3.5 Fiscal Policy

Key Terms:

Government Spending:
The total amount of money spent by the government in a given period of time

Direct Tax:
A tax on income or wealth

Government Revenue:
The source of finance for government spending

Indirect Tax:
A tax on spending, often defined as a tax on goods and services

Balanced Government Budget:
When tax revenue is equal to government spending

Budget Deficit:
When government spending is greater than tax revenue

Budget Surplus:
When tax revenue is greater than government spending

Fiscal Policy:
A policy that uses government spending and taxation to affect the economy as a whole.

Income and wealth redistribution:
Government action, using mainly taxation and benefits, to reduce inequalities of income and wealth

Progressive Tax:
A tax which takes a greater percentage of tax the higher the income

Main areas of expenditure
1. Pensions
2. Health
3. Education

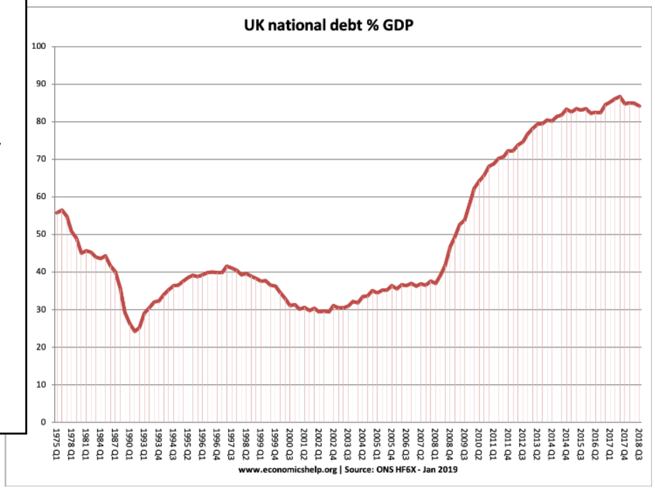
Main areas of revenue:
1. Income tax
2. National Insurance
3. VAT
4. Corporation tax

Direct Tax:

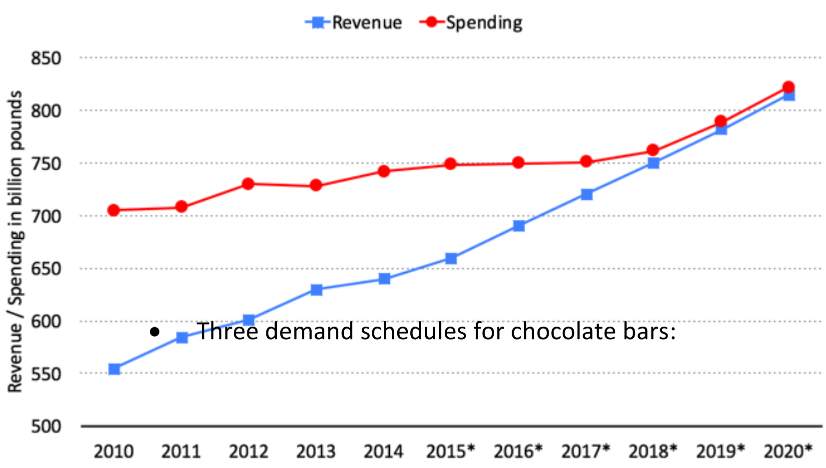
Income, National Insurance, Corporation

Indirect Tax:

VAT, air passenger duty, insurance tax



Total UK Government Spending and Tax Revenue



- Three demand schedules for chocolate bars:

Source: International Monetary Fund, data from 2015 onwards is a forecast

Objective	Budget	Government Spending	Taxation	Effect
Economic Growth	Deficit	Increased	Reduced	Rise in economic growth and employment
Low unemployment	Deficit	Increased	Reduced	Rise in economic growth and employment
Price stability	Surplus	Decreased	Increased	Fall in economic growth, unemployment, inflation falls
Balance of Payments	Surplus	Decreased	Increased	Fall in economic growth, fall in imports

Exam questions:

Calculate:
The final price of the following items. In each case, VAT of 20% is added, except for home energy which is at a rate of 5%. Show your workings.

1. A camera with pre-tax price of £100
2. An annual car service with a pre-tax price of £1.80
3. A packet of crisps with a pre-tax price of £0.30
4. A holiday with a pre-tax price of £1,580
5. An annual electricity bill of £570

- Explain what is meant by fiscal policy (2 marks)

- Explain the term budget deficit (2 marks)

- Evaluate the costs and benefits to the economy of a fiscal policy aimed at achieving economic growth (6 marks)

3.6 Monetary Policy

Current rate: 0.75%
Highest rate: 16%
Lowest rate: 0.25%

<u>Definitions:</u>

<u>Monetary Policy:</u>
A policy that aims to control the total supply of money in the economy to try to achieve the government's economic objectives, particularly price stability

<u>Price Stability:</u>
When the general level of prices stays constant over time, or grows at an acceptably low rate

How monetary policy helps achieve economic objectives

Objective	Interest rates	Effect
Economic Growth	Reduced	Increased spending, output and employment
Low unemployment	Reduced	Increased spending, output and employment
Price stability	Increased	Reduced spending, more price stability
A healthier balance of payments	Increased	Reduced spending, including on imports

What happens when interest rates FALL?

