficit, and offset the upward pressure on the price level that accompanies a boom period.
- 30.7** This could put the 'crowding out' effect into reverse — a process known as 'crowding in'. The private sector would be able to borrow more readily, and there would be resources available for investment and expansion.
- 30.8** Employees' NIC payments are progressive, in that they make up 1.6% of disposable income of households in the bottom quintile, but 4.8% of income of those in the top quintile.
- 30.9** When the demand for a good is relatively price inelastic, producers will be able to pass on an increase in indirect taxes to consumers, as they are insensitive to price. The opposite applies when demand is price-elastic, as consumers will switch away from buying the good if the price is raised.

Answers to Exercises and Case studies

Exercise 30.1

Find out about the stance of the various political parties by checking out the manifestos produced for the most recent general election. In particular, see what is said about the attitudes towards taxation and public spending.

Exercise 30.2

In Figure A30.1a, the economy begins in equilibrium at the full employment level of real output Y_{FE} , and with the aggregate demand curve at AD_0 . An expansionary fiscal policy moves the aggregate demand curve to the right, to AD_1 , and the price level rises to P_1 .

You can see that in this situation fiscal policy cannot affect the equilibrium level of real output, but merely pushes up the general level of prices in the economy.

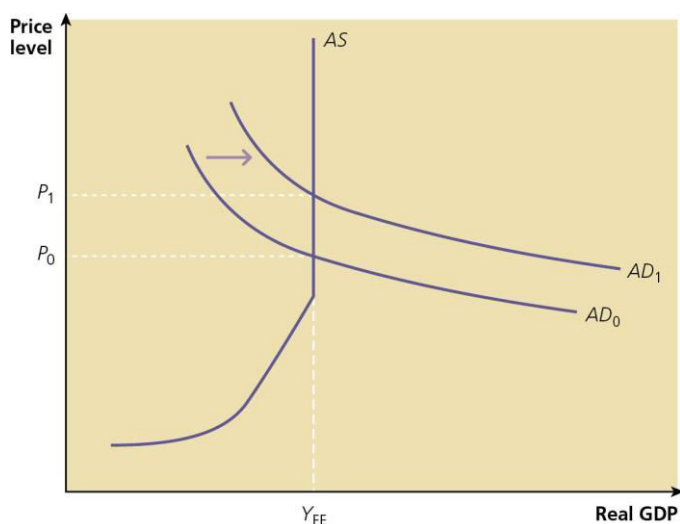


Figure A30.1a The use of fiscal policy (1)

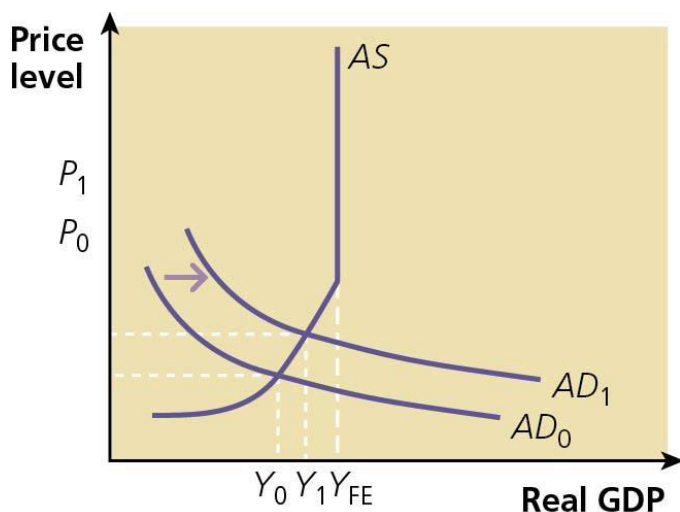


Figure A30.1b The use of fiscal policy (2)

By contrast, in Figure A30.1b, the economy begins in equilibrium with aggregate demand at AD_0 , and with real output below the full employment level. Price is at P_0 . If fiscal policy is used in this situation, it moves the aggregate demand curve to the right to AD_1 , and the new equilibrium position, while still below full employment, has resulted in higher real output, which has increased from Y_0 to Y_1 . The general level of prices has also increased, from P_0 to P_1 . However, fiscal policy has now had some effect on real output, and has taken the economy closer to full employment.

Notice that this analysis implies that the government must be very careful when framing fiscal policy, and needs to know how close the economy is to full employment before using it in an active manner. Policy-makers also need to be aware that fiscal policy measures do not take effect instantaneously, so the policy must be designed to have an impact on the problems that the economy will face in the future. The danger is that by the time the policy takes effect it will no longer be necessary — or appropriate.

Exercise 30.3

Table A30.3 Average and marginal tax rates

Income (£)	Tax paid (£)	Average tax rate (%)	Marginal tax rate (%)
1,000	100	10	—
2,000	300	15	20
3,000	600	20	30
4,000	1,000	15	40

Case study 30.1

The HS2 project and the macroeconomy

- a** In the short run, the expenditure by government constitutes an increase in aggregate demand, so the AD curve would shift to the right, as shown in Figure A30.2. The extent of the shift would depend not only on the direct expenditures, but also would reflect multiplier effects. For example, as part of the construction, workers would be hired who in turn would spend their income, therefore resulting in a second round of spending, benefiting local shops and other businesses.

