3.5 Fiscal Policy

What is Fiscal policy?

Fiscal policy is the use of taxation and government spending to influence the level of economic activity. It can be used to achieve one or more of these objectives:

- Economic Growth
- Low unemployment
- Price stability
- Balance in the balance of payments

How can fiscal policy be used to achieve each objective?

Objective	Budget	Government Spending	Taxation	Effect
Economic Growth	Budget deficit	Increased	Reduced	Increased spending, output and employment
Low unemployment	Budget deficit	Increased	Reduced	Increased spending, output and employment
Price Stability	Budget surplus	Reduced	Increased	Reduced spending so less pressure on the price level
A healthier balance of payments	Budget surplus	Reduced	Increased	Reduced spending so less pressure on the price level

Costs and benefits of fiscal policy

- A budget deficit increases the disposable income of consumers but there is no guarantee that they will spend it. They may save it, particularly if interest rates are high.
- As disposable income increases, much of the extra spending might be on imported goods and services. This may lead to a larger balance of payments deficit.
- As the budget deficit leads to a rise in total demand in the economy, supply rises to meet the demand, leading to more output and employment. However, if supply can't rise to meet demand then inflation could rise:

Examples of Opportunity cost:

- The government promises to spend more on health services and education but maintain a balanced budget. The opportunity cost of the extra spending on health and education is less spending on other areas or increased taxes meaning consumers have less to spend. Either the government has to give up some spending on other areas or the consumers have to give up some of their spending.
- The government cuts income tax rates so that its revenue from tax falls while also promising not to raise other taxes. The opportunity cost is a rise in the budget deficit or a fall in government spending.

What measures are used to redistribute wealth?

Progressive taxes - A higher rate of tax on higher incomes means that income is redistributed in favour of lower income groups.

Inheritance tax - A proportion of the wealth of the deceased person is paid in tax thus redistributing the wealth from the family

Reducing indirect taxes - The government may not wish to do this with things that have a high cost to society (alcohol, cigarettes etc). However there are many goods that have no indirect tax (childrens clothes, books, food etc.)

Government spending and redistribution - Providing societal benefits (transfer benefits) to lower income groups. Spending on health and education increases equality of opportunity.

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