Although the specification clearly expects you to continue with, and build on, your knowledge of fiscal policy from AS, many questions do not require much more than you learnt last year.

THE PURPOSES OF FISCAL POLICY

1) AD – government spending and taxation affect the level of AD in the economy, and this possible ability to control AD may allow the government to go some way to achieving its 4 macro-objectives. Increasing AD (expansionary fiscal policy) will raise GDP and reduce unemployment, cutting AD (contractionary fiscal policy) will reduce inflationary pressures and may cut the current account deficit.

2) LRAS – this is known as 'fiscal supply side policy' and it simply refers to money spent in order to boost the LRAS. In other words the money is not spent to try and affect AD, it is being spent for a specific purpose (but it will have an AD effect). Building HS2 (projected £40bn) should shift LRAS right.

3) PATTERN OF ECONOMIC ACTIVITY – the government is not looking to change the amount we spend (AD), but it is trying to change what we spend on, i.e. merit and demerit goods. It does this through targeted indirect taxes (excise duties) and subsidies (e.g. wind farms).

4) EFFECT ON INCENTIVES – This looks specifically at how the tax and spending structure affects people's incentives to work. Income tax cuts and welfare cuts should lead to greater work.

5) REDISTRIBUTION – the UK has a progressive tax system, and government spending is partially done to support the poor (means-tested rather than universal benefits).

6) CUT THE DEFICIT – arguably this is now the sixth purpose of fiscal policy.

BUDGETARY STANCES

Given the current background, it is more than likely that any question about fiscal policy will revolve around deficits rather than surpluses, so the notes will focus on these. To understand surpluses, simply reverse the analysis.

THE ECONOMIC CONSEQUENCES OF A DEFICIT

These arguments are used to answer any question that sounds like 'To what extent should the government seek to cut the deficit?'

FISCAL RULES – the experiences of Gordon Brown and the Growth and Stability Pact show the problems of time inconsistent policies, and why political control of economic policy will always lead to problems. What politician will make voters worse off in order to promote economic recovery in the future? However much they impose rules and guidelines, when the chips are down it's back to pork barrel politics. Is this why we should welcome the rise of the credit rating agencies? Will they impose external discipline? Ask George Osbourne.

TAXATION

PURPOSES

4) Provide money for spending – their source of income allows the government to spend on current spending (which can help achieve social goals, e.g. focusing money on the NHS and education), capital spending (to pursue supply side policies) and transfer payments (achieving the social goal of equality).
5) AD (and LRAS) manipulation – to achieve the four macro objectives
6) Redistribution of income – this is done by having a progressive tax system.
7) Correcting specific market failures – e.g. bring the private and social costs of smoking and petrol use into line, in order to achieve allocative efficiency.

CANONS (those things that make a good tax – first laid down by Adam Smith)

1) Economical – a good tax collects a lot of money at a relatively low cost.
2) Equitable – taxes should be based on a person's ability to pay (see notes later). Also people (or firms) in the same circumstances should pay the same amount.
3) Convenient – to the taxpayer.
4) Certain – the taxpayer should be able to predict in advance how much tax they will be paying. This is important as it means that anyone facing tax should respond to it in a predictable way (important if you are trying to correct a market failure).

More recently two extra canons have been added:

5) Efficient – a tax should not distort market behaviour (e.g. make people work less), unless this is its purpose.
6) Flexible – the government must be able to quickly change the tax should it so desire.

Supply Side policies - the basics

Supply side economics came to the fore in the early 1980s, championed by the governments of Reagan in the US and Thatcher in the UK. Traditional Keynesian demand management was perceived to have failed to tackle deep structural problem in developed economies, and as a consequence, markets were less efficient and productivity lower than it might otherwise have been. By focussing so much on tinkering with demand, Keynesian economists and politicians has neglected the supply side, and had actually weakened it by introducing a lot of inefficiencies such as red tape for firms, a generous welfare state, and powerful trade unions. This meant that the NRU had increased, so that inflation was occurring at higher and higher levels of unemployment.

Supply side policies aim to improve the efficiency of factor markets, to boost productivity and hence the overall capacity of the economy (shifting long run aggregate supply (LRAS) to the right and pushing out the PPF):