Edexcel

A Level

Economics

(Code: WEC11 01)

Unit 04-Section 5

The role of the state in the market

Chapter 34 – Public expenditure

CAPITAL EXPENDITURE, CURRENT EXPENDITURE AND TRANSFER PAYMENTS

Total government spending is equal to current expenditure plus capital expenditure. This can be broken down as follows.

• **Capital government expenditure** is spending on investment goods.

• **Transfer payments** are mainly welfare payments made to individuals, such as unemployment benefits and state pensions. They are payments by government for which there is no corresponding output.

• **Debt interest** is interest paid on the National Debt by the government.

Current government expenditure The budget deficit refers to a government's inability to cover its day-to-day expenditure, such as wages or heating and lighting. This deficit is considered undesirable as it means borrowing money to pay for current spending, which is not covered by taxes. However, it is reasonable to borrow money for capital expenditure, as future taxpayers will benefit from it.

REASONS FOR THE CHANGING SIZE AND PATTERN OF PUBLIC EXPENDITURE

The size of government spending is normally measured as a percentage of an economy's GDP or government spending per capita. Governments will have different views about how much the public sector should provide, in terms of goods and services and also social protection for individuals.

The next biggest component was health spending. For most governments the composition of government spending includes:

Social protection - this covers transfer payments such as unemployment benefits, benefits to those on low incomes, state pensions, benefits for the sick or disabled. It also includes direct in-kind provision of goods and services, such as free school meals.

Health spending - this includes services provided by state health clinics and hospitals.

Education - this includes government spending on primary, secondary and further education.

Public order and safety - this includes spending on the police, prisons and fire service.

Defence - spending on the army, navy and air force.

Housing this includes government spending on building new housing stock owned by the government and maintaining existing stock.

Environmental spending - this includes spending on parks and environmental protection measures.

Debt interest - this is the interest that the government has to pay on money it has borrowed in the past (the National Debt).

CHANGING AGE DISTRIBUTIONS

Europe and Japan will face increased spending pressure in the next 30 years due to aging populations and a rise in demand for healthcare, pension payments, and social care. Government spending must grow as a percentage of GDP to offset these changes.

CHANGING INCOMES

Lower-income countries typically have lower government spending due to lack of a tax base, difficulty in administering taxes, and the large informal economy. Tax revenue is typically lower in poor countries than high-income countries. Changes in GDP levels also affect public expenditure, with recessions leading to increased spending due to government deliberate choices.

An **expansionary fiscal policy** injects money into the circular flow of income and is a policy tool used to try to get the economy out of a recession.

CHANGING EXPECTATIONS

As a country's GDP increases, citizens demand higher-quality goods and services provided by the government, which tend to be income elastic. As GDP rises, citizens demand better roads, education, and welfare benefits, such as technological advances in healthcare.

OTHER FACTORS

Resource efficiency - Some differences in views about the optimal size of the state focus on how resource efficiency compares between the public and private sector. If the inefficiency of government is greater than the benefits from correcting market failure, then government should be as small as possible. Governments around the world and over time will have different views on whether the public sector.

The austerity debate Some economies are recovering from the 2007-08 financial crisis, which led to increased government spending and decreased tax revenues. Some governments have cut public spending through austerity budgets, increasing interest on national debt. However, changes in interest rates will affect public expenditure patterns. High fiscal deficits and national debts may limit growth in public spending.

Disincentive effects of taxation and welfare benefits High tax rates and welfare benefits discourage individuals from working or saving, leading to free market economists to argue that government spending should be minimized. However, some argue that tax and benefits systems can be designed to minimize these effects, as seen in Nordic countries where high taxes and generous welfare benefits lead to high employment rates and economic growth.

THE SIGNIFICANCE OF DIFFERING LEVELS OF PUBLIC EXPENDITURE AS A PROPORTION OF GDP

Differing levels of public expenditure can have an impact on a large number of economic variables, such as productivity and growth, crowding out and levels of taxation. These will now be considered.

PRODUCTIVITY AND GROWTH

Economists are divided on the impact of government spending on productivity and growth. Free market economists argue that government spending is often wasteful and inefficient, while private sector firms drive down costs, maximize profits, and innovate. They believe that cutting public spending could increase productivity and growth by transferring resources to the more efficient private sector. However, with the right controls and incentives, government can be cost-effective and provide essential goods and services.

CROWDING OUT

If the economy is at full employment and on its production possibility frontier, it would seem logical to suggest that increasing government spending by $1 must lead to $1 less of private sector spending. In Figure 2, an increase in public sector spending of AB must lead to a fall in private sector spending of CD. The movement along the PPF from E to F shows clearly that extra public spending will **crowd out** private sector spending.

However, there are a number of reasons why public sector spending need not crowd out private sector spending.

Transfer payments Transfer payments do not necessarily crowd out private sector spending, as there is no corresponding output. For example, if the government gives $1 billion to the unemployed and raises taxes, the private sector will continue producing goods and services.

Unemployment Unemployment can lead to increased government spending, which in turn increases private sector spending through the multiplier effect, causing the economy to shift from G to E or F.

Economic growth Government investment in the economy can lead to increased private sector spending, as shown in Figure 3, as the economy moves from point E to point F.

Free market economists would tend to disagree with these arguments.

• Increased taxes on workers and profits to fund welfare payments discourage work and profits, shrinking the economy and reducing private sector spending.

• The low multiplier suggests that increasing government spending could lead to higher interest rates, reduced private sector spending, and higher inflation. To address high unemployment, reducing government spending and taxes could incentivize workers and firms, leading to increased employment and reduced unemployment.

• Government spending on investment is often wasteful and badly targeted. The result is that the government wastes money and fails to increase the productive potential of the economy. The private sector is far better placed to seek out profitable opportunities that will increase the size of the economy. Less government spending and more private sector spending is therefore key to long-term economic success.