Borrowing by consumer's rises

Borrowing by firm's rises

Savings fall

Asset prices (houses) rise

Disposable incomes rise

Exchange rate fall

Price Stability? What happens when interest rates RISE

Borrowing by consumer's falls

Borrowing by firm's falls

Savings rise

Asset prices (houses) fall

Disposable incomes fall

Exchange rate rises

<u>Evaluating the effects of monetary policy:</u>

<u>Consumer spending:</u>

When interest rates are high consumer spending will fall as the cost of borrowing increases and savings increase.

<u>Borrowing:</u>

When interest rates are high firms and consumers are less likely to borrow because the cost of borrowing will be too high. This means that individuals are likely to save which means economic growth will fall.

<u>Saving:</u>

Interest rates affect savings. The higher the interest rates the greater returns for savings and more consumers are likely to save. When interest rates are low, individuals will not save.

<u>Investment:</u>

When interest rates are low, investment is high BUT depends on confidence

<u>Exam Questions</u>

- Evaluate the effects of a rise in interest rates on consumer spending (6 marks)
- Explain what is meant by 'monetary policy' (2 marks)
- Analyse the factors that affect the rate of interest on loans (6 marks)

3.8 Limitations of Markets

<u>Definitions:</u>

<u>Externality:</u>
An effect of an economic activity on a third party

<u>Negative Externality:</u>
Harmful effect of an economic activity on third parties, also known as external cost

<u>Positive Externality:</u>
Beneficial effect of an economic activity on third parties, also known as external benefit

<u>Taxation:</u>
A sum of money paid to the government by individuals or firms

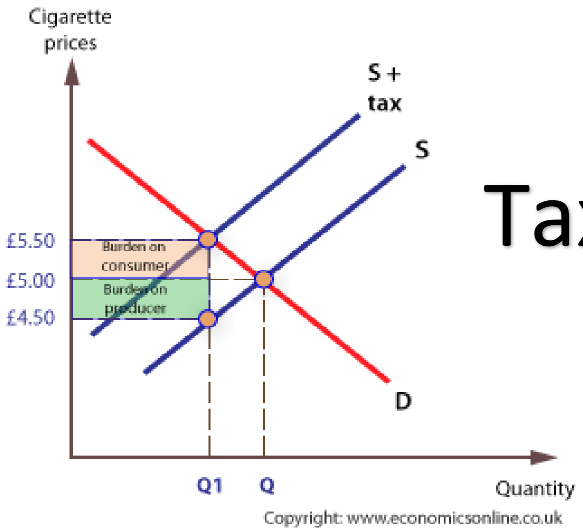
<u>Subsidy:</u>
A sum of money that the government gives directly to firm to encourage production or consumption of a good or service

<u>Legislation:</u>
Laws to control the way people and organisations behave

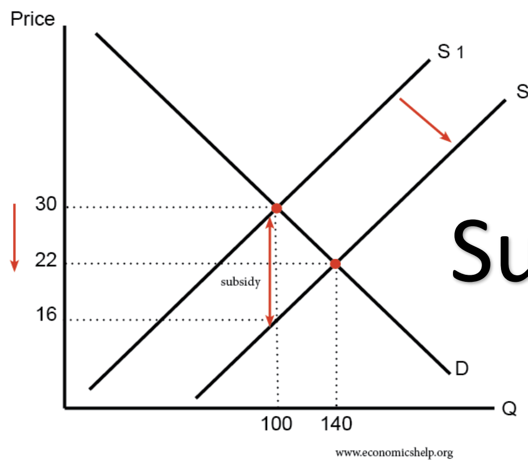
<u>State Provision:</u>
Goods and services provided directly by the government

<u>Regulation:</u>
Rules, directives or government orders to control the way people and organisations behave

<u>Information Provision:</u>
The government provides information to encourage people (especially consumers) and organisations to change their behaviour



Tax



Subsidy

<u>Information provision:</u>
Can shift demand left and right. For example, public health campaign on smoking shifts demand left. The benefits of a library will demand right.

Positive Production & Consumption Externalities

Positive production externalities	Positive consumption externalities
• Flood defence projects benefit the whole community	• Healthcare / Childcare / flu and other vaccines made available to the population
• Projects to reduce deforestation	• Education / Learning / Community Work
• Apps that promote the "sharing" of scarce resources	• Pest control / gardening
• Research and development - spillovers for other businesses	• Usage of mass transport services instead of private motoring
• Bee-keeping and pollination	• Youth clubs and apprenticeships

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Examples of Negative Consumption Externalities

Negative consumption externalities are **spillover costs** generated and received in the consumption of goods and services.


