

Fiscal and Monetary Policy

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Governments do not just let markets run freely — they intervene to correct failures, reduce inequality, and stabilise the economy. The two main instruments are fiscal policy (taxes and spending) and monetary policy (money supply and interest rates).

The Role of Government in Stabilising the Economy

Governments pursue several macroeconomic objectives:

- **Full employment** — minimise unemployment so that resources are not wasted.
- **Price stability** — keep inflation low and predictable.
- **Favourable balance of payments** — ensure the country earns enough from trade to cover what it spends.
- **Economic growth and development** — raise living standards over time.

To pursue these goals, government uses taxation, public expenditure, and transfer payments (welfare benefits, pensions).

The National Budget

The **national budget** is the government's annual statement of planned revenue and planned expenditure for the coming year.

Budget position	Meaning	Consequence
Balanced budget	Revenue = expenditure	National debt unchanged
Budget surplus	Revenue > expenditure	Government can repay debt
Budget deficit	Revenue < expenditure	Government must borrow; national debt rises

National debt is the accumulated total of all past government borrowing that has not yet been repaid. A persistent deficit adds to national debt year after year.

Types of Taxes

Direct Taxes

A **direct tax** is levied on the income or wealth of an individual or company. The burden falls directly on the person paying it and cannot easily be passed on.

Examples: income tax, corporation tax, capital gains tax, wealth tax.

Direct taxes are usually **progressive** — the percentage of income paid in tax rises as income rises, thereby reducing inequality.

Indirect Taxes

An **indirect tax** is levied on the sale of goods and services. The seller pays the tax to the government but typically passes some or all of the burden to the consumer through higher prices.

Examples: value added tax (VAT), excise duties on alcohol and tobacco, customs duties (tariffs), stamp duty.

Indirect taxes are often **regressive** — lower-income households spend a higher proportion of their income on taxed goods than higher-income households, so the tax takes a larger share of poor households' income.

Fiscal Policy

Fiscal policy refers to government decisions about taxation and expenditure used to influence the level of aggregate demand, output, and employment.

Expansionary Fiscal Policy

Used to stimulate the economy during a recession or high unemployment:

- **Increase government spending (G)** — direct injection into the economy, raising aggregate demand.
- **Cut taxes** — increases disposable income for households (raising C) and profits for firms (raising I).
- Leads to a budget deficit, which is financed by borrowing.

Aim: Boost output and reduce unemployment.

Contractionary Fiscal Policy

Used to cool the economy during inflation:

- **Reduce government spending** — withdraws demand from the economy.
- **Raise taxes** — reduces disposable income and spending.
- Leads to a budget surplus or smaller deficit.

Aim: Reduce inflationary pressure by lowering aggregate demand.

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