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Managing the economy - **Fiscal policy**

Fiscal policy is the deliberate alteration of government spending or taxation to help achieve desirable macro-economic objectives by changing the level and composition of aggregate demand.

Types of fiscal policy

There are two types of fiscal policy, discretionary and automatic.

Discretionary policy refers to policies which are decided, and implemented, by one-off policy changes.

Automatic stabilisation, where the economy can be stabilised by processes called fiscal drag and fiscal boost. If direct tax rates are progressive, which means that the % of income, then a rapid increase in national income will be slowed down automatically. Fiscal drag means that, as incomes rise, the impact of rising incomes for the better off is reduced as they pay proportionately higher taxes, and the impact of rising incomes on the poor and unemployed is reduced as they come off benefits, and start to pay tax. The effect is that the increase in disposable income is moderated.

Fiscal boost

Similarly, a potentially rapid and deep decrease in national income would be prevented by fiscal boost. Fiscal boost means as incomes fall in a recession the impact of falling incomes is softened as income earners pay proportionately lower taxes, and retain more post-tax income.

The impact of falling income is to increase unemployment, but rather than experience a complete collapse in personal income, the unemployed, and the poor, receive benefits, and spend more than they would have without such benefits. Hence, a downturn in the economy is also 'moderated'.

Government expenditure

Central and local government – the public sector – spends money for a variety of reasons, including:

1. To supply goods and services that the private sector would fail to do, such as public goods, including defence, roads and bridges; merit goods, such as hospitals and schools; and welfare payments and benefits, including unemployment and disability benefit.
2. To achieve supply-side improvements in the macro-economy, such as spending on education and training to improve labour productivity.
3. To inject extra spending into the macro-economy, so as to achieve increases in aggregate demand and economic activity.
4. To reduce the negative effects of externalities, such as setting pollution limits.
5. To subsidise industries that may need, for one reason or another financial support which would not be available from the private sector.
6. To help redistribute income and achieve more equity.

Central government borrowing

If revenue is insufficient to pay for expenditure, there will be a *fiscal deficit*. In this situation, government must borrow by selling long term bonds or short term bills. Bonds are long-term securities that pay a fixed rate of return over a long period until maturity, such as 10 years after they are originally issued, and are bought by financial institutions looking for a safe return. Government can also sell Treasury Bills, which are issued into the money markets to help raise short-term cash. Bills have a life of 90 days only, whereupon they are repaid.

In 2015, UK government borrowing totalled £75.3bn, which was approximately 5% of GDP, with accumulated debt standing at 83.3% of GDP. (Source OBR). By 2017, borrowing as a % of GDP had fallen to just 2.4%.

Public sector spending

Using public spending to stimulate economic activity has been a key option for successive governments since Keynes. Keynes argued that public spending should be increased at times of recession to compensate for falling private spending. There are two types of spending:

1. Current spending, which is expenditure on wages and raw materials. Current spending is short term, and has to be renewed each year.
2. Capital spending, which is spending on physical assets like roads, bridges, hospital buildings, and equipment. Capital spending is long term as it does not have to be renewed each year – it is also called spending on 'social capital'.

Evaluation of public spending

The advantages

1. Public spending can have a considerable impact on the level of AD, and compensate for failings in other components of AD, such as a fall in household spending on consumer goods and firms spending on capital goods.
2. If the spending is on capital items, then infrastructure can be improved, and this can help improve economic growth.
3. Spending on infrastructure also provides an external benefit to the rest of the economy.
4. Public spending can be targeted to achieve a wide range of economic objectives, such as job creation and reducing unemployment, achieving more equity, road building, action against poverty, and re-building city centres.

The disadvantages

1. There may be a considerable time-lag between spending and the benefits of spending. For example, a decision to increase spending on education will take months to implement, and years and decades to see the full benefits. Indeed, the full benefits may never be 'seen' because of information failure.
2. In trying to promote growth or create new jobs a fiscal stimulus through increased government spending can be inflationary, especially if the government has to borrow from the financial markets or if the spending is too fast, such as with an increase in current spending on wages. This can be seen in the diagram above, with the shift in AD pulling up the price level, from P^1 to P^2.
3. There is a potential 'trade off' between unemployment and inflation, first analysed by A.W. Phillips. If the aim of an increase in public spending is to create jobs there is the strong

possibility that inflation will be created, and growth in jobs may only be temporary as the economy readjusts to the previous level of unemployment.

