FISCAL POLICY

Policy instruments: Tools governments use to implement their policies, such as interest rates, rates of taxation, levels of government spending. They use them to affect other variables (such as aggregate demand, inflation, unemployment, GDP) in the economy and help achieve their macroeconomic objectives.
Fiscal policy: Decisions about government spending, taxation and levels of borrowing that affect aggregate demand in the economy. It can be used to influence behaviours of firms and individuals.
Budget: Yearly published plan of the government, which shows its plans on spending, revenue and dept.

Government Revenue

The main source of revenue for the government is taxation. Reasons why governments impose taxation:

- To pay for public sector services.
- To encourage and discourage certain activities, such as smoking or dumping waste in landfill sites.
- To control aggregate demand in the economy.
- To make the distribution of wealth in the economy fairer (by taxing the wealthy more heavily than the poor).

Direct taxes = Taxes imposed on firms and individuals. They are usually linked to income earned and wealth. Examples:

Inheritance tax: A tax which is paid on the things of value you leave behind when you die. However, in most countries, a certain amount of money can be passed on to relatives, friends and other benefactors before this tax applies.
Corporation tax: A tax on the profits of limited companies. Unincorporated businesses (such as sole traders and partnerships) pay income tax.
Capital gains tax: A tax placed on any financial gains made when selling assets, such as shares, businesses and properties, at a profit.
Income tax: A tax placed on your annual income whether you receive that income from an employer or are self-employed. It is a common and important tax worldwide.
Social insurance tax: A tax placed on wages and salaries of people and used to fund specifically state benefits (pensions, benefits and health care).

Indirect taxes = Taxes imposed on spending. Examples:

Stamp duties: These are paid when buying certain assets, such as houses and shares.
Council tax: A tax placed on households based on the estimated value of the property and the number of people living in it. It is collected by local authorities to help pay for local community services.
Sales tax: A tax on the consumption of goods and services, such as the *value-added tax*.
Customs duties: Taxes placed on imports. If two countries are members of the same customs union, then goods travelling from one country to another would not be subjected to these taxes.

Business rates: A tax placed on businesses based on the estimated value of business property. It is collected by local authorities to help pay for local community services.
(Excise) duties: A heavy tax placed on a select range of goods or services. Governments in some countries often place these on goods such as alcohol and cigarettes.

Environmental taxes = These are designed to protect the environment. Examples:

- **Landfill tax** is imposed on businesses for the disposal of waste in landfill sites. The tax levied usually depends on the weight of waste being dumped in the landfill site.
- **Aggregates levy** is a tax on the rock, sand and gravel that is dug from the ground. It is designed to reduce the environmental damage caused by quarrying.
- **Climate change levies** are used to help countries meet their commitment to reducing greenhouse gases. These are paid mainly by electricity, gas and coal suppliers.

Government Expenditure

CATEGORIES	MAIN EXAMPLES
Social protection	State benefits, pensions, child benefits, jobseekers allowances and disability allowances
Health care	Salaries of nurses, doctors and admin staff; drugs and medicines; equipment and care programmes
Education	Teachers' salaries, equipment for schools and student grants
Defence	Maintenance of the armed forces (army, navy and air force)
Interest	The interest paid on government borrowings such as the national debt
Public order/safety	Spending on the police force, fire service, prison service, the justice system and health and safety
Social services	Spending on the care of children, the elderly and people with learning disabilities
Other	Transport, housing and the environment, industry, agriculture, training, and recreation

▲ Table 31.1 Government expenditure – main focus areas

Some countries divide the government spending into mandatory spending (spending determined by the current systems, automatic and legally obligatory) and discretionary spending ('extra' or 'new' spending).

Fiscal Deficits & Fiscal Surpluses

Fiscal deficit: Occurs when government spending exceeds government revenue. To fund a fiscal deficit, governments must borrow money from both domestic and foreign banks and possibly other governments.

- When analysing fiscal deficits and making international comparisons, it is best to express the deficit as a percentage of GDP, because the amount that needs to be borrowed to cover the deficit is only a serious problem if it is a large percentage of the GDP.

Negative impacts of fiscal deficit:

- With a persistent fiscal deficit, the total amount of money owed by a country, i.e. the national debt, gets bigger and bigger. The government then has to spend more and more of its revenue on paying off this debt and the interest charged which caused an opportunity cost for that money, which could have instead been spent on social provision, infrastructure or to reduce taxes.
- A persistent fiscal deficit and a rising national debt is a burden on future generations, as they will have to pay for the spending and excesses of previous generations.

Fiscal surpluses: Occurs when government revenue exceeds government spending. A government can use the surplus to repay government debts, to provide extra public services or to lower taxes in the economy.

Expansionary fiscal policy: It is a fiscal policy designed to stimulate demand in the economy. It includes measures such as increasing government spending and/or lowering taxes. An expansionary fiscal policy would result in increasing the size of an existing budget deficit or reducing a surplus.

Contractionary fiscal policy: It is a fiscal policy designed to reduce demand in the economy. It includes measures such as increasing taxes and/or lowering spending. A contractionary fiscal policy would result in reducing the size of a deficit or increasing a surplus.

The Impact of Fiscal Policy on Macroeconomic Objectives

1) Inflation

Contractionary fiscal policy can be used to reduce inflation. This is because cutting down government spending and raising taxation would most likely reduce disposable income of people, reducing aggregate demand which would reduce demand-pull inflation in the economy.

2) Economic growth

- Expansionary fiscal policy can be used to help stimulate economic growth. Increase in government expenditure will increase aggregate demand. Also, decreasing taxes leaves consumers with more disposable income. This extra income will mostly be spent on goods and services which would increase aggregate demand and hence the economy will expand to fill the increased demand. Economic growth is more likely to result from government expenditure on capital projects, such as new schools, transport links and airports because money spent on investment is the key to economic growth.
- An expansionary fiscal policy can also have a negative effect on economic growth. This is because the extra demand might be mostly on imports which would worsen the current account as there would be leakages from the economy in the form of imports. This would put the output levels in the domestic economy under threat.

3) Unemployment

- Expansionary fiscal policy can help to reduce unemployment. Again increases in government expenditure and tax cuts can help to stimulate demand. To meet this extra demand, firms will have to produce more. This means more staff will be taking on and unemployment will fall. The government could help by directing its extra spending on construction projects, such as building new hospitals, motorways and rail links. The construction industry is labour intensive, which means that job creation will be higher. Increase in the same supply of labour will cause an increase in wage rates.
- Expansionary fiscal policy may also worsen unemployment. This is because it could lead to demand-pull inflation which increases demand for imports so jobs will not be created in the domestic economy but in countries that produce cheap imports. It may also cause inflation due to extra demand, which would make exports less competitive and cause unemployment in export industries.

4) Current account deficit

Fiscal policy might be used to help influence the balance on the current account. For example, if there is a large deficit on the current account, contractionary fiscal policy will help reduce aggregate demand. This will help to reduce the demand for imports.

5) The environment

- Contractionary fiscal policy reduces economic activity, and this could mean less pollution, less resource depletion and reduced environmental damage.
- Increase in taxes such as landfill tax, climate change levy and the aggregates levy could also help to reduce environmental damage.
- If an expansionary fiscal policy entails spending more government money on subsidies given to producers of environmentally friendly practices, this could also help to protect the environment.