FIGURE 2

Crowding out

If the economy is at full employment, producing on its production possibility frontier, then an increase in public sector spending of AB will crowd out CD of private sector spending. However, if there is unemployment and the economy is at G, a move to the PPF can give both extra public sector and private sector spending.

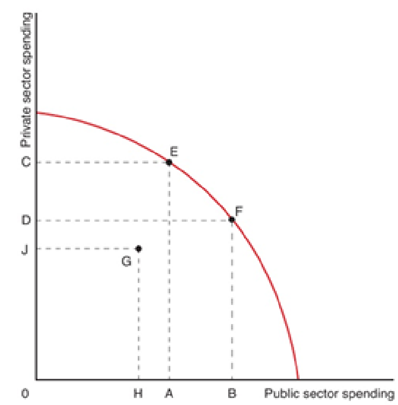
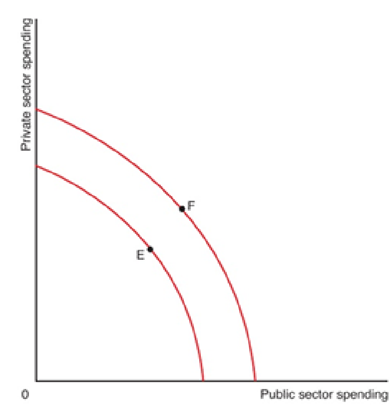


FIGURE 3

Crowding in

Assume the economy is at full employment on its production possibility frontier at E. Public sector investment increases the productive potential of the economy, shifting the PPF right and moving production to the point F. Increased public sector spending has crowded in both private sector and public sector spending.



LEVELS OF TAXATION

If government is spending a high proportion of GDP, this is only sustainable in most cases if tax revenues are also a high proportion of GDP. There are exceptions to this, such as oil-rich countries, where revenues from oil pay for most government spending.

SUBJECT VOCABULARY

Asian tigers the economies of Hong Kong, Singapore, South Korea and Taiwan, which all experienced rapid industrialisation and, at the same time, exceptionally high economic growth rates

capital government expenditure spending by government on investment goods, such as new roads, new hospitals or new street lighting

crowding in in the context of public sector spending, crowding in occurs when extra government spending leads to higher private sector spending

crowding out in the context of public sector spending, crowding out occurs when extra government spending leads to lower private sector spending

current government expenditure spending by government on goods and services which will be consumed in the short term, such as teachers' salaries or heating for government buildings; it also includes transfer payments and debt interest

expansionary fiscal policy fiscal policy that leads to an increase in aggregate demand

transfer payments spending for which there is no corresponding real output; in government expenditure, transfer payments are welfare payments such as the state pension or child benefit

Chapter 35 – Taxation

THE REASONS FOR TAXATION

- Governments use taxation for a number of purposes: To pay for government expenditure - governments need to raise finance for their expenditure programmes. They can borrow a limited amount of money for this, but most of the finance must come from taxation if inflation is to be avoided.
- To correct market failure such as externalities governments can intervene in individual markets by changing taxes and thus changing demand.
- To manage the economy as a whole - taxation can have an important influence on the macro-economic performance of the economy. Governments may change tax rates in order to influence variables such as inflation, unemployment and the balance of payments.
- To redistribute income - a government may judge that the distribution of resources is unfair. To redistribute income, it may impose taxes which reduce the income and wealth of some groups in society and use the money collected to increase the income and wealth of other groups.

THE DISTINCTION BETWEEN DIRECT AND INDIRECT TAXES

One way of classifying taxes is to make the distinction between direct and indirect taxes. A direct tax is a tax levied directly on individuals or companies. Examples of direct taxes used by many economies include:

- income tax - a tax that individual income earners have responsibility for paying.
- corporation tax - a tax paid by companies, levied on company profits.
- capital gains tax - a tax which is paid on the profit made when assets, such as bonds and shares, are sold. It is tax paid on the gain in value of an asset.
- inheritance or estate tax - a tax paid by a person who receives money or property due to the death of its previous owner.
- social security contributions – compulsory payments by both employees and employers. These are payments to the government as a form of insurance premium. This means individuals will gain a future social benefit which includes unemployment benefits, sickness benefits, hospital expenses etc.

An **indirect tax** is a tax levied on goods or services. Examples include:

- value added tax (VAT), known in some countries as a goods and services tax.
- excise duties - taxes on specific groups of products, for example tobacco.
- customs duties - a tax on either the export or import of goods and services.
- Economies will raise tax revenue from both direct and indirect taxes.

THE DISTINCTION BETWEEN PROGRESSIVE, PROPORTIONAL AND REGRESSIVE TAXES

A progressive tax is a tax where the proportion of income paid in tax rises as the income of the taxpayer rises.

A regressive tax Taxes on spending and cigarettes are regressive, as they fall as income increases, affecting low-income households more than high-income households. Indirect taxes like VAT and VAT are more regressive.

A proportional tax is one where the proportion paid in tax remains the same when the income of the taxpayer changes (although the actual amount paid increases as income increases).

INCOME TAX: AVERAGE AND MARGINAL RATES OF TAX

Income tax systems typically have a tax exemption level of income, which is not taxed, and taxable income, which is taxed at a higher rate as income increases. The marginal rate of income tax differs from the average rate, as it is the tax rate on the last $1 earned. For example, a worker earning $100,000 would have a marginal rate of 40%, but their average rate of tax would be $28,000 divided by their income. In a progressive tax system, the marginal rate of tax increases with income.

