Managing the UK economy

Fiscal and monetary policy since 1945

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

AY 2025-26

Department of Political Economy

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GOV.UK

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Press release

Budget to address economy that's "not working well enough for working people"

Today (Wednesday 3 September), the Chancellor has confirmed that the date of the Budget will be Wednesday 26 November.

From: HM Treasury

Published 3 September 2025

Last updated 4 September 2025 — See all updates

What precisely is "the budget"? What does it do?

How can it "address [an] economy that's not working well for working people"?

News | Opinion | Sport | Culture | Lifestyle

Business Economics Banking Money Markets Project Syndicate B2B Retail

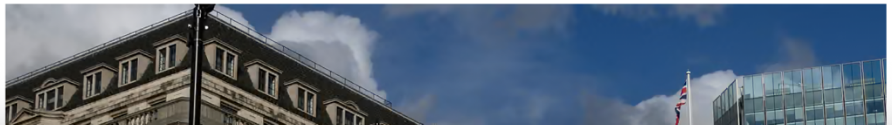
Interest rates

Bank of England holds interest rates at 4% and slows scheme to sell stock of UK bonds

Decision on government debt holdings could reduce market jitters and Treasury's borrowing costs

Heather Stewart
Economics editor

Thu 18 Sep 2025 12.00 BST



sky news

24 Sep

The big story from Bank of England is an easing in tightening to avert massive losses

Sky's economics and data editor Ed Conway explains how an unwinding of historic Bank support for the UK economy has been rowed back on, to save us many billions of pounds.

Ed Conway
Economics and data editor @EdConwaySky

Thursday 18 September 2025 14:45, UK

What is the interest rate in question?

Why did the BoE hold it at 4%?

What on Earth is an "easing in tightening", and how will it avert "massive losses"?

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 (& any electronic devices) 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.

THE NEW YORKER

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ANNALS OF TECHNOLOGY

THE CASE FOR BANNING LAPTOPS IN THE CLASSROOM

By Dan Rockmore June 6, 2014

SCIENTIFIC AMERICAN

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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

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 machinery of economic policy in the UK (Prof. Blick)

(Sep 29 to Oct 13)





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 Thatcherism & 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 20 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 = Revenues - Expenditure

*BB = Tax revenues (**T**) – Non-interest spending (**G**) – Interest spending (**INT**)*

