

Cambridge IGCSE · Economics 0455 · Notes

Fiscal policy

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Read first: [The macroeconomic aims of government](#), [Market failure](#), [Price elasticity of demand \(PED\)](#)

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What you need to know

This topic has nine syllabus outcomes. In plain words, you should be able to:

1. **The government budget:** define it as the government's plan of its spending and revenue (mainly taxes) for the coming year.
2. **Government spending:** name the main areas the government spends on (health, education, defence, infrastructure, benefits and pensions), and explain **why** it spends on each and what the **effects** are.
3. **Reasons for taxation:** explain that taxes are the government's main source of revenue, and why governments tax (to raise revenue, change behaviour, redistribute income and manage the economy).
4. **Classifying taxes:** **progressive**, **regressive** and **proportional**; **direct** and **indirect**, with examples of each.
5. **Principles of taxation:** the qualities of a good tax.
6. **The impact of taxation** on consumers, producers, the government and the economy as a whole.
7. **Fiscal policy:** define it.
8. **Fiscal policy measures:** the tax and spending changes that create a **balanced budget**, a **budget deficit** or a **budget surplus**, and calculate the size of a deficit or surplus.
9. **Fiscal policy and the macroeconomic aims:** explain how tax and spending changes can help the government reach economic growth, full employment, stable prices, balance of payments stability and a fairer distribution of income.

You do not need aggregate demand and aggregate supply diagrams: write about **total demand** (total spending in the economy) in words.

Understand it

The government budget

The **government budget** is the government's plan, set out once a year, of how much it expects to **spend** and how much **revenue** (mostly tax) it expects to collect over the year ahead.

Comparing the two totals gives the **budget balance**:

- **Balanced budget:** government spending equals government revenue.
- **Budget deficit:** government spending is **greater** than revenue. The gap is covered by **borrowing**, which adds to the **national debt** (the total the government owes).
- **Budget surplus:** revenue is **greater** than spending. The extra can repay debt.

Here is a made-up budget for Country M, whose GDP is \$1000bn:

Revenue	\$bn	Spending	\$bn
Income tax	180	Health	110
Corporation tax	40	Education	95
Sales tax (VAT)	120	Pensions and benefits	130
Excise duties	25	Defence	35
Import duties	15	Roads and other	50
Total	380	Total	420

Spending is \$420bn and revenue is \$380bn, so Country M has a **budget deficit of \$40bn**, which is **4% of GDP** ($\$40\text{bn} \div \$1000\text{bn} \times 100$). It must borrow \$40bn this year.

Why governments spend

Area of spending	Why the government spends on it	Effects
Education and healthcare	They are merit goods : people under-use them if left to the market, but they bring external benefits to others	A healthier, more skilled, more productive labour force; higher incomes and growth in the long run
Defence, law and order, street lighting	They are public goods : non-excludable, so private firms would not supply them	Security and order that markets would not provide
Infrastructure (roads, ports, broadband)	Private firms may not build it, or not enough of it	Lower costs of transport for firms, more investment, growth, jobs in building
Benefits and pensions (transfer payments)	To support people with low or no income: the unemployed, the old, the sick	Less poverty , a fairer distribution of income
Subsidies	To encourage goods with external benefits or protect key industries	Lower prices, more output and jobs in that industry

All spending also adds to **total demand**, so more spending means more output and jobs, and less spending means less. Every choice has an **opportunity cost**: money spent on defence cannot be spent on schools.

Why governments tax

Taxes are the main source of government revenue. Other sources, such as profits of state-owned firms or selling government assets, are much smaller, and selling an asset is **not** a tax. Governments tax:

1. **To raise revenue** to pay for public goods, merit goods, infrastructure and benefits.
2. **To discourage demerit goods** and harmful activities (cigarettes, alcohol, sugary drinks, pollution), and to **conserve** scarce resources such as oil: a tax raises the price, so less is bought.
3. **To redistribute income**: progressive taxes take a bigger share from the rich, and the revenue pays for benefits for the poor.
4. **To manage the economy**: raising taxes reduces total demand (to fight inflation); cutting taxes raises total demand (to fight unemployment and recession).
5. **To protect domestic industries**: import duties (tariffs) make imports dearer.

