



# Managing the UK economy

## Fiscal and monetary policy since 1945

### Week 1: Fiscal policy and its impact on the economy (an introduction)

AY 2024-25

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Economy

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## Budget will be painful, Starmer warns in Downing Street speech

© 27 August 2024



*What precisely is “the budget”? What does it do?*

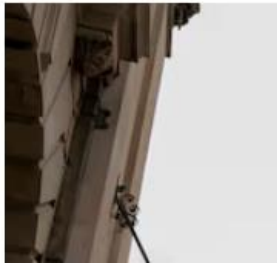
*Why Starmer says it has got to be “painful”?*

*And “painful” how? For whom?*

# Bank of England cuts rates from 16-year high, 'careful' on future moves

By Reuters

August 1, 2024 12:26 PM GMT+1 · Updated a month ago



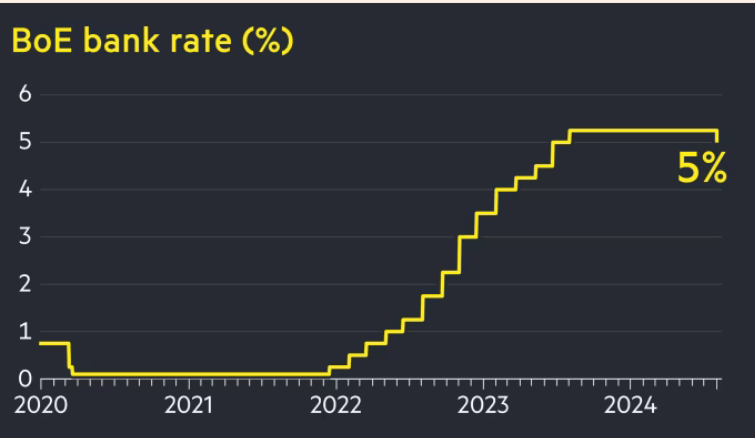
## FINANCIAL TIMES

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UK Interest rates [+ Add to myFT](#)

### Bank of England lowers rates to 5% in first cut since 2020

Knife-edge vote marks boost to Labour government's promise to kick-start economic growth



The Monetary Policy Committee voted five to four to reduce the bank's key rate by a quarter of a percentage point to 5% © FT

Sam Fleming in London AUGUST 1 2024

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*What is the 'Bank rate'?*

*Why was it lowered from 5.25 to 5%?*

*Why does it matter?*

*Why is the BoE "careful" on future moves?*

*Why the FT says it's a "boost to Labour government's promise to kick-start economic growth"?*

# Macroeconomic policy

- *Macroeconomic policy:*

Government actions aimed at achieving specific goals for the economy as a whole – stability, low inflation, economic growth

- Government budget → *fiscal policy*

- BoE interest rate → *monetary policy*

- Both have existed for centuries, but are used for managing the economy only since around the 1940s.

# What to expect from this module

- ~~• Ready-made answers to questions about economic policy.~~
- ~~• Iron laws of macroeconomic policy.~~
- ~~• List of right vs wrong policies in absolute terms.~~
- Language & conceptual tools to understand and debate macroeconomic policy.
- Historical background on UK macroeconomic policy.
- Goal: Learn to form *your own* analysis & informed opinions about macroeconomic policy in the UK.

# Laptop Ban

The use of laptops, tablets, smartphones and similar devices is banned during this module's lectures

*Research shows that the use of laptops in class harms learning and reduces students' grades.*



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## A Learning Secret: Don't Take Notes with a Laptop

Students who used longhand remembered more and had a deeper understanding of the material



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ANNALS OF TECHNOLOGY

## THE CASE FOR BANNING LAPTOPS IN THE CLASSROOM

By Dan Rockmore June 6, 2014



The New York Times

ECONOMIC VIEW

## *Laptops Are Great. But Not During a Lecture or a Meeting.*



# First three weeks: intro & overview

1. Fiscal policy & its impact on the economy (an introduction)
2. Financial system & monetary policy (an introduction)
3. The UK economy & the machinery of economic policy since 1945: an overview