Vehicle pollution


Household waste

Noise pollution from neighbours


Air pollution from smokers


Traffic congestion

Gambling addiction


Litter from tourists


Spillover costs from obesity

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4.1 International Trade

Definitions:

Exports:
Goods and services sold abroad

Extension:
What are the advantages and disadvantages of the UK leaving the EU?

Imports:
Goods and services bought from abroad

International Trade:
The exchange of goods and services between countries

Free Trade Agreement:
Free movement of goods and services between countries without any restrictions

European Union (EU):
An economic and political group of countries in Europe that have free trade with each other

Reasons for international Trade:

1. Resources (for example oil)
2. Climate
3. Expertise

Benefits of imports and exports to CONSUMERS

- Lower prices
- Better quality
- More choice

Benefits of imports and exports to PRODUCERS

- Access to larger market to sell goods and services
- Increased competition -> great efficiency
- Specialisation and lower costs
- Larger market for buying resources at a lower cost

Free trade agreements

- EU
- NAFTA
- ASEAN

No tariffs so buying goods from the countries in the trade bloc is cheaper. Encourages trade but reduces trade with countries outside the trade bloc.

Advantages:	Disadvantages
Employment	Increases competition
Cheaper goods and services	Reduces trade with more efficient producers outside bloc
Improved quality of goods and services	

4.2 Balance of Payments

Key Terms:

Balance of Payments:
The record of all financial transactions between one country and the rest of the world

Current Account:
The record of trade in good and services, income flows and transfers between one country and the rest of the world

Balance of payments on current account:
The total of net trade in goods and services, income flows and transfers between one country and the rest of the world

Balanced current account:
Where the sum of exports plus the inflow of income and transfers is equal to the sum of imports plus the outflow of income and transfers.

Current account deficit:
Where the sum of exports plus the inflow of income and transfers is less than the sum of imports plus the outflow of income and transfers.

Current account surplus:
Where the sum of exports plus the inflow of income and transfers is greater than the sum of imports plus the outflow of income and transfers.

Activity

Table 4.2.2 Trade balance and current account balance

Country	Trade in goods (£bn)	Trade in services (£bn)	Trade balance (£bn)	Income flows (£bn)	Transfers (£bn)	Current account balance (£bn)
A	–20.2	+13.2		+6.5	–4.0	
B	+40.5	–30.3		–12.6	+12.1	
C	–17.1	+9.7		+4.5	–2.0	

1 Complete Table 4.2.2, adding the trade balance and current account balance for each country.

2 Add in each case whether it is a surplus or deficit.

Historic Data

- Since 1998 the trend in services surplus has been less than the trade in goods deficit, so overall there have been a deficit in trade of approximately 2-3%
- The trade in goods balance has been getting worse
- Exports to countries in the EU have fallen
- There has been an increasing demand for importing goods in the UK partly due to an increase in UK demand for imports of oil, gas and consumer goods

Effects of a current account deficit…

Positive	Negative
Could lead to a fall in exchange rates which improves the competitiveness of our exports	Could reflect fall in demand for domestic goods and services
Could reduce inflation in an economy as demand for domestic goods is falling	Could reflect low productivity and a fall in UK competitiveness

Causes of deficits:

- Structural problems in the economy – firms overpricing goods or producing poor-quality goods
- Fall in productivity which makes the goods more expensive to produce and therefore more expensive overseas
- Falling incomes overseas
- Rise in exchange rates
- Increase in economic growth and demand for more imports

4.3 Exchange Rates

S Stronger
P Pound
I Imports
C Cheaper
E Exports
D Dearer

Definitions:

Currency:
The system of money used in a country or group of countries

Exchange Rate:
The price of one currency in terms of another currency

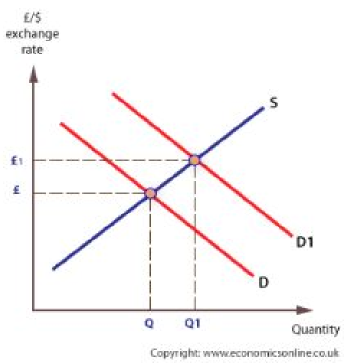
Appreciation:
When the currency gets stronger. It is worth more. For example: £1 = $1.20 and now £1 = $1.50

Depreciation:
When the currency gets weaker. It is worth less. For example: £1 = $1.50 and now £1 = $1.20

Currency Conversion	Method	Example: exchange rate of £1 = €1.20
Convert £ into €	£ amount x € exchange rate	Convert £5.70 into Euros
Convert € into £	€ amount / € exchange rate	Convert €3.45 into pounds

Change in the exchange rate	Change in demand or supply of £'s	Change on diagram	Example of cause
Rise	Decreased supply of £'s	Supply curve shifts left	Fewer imports
Rise	Increased demand for £'s	Demand curve shifts right	More exports
Fall	Increased supply of £'s	Supply curve shifts right	More imports
Fall	Decreased demand for £'s	Demand curve shifts left	Fewer exports

EXPORTS



IMPORTS