Direct and indirect taxes

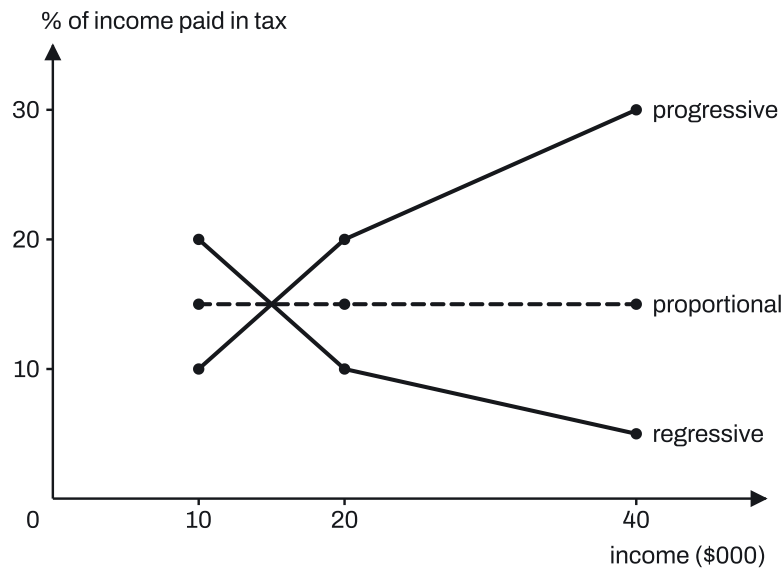
- A **direct tax** is a tax on **income or wealth**, paid straight to the government by the person or firm it is charged on: **income tax**, **corporation tax** (on firms' profits), **inheritance tax**, taxes on wealth or property, and social security taxes on wages.
- An **indirect tax** is a tax on **spending** on goods and services. The seller pays it to the government but passes some or all of it on in the price: **sales tax / VAT**, **excise duties** (on fuel, tobacco, alcohol), **import duties / customs duties / tariffs**, air passenger duty.

Progressive, proportional and regressive taxes

These words describe how the **percentage of income** paid in tax changes as income rises. Look at the percentage, not the amount.

- **Progressive**: the percentage of income paid **rises** as income rises. Income tax with a tax-free allowance and higher rates on higher bands is progressive.
- **Proportional**: the **same percentage** of income at every level of income, for example a flat 15% tax on all wages.
- **Regressive**: the percentage of income paid **falls** as income rises. Indirect taxes are usually regressive: a poor family spends most of its income, so the sales tax it pays is a bigger share of its income than a rich family's.

Income	Progressive tax	Proportional tax	Regressive tax
\$10 000	\$1000 (10%)	\$1500 (15%)	\$2000 (20%)
\$20 000	\$4000 (20%)	\$3000 (15%)	\$2000 (10%)
\$40 000	\$12 000 (30%)	\$6000 (15%)	\$2000 (5%)



In the regressive column everyone pays the same **amount**, yet the **percentage** falls, so it is regressive.

Raising the top rate or the tax-free allowance makes income tax **more progressive**; **cutting** the allowance hits low earners hardest, a **regressive** change.

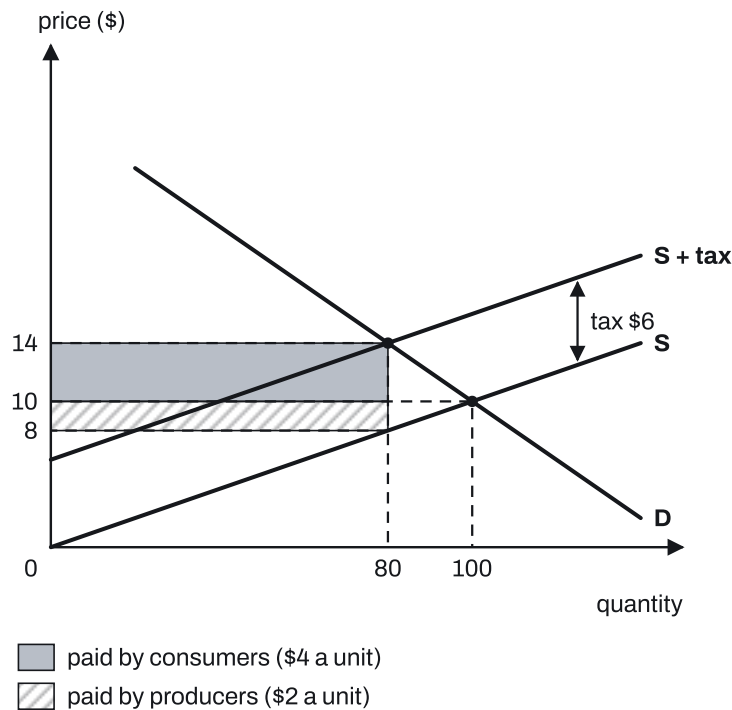
The qualities of a good tax

A good tax should be:

- **Equitable (fair)**: based on the **ability to pay**, so people with more income or wealth pay more.
- **Certain**: taxpayers know how much they must pay, when and how.
- **Convenient**: easy and simple to pay, at a sensible time (income tax taken from each pay packet).
- **Economical**: cheap to collect compared with the revenue it raises.
- **Efficient**: it raises the revenue intended without big harmful side effects, such as making people work less or firms invest less. A very high top rate of income tax can make high earners cut their hours, so the tax does **not** raise as much revenue as it could.
- **Flexible**: easy to change when the economy changes.