*(Sep 23 to Oct 12)*



## Weeks 4 to 10: UK macro policy since 1945

4. 1945-51 Fiscal & monetary policy of the post-war Labour governments.
5. 1951-67 Fiscal activism & macroeconomic 'fine-tuning'.
6. 1967-79 Inflation & the crisis of the post-war model.
7. 1979-96 Monetarism & turn toward markets.
8. 1997-07 Independent Central Bank, New Labour governments, & 'Great Moderation'.
9. 2008-19 Great Recession, unconventional monetary policy, & austerity
10. 2020s Coping with the Covid shock, Brexit, & the return of inflation. *(Oct 14 to Dec 8)*



# Plan for today

1. Fiscal policy & the government budget.
2. The effects of fiscal policy on the economy
3. Public debt
4. Module logistics

# Fiscal policy

- Influences the economy through government spending & taxation.
- Government fiscal balance

$$BB = \text{Revenues} - \text{Expenditure}$$

$$BB = \text{Tax revenues (T)} - \text{Non-interest spending (G)} - \text{Interest spending (INT)}$$

- $BB < 0 \rightarrow$  budget *deficit*.
- $BB > 0 \rightarrow$  budget *surplus*

*Primary* fiscal balance (T – G)

# Budgets in the UK

- Government needs parliament's authorization to spend money or change tax rates.
- Once or twice a year, gov't lays out its budget plans for next fiscal year.
  - Planned expenditure & its allocation across departments.
  - Any changes to tax laws & overall expected revenues.
  - Usually also discusses the state of the economy & its economic strategy.
- Parliament then votes on this plan, in the form of a *finance bill*.