THE ECONOMIC EFFECTS OF CHANGES IN DIRECT AND INDIRECT TAX RATES

Changes in direct and indirect tax rates will have an impact on a number of economic variables including incentives to work, tax revenues etc.

INCENTIVES TO WORK

Taxes, such as income and corporation taxes, discourage economic activity by reducing marginal rates. Free market economists believe that labor supply is elastic, and a reduction in income tax rates can increase 'work', leading to longer hours, promotion, and geographical mobility. Work is considered an inferior good, while leisure is a normal good. A cut in marginal tax rates can have a negative income effect, but a positive substitution effect, increasing incentives to work.

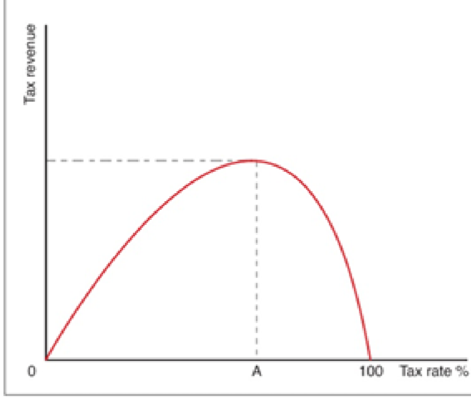
TAX REVENUES: LAFFER CURVE ANALYSIS

The Laffer curve effect suggests that if marginal income tax rates are cut, it could increase tax revenues by encouraging workers to work harder and earn more. This effect, named after Arthur Laffer, shows that as tax rates increase, the growth rate of tax revenue falls due to the disincentive effects of the tax. However, there is debate about whether this reflects real-world economic behavior.

FIGURE 2

The Laffer curve

As tax rates increase, economic activity is discouraged and hence the rate of growth of tax revenues falls. Above OA, an increase in tax rates so discourages economic activity that tax revenues fall.



INCOME DISTRIBUTION

Changes in direct and indirect tax rates can impact income distribution. Direct taxes are progressive, affecting low-income households and high-income households. Indirect taxes, like VAT, are regressive, as households spend less and save more. Regressive taxes, like cigarettes, are more regressive, causing greater inequality. The distinction between progressive, regressive, and proportional taxes is crucial in understanding income and wealth distribution. More progressive taxes lead to resource redistribution.

REAL OUTPUT, THE PRICE LEVEL AND EMPLOYMENT

A change in tax rates is likely to have an effect on real output, the price level and employment. Some tax changes affect aggregate demand while others affect aggregate supply.

Aggregate demand Some taxes, such as income tax and employees' National Insurance contributions, affect aggregate demand. A rise in income tax rates, for example, will reduce household disposable income. Households will then spend less. This fall in consumption will reduce the output demanded at any given price. This is shown by a shift to the left in the aggregate demand curve in Figure 3.

FIGURE 3

An increase in tax leads to a fall in aggregate demand

An increase in income tax, for example, leads to a fall in disposable incomes. This leads to a fall in consumption and hence aggregate demand. This results in a fall in the price level and equilibrium output in the short run.

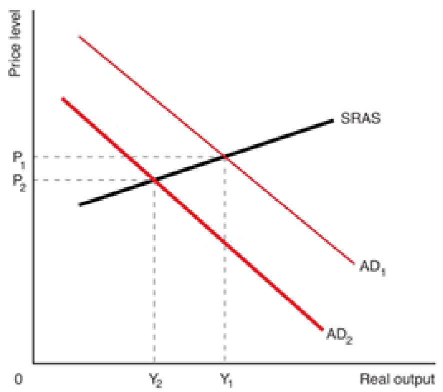
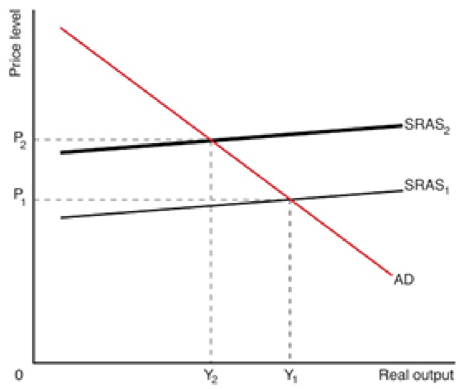


FIGURE 4

An increase in tax leads to a fall in aggregate supply

An increase in VAT, for example, leads to an increase in costs for firms. This means that at any given level of output, firms will charge higher prices, shifting the SRAS curve upwards. This leads to a rise in the price level and a fall in equilibrium output in the short run.



Aggregate supply Some taxes, such as VAT, excise duties and social security contributions made by employers, raise costs to firms. A rise in indirect taxes such as VAT and excise duties means that at any given level of output, firms have to charge a higher price for their products. They need to regain the extra VAT or excise duties they will pass on to government. If the rise is an increase in employers' social security contributions, the cost of employing labour will increase. Higher costs will shift the short run aggregate supply curve up. This is shown in Figure 4.

THE TRADE BALANCE

Increased taxes on households reduce disposable income, reducing consumption and spending on imports, improving trade balance. This reduces aggregate demand, reducing firms' investment needs. However, reduced investment could make domestic firms less internationally competitive, potentially deteriorating the trade balance in the long term.

FDI FLOWS

Foreign direct investment (FDI) is normally defined as investment by a foreign company where the foreign company acquires 10 per cent or more of the shares of the domestic company.

Countries are attracting foreign direct investment (FDI) to boost their economies, boost output, and increase tax revenues. Some countries have offered lower rates of corporation tax, particularly on company profits, to encourage FDI inflows. This is because increased economic growth and prosperity from the investment will offset any loss of tax revenues. In the long term, governments may collect more in tax due to the investment.