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

Primary fiscal balance $(\mathrm{T} - \mathrm{G})$

Budgets in the UK

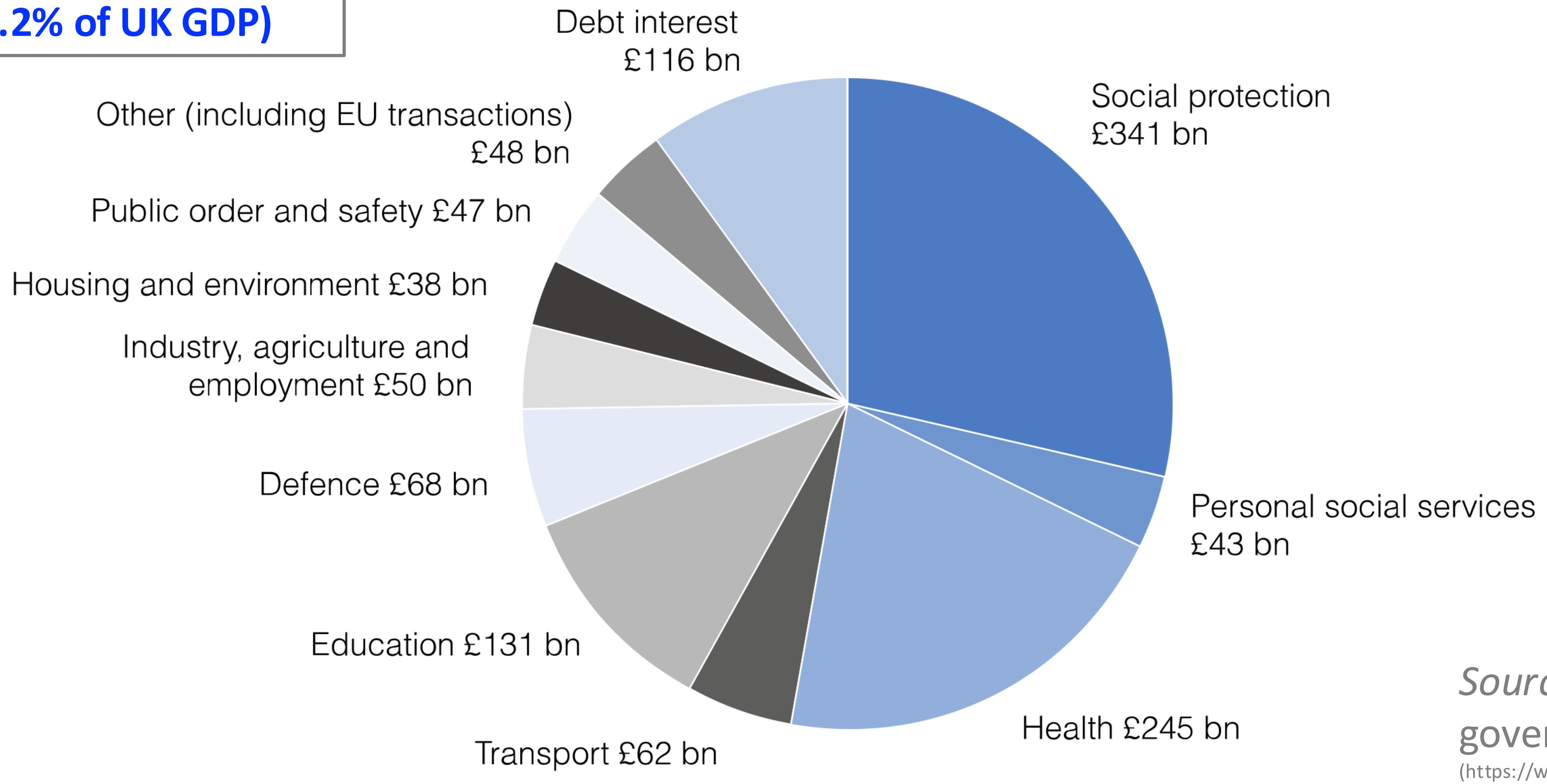
- Government needs parliament's authorization to spend money or change tax rates.
- Once or twice a year, gov't lays out its budget plans for next fiscal year.
  - Planned expenditure & its allocation across departments.
  - Any changes to tax laws & overall expected revenues.
  - Usually also discusses 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