Who pays an indirect tax?

An indirect tax is added to the seller's costs, so the supply curve shifts **up** by the amount of the tax. The price rises, but usually by **less** than the tax, so the burden is **shared** between consumers and producers.



In the diagram the tax is \$6 a unit. The price rises from \$10 to \$14, so **consumers pay \$4** of each \$6. Producers receive \$14 but hand \$6 to the government, keeping \$8 instead of \$10, so **producers pay \$2**. The government collects $\$6 \times 80 = \480 : \$320 from consumers (the grey area) and \$160 from producers (the hatched area).

Who pays more depends on **price elasticity of demand**:

- **Inelastic demand** (necessities, fuel, cigarettes): buyers keep buying, so producers can pass **most** of the tax on as a higher price; quantity falls only a little, so the government collects a lot of revenue. In the diagram the price rises 40% while quantity falls only 20% ($PED = -0.5$). If demand is **perfectly inelastic**, consumers pay **all** of the tax.
- **Elastic demand**: buyers switch away, so producers must absorb **most** of the tax; quantity falls a lot and less revenue is raised.

The impact of taxation

Who	Main effects of higher taxes
Consumers	Higher income tax cuts disposable income , so they spend less; higher indirect taxes raise prices , so they buy less of the taxed good (more so if demand is elastic). Low-income households are hit hardest by indirect taxes.
Producers	Higher corporation tax cuts profits after tax , so firms have less to invest and less incentive to expand. Indirect taxes raise costs, cut sales and can cost jobs. Lower demand from consumers also cuts sales.
Government	More revenue to spend on public services or to reduce a deficit, but very high rates may cut revenue if people work less, avoid or evade tax, or leave the country (brain drain).

Who	Main effects of higher taxes
Economy	Lower total demand → less output and fewer jobs, but less inflation ; progressive taxes make income more equal ; high taxes may discourage work, enterprise and foreign investment (multinational companies may go elsewhere).

Tax cuts work the other way. Lower **direct** taxes can raise both **demand** (more to spend) and **supply** (a bigger reward for working and investing).

What fiscal policy is

Fiscal policy means the government adjusting its **taxes** and its **own spending** in order to change the level of spending in the whole economy, and through it output, jobs and prices. It is decided by the **government**, not the central bank. Changes in interest rates, the money supply or the exchange rate are **monetary policy**; training schemes, privatisation and cutting trade-union power are **supply-side policy**.

- **Expansionary fiscal policy:** **raise** government spending and/or **cut** taxes. Total demand rises. It usually moves the budget towards a **deficit**. Used against unemployment and recession.
- **Contractionary fiscal policy:** **cut** government spending and/or **raise** taxes. Total demand falls. It moves the budget towards a **surplus**. Used against inflation, a current account deficit or a large debt.

The budget balance also moves on its own with the economy. In a **recession**, unemployment rises (cyclical unemployment), so income tax and sales tax revenue fall and benefit spending rises: the deficit grows. In a boom, revenue rises and benefit spending falls, so the deficit shrinks.

Fiscal policy and the macroeconomic aims

Aim	Fiscal measure	How it works
Economic growth	Spending on infrastructure, education, health; lower corporation tax	More total demand → firms produce more; better skills and transport raise productivity and productive capacity
Full employment	Higher spending, lower income tax	Disposable income rises → consumer spending rises → firms need more workers (labour is a derived demand) → cyclical unemployment falls
Stable prices	Higher income tax, lower spending	Less disposable income → less spending → total demand falls → less demand-pull inflation
Balance of payments stability	Higher income tax, import duties	Less spending, including on imports; tariffs make imports dearer → current account improves
Redistribution of income	More progressive taxes, higher benefits, free education and health care	The rich pay a bigger share; the poor receive more → less inequality and poverty

Why fiscal policy may not work

It can **conflict** with other aims (more demand brings inflation and imports; less demand brings unemployment), a deficit adds to **debt**, projects and tax changes take **time**, worried people may **save** a tax cut, high taxes can blunt **incentives**, and extra demand raises output most when there is **spare capacity**. How to do it, sections 3 and 9, turns these into Discuss answers.

Key facts and formulas

There is no formula list for 0455. "Learn it" means you must remember it.