SUBJECT VOCABULARY

direct tax a tax levied directly on an individual or organisation

indirect tax a tax on a good or service

Laffer curve a curve which shows that at low levels of taxation, tax revenues will increase if tax rates are increased. However, if tax rates are high, then a further rise in rates will reduce total tax revenues because of the disincentive effects of the increase in tax

progressive tax a tax where the proportion of income paid in tax rises as the income of the taxpayer rises

proportional tax a tax where the proportion paid in tax remains the same while the income of the taxpayer changes

regressive tax a tax where the proportion of income paid in tax falls as the income of the taxpayer rises

Chapter 36 PUBLIC SECTOR BORROWING AND PUBLIC SECTOR DEBT

FISCAL DEFICITS AND FISCAL SURPLUSES

A fiscal deficit is when government spending is greater than its income (also called revenue) in a given year. A fiscal deficit means a government must borrow that year to finance its spending. A fiscal deficit is often measured as a percentage of a country's GDP.

A fiscal surplus is when government spending is lower than its revenue in a given year.

FISCAL DEFICITS AND THE NATIONAL DEBT

National debt is the total government borrowing remaining to be paid to lenders. Fiscal deficits or surpluses directly impact the size of the national debt. A fiscal deficit of $20 billion in one year increases the national debt by $20 billion, while a fiscal surplus of $30 billion decreases it by $30 billion. Measures of fiscal balances and national debt can be in money terms or as a percentage of GDP. GDP measures are more useful as they indicate how easy it is for the government to finance deficits or repay the national debt. Countries with high oil reserves have lower national debt levels, such as Saudi Arabia and the UAE.

AUTOMATIC STABILISERS AND DISCRETIONARY FISCAL POLICY

Automatic stabilizers are rules on welfare payments, income tax, and goods and services tax that influence government spending and taxation without intervention from policymakers. These changes help reduce economic cycle variation and reduce variation in government spending and tax revenue. In a recession, the government increases welfare payment spending, paying out more unemployment benefits. Tax revenues fall faster than income due to higher marginal tax rates. Household spending falls, and value-added taxes, such as GST, reduce tax collection. These automatic stabilisers result in less aggregate demand during a recession.

The opposite is **discretionary fiscal policy**. This is deliberate decision making by government to change rates of tax, introduce new taxes or change levels of government spending.

CYCLICAL AND STRUCTURAL DEFICITS

The size of a fiscal deficit is influenced by the state of the economy. Because of automatic stabilisers, government spending and revenues vary depending on whether an economy is experiencing a period of negative economic growth or positive economic growth.

A distinction can be made between cyclical and **structural deficits**. A **cyclical deficit** occurs because government spending and revenues change through the trade cycle. When the economy is growing quickly during a boom, spending on welfare benefits such as unemployment benefit is likely to be relatively low and tax revenues are likely to be relatively high. This pattern is shown in Figure 1.

FIGURE 1

Cyclical and structural deficits
There is a structural deficit in this economy of 2 per cent of GDP because the lowest level of the cyclical deficit is 2 per cent of GDP.

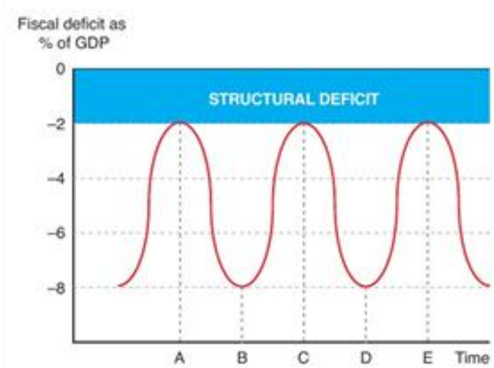
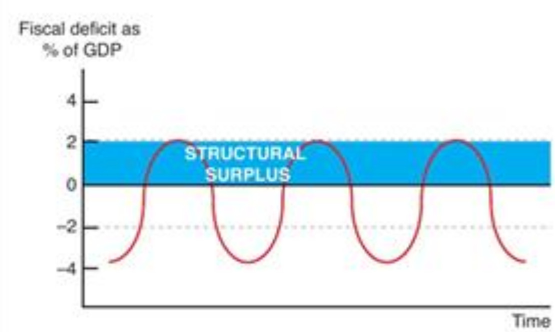


FIGURE 2

Cyclical and structural deficits and surpluses
There is a structural surplus in this economy of 2 per cent of GDP because the highest cyclical surplus is 2 per cent of GDP.



The economic cycle consists of boom and recession periods, with a low fiscal deficit at points A, C, and E, and a large deficit at points B and D. The cyclical deficit ranges from 6% to 6%. The best position for the budget is a deficit of 2%, representing the government's structural deficit. The actual deficit is equal to the structural deficit plus the cyclical deficit, with the lowest being 2% at point A and 6% at point B.

CURRENT BUDGET DEFICITS, PRIMARY BUDGET DEFICITS AND ACTUAL BUDGET DEFICITS

A current budget deficit occurs when government revenues are less than current expenditure. The government is not covering even its day-to-day spending and has to borrow money for this. When the economy is in recession, there may well be a current budget deficit as the government attempts to increase aggregate demand. However, over the trade cycle, economists argue that the government needs to run a current budget surplus.

A distinction can also be made between primary budget deficits or surpluses and actual budget deficits or surpluses. **The primary deficit** is the actual deficit but does not include interest payments on the national debt. Therefore:

Primary deficit + debt interest payments = actual deficit

If a government is in financial difficulties, it might find it difficult to borrow more money on the world financial markets. In order not to increase the size of the national debt, it then needs to run a **primary surplus** that is at least equal to debt interest payments.

FACTORS INFLUENCING THE SIZE OF FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT IN NOMINAL TERMS

Several factors influence the size of fiscal deficits and surpluses measured in money terms.