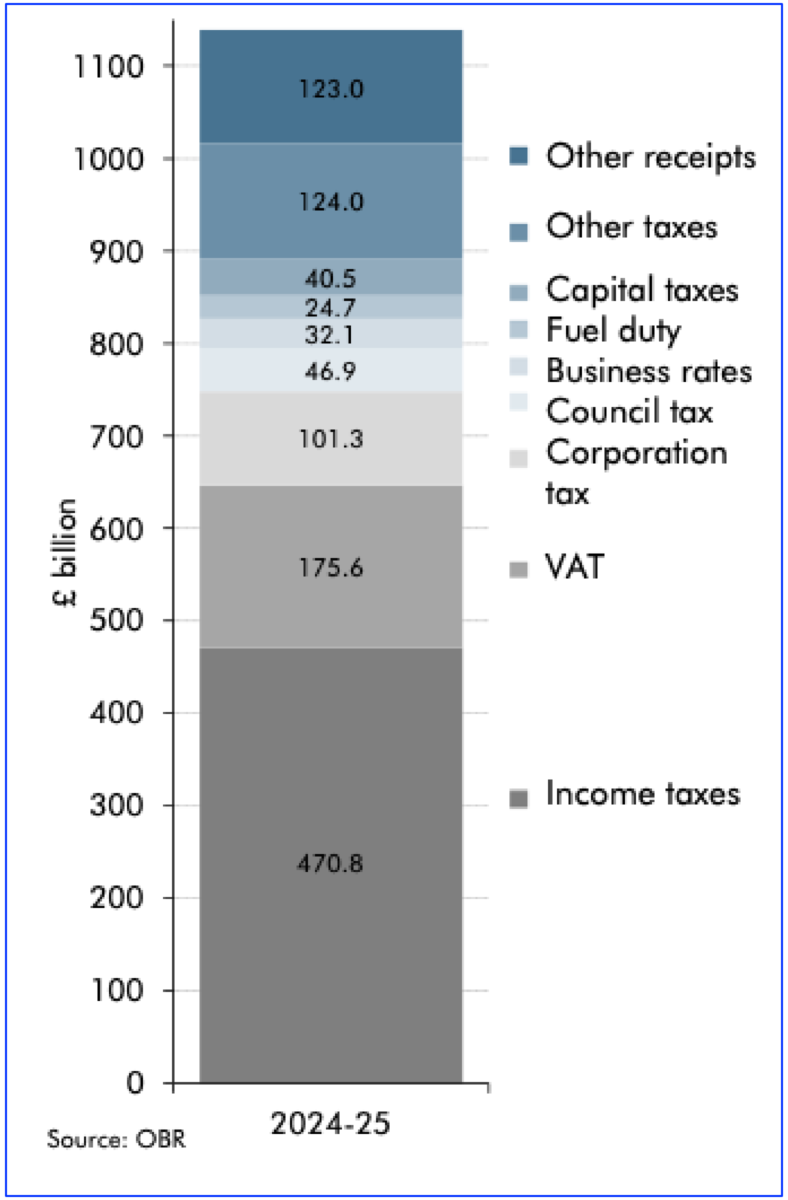
Direct taxes

- ○ Sales taxes (VAT, excise duties…)

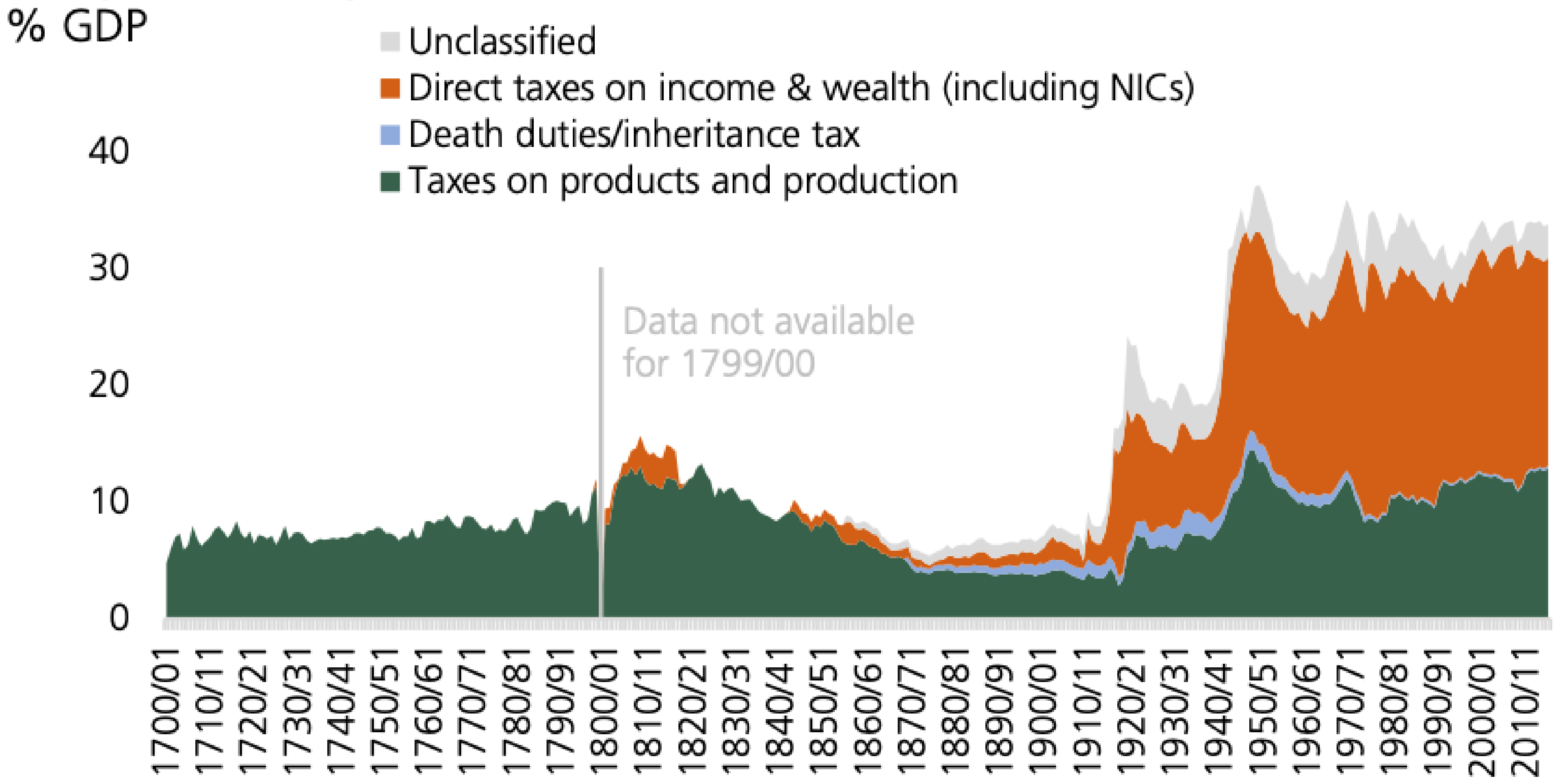
Indirect taxes

- Progressive if the tax *rate* increases with income/wealth.