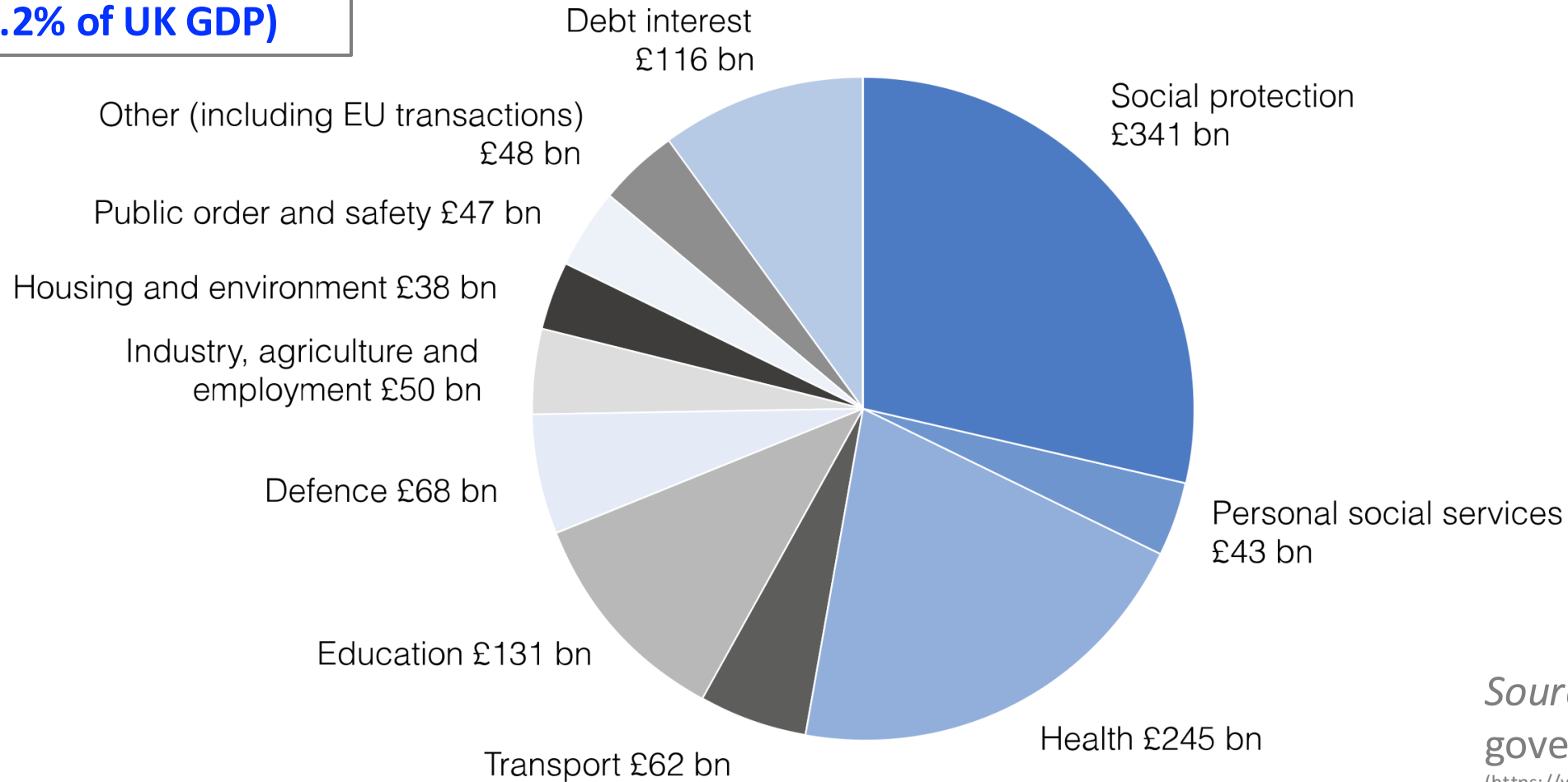
# Government expenditure

- Today, main items are
  - Social security
  - Health
  - Education
  - Military
- Useful distinctions:
  - Interest spending **vs.** non-interest spending.
  - Spending on goods & services **vs.** Transfers.
  - Current spending **vs.** Investment.



# UK government expenditure in 2023-24

Total spending:  
**£1,189 bn**  
**(44.2% of UK GDP)**



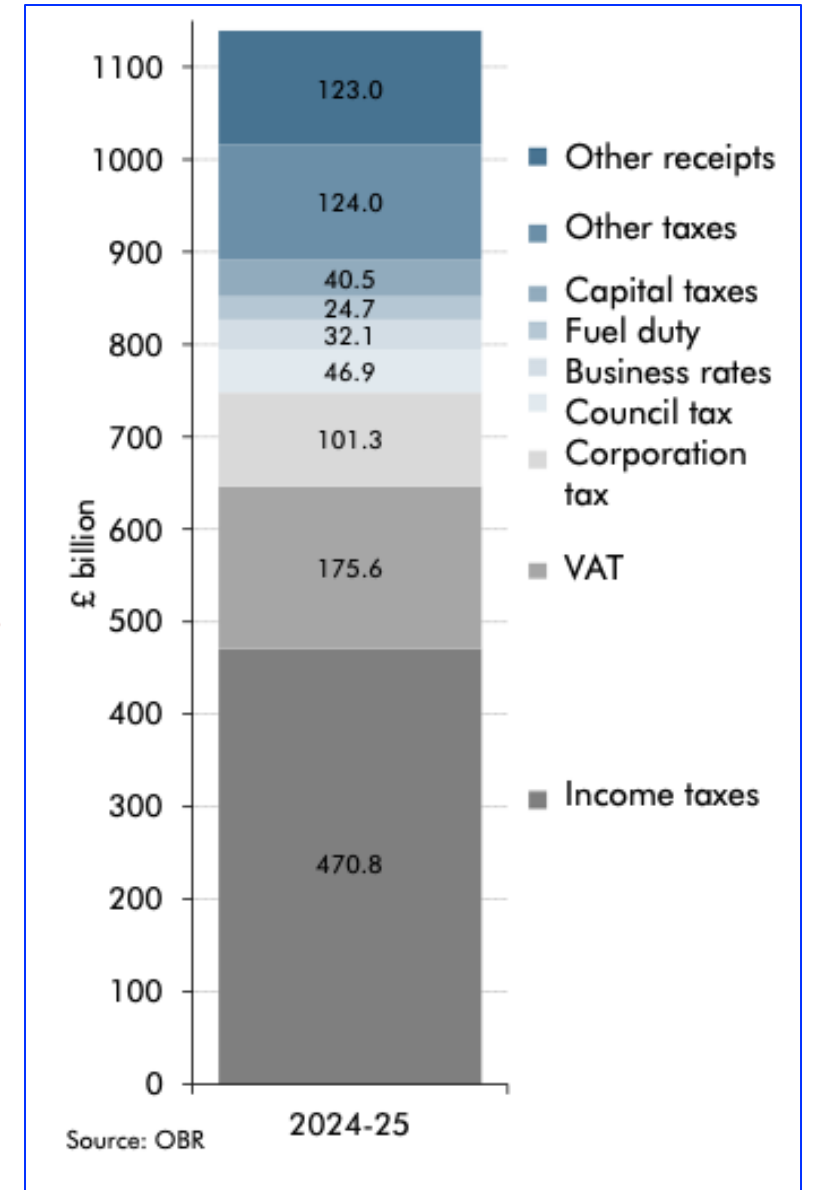
Source: UK government

(<https://www.gov.uk/government/publications/spring-budget-2023/spring-budget-2023-html>)