Formula or fact	Status
Budget balance = government revenue – government spending (negative: a deficit; positive: a surplus)	Learn it
Deficit as % of GDP = $\frac{\text{deficit}}{\text{GDP}} \times 100$	Learn it
Tax as a % of income = $\frac{\text{tax paid}}{\text{income}} \times 100$; rising = progressive, constant = proportional, falling = regressive	Learn it
Direct taxes: income tax, corporation tax, inheritance tax, wealth and property taxes, taxes on wages	Learn it
Indirect taxes: sales tax/VAT, excise duties, customs and import duties (tariffs), air passenger duty	Learn it
Consumers' share of an indirect tax per unit = rise in price; producers' share = tax – rise in price	Learn it
Tax revenue from an indirect tax = tax per unit × new quantity	Learn it
Expansionary: spending ↑ and/or taxes ↓; contractionary: spending ↓ and/or taxes ↑	Learn it
Qualities of a good tax: equitable, certain, convenient, economical, efficient, flexible	Learn it

How to do it

We have tagged 80 questions on this topic (2021–2025): 48 multiple choice on Paper 1 and 32 structured questions on Paper 2. One multiple-choice question was set on three papers, so 78 are different. Each structured question has one part about this topic except four, which have two parts of different types, so the counts below add up to 84.

Question type	Questions
Work out and explain the budget balance (deficit/surplus)	13
Recognise the definition of the government budget and of fiscal policy measures	12
Discuss whether a change in government spending benefits the economy	8
Analyse how a tax or spending change affects an aim (employment, growth, inflation, poverty)	8
Pick the fiscal measure that meets a given aim (MCQ)	7
Calculate direct or indirect tax revenue from a table	6
Classify a tax as progressive, regressive or proportional	6
Give reasons for taxation and classify spending (public/merit goods)	6
Discuss whether tax cuts / fiscal policy benefit the economy or meet an aim	6
Show who bears an indirect tax (incidence, PED)	4
Identify the principles (qualities) of a good tax	3
Discuss whether a particular product should be taxed (more)	3
Explain why tax revenue changes	2

Written answers. Analyse (4 or 6 marks) and Explain (4 marks) are points-marked: a mark for each link in a chain of reasoning, so write **three developed chains** for 6 marks and **two** for 4. Discuss parts are worth 8 marks in Section B (levels-marked: Level 3, 6–8 marks, needs both sides developed and a judgement) or 6 marks in Section A (up to 4 marks a side). Plan every Discuss answer the same way: **point** → **developed chain of reasoning** → **the other side (new points, not the first side reversed)** → **a justified judgement** that says what the answer depends on. Aim for two or three developed points a side.

1. Work out and explain the budget balance (deficit/surplus) (13 questions)

- 1. Compare spending with revenue.** Spending > revenue: deficit. Revenue > spending: surplus. Equal: balanced.
- 2. Calculate the size:** deficit = spending – revenue (or surplus = revenue – spending), with units. To compare two years, work out each year's balance first.
- 3. Explain the change** by thinking about both sides: what happens to tax revenue (income tax, corporation tax, sales tax) and to spending (benefits, pensions).

For example, revenue \$70bn and spending \$82bn in year 1, then revenue \$76bn and spending \$82bn in year 2: the deficit **falls** from \$12bn to \$6bn.

Variations you will meet:

- Multiple choice** (7 questions). Work out the balance, then follow cause and effect: cutting spending from a balanced position gives a **surplus**; boosting the economy with a deficit means spending **more than it collects**; spending climbing while revenue falls points to a **downturn that throws people out of work**

(less tax, more benefits); a deficit is borrowed, so it adds to debt and maybe inflation, but does **not** raise exports; raising taxes on spending alone brings in more revenue, so it is meant to **shrink a deficit**.

- **"State why the budget increased total demand"** (2 marks): spending was greater than tax revenue (a deficit) (1), so the government added more to spending in the economy than it took out in taxes (1).
- **"Analyse how unemployment / a later retirement age / immigration affects the budget"** (4 marks). Cover both halves. More unemployment: less income tax (1) and sales tax (1), more benefits paid (1), so the deficit grows (1). Working longer: more income tax and fewer years of pensions, so the deficit falls. Immigration: more income, sales and corporation tax, but more spent on schools and health care.
- **Discuss whether a budget will be in deficit, or whether a policy will reduce a deficit** (6 or 8 marks). It may shrink if the policy makes the economy grow: more people in work pay income tax and claim fewer benefits; bigger profits bring more corporation tax; more spending brings more sales tax; selling a state firm brings a one-off sum. It may grow if the policy costs money before it pays off, if tax rates are cut, if newly skilled workers move abroad, or if a profitable state firm is sold. Judge by how long the benefits take. Keep to the **government's** budget, not exports and imports.