Sources of tax revenues in UK



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



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.
- higher economic activity → higher tax revenues
- lower economic activity → more spending on unemployment benefits, income support payments, …
    - *automatic stabilizers*

→ *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 on goods & services
(excluding interest & 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 → 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 π

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

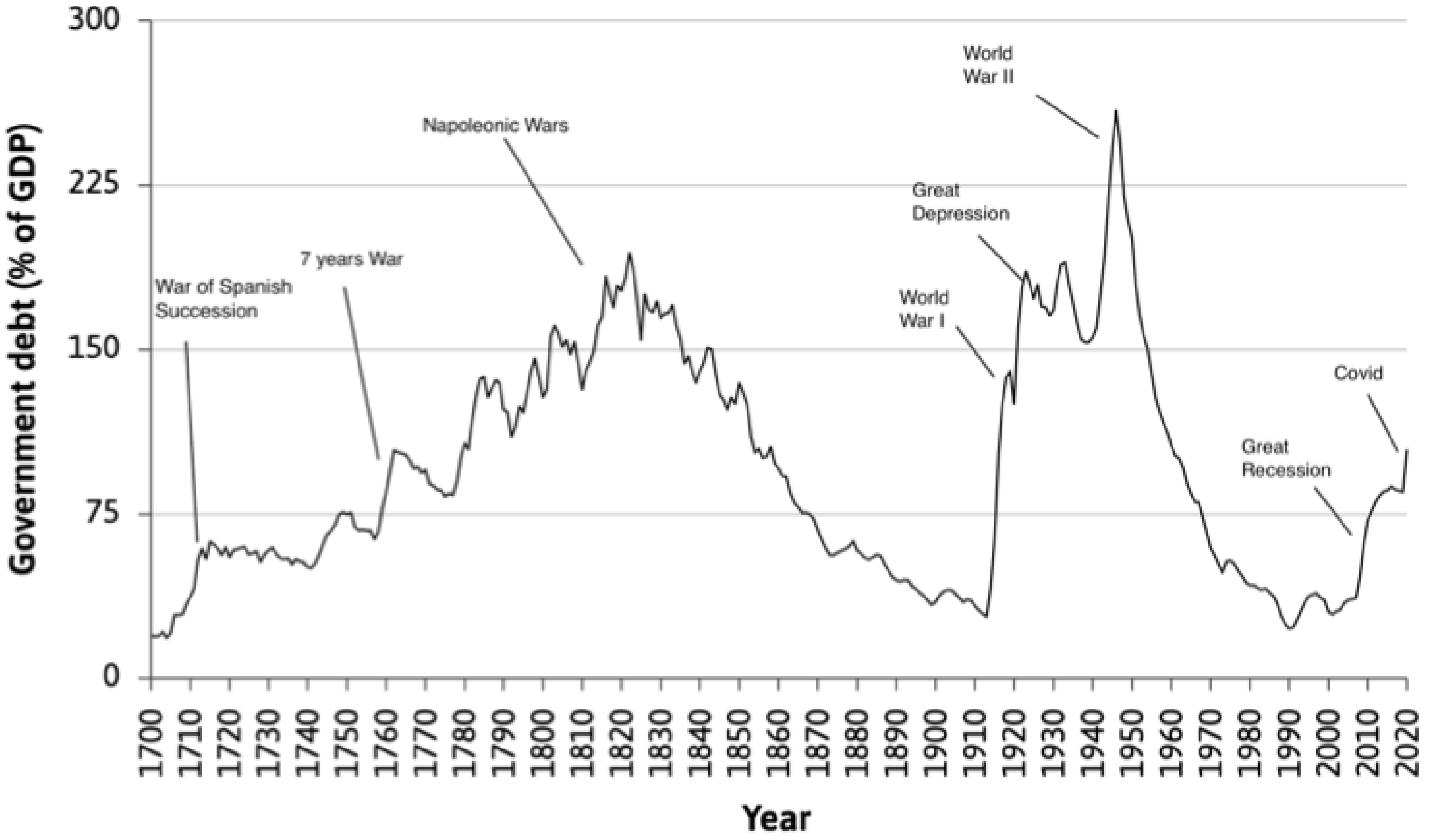
Inflation rate

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!