STATE OF THE ECONOMY

Cyclical deficits and surpluses are caused by automatic stabilisers on government spending and tax revenue, which are out of the government's control in the short term. The impact on government finances varies depending on the severity of the recession or boom. Discriminatory fiscal policy is used by governments to manipulate economic activity during recessions.

DEMOGRAPHIC FACTORS

The size and age composition of the population may affect the size of the fiscal deficit.

RESPONSIBLE GOVERNMENT FINANCING

Many countries, both advanced and developing, are more aware of responsible government financing. As a result, either by choice or by terms dictated by institutions such as the IMF or, for Eurozone countries, the EU, governments have deliberately cut spending and raised taxation to reduce fiscal deficits to target level.

TAXATION

The size of the tax base might increase if new taxes are introduced. This will reduce a fiscal deficit.

ECONOMIC DEVELOPMENT

In developing countries, government spending may be linked to economic development. When the economy is doing well, there is a temptation on the part of government decision-makers to assume that it will continue to do well in the future.

PRICE OF COMMODITIES

The tax revenue for some countries is heavily dependent on commodity prices.

DEBT INTEREST

Debt interest is part of a fiscal deficit or surplus. The larger the debt interest paid, the larger the deficit or the smaller the surplus. Debt interest is determined by two factors. One is the size of the national debt, the total amount the government owes to its creditors. The other is the rate of interest it has to pay on its debt. The higher the average rate of interest, the higher the debt repayments. New borrowing takes place at current market rates of interest.

The rate of interest paid on new borrowing will depend on two factors:

- the market rate of interest at the time
- The government's credit rating determines its ability to repay future loans, with high ratings allowing low interest rates, and low rates for those at risk of non-repayment.

UNFORESEEN EVENTS

Governments may face unforeseen events that cannot be covered by funds set aside for such situations. The 2007-08 financial crisis demonstrated that major economies can be at risk from unforeseen events. Developed countries like the UK nationalized banks and other financial institutions, adding £60 billion to their fiscal deficits. Similarly, privatisation could reduce a fiscal deficit.

THE SIGNIFICANCE OF THE SIZE OF FISCAL DEFICITS AND NATIONAL DEBTS

The size of fiscal deficits or surpluses has implications for other economic variables.

THE IMPACT ON INTEREST RATES

All other things being equal, a rise in government borrowing in a national economy should lead to a rise in market interest rates in that country. This is because the demand for borrowed funds rises relative to existing supply. The price of borrowed money is the rate of interest.

However, this rise in interest rates may not happen for a number of reasons.

- The increase in government borrowing may be relatively small and so have a barely noticeable impact on interest rates.
- If the central bank is operating a policy of quantitative easing, the government is likely to be able to borrow more at virtually zero rates of interest.
- The government may borrow on international financial markets. This increases the potential supply of borrowed funds and so it may be able to borrow at no increase in interest rates.
- In a recession, government borrowing is likely to rise, but private sector borrowing will fall as investment and consumption fall. Reduced private sector borrowing reduces any impact on interest rates of higher government borrowing.

In 2010, economists and politicians warned that rising national debt and fiscal deficits would decrease government credit ratings, leading to increased interest rates. Private sector credit ratings estimate the likelihood of debt default.

- The best credit rating is AAA and the worst is D.
- Credit ratings influence the rate of interest at which companies and governments can borrow. The lower the credit rating, the higher the rate of interest savers demand to buy the bonds or debt issued. It could

be argued that the more debt issued by a company or a government, the lower should be its credit ratings. More debt equals more risk.

However, in reality the situation is more complex:

- If a government or company has little debt in the first place, doubling its size is likely to have no impact on the risk of default.
- Equally, credit ratings are relative. Savers have to put their money somewhere.

DEBT SERVICING

Debt servicing involves regular repayments on outstanding loans, including interest payments. As government borrowing increases, so does the interest paid on national debt. The impact depends on the current interest rate, with rising rates adding to fiscal deficits and national debt, while falling rates may decrease interest payments.

INTERGENERATIONAL EQUITY

Intergenerational equity refers to fairness between different generations. Some economists and politicians have argued strongly that increasing fiscal deficits and national debts benefit current citizens at the expense of future generations. However, others argue that high fiscal deficits and national debts today do not create a problem for future generations. In fact, there are arguments to support both views.

In some cases, government spending has been cut drastically and taxes increased in an attempt to reduce the fiscal deficit. This policy has caused some problems for particular age groups. If the economy slows down as a result of **fiscal austerity,** the youth unemployment rate often rises faster than overall unemployment rate.

FOREIGN DIRECT INVESTMENT (FDI)

Countries with very large fiscal deficits and national debts are more likely to have problems financing those deficits than those with low fiscal deficits and national debts. If a government has borrowed from abroad, it may struggle to obtain enough foreign currency to make repayments on its debts. One way of getting foreign currency is to increase inward foreign direct investment.

SUBJECT VOCABULARY

automatic stabilisers mechanisms which affect levels of government spending and taxation, without any direct intervention by the government, when national income changes; they occur automatically and act to minimise fluctuations in actual GDP around the long-term growth rate

current budget deficit occurs when government revenues are less than current expenditure; it does not include government capital expenditure

cyclical deficit that part of the fiscal deficit which is caused by government spending and taxes changing through the trade cycle

debt servicing the regular repayments which need to be made to the lender on outstanding loans; this includes interest repayments

discretionary fiscal policy the deliberate manipulation of government spending and taxes to influence the economy

fiscal austerity tax rises or government spending cuts designed to reduce a fiscal deficit

fiscal deficit when government spending is greater than government revenue

fiscal surplus when government spending is less than its revenue

intergenerational equity fairness between different generations

national debt the total accumulated borrowing of the government which remains to be paid to lenders

primary deficit or surplus the actual fiscal deficit or surplus, not taking into account interest payments on the national debt

structural deficit that part of a fiscal deficit that exists even when the cyclical deficit is zero at the top of a boom

Chapter 37 – Using macroeconomic policies

MACROECONOMIC POLICIES USED BY GOVERNMENTS

The policies used by governments include:

Fiscal policy - The use of taxation and government spending by the government to achieve its policy objectives.

