

3.5 Fiscal Policy

- **Fiscal policy** is the use of taxation and government spending to influence the economy. The government spends on a variety of objectives such as public goods, benefits and law and order.
- The government can adjust fiscal policy to influence economic growth and inflation.
- **The budget** is the sum of all government spending and taxation. The budget details how the government spends its money and where the money is collected.
- **Balanced budget** – when government spending = government revenue.

Expansionary fiscal policy

- **This aims to increase economic growth.** This involves lower taxes and higher government spending. Lower income tax increases disposable income of consumers, therefore encouraging spending.
- **Higher government spending** (e.g. on building new roads) creates employment and investment in the economy.
- Expansionary fiscal policy (higher spending / lower tax) leads to **higher government borrowing**.

Evaluation

- To cut taxes and increase spending means the government will have to **borrow more** from the private sector. The private sector may not want to lend the government money
- If the government decides to increase spending, there will be a **time lag** to increase actual demand in the economy;
- Governments may have poor information about the best types of investment projects to spend money on.

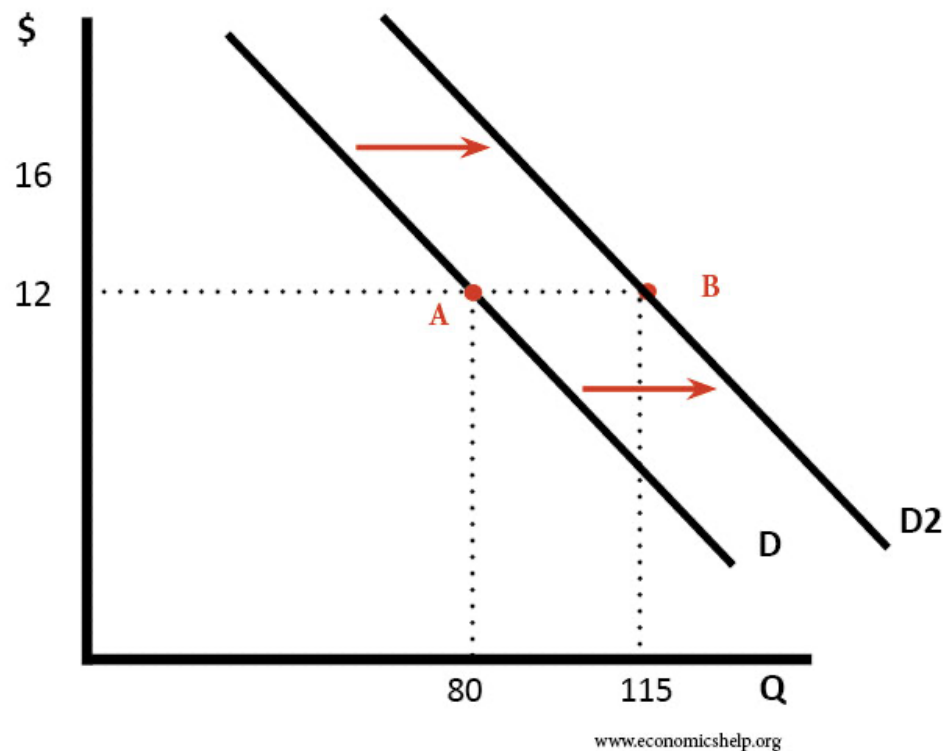
Tight Fiscal policy

- This aims to **reduce inflation**. It involves higher taxes and lower spending. It will also reduce government borrowing.
- For example, an **increase in income tax** reduces disposable income and leads to lower spending and lower economic growth. This helps reduce inflation.

Evaluation

- It may be **politically difficult to increase taxes** just to reduce inflation.
- Generally, the government don't use fiscal policy to control inflation, but leave it to **monetary policy**.
- Higher income tax **may reduce the incentive to work**. Lower government spending may conflict with a commitment to provide public services.

Shift in the Demand Curve



- A **shift in the demand curve** occurs when there is greater quantity demanded – even at the same price.
- The demand curve shifts due to factors **other than price**, such as income.
- For example, an **increase in income** would mean people can afford to buy more widgets even at the same price.

The demand curve could shift to the right for the following reasons:

- An **increase in disposable income**, such as higher wages and lower taxes giving consumers more spending power.
- An increase in the **quality of the good**. For example, mobile phones are now more versatile and powerful, making them more attractive.
- **Advertising** can increase brand loyalty to goods and increase demand.
- An **increase in the price of substitutes**. For example, if Samsung phones increase in price, demand for Apple phones shifts to the right.
- A **fall in the price of complements**. For example, a lower price for Apple apps will increase demand for Apple iPhones.
- **Weather**. Cold weather increases demand for heating.

Evaluation

- It **depends on the type of good**. A rise in income will not have any effect on demand for salt, but it will have a bigger effect on demand for luxury cars.
- Some goods will vary due to **seasonal factors** like the weather and time of year (e.g. scarves and air conditioners).