4. A major constraint to government spending across the EU is a country's membership of the *Stability and Growth Pact*. This pact limits government borrowing to no more than 3% of national income in any one year, and to no more than an accumulated public debt of 60% of the value of national income. The purpose of the Stability Pact is to stop Euro area countries weakening the value of the Euro by 'printing money', which occurs when governments borrow from the money markets. The UK Chancellor has imposed a different constraint – that borrowing is acceptable if it funds capital, rather than current, public sector spending.

However, the financial crisis of 2008 – 2010 and the subsequent global recession, forced many countries to break this pact, as they borrowed substantial amounts to help stimulate their domestic economies. Perhaps the worst case to emerge was that of Greece, whose annual deficit exceeded 12% of GDP in 2009 (four times the pact limit), and whose accumulated deficit is predicted to reach 135% of GDP by 2011 (twice the agreed limit). The situation for Greece is made especially worse given the size of its hidden economy, estimated at over 30% of GDP.

(Sources: The Guardian and The Telegraph).

Revenue and tax policy

Central government must raise revenue in order to meet its spending commitments. Revenue is raised from a number of sources including:

Taxation

Direct taxes, such as income tax and corporation tax, and indirect taxes such as Value Added Tax (VAT), are the main sources of revenue to the UK Treasury.

National insurance

National insurance is a compulsory contribution from both employer and employee to provide workers with a minimum welfare payment during periods of unemployment.

Charges

Both central and local government can charge for using resources under their control, such as parking charges, prescription charges, and TV licences.

Privatisation

The sale of state-owned assets, such as public utilities like gas, water, and electricity, has in the past provided 'windfall' revenue to the UK government. The sale of property rights provides a similar source of revenue, such as selling licences to broadcasters and to mobile phone companies for the right to use the public 'airwaves'.

Borrowing

Borrowing has become an increasingly significant source of funding for many governments. If a government does not have enough revenue to fund its spending plans, it may borrow from the commercial banks or the public by selling short term securities, called bills, and long term securities, called bonds. Both central and local government may need to borrow heavily from time to time to fund spending commitments.

Changing tax rates

Taxes can be raised or lowered to control or expand household spending, and AD. Income tax can be adjusted in a number of ways, such as by changing:

1. The *tax free allowance* (the *standard personal allowance*) – all income earners are allowed to earn an amount of income before they start to pay tax. For example, the personal tax free allowance in the UK for 2015/16 was £10,600. Therefore, to stimulate demand, this allowance could be increased to give households more disposable income.
2. *The basic tax rate* – which is 20%. *Basic rate* means the rate that affects most income earners.
3. *The number of tax bands* – for example, before 2009 there were three bands of: 0 – £2320 of taxable income from savings is taxed at 10%; £0 – £34,800, taxed at 20% tax, and over £34,800 is taxed at 40%, which is the higher tax rate. By adding new lower or higher bands the level of consumption and the distribution of income can be altered. In 2014 a new higher tax band of 45% was added for people earning a taxable income over £150,000.
4. *The range of income in each band* – each band could be widened or narrowed by increasing or reducing the range of income in each band.

Evaluation of tax policy

The advantages

1. Indirect taxes can be targeted very specifically at altering behaviour, such as *polluter pays* taxes, and taxes on demerit goods.
2. Taxation can stabilise the macro-economy automatically, through fiscal drag and boost.
3. Discretionary changes in direct taxes can help regulate aggregate demand.
4. Taxes and welfare spending can also be used to help reduce the income gap between rich and poor, reduce poverty, and to help to promote equity.

The disadvantages

1. Changing tax rates, allowances and bands, is a highly complex business, especially in comparison with changing interest rates. Because of this changes are relatively infrequent, with only small adjustments being made each year in the annual budget.
2. Households may increase or reduce their savings following tax changes, so the effect on household spending of an increase or decrease in taxes may be weak.
3. There may be considerable time-lags between changing taxes and changes in household spending.
4. Higher taxes may have a disincentive effect on work and enterprise, as some individuals alter their perception of the relative costs and benefits of work, in comparison with leisure.

Impact of Expansionary Fiscal Policy: 25 July 2019 by Tejvan Pettinger

Definition of expansionary fiscal policy. This involves the government seeking to increase aggregate demand – through higher government spending and/or lower tax.

Expansionary fiscal policy is usually financed by increased government borrowing – and selling bonds to the private sector.

Keynes said expansionary fiscal policy should be used during a recession – when there is unemployment, surplus saving and falling real output. He argued this injection of government spending could stimulate economic activity and get the unemployed resources back into productive use. This enables the economy to recover more quickly than a laissez-faire approach.