# Taxation

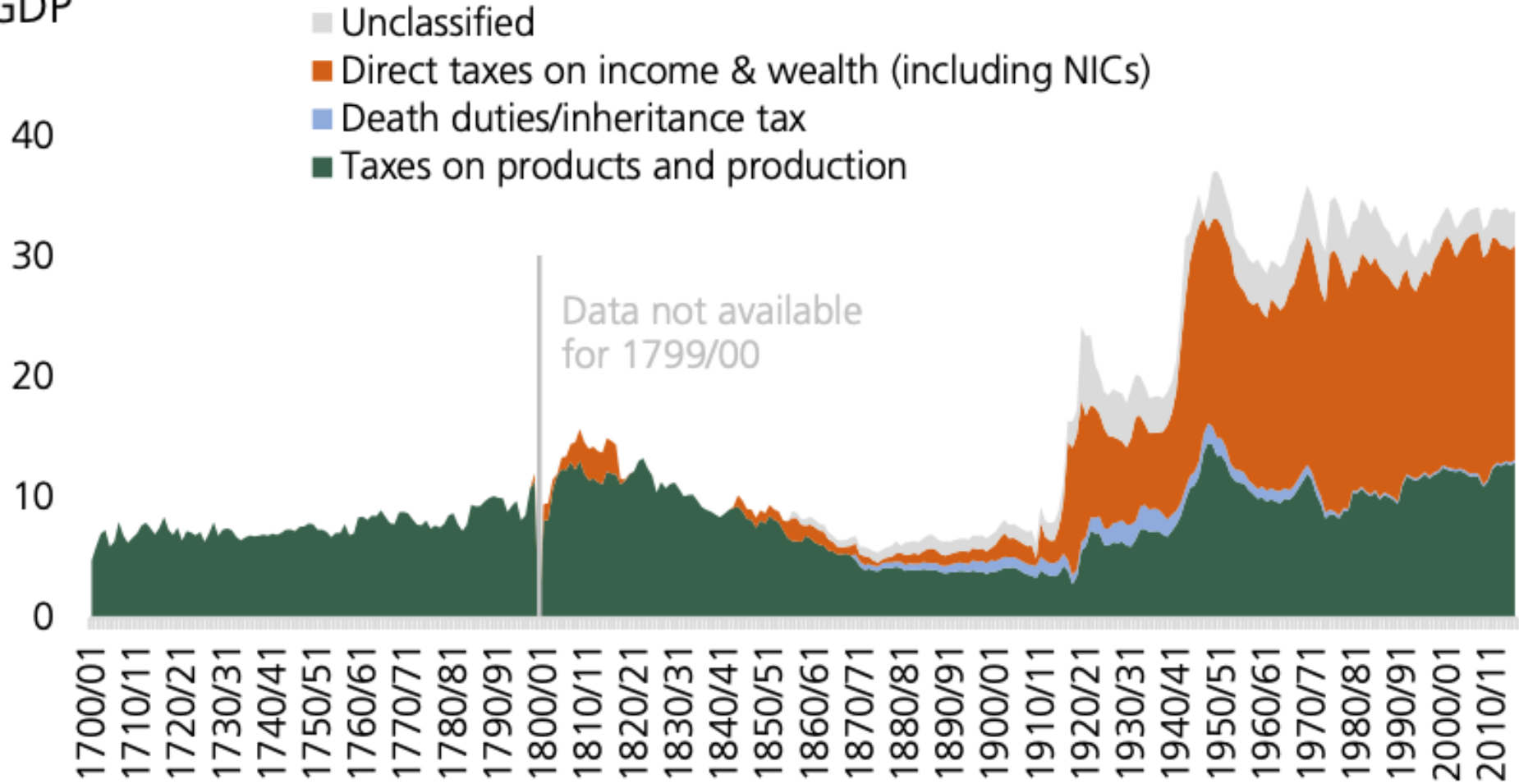
- Income taxes on people
  - Corporate taxes
  - Wealth/inheritance taxes
  - Sales taxes (VAT, excise duties...)
  - Progressive if the tax *rate* increases with income/wealth.
- Direct taxes
- Indirect taxes

