Fiscal Policy

AQA A-Level Economics

Government Spending · Taxation · Budget Deficit · National Debt · Multiplier · Austerity

What is Fiscal Policy?

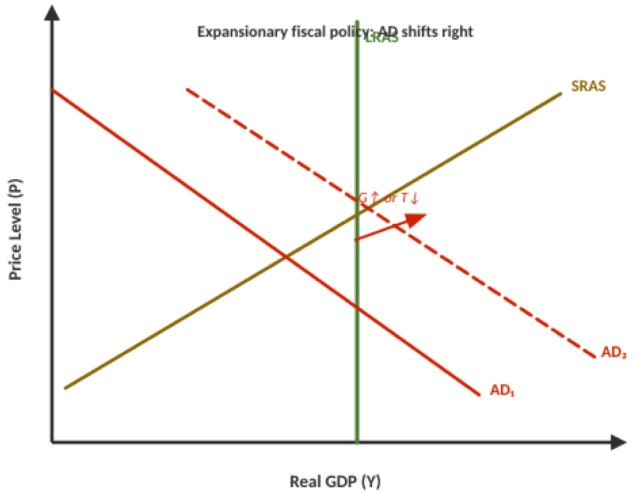
Definition:
Fiscal policy is the use of government taxation and expenditure to influence the level of aggregate demand, the distribution of income, and the allocation of resources in the economy.

Two tools:
Government spending (G): direct injection into the circular flow — spending on public services, infrastructure, welfare, and defence.
Taxation (T): withdrawals from the circular flow — income tax, corporation tax, VAT, excise duties. Higher taxes reduce disposable income and spending.

Expansionary fiscal policy:
G↑ and/or T↓ → disposable income rises → C↑ → AD shifts right → GDP rises, unemployment falls. Used in recession or when the economy is below potential output.

Contractionary fiscal policy (austerity):
G↓ and/or T↑ → disposable income falls → C↓ → AD shifts left → inflation falls, budget deficit narrows. Used when economy is overheating or to reduce public borrowing.

Fiscal policy vs monetary policy: fiscal policy is set by elected government — subject to political pressures and time lags from legislation. Monetary policy is set independently by the Bank of England. Both aim to manage AD.



Real-World Example

UK COVID 2020: Chancellor Sunak deployed the largest peacetime fiscal expansion — furlough scheme (£70bn), business grants, and VAT cuts totalling ~£400bn. G surged from ~40% to ~53% of GDP. AD was supported, preventing a deeper and longer recession.

Automatic Stabilisers

Definition:

Automatic stabilisers are built-in features of the tax and spending system that automatically moderate the economic cycle — stimulating the economy in a downturn and cooling it in a boom — without any deliberate government action.

In a recession (GDP falls):

Tax revenues fall automatically: as incomes and profits fall, income tax and corporation tax receipts decline. As spending falls, VAT receipts fall. The government collects less without changing rates.

Benefits spending rises automatically: more people claim Universal Credit, housing benefit, and other means-tested support. Transfer payments increase without any new policy decision.

Net effect: a net fiscal stimulus that partially offsets the fall in AD — the recession is automatically less severe than it would otherwise be.

In a boom (GDP rises above trend):

Tax revenues rise automatically (more income, profits, and spending to tax). Benefits spending falls as unemployment declines. Net fiscal drag automatically moderates the boom and inflationary pressure.

Key advantage of automatic stabilisers: they act immediately with no time lags from legislation, no political debate, and no risk of poor policy timing. A very important feature of a well-designed fiscal system.

Progressive Income Tax

As incomes rise, more income enters higher tax bands — tax revenue rises more than proportionally. As incomes fall in recession, revenue drops sharply. Automatically stabilises disposable income across the cycle.

Universal Credit / Benefits

Means-tested benefits automatically rise in recession as more people qualify. Maintains a floor under household incomes, supporting C. As employment recovers, benefit spending automatically falls — reducing fiscal stimulus.

Real-World Example

UK 2008–09: automatic stabilisers absorbed a significant share of the GDP shock. Tax revenues fell ~£40bn and benefits spending rose ~£10bn automatically — even before any discretionary fiscal action. The structural deficit (what remained after the cycle) was far smaller than the headline deficit.