How expansionary fiscal policy works

If the government cut income tax, then this will increase the disposable income of consumers and enable them to increase spending. Higher consumption will increase aggregate demand and this should lead to higher economic growth.

Alternatively, if the government increased investment in public work schemes, this government spending would create jobs, increase incomes and lead to greater aggregate demand.

This injection of money into the economy can also cause a positive multiplier effect. For example, builders who gain a job will also spend more creating jobs elsewhere in the economy. From the government's initial injection the final increase in real GDP will be more than the initial investment.

Expansionary fiscal policy can also lead to inflation because of the higher demand in the economy.

Paradox of thrift

One argument for fiscal policy is that the government spend more to offset the rise in private sector saving and fall in private sector spending.

At the start of the recession in 2009, the saving ratio rose rapidly as consumers cut back on spending. This caused a fall in demand. Fiscal policy can make use of this rise in saving and spend more.

Expansionary fiscal policy and government borrowing

In 2009/10, UK government borrowing increased as they pursued expansionary fiscal policy.

A potential problem of expansionary fiscal policy is that it will lead to an increase in the size of a government's budget deficit.

Higher borrowing could:

- Financial crowding out. Larger deficits could cause markets to fear debt default and push up interest rates on government debt. (this happened in Eurozone without Central Bank to purchase bonds, but bond yields fell in UK/US due to strong demand for bonds.
- Resource crowding out. If private investors buy government bonds, they have less to use for private sector investment.

Evaluation of expansionary fiscal policy

The impact of expansionary fiscal policy will depend on many factors:

1. What else is happening in the economy?

- Lower income tax may fail to boost AD if we also have falling house prices and low confidence.
- For example in 2008, the US tried to cut taxes; in theory, this lower tax should boost spending. However, the economy was also experiencing falling house prices, lower confidence and a shortage of credit; because of all these factors, expansionary fiscal policy was relatively ineffective in promoting rapid economic growth.

2. Crowding out

- Crowding out occurs when the government spends more, but because they borrow from the private sector, the private sector reduces private sector investment and therefore government spending 'crowds out' private sector spending.
- However, in a liquidity trap/recession, private saving rates rise rapidly. Therefore, expansionary fiscal policy helps to offset the rise in private sector saving and injects money into the circular flow and doesn't cause crowding out.

3. Timing of fiscal policy – amount of spare capacity

The impact of an increase in AD depends on situation of the economy.

- A key issue of expansionary fiscal policy is the state of the economy. If expansionary fiscal policy is pursued when the economy is close to full capacity (e.g. AD3 to AD4), then the increased government borrowing is likely to cause crowding out and/or contribute to higher inflation – but little increase in real GDP.
- In a deep recession, with spare capacity in the economy, expansionary fiscal policy won't cause crowding out or inflation. (AD1 to AD2 causes real GDP to rise from Y1 to Y2.)

Supply side effects of fiscal policy

- Lower income tax may increase incentive to work
- Higher government spending on education and training, could increase long-term labour productivity and help the long-term trend rate of economic growth.
- But, also government spending could be inefficient and wasteful – it depends on what the government spends the extra spending on.

Automatic vs Discretionary fiscal policy

- Automatic fiscal stabilisers. In a recession, the government will automatically spend more on unemployment benefits (because more people will be unemployed). Also, in a recession, people pay less income tax (because they earn less)
- Discretionary fiscal stabilisers. This occurs when the government changes tax rates or increases/decreases level of government spending

Different views on fiscal policy

- Keynesians argue that fiscal policy should be pursued during a recession – when there is a rise in demand-deficient unemployment and surplus savings. Keynesians argue there will not be crowding out if the economy is below full capacity.

- Monetarists tend to be more critical of fiscal policy arguing that higher government borrowing is likely to cause crowding out – higher government spending only leads to a fall in private sector spending.
- Modern Monetary Theory (MMT). This argues expansionary fiscal policy can be financed by printing money – so long as inflation is kept within a suitable target.
- Ricardian equivalence. This argues that expansionary fiscal policy doesn't cause any increase in demand because if consumers receive a tax cut now, then they expect taxes to rise in the future to pay off the rise in government debt.

About: Tejvan Pettinger studied PPE at LMH, Oxford University. Find out more

Maastricht indicators

The Maastricht Treaty stipulated a number of convergence criteria (Maastricht criteria). Under these criteria, member states may only enter the European Economic and Monetary Union if they satisfy the Maastricht fiscal and monetary criteria.

