

# Fiscal policy

In this centrespread about macroeconomic policy, **Peter Smith** highlights the key aspects of fiscal policy

## What is fiscal policy?

- Fiscal policy is the use of government expenditure and revenue to influence the path of the economy.
- The level of government expenditure is part of aggregate demand.
- Taxation can be seen as a withdrawal from the circular flow.
- Fiscal policy was used actively in the period after the Second World War.
- This was under the influence of Keynesian thinking.
- This was a period when sterling was tied to the US dollar.
- Fiscal policy became less effective when the pound was floated in 1972, but it still has a role in influencing the economy.

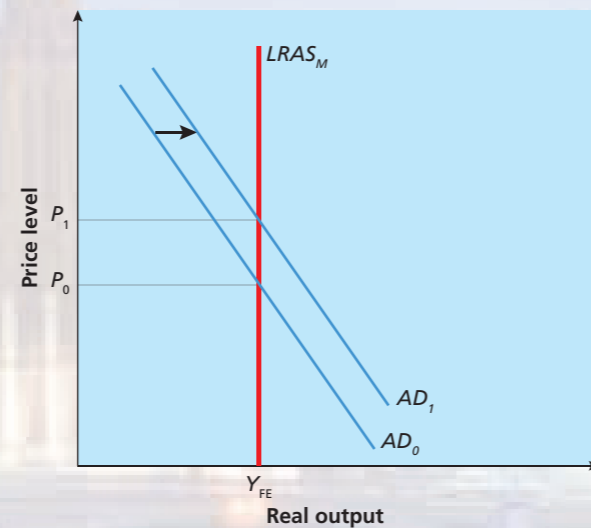
## The tools of fiscal policy

- An increase in government spending can have multiplier effects, enhancing the impact on aggregate demand.
- Reducing the level of taxation can also affect aggregate demand.
- The impact of tax changes is different from that of expenditure changes, as tax changes work through the spending of economic agents.
- The overall impact of fiscal changes depends on the balance between government expenditure and revenue.
- In a period, if government expenditure exceeds revenue, the government runs a budget deficit.
- Such a deficit needs to be financed through borrowing.

## Fiscal policy and the AD/AS model

- Figure 1 shows the impact of an increase in government expenditure under different assumptions about the shape of long-run aggregate supply (LRAS).
- In the top panel, the LRAS is drawn to reflect a classical (or monetarist) view.
- LRAS is vertical, because it is assumed that the economy returns rapidly to the full employment level of real output ( $Y_{FE}$ ).
- Under this assumption, the increase in AD has no impact on real output, but results in an increase in the equilibrium price level.
- In bottom panel, the LRAS is drawn to reflect Keynesian assumptions, with the economy starting at an equilibrium that is below full employment.
- In this situation, an increase in AD does affect real output, although there is also an increase in the price level.

An increase in AD with a 'Monetarist' LRAS curve



An increase in AD with a Keynesian LRAS curve

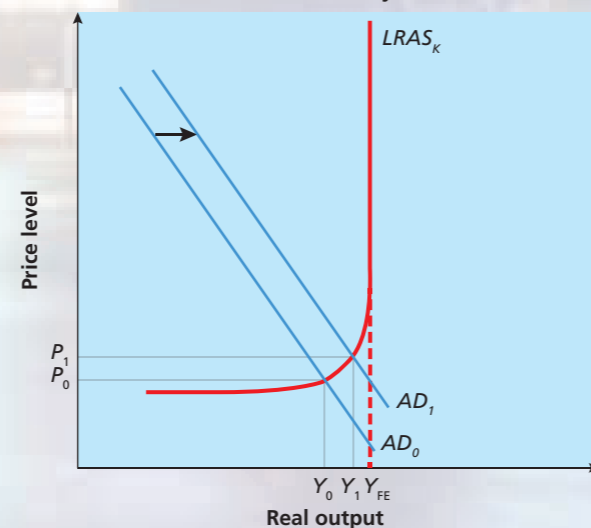


Figure 1 An increase in aggregate demand in the AD/AS model

## Timing issues with fiscal policy

- An issue with fiscal policy is that measures that are introduced take some time to take effect.
- Once policy changes come into effect, it then takes time for firms and households to revise their behaviour.
- It is also important to realise that at the time when policy changes are being planned, they must be designed based on forecasts of how the economy will be changing in the future.
- All this means that the lags between designing a policy and seeing it affecting the economy can be very long.
- In some situations, fiscal policy measures will start affecting the economy when the original problems for which they are designed have already changed.

## Rules or discretion?

- An important issue is whether policy changes should be dictated by rules, or whether the authorities should be able to use discretion.
- Monetarists have long argued that it is crucial to operate macroeconomic policy through setting rules.
- This applies especially to fiscal policy, because the impacts of policy changes and their timing can be unpredictable.
- This means that discretionary changes to policy can be damaging for the economy, whereas a rules-based approach helps to raise the credibility of policy, and therefore enables more stability.
- A rules-based approach to fiscal policy was introduced by the Labour governments of 1997–2010, stating that government borrowing should only be used for investment rather than current consumption.
- Under this 'Golden Rule' the national debt should not rise above 40% of GDP.
- This approach was abandoned in the face of the financial crisis and the pandemic.

## The public finances

- When the government runs a budget deficit, it must raise finance through borrowing.
- Such borrowing adds to the national debt (public sector net debt).
- This debt needs to be serviced — in other words, interest payments must be made.
- At the time of the financial crisis of 2008/09, the government bailed out some banks that were in difficulty.
- Substantial further spending was undertaken during the Covid-19 pandemic.
- The result was that public sector net debt rose to more than 100% of GDP.
- As interest rates were increased during the cost-of-living crisis in 2022/23, the cost of servicing government debt rose, calling into question the sustainability of the public finances.

## Fiscal policy in macro and micro contexts

- Fiscal policy can also be used to tackle microeconomic issues.
- One example of this is the use of taxes to tackle market failure, such as externalities.
- Taxes are also utilised to affect the distribution of income between groups in society.
- The distribution of income can also be affected by some items of government expenditure.
- For example, transfer payments through social security benefits can transfer resources from richer to poorer groups.

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