2. Recognise the definition of the government budget and of fiscal policy measures (12 questions)

All multiple choice. Learn the two definitions:

- **Government budget:** the government's yearly plan of what it expects to **collect and spend** over the coming year. Items in it: taxes of every kind, public spending, and the gap between the two. Items not in it: trade flows (exports and imports), the exchange rate, household saving and spending, and ideas such as external costs or opportunity cost.
- **Fiscal policy:** the government changing its **taxes and its own spending** to shift total spending in the economy. Any change in a tax (income, corporation or another direct tax) or in a spending programme (such as defence) counts. Interest rates and the money supply are **monetary**; the exchange rate is exchange-rate policy; training and trade-union laws are **supply-side**.
- **Expansionary fiscal policy** to raise growth means **lower taxes plus higher public spending**, never a change in interest rates or the money supply.

3. Discuss whether a change in government spending benefits the economy (8 questions)

Section B, 8 marks (6 in Section A). Questions: an increase in government spending in general, or on healthcare, housing or unemployment benefit; a **cut** in spending or in pensions; whether high spending helps the macroeconomic aims or ends a recession.

1. **Name what the spending is on** and what it does first (for example, "healthcare is a merit good").
2. **Why it might benefit** (two or three chains):
 - **benefits** and free services lift the incomes of the poorest, narrowing **inequality**;
 - schools and hospitals make workers more skilled and healthier, so each produces more and firms' costs fall;

- goods that markets under-supply (public and merit goods, affordable housing) get provided;
- the spending itself is someone's income → firms sell more and hire → fewer unemployed, more output.

3. Why it might not (two or three new chains):

- **opportunity cost**: every dollar spent on one programme is a dollar not spent on another, and projects can take years to finish;
- the money has to come from somewhere: **borrowing** adds to the national debt and its interest bill, and **higher taxes** later leave people less to spend;
- if the economy is already close to full capacity, the extra spending pushes prices up (**demand-pull inflation**) more than it raises output;
- if the goods bought come from abroad (equipment, medicines), much of the money leaks out as **imports**, helping foreign jobs and worsening the current account;
- state-run projects may suffer from **waste**, delays and poor value for money.

4. Judgement: it depends on what the money is spent on (education raises long-run productivity; spending on imports does little for jobs at home), how much spare capacity the economy has, and how it is financed.

For a **cut** in spending, turn the chains round (lost jobs, more poverty); against: the savings can cut taxes or the deficit, and inflation eases.

4. Analyse how a tax or spending change affects an aim (employment, growth, inflation, poverty) (8 questions)

Analyse, usually 6 marks (one 4-mark data part). Write three chains, each step one mark, ending at the aim in the question.

- **A tax or spending change → jobs.** Go step by step from the change to the job market. A rise in sales tax (1) makes goods dearer (1), so households buy less (1); firms sell less (1) and need fewer staff, since they hire only to make what they can sell (1), so **cyclical** unemployment rises (1). Other chains: **work incentives** (if tax takes more of each pay packet, some people stop looking for work) and **profits** (a higher tax on profits leaves less to reinvest, so firms expand and hire less).
- **Lower taxes and higher spending → less unemployment, more growth.** Reverse the chains. Spending on a project (a new railway, schools) creates jobs on the project itself (1) and at the firms supplying materials (1); these workers spend their wages in local shops (1), so total demand and GDP rise further (1).
- **Higher income tax → lower inflation.** Less disposable income (1) → less consumer spending (1) → total demand falls (1) → less demand-pull inflation (1); workers may ask for higher wages to make up for the tax (1) → cost-push inflation, so the effect may be smaller (1).
- **A spending cut → more poverty.** Less spent on benefits and pensions → lower incomes for the poor; fewer public-sector jobs → unemployment; poorer education and health services for those who cannot pay.
- **Data (4 marks):** "Analyse the relationship between government spending and GDP" — state the relationship (positive or inverse), quote figures from the source, note any exception year, and give a reason.

5. Pick the fiscal measure that meets a given aim (MCQ) (7 questions)

1. Name the aim: more demand (unemployment, recession) or less demand (inflation), redistribution, or the budget.
2. Pick the direction: expansionary for more demand, contractionary for less; **more progressive** for equality.
3. If there are two aims, check the measure works for **both**.

Linking measures to aims: a tax rise when prices are rising fast is meant to **cool total demand**; raising rates on the rich while cutting them for the poor makes income tax **more progressive**, so it narrows the income gap; planning to spend more than it collects (a deficit) adds to demand, so its main effect is **more jobs**; cutting taxes on income and profits leaves people more to spend and a bigger reward for working and investing, so it **raises both demand and supply**. When there are two aims, test each option against both: for example, to reduce a deficit **and** poverty at once, you need a measure that raises revenue mainly from the rich (a heavier tax on high incomes), not one that cuts help for the poor; to create jobs **and** narrow the income gap, ease the tax burden on low earners and give more support to low-income households.