Discretionary Fiscal Policy

Discretionary fiscal policy involves deliberate, active decisions to change G or T to influence the economy — beyond what automatic stabilisers do:

Expansionary Discretionary Policy

Government actively raises spending or cuts taxes beyond automatic movements.

Tools: infrastructure projects, public sector hiring, tax cuts, benefits increases, specific sector subsidies.

Effect: multiplier works through economy — each £1 of G raises national income by more than £1 (if MPC > 0 and spare capacity exists).

Used in: deep recessions where monetary policy is constrained (e.g. at zero lower bound), structural deficiencies in AD, or where specific sectors need support.

e.g. UK 2009 (Darling budget): £500 VAT cut from 17.5% to 15% for 13 months — direct boost to consumer spending power.

Contractionary Discretionary Policy

Government actively cuts spending or raises taxes to reduce the budget deficit or cool inflationary pressure.

Tools: public spending cuts (departmental budgets), benefit freezes, tax rises (income tax, VAT, council tax), public sector pay restraint.

Effect: multiplier works in reverse — AD falls by more than the spending cut. Risk of recession or worsening deficit if multiplier is large.

Used in: reducing an unsustainable budget deficit, controlling inflation, restoring market confidence in public finances.

e.g. UK 2010–19 austerity: Osborne cut public spending by ~£80bn relative to trend — the largest peacetime fiscal consolidation in UK history.

The Budget Deficit & National Debt

Budget (Fiscal) Deficit:

When government spending exceeds tax revenues in a given year: G > T. The shortfall must be borrowed — the government issues gilts (government bonds) to the financial markets.

Cyclical vs Structural Deficit:

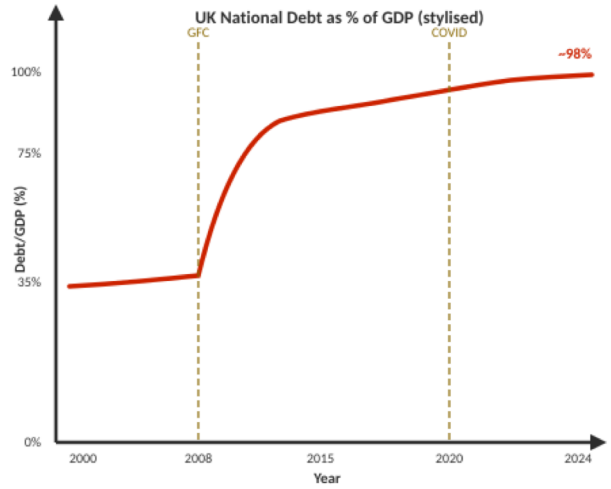
Cyclical deficit: arises automatically in recession due to automatic stabilisers — tax revenues fall and benefits rise. It disappears when the economy recovers. Not a sign of underlying fiscal weakness.
Structural deficit: persists even at full employment — indicates the government is spending more than revenues can sustain in the long run. Requires deliberate policy action to eliminate.

National (Public) Debt:

The accumulated stock of all past borrowing — the sum of all annual deficits minus any surpluses. Each year's deficit adds to the national debt. Interest payments on the debt become a significant and growing spending commitment.

Debt sustainability:

Debt/GDP ratio is the key measure. If nominal GDP grows faster than the debt stock, the ratio falls over time. If interest rates exceed GDP growth, debt spirals unsustainably. Many economists now focus on interest payments as % of GDP rather than the gross debt level.



Real-World Example

UK debt rose from ~35% of GDP (2007) to ~100% (2024) — driven by the 2008 crisis and COVID. Interest payments now ~£100bn/year, exceeding the education budget. OBR projects debt above 90% GDP for decades without major fiscal adjustment.

The Fiscal Multiplier

The multiplier:

A £1 increase in government spending raises national income by more than £1, because each round of spending generates further income and spending. The multiplier (k) = 1 ÷ MPW.