Sources of tax revenues in UK



# Composition of public income, UK, 1700/01 - 2015/16

% GDP



Source: Bank of England, *A millennium of macroeconomic data, V3.1*, 2 March 2017

# The economy affects the budget

- Some changes in G & T are *discretionary*.
  - But G & T also fluctuate in response to economic conditions.
  - The higher economic activity, the higher T.
  - Some components of G called *automatic stabilizers* are higher when GDP is lower.
    - unemployment benefits, income support payments...
- *Other things equal, the deficit increases in recession and decreases under strong economic growth.*



# Composition of the economy's output

$$GDP = C + I + G + X - IM$$

Gross Domestic Product

(market value of all goods & services produced in the country during the year)

Private Consumption

Private Investment  
(housing + business)

Gov't spending  
(excluding interest and transfers)

Exports

Imports

# The budget affects the economy

- Composition of the economy's output:

$$GDP = C + I + G + X - IM$$

- G directly affects GDP
- G & T both have indirect effects through C, I, X and IM
  - Higher G increases people's and firms' incomes, potentially raising C & I.
  - But in some cases, it might also displace resources from C & I.
  - Higher T reduces income available for C & I.
  - More overall spending also increases imports (IM)
  - Through effects on exchange rates, can affect IM and X also in other complicated ways.

# Effects of fiscal policy

- An increase in  $G$  generally boosts GDP & reduces unemployment.
- An increase in  $T$  generally lowers GDP & increases unemployment.
- **Fiscal contraction** (or consolidation) = decrease in deficit  $G - T$ .
- **Fiscal expansion** = increase in deficit  $G - T$ .
- Fiscal expansion boosts the economy.
- But might also create inflation, produce a trade deficit (= imports outpace exports), and increase public debt.

# Fiscal multipliers

- *Spending multiplier*: how much GDP increases if G increases by 1£.
- *Tax multiplier*: how much GDP decreases if T increases by 1£.
- Multipliers are higher when the economy is working below capacity & unemployment is high.
  - Fiscal expansion is most powerful (& contraction most harmful) when the economy is depressed.
  - Policymakers should let the deficit increase in bad times, reduce it in good times.

# Public debt

- Deficits are financed by borrowing → Public debt.
  - Deficit (or surplus) = *flow*.
  - Debt = *stock*.
- Unlike a household, gov't does not need to repay its debt.
- What matters is not debt in £, but *debt-to-GDP ratio*.
  - Debt sustainable if Debt/GDP stable (or decreasing) over time.

# The dynamics of public debt

- Budget deficit  $\rightarrow$  increase in public debt in £.
- But debt-to-GDP ratio depends also on other stuff.
- Factors affecting the evolution of debt/GDP over time:
  - Primary deficit  $G - T$
  - Interest rate  $i$
  - Economic growth  $g$
  - Inflation  $\pi$

# The dynamics of public debt

$$\frac{Debt_t}{GDP_t} - \frac{Debt_{t-1}}{GDP_{t-1}} = (i - g - \pi) \frac{Debt_{t-1}}{GDP_{t-1}} + \frac{G_t - T_t}{GDP_t}$$