6. Calculate direct or indirect tax revenue from a table (6 questions)

1. Label every line **D** (direct: income, profits, inheritance, wealth) or **I** (indirect: goods, services, sales tax, VAT, excise, customs, import duty, air passenger duty).
2. Cross out anything that is **not a tax**, such as the sale of government assets.
3. Add up the group asked for. Re-read whether it asks for direct or indirect.

For example, with income tax 150, profits tax 90, inheritance tax 20, sales tax 260, import duty 45 and fuel duty 15, indirect revenue is $260 + 45 + 15 = 320$ and direct revenue is $150 + 90 + 20 = 260$. In a table of taxes as a percentage of GDP, add the direct columns for each country and compare.

7. Classify a tax as progressive, regressive or proportional (6 questions)

1. Work out $\text{tax} \div \text{income} \times 100$ at each income level (or read the rate from the table).
2. Rising percentage: progressive. Same: proportional. Falling: regressive.
3. A diagram of "% paid in tax" against income: a line sloping **down** is regressive, **up** is progressive, flat is proportional.

For example, tax of \$600 on \$4000 (15%), \$1500 on \$6000 (25%) and \$3500 on \$10 000 (35%): the percentage rises, so it is **progressive**. A flat 2% charged on all wages to pay for pensions is **direct and proportional**. Cutting the tax-free allowance is a **regressive** change.

Explain (4 marks) the difference between proportional and progressive: a proportional tax takes the same percentage of income at all levels (1), for example a 10% rate on every income (1); a progressive tax takes a rising percentage as income rises (1), for example a 10% rate on lower incomes and 40% on higher incomes (1).

8. Give reasons for taxation and classify spending (public/merit goods) (6 questions)

- **Reasons for a tax (MCQ):** match the tax to its purpose. A tax on a scarce natural resource raises its price, so less is used and more is left for the future. Taxes on incomes and profits are broad and raise large sums, so their usual purpose is **paying for services** such as schools, hospitals and defence; steering people away from particular products is the job of taxes on those products.
- **Spending charts:** add the right bars. **Merit goods** = education + health; **public goods** = defence + law and order. Unemployment benefits and social security are transfer payments, neither.
- **Explain two reasons why governments tax cigarettes** (4 marks): to raise revenue (1), as demand is inelastic, so sales fall little and much tax is collected to spend on health care (1); to discourage smoking, a demerit good (1), as the higher price reduces the quantity bought and the harm to smokers and others (1).

9. Discuss whether tax cuts / fiscal policy benefit the economy or meet an aim (6 questions)

Section B, 8 marks (6 in Section A). Questions: whether low tax rates benefit an economy; whether a cut in income tax raises living standards or ends a recession; whether fiscal policy can reduce poverty or achieve full employment.

Low taxes, why they might benefit (develop two or three):

- firms keep more of their profit, so they can afford new machinery and expansion, and the country becomes a more attractive base for foreign firms → more output and jobs;
- households keep more of what they earn → they spend more → firms sell more and hire more; working also pays better, so more people take jobs;
- low taxes on spending keep shop prices down, which helps low-income households most;
- skilled people are less tempted to move to lower-tax countries.

Why they might not:

- people may **save** a tax cut rather than spend it if they are worried about their jobs, so spending barely rises (why a tax cut may not end a recession);
- if spending rises faster than output, prices rise (**inflation**);
- the government collects less, so it must cut services such as schools and hospitals or borrow more (a **deficit** and more debt);
- cutting the top rates helps the rich most, so **inequality** widens;
- low taxes on harmful goods mean more of them are consumed.

Fiscal policy and poverty / full employment: for = training gives the poor skills and better jobs; higher benefits raise incomes; expansionary policy creates jobs; lower taxes on spending make necessities cheaper. Against = inflation hurts the poor most; high taxes on the rich may drive them abroad; benefits may weaken the incentive to work; more demand does not cure structural or frictional unemployment; time lags.

Judgement: it depends on the type of unemployment or poverty and how much spare capacity there is.

10. Show who bears an indirect tax (incidence, PED) (4 questions)

1. The tax shifts supply **up** by the tax per unit.
2. **Consumers' share** per unit = new price – old price. On a diagram, the consumers' area is the rectangle between the old and new price, up to the **new** quantity.
3. **Producers' share** per unit = tax – consumers' share.
4. Check elasticity: **inelastic** demand → most passed on to consumers, quantity falls a little, **government revenue rises**; **perfectly inelastic** → consumers pay all of it; elastic demand → producers pay most.

So when a firm can pass most of a tax on to its customers, the tax must be one on spending (indirect), and buyers must be unresponsive to price. For a product people cannot easily do without, a higher tax cuts sales only slightly, so the government's revenue goes **up**.