The multiplier is LARGER when:

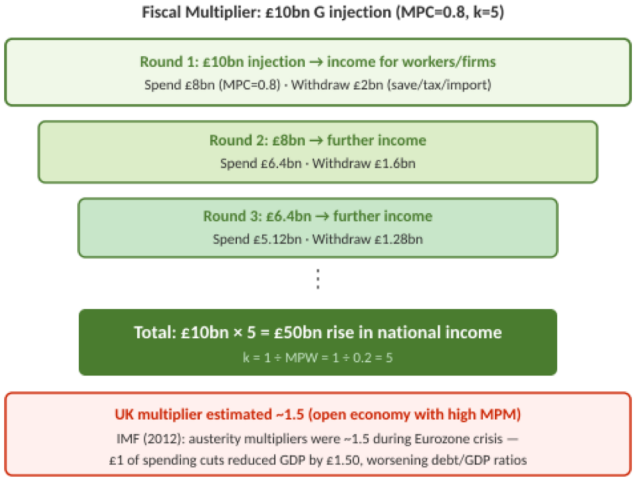
Economy has spare capacity (Keynesian horizontal range) · MPC is high · Import propensity is low · Monetary policy accommodates (keeps rates low) · Multiplier for G spending > tax cuts (G has direct effect).

The multiplier is SMALLER when:

Economy near full employment (crowding out, inflation) · High import propensity (open economy) · Interest rates rise in response to borrowing (crowding out) · Ricardian equivalence · Expectations of future tax rises.

Crowding out:

If government borrows to fund G, it competes with private sector for funds → interest rates rise → private investment I falls. If full crowding out occurs, £1 of G crowds out £1 of I → multiplier = 0. Keynesian response: crowding out is minimal when rates are near zero or there is spare capacity.



Real-World Example

UK 2010–12: OBR initially forecast austerity multiplier of ~0.5. Actual multiplier was closer to 1.5. Every £1 of cuts reduced GDP by ~£1.50 — growth stalled and deficit reduction was slower than planned. The multiplier debate fundamentally changed macroeconomic policy thinking.

Evaluation of Fiscal Policy: Strengths

Fiscal policy is powerful but has important limitations — understanding these is essential for AQA evaluation marks:

Direct Impact on AD

Government spending directly injects into the economy — unlike interest rate cuts (which work through banks and borrowers), G has an immediate first-round effect on output and employment.

e.g. Infrastructure spending employs workers directly from day one of construction — a faster, more certain impact than waiting for monetary transmission.

Effective at Zero Lower Bound

When interest rates are already near zero (as in 2009–21), monetary policy loses traction. Fiscal stimulus becomes the primary tool for managing AD — as Keynesians advocate.

e.g. 2009 global financial crisis: central banks cut rates to near-zero worldwide. Only fiscal stimulus (G↑) could provide further support — hence G20 coordinated fiscal expansion.

Can be Targeted

Fiscal policy can be targeted at specific groups (e.g. low-income households with high MPC) or sectors (e.g. green investment, housing). More precise than monetary policy which affects all borrowers.

e.g. UK Help to Buy: targeted housing support that boosted construction and first-time buyers rather than stimulating all spending indiscriminately.

Evaluation of Fiscal Policy: Limitations

The key limitations — use these to build evaluation in exam answers:

✗ Time Lags

Implementation lag: legislation takes time — budgets are annual events. Impact lag: infrastructure projects take years to complete. Recognition lag: economists disagree on the state of the cycle when policy is set.

e.g. UK HS2 announced 2011, still not complete by 2024. By the time fiscal stimulus reaches the economy, the cycle may have turned — risking pro-cyclical timing.

✗ Crowding Out

Government borrowing may raise interest rates, displacing private investment. At full employment, G simply replaces I with no net increase in AD. Classical economists argue the multiplier is zero due to crowding out.

e.g. UK 2022: with the economy near capacity, government energy support schemes risked crowding out private investment — contributing to inflationary pressure.

✗ Political Constraints

Elected governments face incentives to run deficits before elections and cut spending after. Fiscal rules (like OBR oversight) aim to impose discipline but have repeatedly been revised. Short-termism is a major risk.

e.g. UK governments have repeatedly announced fiscal rules ('golden rule', 'fiscal mandate') and then changed them when inconvenient — undermining credibility.

Fiscal Rules

Why have fiscal rules?

Without rules, governments face a deficit bias — electoral pressures encourage spending before elections and reluctance to raise taxes. Rules aim to enforce fiscal discipline, maintain market credibility, and ensure long-run debt sustainability.