Monetary policy - The changes to monetary variables by central banks, such as interest rates and the money supply, to achieve their objectives.

Exchange rate policy - The manipulation of the exchange rate to achieve policy objectives. Developing countries use a wide range of different exchange rate systems.

Direct controls government measures that are imposed on the price or the quantity of a single product or factor of production. Examples of direct controls include:

- imposing a maximum price on a good such as bread, petrol or electricity
- setting a minimum or maximum wage
- fixing a quota on imports of beef
- limiting the amount of foreign currency a citizen can buy during a year
- fixing a maximum interest rate that payday lenders can charge their borrowers for small loans
- limiting the amount an individual can borrow for a mortgage.

Supply-side policies Government policies designed to increase the productive potential of the economy. Some supply-side policies can be classified as other policies.

USING MACROECONOMIC POLICIES TO ACHIEVE OBJECTIVES

Macroeconomic policies were largely discussed in the Year 1 course as policies which can be used to manage or manipulate either aggregate demand or aggregate supply. An understanding of **demand management** is assumed in this chapter. The focus of this chapter is to discuss how macroeconomic policies are used to:

- reduce fiscal deficits and national debt
- control the rate of inflation
- respond to external shocks in the global economy
- reduce poverty and inequality.

POLICIES TO REDUCE FISCAL DEFICITS AND NATIONAL DEBTS

Governments aim to control fiscal deficits and national debts for long-term sustainability. Post-2007-08 financial crisis, developed countries faced increasing fiscal deficits and growing national debts. Fiscal deficits above 3% of GDP lead to growing national debts, making it difficult to finance education, roads, or welfare benefits. In extreme cases, such as Greece's 2012 crisis, debt becomes impossible to finance, leading to default or bailouts. Governments can tackle large fiscal deficits through write-downs or other measures.

One is through fiscal austerity. The government cuts public spending or raises taxes or, more likely, does both.

• One problem with fiscal austerity is that it reduces the welfare of citizens both now and in the future..

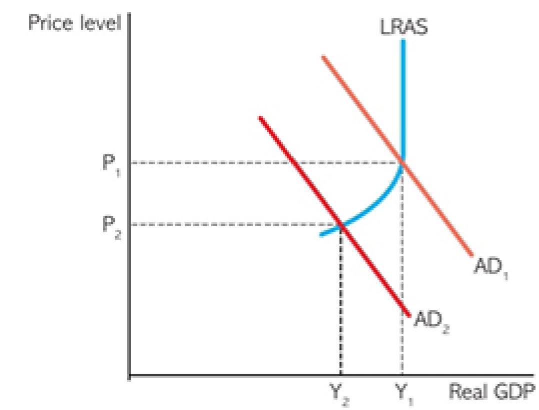
• Another problem is that fiscal austerity causes, in the short term at least, a fall in GDP from what it would otherwise have been. The more severe the fiscal austerity measures, the greater the negative impact on GDP.

• A third related problem with fiscal austerity is that, in the short term at least, for every $1 cut in public spending or $1 rise in tax, there is a less than $1 cut in the budget deficit. Cuts in public spending or rises in taxes reduce aggregate demand.

The other way to reduce a fiscal deficit is for the government to do nothing and wait for the **automatic stabilisers (or built-in stabilisers)** to do their work.

FIGURE 1

Fiscal austerity is contractionary fiscal policy which reduces aggregate demand. Real GDP falls from Y_1 to Y_2.



Governments have a variety of ways of reducing the national debt.

• Having a fiscal surplus will cut the debt in money terms.

• Balancing the government finances combined with economic growth will reduce the national debt as a percentage of GDP.

• Inflation will reduce the real value of the debt.

• If, as some economists argue, quantitative easing is a way of governments printing money to finance their deficits, then more quantitative easing will reduce the national debt held outside the central bank.

• Governments can default on their debts. The economic cost of this option to the economy is so large that governments only default when all other options have failed.

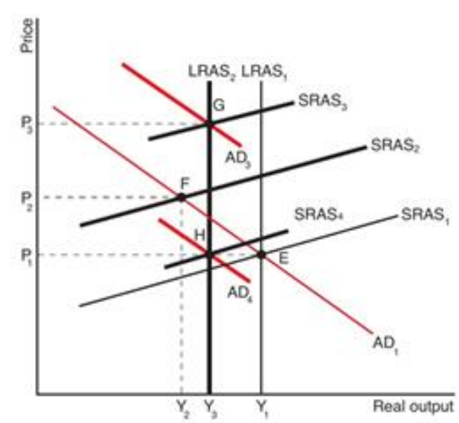
POLICIES TO CONTROL THE RATE OF INFLATION

The implementation of monetary policy is the responsibility of central banks. In many developed countries, central banks are independent of government. In many developing countries, central banks are effectively part of government with politicians deciding on the monetary policy that central banks will pursue.

FIGURE 2

A sharp oil price rise

Government can respond to a sharp oil price with expansionary fiscal and monetary policies but this raises the long-run price level from P_1 to P_3. Or it can use deflationary fiscal and monetary policies, keeping the price level at P_1 but creating short-term unemployment as a result.



POLICIES TO RESPOND TO EXTERNAL SHOCKS IN THE GLOBAL ECONOMY

Macroeconomic policies can be used to address the effects of negative shocks to an economy such as a rise in commodity prices for commodity importers.