Change in debt-to-GDP over time

(Nominal) Interest rate

Real growth rate

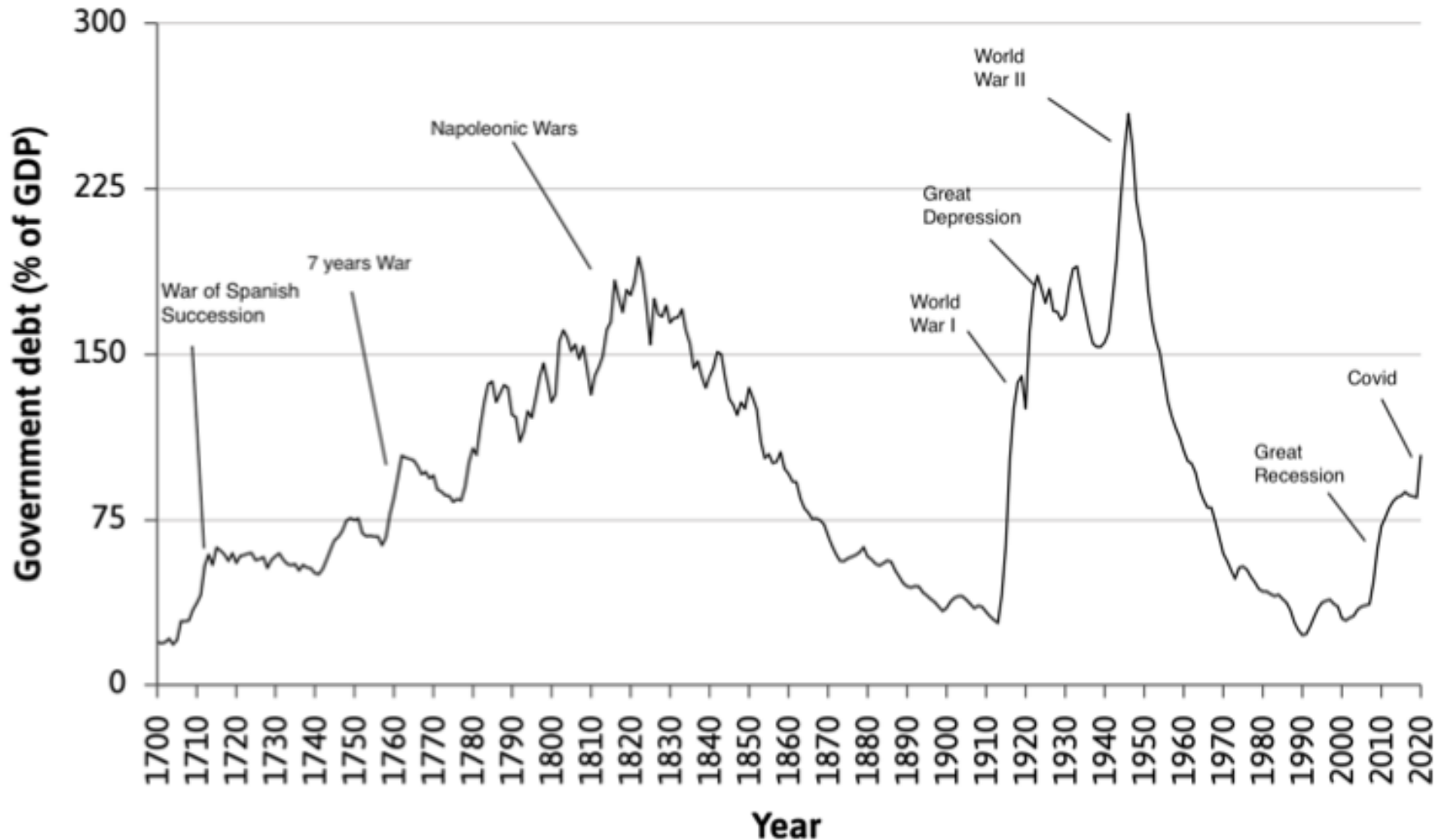
Inflation rate

Debt/GDP in previous year

Primary deficit/GDP

- > Debt/GDP increases during recessions, tends to fall with sustained growth.
- > When  $g + \pi > i$ , Debt/GDP can decrease (or remain stable) even with a deficit!

# UK Government debt (% GDP), 1700-2020



- Debt/GDP increases during wars, epidemics & recessions.
- Today's level (~100%) high but not unprecedented.
- Recent rise triggered by 2008 financial crises, deepened by 2020 Covid crisis.



# Module logistics

- Required readings for each Section available on Keats.
- *Useful (optional) resources:*

To catch up on the relevant economics:

▼ [What You Need to Know about Economics](#)



by George Buckley , and Sumeet Desai

**PUBLISHER**  
John Wiley & Sons, Incorporated

**DATE**  
2011-03-21

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On UK recent history:



BOOK

[Hope and glory : Britain, 1900-2000](#)

Clarke, P. F.

2004

[Available at Maughan Lib. Chancery Lane \[](#)

[Book reviews \(1\) >](#)

# Module assessment

- 4,500 words essay, due Jan 10 at 3pm
- A specific period, event, or conceptual problem related to UK fiscal/monetary policy in 1945-2024.
- Topic must be agreed with me beforehand (and I'm happy to help choose a topic!).
- Examples:
  - *"The use of quantitative easing by the BoE"*
  - *"Thatcher's Monetarist Experiment, 1979-85"*
  - ....

# Next reading

- Lecture notes “The Financial System and Monetary Policy: An introduction”
- Available on Keats.
- Read before next Monday’s lecture



**Thank you for your attention**