UK fiscal rules (various):

Golden Rule (Blair/Brown): borrow only to invest, not to fund current spending, over the economic cycle.
Fiscal Mandate (Osborne 2010): eliminate structural deficit within Parliament. Revised multiple times as targets were missed.
Debt falling rule: public sector net debt as % of GDP must be falling by end of forecast period.

Liz Truss Mini-Budget (Sep 2022)

The Truss government announced tax cuts without OBR forecasts — financial markets panicked. Gilt yields spiked, the pound fell to a record low vs the dollar. The budget was reversed within weeks — a lesson in the importance of fiscal credibility.

UK Austerity 2010–19

Osborne's fiscal consolidation cut the deficit from ~10% to ~2% of GDP. But the OBR's growth forecasts proved too optimistic — multipliers were higher than assumed, slowing recovery and keeping the structural deficit larger than planned.

The Office for Budget Responsibility (OBR)

The Office for Budget Responsibility (OBR):
Independent body created in 2010 to provide independent economic and fiscal forecasts. The government cannot publish a budget without an OBR assessment. Removes political bias from fiscal forecasting.

Evaluation of fiscal rules: provide credibility and discipline BUT can be procyclical (forcing austerity in recessions). Too rigid — rules have been changed repeatedly. 'Fiscal councils' like OBR improve transparency but cannot enforce rules — only Parliament can.

Real-World Example

OBR independence matters: when Truss bypassed the OBR for the mini-budget, the lack of independent scrutiny allowed unfunded tax cuts to be announced. Markets immediately priced in fiscal risk — mortgage rates surged and the Bank of England had to intervene to stabilise gilt markets. The episode demonstrated the value of independent fiscal institutions.

★ Bonus: Fiscal vs Monetary Policy Compared

Both fiscal and monetary policy aim to manage AD — but they differ significantly in how they work, their speed, and their political economy:

Issue	Fiscal Policy	Monetary Policy
Who sets it?	Elected government (Chancellor / Cabinet). Subject to political pressures and electoral cycle.	Independent Bank of England MPC. Nine members. Removes short-term political bias.
Speed of implementation	Slow — annual budgets, legislation required. Emergency packages can be faster (e.g. COVID furlough).	Fast — MPC meets monthly. Rate decision takes effect immediately.
Time lag to impact	Variable — direct G spending is faster; tax changes take longer as behaviour adjusts.	Long — 12–24 months for rate changes to fully feed through to output and prices.
Effectiveness at ZLB	Most powerful when monetary policy is stuck at zero. Fiscal stimulus fills the gap that rate cuts cannot.	Conventional rate cuts ineffective. Must rely on unconventional QE with uncertain and unequal effects.
Risk of crowding out	Government borrowing may raise interest rates → reduces private investment. Risk greatest near full employment.	No direct crowding out — rate cuts encourage private investment rather than replacing it.
Distributional effects	Highly targeted — progressive tax and benefits redistribute income. The primary tool for reducing inequality.	Rate changes hit all borrowers. QE benefits asset-owners most — worsens wealth inequality.

Summary: Key Terms & Relationships

Key Term	Meaning
Fiscal policy	Use of government spending (G) and taxation (T) to influence AD, income distribution, and resource allocation.
Expansionary fiscal policy	G↑ or T↓ → AD shifts right → GDP↑, unemployment↓. Used in recession or below potential output.
Contractionary fiscal policy	G↓ or T↑ → AD shifts left → inflation falls, deficit narrows. Austerity.
Automatic stabilisers	Built-in features (benefits, progressive tax) that moderate cycles automatically without legislation.
Discretionary fiscal policy	Deliberate, active changes to G or T beyond automatic movements. Requires political decision.
Budget deficit	G > T in a given year. Government must borrow — issues gilts. Adds to national debt.
Cyclical deficit	Deficit from automatic stabilisers in recession. Disappears when economy recovers.
Structural deficit	Deficit persisting even at full employment. Requires active policy action to reduce.
National debt	Accumulated stock of all past borrowing. UK ~£2.7tn (~98% of GDP) in 2024.
Fiscal multiplier	k = 1 ÷ MPW. Initial G injection raises national income by k × the injection.
Crowding out	Government borrowing raises rates → reduces private investment. Limits fiscal multiplier.
OBR	Office for Budget Responsibility — independent body providing fiscal and economic forecasts.