MACROECONOMIC POLICIES

Fiscal Policy

> When a national government makes decisions on **taxation** and **spending** with a view to influencing the level of production and employment, this is called "fiscal policy."

Fiscal policy is the use of government expenditure and taxation to manage the economy. The main changes in fiscal policy happen once a year in the Budget. It is in the Budget that the Government sets the levels of taxation and government expenditure for the next *fiscal yea*. The fiscal year runs from 5th April one year until 4th April the following year. This is why the budget is usually in March. The changes in it come generally into effect in the following month.

FISCAL POLICY – Demand side

Expansive fiscal policy

Fiscal policy can be used in various different ways. It may be used to try to boost the level of economic activity when the economy is flagging a little. In this case it is called ***expansive policy***. Governments may choose to use *expansive fiscal policy* in times of recession or a general downturn in economic activity. In this situation they will use their fiscal policy to give a boost to the economy. They may do this by lowering taxes in some form or by increasing the level of government expenditure. This will encourage people to spend more.
Expansive fiscal policies could therefore include:

- Cutting the lower, basic or higher rates of tax
- Increasing the level of personal allowances (see the income tax explanation for more details on these)
- Increasing the level of government expenditure

Restrictive fiscal policy

Alternatively the economy may be doing a little too well and in need of slowing down. In this case ***restrictive*** is called for. It is likely to be most appropriate in times of economic boom. If the economy is growing at above its capacity this is likely to cause inflation and balance of payments problems.
Restrictive fiscal policies could therefore include:

- Increasing the lower, basic or higher rates of tax
- Reducing the level of personal allowances
- Reducing the level of government expenditure

To help imagine how these policies works think of the economy as a balloon. The air in the balloon is the level of demand or economic activity. If the balloon is a little low and short of air you want to reflate it, but if it is over-expanded and in danger of bursting then you deflate it. The same is true of the economy, though when it is over-expanded instead of bursting we get other problems such as higher inflation and a larger balance of payments deficit. Supply-side policies are then policies that manage the capacity of the

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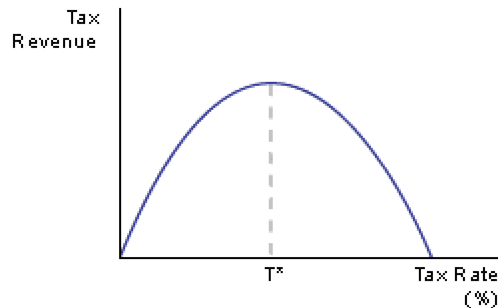
balloon; making it bigger so it can take more air or making the balloon material stretcher so it can expand further and so on.

Laffer curve

Invented by Arthur Laffer who was an advisor to President Reagan in the early 1980s. This curve shows the relationship between tax rates and tax revenue collected by government.



The curve suggests that, as taxes increase from low levels, tax revenue collected by the government also increases. It also shows that tax rates increasing after a certain point (T*) would cause people not to work as hard or not at all, thereby reducing tax revenue. Eventually, if tax rates reached 100% (the far right of the curve), then all people would choose not to work because everything they earned would go to the government.

Governments would like to be at point T, because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard.*

Laffer and other right-wing economists used the curve to argue that taxes were currently too high and should therefore be reduced to encourage incentives and harder work (a *supply-side policy*.

FISCAL POLICY – Supply side

Supply-side policies are policies that aim to increase the capacity of the economy to produce. Fiscal policy usually acts on the level of demand in the economy and the deflationary and expansionary policies as mentioned above and these are often known as *demand-side policies*. However, it is also possible for fiscal policy to act on the level of supply as well.
Income tax will always have an effect on people's incentives to work. This will be true at most income levels. If income tax at low-income levels is too high, people may choose not to work but to remain on benefits instead. If income tax on high levels of income is too high, people may choose not to work so hard and take risks. Ultimately they may even choose to leave the country if taxes elsewhere are much lower (a "brain drain").
Supply-side fiscal policies could therefore include:

- Cutting the lower and basic rates of tax to open up the gap between earnings in and out of work and ensure people have an incentive to work