11. Identify the principles (qualities) of a good tax (3 questions)

- **Identify two** (2 marks): two of equitable, certain, convenient, economical, efficient, flexible.
- Multiple choice: a principle describes how a good tax treats taxpayers (for example, people in the same position paying the same, and richer people paying more); collecting as much money as possible is not a principle. If very high rates make high earners work fewer hours, the tax brings in less than it could: it breaks the **efficiency** principle.

12. Discuss whether a particular product should be taxed (more) (3 questions)

Section B, 8 marks (6 in Section A): perfume compared with food, sports equipment, airline fuel.

- **Should**: if it harms people or the environment (a **demerit good**, **external costs**), a higher price cuts use; if demand is **inelastic**, it raises plenty of revenue; if it is a luxury, those who pay can afford it.
- **Should not**: if demand is **elastic**, sales collapse, little revenue comes in and home producers cut **jobs**; if it is good for people (a **merit good**), use falls; on a necessity the tax is **regressive** and adds to poverty.
- **Judgement**: it depends on the product's PED, who buys it, whether it is merit or demerit, and whether it is made at home.

13. Explain why tax revenue changes (2 questions)

Explain (4 marks) or analyse (6 marks). Each reason with its link:

- **tax rates change** (a higher rate raises revenue unless people work less or avoid tax);
- **economic growth**: higher incomes → more income tax; more spending → more sales tax; more profit → more corporation tax;
- **employment** rises → more people paying income tax;
- **population** grows or immigration rises → more taxpayers; emigration → fewer;
- **inflation** raises prices, so sales-tax revenue rises;
- **tax avoidance and evasion** reduce revenue; better collection raises it.

Worked examples

Example 1

The table shows Country K's budget forecast for next year (\$bn).

Revenue	\$bn	Spending	\$bn
Income tax	64	Health	40
Corporation tax	18	Education	38
Sales tax	46	Pensions and benefits	52
Excise duties	12	Defence	14
Import tariffs	6	Other	8

(a) Calculate Country K's revenue from indirect taxes. [1]

(b) Calculate Country K's budget balance and state whether it is a deficit or a surplus. [2]

(c) Explain two reasons why a government spends on education and health. [4]

(a) Indirect taxes are sales tax, excise duties and import tariffs: $\$46\text{bn} + \$12\text{bn} + \$6\text{bn} = \text{\$64bn}$ (1).

(b) Revenue = $\$64\text{bn} + \$18\text{bn} + \$64\text{bn} = \146bn ; spending = $\$40\text{bn} + \$38\text{bn} + \$52\text{bn} + \$14\text{bn} + \$8\text{bn} = \152bn (1). $\$146\text{bn} - \$152\text{bn} = -\$6\text{bn}$, a **budget deficit of \\$6bn** (1).

(c) Education and health care are merit goods, which people would under-consume if they had to pay the full price (1), so the government provides them to make sure everyone, including the poor, can use them (1). A healthier, better-educated labour force is more productive (1), which raises output and economic growth (1).

Example 2

Analyse how a cut in government spending could reduce the inflation rate. [6]

A cut in government spending, for example on roads or public-sector wages, directly reduces total demand (1). Firms that supply the government sell less, so they produce less and employ fewer workers (1). Those workers, and public-sector workers whose pay is frozen, have lower incomes and cut their own spending (1), so total demand falls further (1). With less spending chasing goods and services, firms cannot raise prices as easily, so demand-pull inflation falls (1). Higher unemployment also weakens workers' bargaining power, so wage rises are smaller, firms' costs rise more slowly and cost-push inflation falls (1). (Any 6.)

Example 3

Discuss whether or not a government should increase the tax on sugary drinks. [8]

A tax on sugary drinks is an indirect tax: it is added to the price the consumer pays.

Why it should. Sugary drinks are a demerit good: they harm health, and treating obesity and diabetes adds to the cost of public health care. A higher price cuts the quantity bought, so people become healthier and the health service spends less (developed point for).

Demand for sugary drinks is likely to be price-inelastic because many people buy them out of habit, so sales fall only a little and the tax raises a lot of revenue. The government can spend it on health care or school sports (developed point for).

Why it should not. Because demand is inelastic, consumption may fall only a little, so the health aim is not met; people may switch to other sugary foods that are not taxed (developed point against).

The tax is regressive: low-income households spend a larger share of their income on such drinks, so they lose most. If sales do fall, drinks firms cut output and jobs (developed point against).

Judgement. It depends on the price elasticity of demand. If demand is very inelastic, the tax works better as a source of revenue than as a way to change behaviour, so it is most effective if the revenue is used for health and the tax is combined with education about diet. Both sides are developed and the judgement says what the answer depends on, so this meets the Level 3 descriptor (6–8 marks).