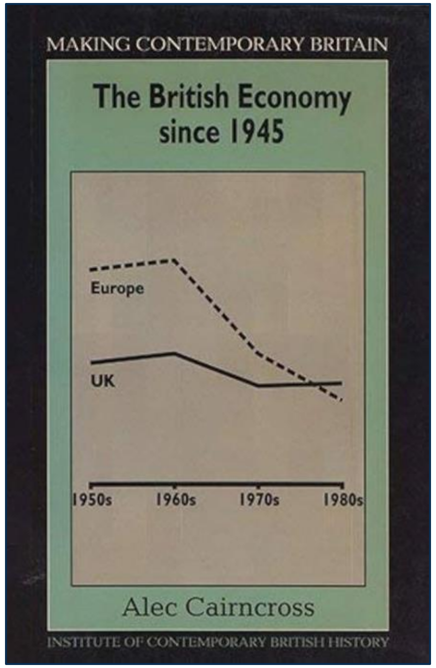
UK Government debt (% GDP), 1700-2020

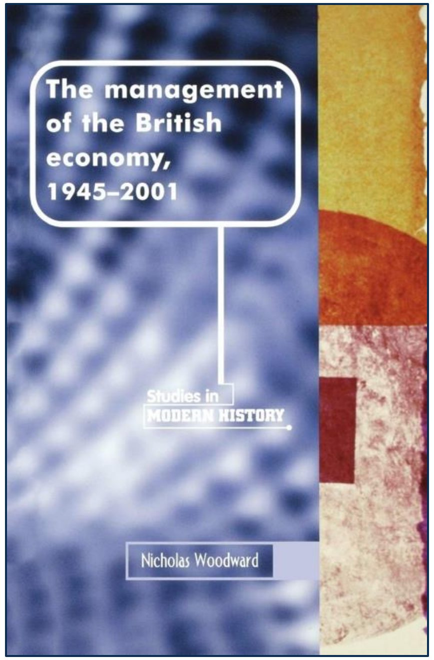


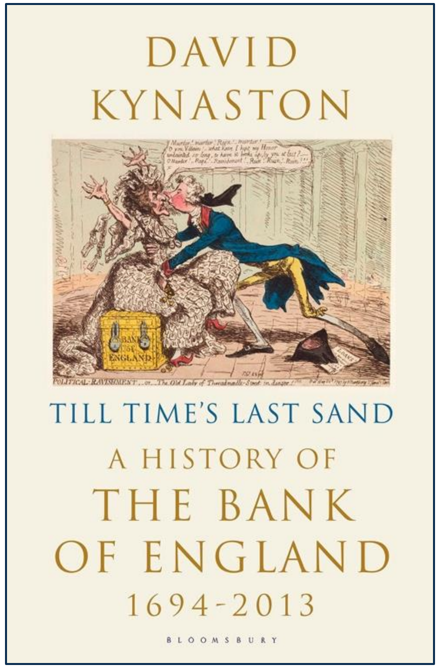
- Debt/GDP increases during wars, epidemics & recessions.
- Today's level (~100%) high but not unprecedented.
- Recent rise triggered by 2008 financial crises, deepened by 2020 Covid crisis.

Module logistics

- Required readings for each Section will be on Keats.
- *Often will be taken from:*





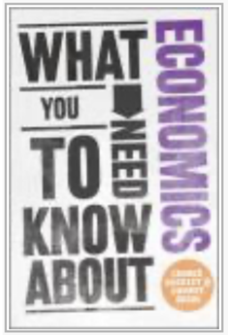


Module logistics

- *Useful (optional) resources:*

To catch up on the relevant economics:

▼ What You Need to Know about Economics



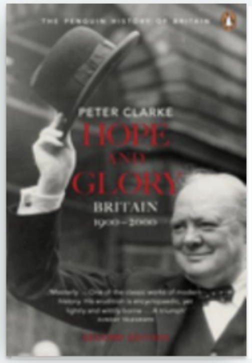
by George Buckley , and Sumeet Desai

PUBLISHER
John Wiley & Sons, Incorporated

DATE
2011-03-21

More...

To catch up on recent UK 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 15 Jan 2026 at 3pm
- A specific period, event, or conceptual problem related to UK fiscal/monetary policy in 1945-2025
- Topic must be agreed with me beforehand (and I'm happy to help you 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