The Maastricht fiscal criteria to be met are as follows:

- The ratio of the government deficit to gross domestic product (GDP) must not exceed 3%.
- The ratio of government debt to GDP must not exceed 60%.

The Maastricht monetary criteria to be met are as follows:

- The national inflation rate must be no more than 1.5 percentage points higher than the rate of the three best-performing EU member states.
- The long-term interest rate must not be more than 2 percentage points higher than the rate of the three best-performing EU member states.

The Fiscal & Economic Impact

A strong fiscal outlook is an essential foundation for a growing, thriving economy. Putting our nation on a sustainable fiscal path creates a positive environment for growth, opportunity, and prosperity. With a strong fiscal foundation, the nation will have increased access to capital, more resources for future public and private investments, improved consumer and business confidence, and a stronger safety net.

However, if we fail to act, the opposite is also true. If our long-term fiscal challenges remain unaddressed, our economic environment weakens as confidence suffers, access to capital is reduced, interest costs crowd out key investments in our future, the conditions for growth deteriorate, and our nation is put at greater risk of economic crisis. If our long-term fiscal imbalance is not addressed, our future economy will be diminished, with fewer economic opportunities for individuals and families and less fiscal flexibility to respond to future crises.

Rising debt threatens America's future in a number of critical ways:

Reduced Public Investment. As the federal debt mounts, the government will spend more of its budget on interest costs, increasingly crowding out public investments. Over the next 10 years, the Congressional Budget Office (CBO) estimates that interest costs will total $5.4 trillion under current law. Currently, the United States spends over $900 million per day on interest payments.

As more federal resources are diverted to interest payments, there will be less available to invest in areas that are important for economic growth. Although interest rates are currently low to help the economy recover from the pandemic, we can't expect that situation to last forever. As interest rates rise, the federal government's borrowing costs will increase markedly. Within 30 years, CBO projects that interest costs would be the largest federal spending "program" and would be more than three times what the federal government has historically spent on R&D, non-defense infrastructure, and education combined.

Reduced Private Investment. Federal borrowing competes for funds in the nation's capital markets, thereby raising interest rates and crowding out new investment in business equipment and structures. Entrepreneurs face a higher cost of capital, potentially stifling innovation and slowing the advancement of new breakthroughs that could improve our lives. At some point, investors might begin to doubt the government's ability to repay debt and could demand even higher interest rates — further raising the cost of borrowing for businesses and households. Over time, lower confidence and reduced investment would slow the growth of productivity and wages of American workers.

Fewer Economic Opportunities for Americans. Growing debt also has a direct effect on the economic opportunities available to every American. If high levels of debt crowd out private investments in capital goods, workers would have less to use in their jobs, which would translate to lower productivity and, therefore, lower wages. On the other hand, reducing federal borrowing would counter such effects. In addition, high levels of debt would affect many other aspects of the economy in the future. For example, higher interest rates resulting from increased federal borrowing would make it harder for families to buy homes, finance car payments, or pay for college. Fewer education and training opportunities stemming from lower investment would leave workers without the skills to keep up with the demands of a more technology-based, global economy. Faltering support for research and development would make it harder for American businesses to remain on the cutting edge of innovation, and would hurt wage growth in the United States. Furthermore, slower economic growth generally would also make our fiscal challenges even worse, as lower incomes lead to smaller tax collections and put the federal budget further out of balance. Vital safety net programs would come under even greater budgetary pressure, threatening support for those who need them most.

Greater Risk of a Fiscal Crisis. If investors lose confidence in the nation's fiscal position, interest rates on federal borrowing could rise as higher yields would be demanded to purchase such securities. A rapid increase in Treasury rates could also lead to higher rates of inflation, which would reduce the value of outstanding government securities and result in losses by holders of those securities — including mutual funds, pension funds, insurance companies, and banks — which could further destabilize the U.S. economy and erode confidence in U.S. currency on an international scale.

Challenges to National Security. Our fiscal security is also closely linked to our national security and ability to maintain a leading role in the world. As Admiral Mullen, former Chairman of the Joint Chiefs of Staff, put it: "The most significant threat to our national security is our debt." As the national debt grows, not only are we more beholden to creditors around the globe, but we have fewer resources to invest in strength at home.

Imperiling the Safety Net. America's high debt jeopardizes the safety net and the most vulnerable in our society. If our government does not have the resources and stability of a sustainable budget, those essential programs, and the individuals who need them most, are put in jeopardy.