COMMODITY PRICE SHOCKS

Assume the world price of oil triples in a year. This will provide a negative supply-side shock to any country that imports most or all of its oil requirements.

Governments may respond in a variety of ways. One approach is to accommodate the oil price increase. This means accepting that prices will rise, attempting to get the economy back to full employment quickly and protecting household incomes. Governments can do this using fiscal policy, by raising their spending and cutting taxes, and monetary policy, by central banks reducing interest rates, so increasing lending and borrowing. These are examples of **reflationary policies** which shift the aggregate demand curve to the right.

Another approach is for the government to attempt to remove the inflation caused by the oil price rise from the economic system. It can do this by using **deflationary** fiscal and monetary policies and moving the economy to the point H.

DEMAND-SIDE SHOCKS

A single economy may see its exports fall as a result of a fall in aggregate demand in other economies. This produces a demand-side shock as the fall in exports leads to a fall in aggregate demand. For example, the Great Depression of the 1930s saw many countries fall into recession because the USA, the largest

economy in the world at the time, went into a severe recession. Another situation in which governments have had to respond to an external demand-side shock was the Global Financial Crisis of 2008. Demand-side policies which were used in response to this crisis are discussed in the next chapter.

POLICIES TO REDUCE POVERTY AND INEQUALITY

Understanding the causes of changes in absolute and relative poverty (discussed in Chapter 32) will help governments implement policies to reduce poverty. Policies to reduce poverty and inequality include the following.

POLICIES TO INCREASE ECONOMIC GROWTH

Policies to increase economic growth are likely to help reduce poverty. Reflationary demand-side policies, both fiscal and monetary, can be used to increase real GDP. Supply-side policies can also be implemented to achieve a long-term increase in real GDP. Both these will raise real GDP per capita.

FISCAL POLICY

Government spending targeted to those most in need Economic growth is essential for poverty reduction, but it's not always enough. Governments often use welfare spending to support the poorest groups, but free market economists argue that lower welfare payments and job creation policies are more effective. Governments may also provide goods and services to low-income earners, but this can be costly for middle and high-income earners. Health and education spending also contributes to poverty reduction. The role of the state in redistributing income is controversial, with Nordic countries having a comprehensive welfare state.

Use of taxation Changes in the tax structure, which raise more tax revenue, should also provide more scope for government spending in areas such as education and training, which arguably have a big impact on poverty reduction. The tax system can also be used to redistribute income and wealth.

DIRECT CONTROLS

Direct controls can be imposed by governments or central banks to address poverty and inequality. These controls focus on specific problems, such as health issues or payday lenders. In developing countries, they can set maximum prices for essential goods and services, such as rents or fares, to increase the spending power of low-income households. However, if market distortions are large enough, the benefits of direct controls can be wiped out, making the problem worse. For instance, a maximum price on rice may lead to black markets where higher prices are charged, affecting the availability of rice. Additionally, maximum wages can be fixed to reduce inequality, raising the incomes of the lowest-paid workers but potentially negatively impacting employment.

THE COSTS OF REDISTRIBUTION

Taxation policies can lead to higher economic welfare for some but may also result in lower welfare for others. Increased taxation can lead to a loss of freedom for taxpayers, as they lose the ability to allocate scarce resources. Redistribution, as suggested by classical or free-market economists, can also have heavy costs in terms of economic growth, employment, and market inefficiencies. Raising income tax rates can lower employment incentives, discourage investment, and lead to capital and labor leaving the country. High minimum wages may discourage employers from hiring workers, while low maximum wages may discourage workers from taking on more challenging jobs. Maximum prices can lead to shortages and queues, and inefficiencies can arise. Free-market economists use the concept of trickle down, arguing that increasing wealth of the rich leads to gradual increases in income for the poorest.

SUBJECT VOCABULARY

automatic or **built-in stabilisers** mechanisms that reduce the impact of changes in the economy on national income

bailout when financial support is provided to a company or a country facing a potential bankruptcy threat

deflationary policies fiscal or monetary policies aimed at reducing aggregate demand

demand management government use of fiscal or other policies to manipulate the level of aggregate demand in the economy

direct control a government measure that is imposed on the price or the quantity of a single product or factor of production

exchange rate policy the manipulation of the exchange rate to achieve policy objectives

fiscal austerity tax rises or government spending cuts designed to reduce a government budget deficit

fiscal policy the deliberate manipulation of government expenditure and taxes to influence the economy

monetary policy changes to monetary variables by central banks, such as interest rates and the money supply, to achieve its objectives

payday lenders lenders who give loans for small amounts to borrowers who are supposed to repay the loan on their next pay day or when they next receive their welfare benefit; users of payday lenders often find it hard to arrange credit elsewhere

reflationary policies fiscal or monetary policies aimed at increasing aggregate demand

supply-side policies government policies designed to increase the productive potential of the economy

Chapter 38 – Impact and problems of macroeconomic policies

DEMAND-SIDE POLICIES IN RESPONSE TO THE GLOBAL FINANCIAL CRISIS

The Global Financial Crisis caused a demand-side shock to the global economy. This was discussed in detail in the 'Thinking Like an Economist' section in Chapter 33 of Book 1. The 2007-08 financial crisis severely tested governments.