Common mistakes

- **Confusing a budget deficit with a current account deficit.** Examiners see this every year, even when the question defines the budget. A budget deficit is government spending above government revenue; it has nothing to do with exports and imports.
- **Thinking the central bank runs fiscal policy.** The government sets taxes and spending; the central bank sets interest rates (monetary policy). Answers that had a central bank cutting taxes were outside the question.
- **Judging a tax by the amount paid.** Progressive, proportional and regressive depend on the **percentage of income**. Work it out at each income.
- **Counting non-taxes.** Selling government assets or profits of state firms are revenue but not taxes; leave them out of tax totals.
- **Saying "tax revenue will rise" without naming the tax.** Examiners want the link: higher wages → more **income tax**; higher profits → more **corporation tax**; more spending → more **sales tax**.
- **Getting the direction wrong.** A cut in income tax raises demand, so it puts prices **up**, not down. Some answers said a tax cut would cause deflation.
- **Jumping stages.** "Higher tax → more unemployment" is one mark at most. Write every link: disposable income → spending → total demand → demand for labour → unemployment.
- **One-sided Discuss answers.** Level 3 needs both sides developed and a judgement; reversing a "for" point is not a new "against" point.

How to get the marks

- **Define** (2 marks): two parts, for example "the government's plan of its spending (1) and its revenue for the year ahead (1)"; "changing taxes and government spending (1) to alter the level of spending, output and prices in the economy (1)".
- **Identify** (2 marks): two precise answers, such as "income tax" and "corporation tax", or two qualities of a good tax. Only the first ones you write count.
- **Calculate**: show the working and give units (\$bn) and the word deficit or surplus.
- **Explain** (4 marks): two points, each identified (1) and developed (1).
- **Analyse** (6 marks): a mark per link. Three short chains, each ending at the aim in the question (unemployment, inflation, growth, poverty). Write in short sentences; examiners noted sentences ten lines long.
- **Discuss** (8 marks): both sides developed, then a judgement that says **what it depends on**. In Section A (6 marks), up to 4 marks a side.
- **Use economic terms**: disposable income, total demand, derived demand, cyclical unemployment, demand-pull inflation, merit and public goods, progressive, regressive, budget deficit, national debt.
- **Multiple choice**: 1 mark each, no penalty for guessing. For tables, write D or I next to each line before adding.

Quick check

1. A government's revenue includes income tax \$240m, corporation tax \$60m, VAT \$150m, excise duties \$30m, import tariffs \$20m and the sale of government land \$40m. What is its revenue from indirect taxes?
 - **A** \$170m
 - **B** \$200m
 - **C** \$240m
 - **D** \$300m
2. People earning \$20 000, \$40 000 and \$60 000 pay income tax of \$2000, \$4000 and \$6000. What type of tax is this?
 - **A** indirect
 - **B** progressive
 - **C** proportional
 - **D** regressive
3. In year 1 a government's revenue is \$80bn and its spending \$92bn. In year 2 revenue is \$86bn and spending \$90bn. What happened to the budget?
 - **A** the deficit fell by \$8bn
 - **B** the deficit rose by \$8bn
 - **C** the surplus fell by \$8bn
 - **D** the surplus rose by \$4bn
4. Which is a fiscal policy measure to reduce inflation?

- **A** raising the rate of interest
- **B** raising the rate of income tax
- **C** reducing the money supply
- **D** increasing government spending on roads

5. Explain two qualities of a good tax. **[4]**

Answers

1. **B.** Indirect taxes: VAT, excise duties and tariffs: $150 + 30 + 20 = \$200\text{m}$. Income and corporation tax are direct ($\$300\text{m}$), and selling land is not a tax. (1)
2. **C.** Each pays 10% of income, so it is proportional. (1)
3. **A.** Year 1: $80 - 92 =$ deficit of $\$12\text{bn}$. Year 2: $86 - 90 =$ deficit of $\$4\text{bn}$. The deficit fell by $\$8\text{bn}$. (1)
4. **B.** Higher income tax cuts disposable income and so total demand. A and C are monetary policy; D raises total demand. (1)
5. A good tax is equitable (1): it is based on ability to pay, so people with higher incomes pay more (1). A good tax is economical (1): it costs little to collect compared with the revenue it raises, so most of the money can be spent on services (1). (Also: certain, convenient, efficient, flexible, each with its explanation.)

Past questions to try

- 0455/11/O/N/24 Q18: reading a budget forecast for two years.
- 0455/13/O/N/24 Q18: classifying a tax from a table of earnings and tax paid.
- 0455/21/O/N/24 Q5: part (d), whether fiscal policy reduces poverty.
- 0455/23/O/N/24 Q3: part (d), whether a government should tax sports equipment.