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- Increasing the level of personal allowances for the same reason
- Reducing the top rate of tax to encourage enterprise, risk-taking and the incentive to work hard

Monetary Policy

Monetary policy is the use of **interest rates** and the level of the **money supply** to manage the economy. Interest rates always used to be set by the government (the Chancellor), but the incoming Labour government in 1997 passed control over interest rates to the Bank of England. The 'operational independence' of the Bank of England means that it can set targets for inflation and set interest rates at the level most appropriate to achieve those targets. The level is set at monthly meetings of the *'Monetary Policy Committee'*. A majority decision of the Committee is all that is required to change the level of interest rates.

Monetary policy may be used either to *boom* the economy or to *deflate* the economy. To find out more about each of these and how monetary policy changes may affect the rest of the economy follow the links below or at the foot of the page:

Expansive

If the Monetary Policy Committee considers that inflation is falling and they will easily meet their inflation target, then they may consider cutting interest rates. If there is a danger of the economy suffering a downturn this will help reinforce this decision. Cutting interest rates will encourage people (and firms) to borrow more money. It will also give people who have mortgages more money to spend each month as their mortgage payments fall. The combination of these effects will increase the levels of consumption and investment. Since consumption and investment are two of the key components of *aggregate demand*, cutting interest rates should result in increased economic growth and reduced unemployment.

Expansive monetary policies are therefore:

- Cutting interest rates
- Allowing money supply to increase

Restrictive

If the Monetary Policy Committee considers that inflation is in danger of rising and perhaps going over their inflation target, then they may consider increasing interest rates. Increasing interest rates will discourage people (and firms) from borrowing money. It will also give people who have mortgages less money to spend each month as their mortgage payments rise. The combination of these effects will reduce the levels of consumption and investment. Since consumption and investment are two of the key components of *aggregate demand*, increasing interest rates should result in reduced economic growth and increased unemployment.

Restrictive monetary policies are therefore:

- Increasing interest rates
- Reducing money supply

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The Impact on the Rest of the Economy

Interest rates

The effects of changing interest rates on the macroeconomics have already been discussed above, but it is also important to consider the effects at a micro level.

If interest rates are cut then this should increase the level of investment, but by how much? The amount by which investment increases depends on the interest elasticity of demand for investment. If investment is interest elastic then there will be a large increase in investment following an interest rate cut. This is shown in the first figure below. If investment is, however, interest-inelastic then there will be a much smaller increase, as shown in the second figure.

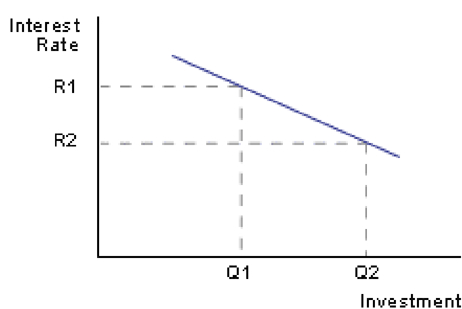

Figure 1

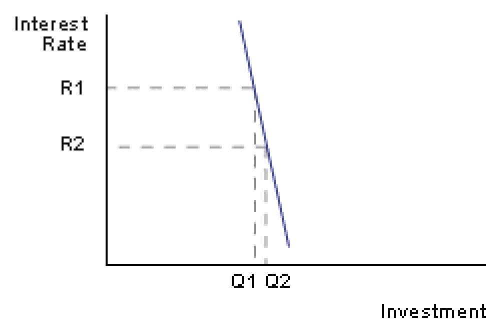

Figure 2

The effect of an interest rate cut on savings also has to be considered. Lower interest rates will tend to discourage people from saving so much which may create a shortage of funds for banks to lend to firms for investment. For this reason governments will often try to encourage savings by offering tax advantages. An example of this is the ISAs *(Individual Savings Accounts).*

Money Supply

Many economists argue that changes in the money supply will have an impact on inflation. Monetarists and classical economists use the *Quantity Theory of Money* to back up their argument that excess money supply growth will feed through to increases in prices.

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