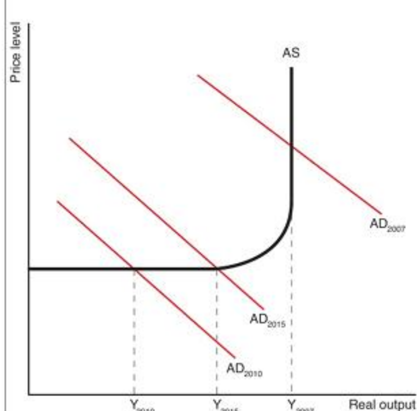
MONETARY POLICY

Following the 2007-08 financial crisis, governments in the UK and USA implemented expansionary monetary policies, cutting interest rates to near zero. However, this did not stimulate spending enough, leading to the adoption of quantitative easing. This policy aimed to free up credit in financial markets, increase lending by commercial banks, and put downward pressure on long-term interest rates and currency value. Critics argue that this policy did not create extra lending, and it benefited some groups at the expense of others.

FIGURE 1

The effects of fiscal austerity on an economy

The financial crisis of 2007–08 moves equilibrium output from OY_{2007} to OY_{2010}. The subsequent recovery increases output to OY_{2015} but this is still below the 2007 level.



FISCAL POLICY

In the UK, fiscal policy became more expansionary in 2009 as a policy response to the crisis. The US, UK, Greece, Ireland, Spain, and Portugal implemented fiscal policies to address their high fiscal deficits and national debts. Countries like France and Italy resisted austerity due to high national debts. Ireland, for example, experienced a financial crisis in 2007-08, leading to a decrease in output to OY 2010. Despite recovery in 2015, output remains below its 2007 level.

MEASURES TO CONTROL TNCS

National economies often welcome the activities of transnational companies because they can create jobs, incomes, exports and tax revenues. Transfers of knowledge as well as foreign direct investment in building new manufacturing plants or opening new outlets can also benefit countries.

REDUCING TAX AVOIDANCE

Many transnationals have structured their business to pay the minimum amount of tax possible by moving revenues and profits into low tax countries. Firms which operate in several countries (i.e. transnationals) are able to engage in **tax avoidance.**

THE REGULATION OF TRANSFER PRICING

In 2015, more than 60 governments agreed worldwide measures to reduce tax avoidance. The proposals were to improve reporting, re-write laws where needed to prevent avoidance, and restrict the use of tax havens. Some of the new rules, such as changes to transfer pricing guidelines, were to be adopted immediately by some governments. By 2018 national laws to implement the OECD's 15-point action plan to cut aggressive tax avoidance were starting to come into force. So by 2019 it was hoped that the proportion of tax paid by transnationals would start to rise.

LIMITS TO GOVERNMENT ABILITY TO CONTROL TNCS

Governments in the past have had some success at controlling unacceptable behaviour of multinational companies. These include:

- It is illegal for transnational companies operating in the EU or the USA to use bribery or corrupt practices anywhere in the world. A US-based transnational can be fined heavily by the United States government for using bribery to gain orders in, say, Nigeria.
- A number of developing countries don't allow transnational companies to set up in their countries without first setting up a joint company with a local partner. So at least some of the profits made are retained within the country. Also there is a transfer of knowledge and technology to local partners. This in future might create local competition with the transnational.
- Where a transnational wants to set up a manufacturing facility to make products for sale to individuals or firms in a country, the government in that country can negotiate deals where a proportion of the production is exported. This helps the country to earn foreign currency which can be used to pay for imports.
- Many contracts with governments involve clauses where the transnational has to manufacture at least some of the value of the order in the country.

THE IMPACT OF POLICY CHANGES ON DIFFERENT ECONOMIES

Any policy change by a government, whether it is fiscal policy, monetary policy, exchange rate policy, supply- side policy or direct controls is usually designed to have an impact on the domestic economy. Sometimes, the impact might be more strongly felt on a region within the economy. In other cases, the policy change will be expected to affect the economy in general.

THE IMPACT OF POLICY CHANGES ON LOCAL ECONOMIES

Sometimes a policy change will affect particular cities, districts or parts of an economy more than others.

THE IMPACT OF POLICIES ON NATIONAL ECONOMIES

Governments usually make policy changes to influence the economy as a whole.

THE IMPACT OF POLICIES ON THE GLOBAL ECONOMY

Large world economies like China and the US are shifting from export-based growth to consumption-led growth, impacting global economic growth. This shift affects other countries, as rising consumption in China leads to export-led growth. The US's increased protectionism measures, influenced by Donald Trump, have led to similar measures from other countries, potentially affecting global economic growth.

PROBLEMS FACING POLICY MAKERS

Policy makers such as governments face many problems when making decisions. These problems include the following.

INACCURATE INFORMATION

Policy makers' information can be inaccurate due to difficulties in collecting data, such as estimating GDP figures. Governments may prioritize collecting taxes from illegal tax evaders, but this may not accurately reflect the amount invested in illegal schemes. Additionally, outdated information, such as central banks' interest rate decisions, can give an inaccurate picture of the economy's current trends, as trends may change over time. These factors can lead to inaccuracies in government decisions.

RISKS AND UNCERTAINTIES

The future is always uncertain to some degree. Some uncertainties are fairly easy to predict.

EXTERNAL SHOCKS

External shocks cannot be controlled by national governments. In 1974-75, for example, the world experienced its first oil crisis as OPEC increased the price of oil from $2 a barrel to $11 a barrel. This created large inflationary pressures in oil-importing countries. In 2007-08, economies were thrown into the worst recession since the 1930s by the financial crisis starting in the US but spreading through the international financial markets into Europe and other parts of the world.

SUBJECT VOCABULARY

external shock a demand-side or supply-side shock to an economy which has been caused by factors outside the individual country's control

hyperinflation large increases in the price level

regulation of transfer pricing rules made by governments on transfer pricing to ensure the amount of profits paid by TNCs is 'fair'

tax avoidance when an individual or firm deliberately manipulates the tax system to pay less than the 'fair' amount

transfer pricing an accounting technique used by transnational companies to reduce taxes on profits by selling goods at a low price internally from a high-tax country to another part of the company in a low-tax country