Explain how fiscal policy can be used to influence both the level and pattern of economic activity?

Fiscal policy involves the use of **government expenditure** and **taxation** to influence the level and composition of AD. A rise in government expenditure, or a fall in taxation, should increase aggregate demand and boost employment. The size of the resulting final change in equilibrium national income is determined by the multiplier effect. The larger the national income multiplier, the greater the change in national income will be.

Fiscal policy can affect aggregate demand in a number of ways. Firstly through an increase in government spending on services such as the NHS will create more jobs and thus increase consumption as consumers now have more disposable income.

A change in direct taxation such as a change in level of corporate tax on firms may cause firms to increase investment spending due to spare money that hasn't been removed by the burden of tax. This may lead to an accelerator effect which will feed through the circular flow of income and increase the level of national income and output.

A change in indirect taxation will have an immediate effect on aggregate demand because goods will be cheaper and therefore consumers will respond by buying of more of the good or increasing consumption patterns due to their relative increase income.

Fiscal policy can also affect the economy in times of slump or severe recession. Keynesians believe that in a recession we expect to see a rise in government spending and a cut in tax revenue. The increase in government spending and decrease in tax revenue due to the increase use of social security benefits are described as automatic stabilisers and help to reduce the severity of a recession or slump.

If the government reflates AD by reducing taxation, or by increasing government spending, then this may lead to a budget deficit. To finance the deficit the government will have to sell debt to the private sector. Attracting individuals and institutions to purchase the debt may require higher interest rates. A rise in interest rates may crowd out private investment and consumption, offsetting the fiscal stimulus. This type of crowding out is unlikely to make fiscal policy wholly ineffective – but large budget deficits do require financing and in the long run, this requires a higher burden of taxation.

When the government sells debt to fund a tax cut or an increase in expenditure then a rational individual will realise that at some future date he will face higher tax liabilities to pay for the interest repayments. Thus, he should increase his savings as there has been no increase in his permanent income. The implications are clear. Any change in fiscal policy will have no impact on the economy if all individuals are rational.

Partly because of the limitations of fiscal policy as a tool of demand management, many governments have switched the focus of fiscal policy towards using it to

improve aggregate supply as a means of creating the conditions for sustainable economic growth.

Supply-side economic policies have as their main aim the objective of raising the economy's potential growth per head. Many economists believe that fiscal policy changes can help to improve the working of markets and boost total supply in the economy. The impact of **fiscal reform** tends to be long-term.

Some economists argue that taxes have a significant effect on the intensity with which people work and their overall efficiency and productivity. But there is little substantive empirical evidence to support this view. Many factors contribute to improving productivity – tax changes can play a role, but isolating the impact of tax cuts on productivity is extremely difficult.

Lower rates of corporation tax and other business taxes can stimulate an increase in business fixed capital investment spending. If planned investment increases, the nation's capital stock can rise and the capital stock per worker employed can rise.

The government might also use tax allowances to stimulate increases research and development and encourage an increase in the rate of small business start-ups. A favourable tax regime could also be attractive to inflows of foreign direct investment – a stimulus to the economy that might benefit both aggregate demand and supply.

Overall we have to consider both long run and short run effects of fiscal policy. Fiscal policy may have an impact on AD in the short run but it is unlikely to affect economic activity or the pattern of activity in the long run. However, the effect that fiscal policy has in the long run on the supply side of the economy is particularly important and has been applied today by present government. Over time we have seen a switch away from the use of fiscal policy as government tool for demand management and a turn towards its use as a supply side incentive.

We also have to consider time lags. Fiscal policy may cause an increase in AD but it takes time to recognise that AD is growing either too quickly or too slowly. It then takes time to implement an appropriate policy. It takes time for the policy to work, as the multiplier process is not instantaneous. These time factors play a significant role when assessing the effectiveness of this policy.