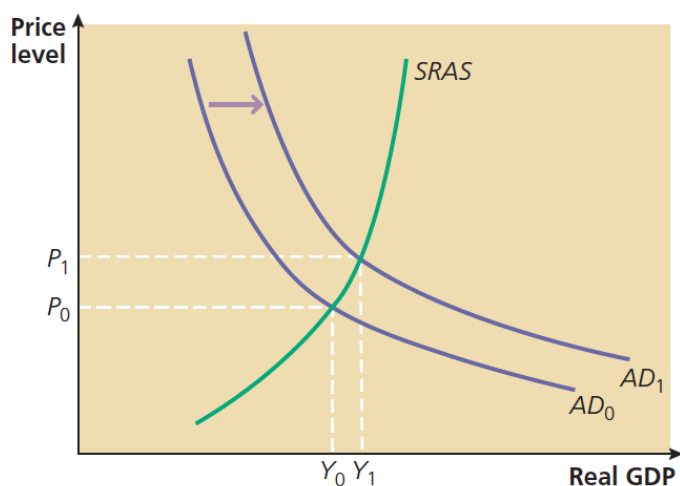


Figure A30.2 An increase in aggregate demand in the short run

- b** In the long run, the benefits from the project should increase the productive capacity of the economy through the cost savings of faster travel and the easing of capacity on other routes.

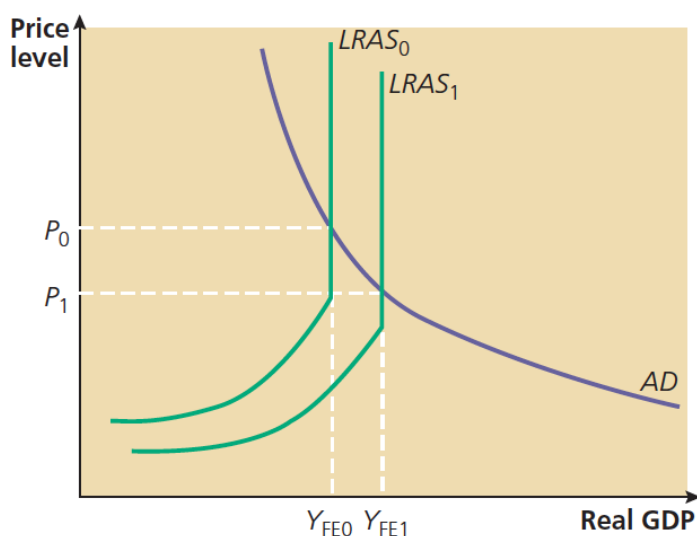


Figure A30.3 An increase in aggregate supply in the long run

Figure A30.3 shows the effect of an increase in aggregate supply from $LRAS_0$ to $LRAS_1$. The full employment level of output rises from Y_{FE0} to Y_{FE1} and there is downward pressure on the overall price level.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 c. National insurance payments
- 2 a. Surplus
- 3 a. Changes to government revenue and expenditure that happen without direct intervention

B Knowledge and understanding questions

- 4 Discretionary fiscal policy is a situation in which the government uses its discretion to intervene in the economy in an attempt to stabilise it.

A full explanation of discretionary fiscal policy	2 marks
A vague or partial explanation of discretionary fiscal policy	1 mark

- 5 At low rates of tax revenue increases, but beyond a certain point the revenue begins to fall. If an economy has been operating with a tax rate above this point then a reduction in the tax rate will actually increase the revenue raised by the tax.

An explanation of the relationship between the taxation rate and the amount of government revenue raised through taxation	up to 2 marks
An explanation of the Laffer curve	up to 2 marks

- 6 Effects may include:

- An increase in taxation is likely to decrease consumption leading to a decrease in AD and real GDP
- An increase in taxation may also disincentivise investment also leading to a decrease in AD and real GDP

An explanation of the likely effect of an increase in taxation	up to 2 marks
An explanation of the likely effect of an increase in taxation — decrease in AD	up to 2 marks

C Stimulus response question

- 7 a Government spending on public goods, such as the National Health Service.

An explanation of expenditure on public services AND an appropriate example	2 marks
An explanation of expenditure on public services OR an appropriate example	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- Fiscal policy

Application (1 mark) is likely to include:

- Application to the UK economy:
 - Expenditure for public services will grow above inflation until 2023
 - Fuel duty (taxation) was frozen for the ninth year in a row
 - A new tax (from April 2020) on large digital firms revenue

Analysis (5 marks) is likely to include:

Analysis of possible effects of fiscal policies, for example:

- Increased government expenditure, leading to an increase in *AD*
- Increased taxation leading to a decrease in *AD*

Evaluation (5 marks) is likely to include:

Evaluation that the effects may not lead to changes in the economy, for example:

- Depends upon the level of taxation/government expenditure
- Depends upon the relative size of the proposed changes
- Depends upon the timescale
- Depends upon other factors influencing the economy
- Depends upon the state of the economy

A judgement of both the likely effects and the largest effect of the fiscal policies outlined in the data

D Essay question

8

AO1 Knowledge	3 marks
AO2 Application	4 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (3 marks) likely to include:

- Fiscal policy:
 - Use of taxation
 - Use of government spending

Application (4 marks) is likely to include:

- Application to the macroeconomic objective of economic growth

Analysis (6 marks) is likely to include:

Analysis of the effects of fiscal policy, for example:

- Increased government expenditure, leading to an increase in *AD* and short-run economic growth
- Decreased taxation, leading to an increase in *AD* and short-run economic growth

Evaluation (7 marks) is likely to include:

Evaluation that the given causes may not lead to economic growth in the economy, for example:

- Increases in *AD* may not lead to an increase in real GDP (classical *LRAS* or economy at full employment)
- Increases in *AD* may only have an inflationary effect
- Depends upon the size of the changes to fiscal policy
- Depends upon future expectations of the macroeconomy
- Depends on the output gap
- Growth may occur only in the short run

A judgement of the effectiveness of fiscal policy is achieving the government macroeconomic objective of economic growth