# Edexcel Economics (A) A-level

## Theme 4: A Global Perspective

## 4.5 Role of the State in the Macroeconomy

**Summary Notes**

# 4.5.1 Public expenditure

## Difference between capital expenditure, current expenditure and transfer payments

**Current government expenditure** is spending which recurs. This is on goods and services which are consumed and last for a short period of time. For example, it could be on drugs for the health service.

**Capital government expenditure** is spent on assets, which can be used multiple times. For example, it could be government expenditure on roads or building a school.

**Transfer payments** are welfare payments from the government. They aim to provide a minimum standard of living for those on low incomes. No goods or services are exchanged for transfer payments.  Examples of transfer payments in the UK include: Job Seeker's Allowance, Income Support, child benefit and the state pension.

These are in place to ensure people have a basic standard of living and to help reduce the level of inequality in society. Transfer payments are a means for the government to redistribute income from the rich to the poor.

## Reasons for the changing size and composition of public expenditure in a global context

In the UK, the government spends most of their budget on pensions and welfare benefits, followed by health and education. Education spending in the UK has remained relatively constant. This is because it is protected so it does not fall, but it also does not increase much either.

Social security payments are payments from the government to assist those who have low incomes. After the war, people saw this as necessary, so there has been a general increase in spending.  Defence spending in the UK is falling. This is the area the government spends least on.

As a country grows, the government tends to spend a higher percentage of GDP. This is because they have larger tax revenue, due to higher incomes and wealth and efficiency in collection. Citizens in high income countries also demand more from their governments. The amount spent by the government also depends on government aims and views in the country.

The Global Financial Crisis led to huge increases in government spending as governments had to increase welfare spending and bail out the banks. The UK government is now following a period of austerity in order to bring about a balanced budget. This means that government spending is falling.

Ageing populations in Europe and Japan will mean there is more pressure on govermnet spending, due to higher pension bills and higher levels of care needed.

## The significance of differing levels of public expenditure as a proportion of GDP on:

- **Productivity and growth**
  Governments can spend money on supply-side policies to improve human capital and boost long run growth. Human capital is important for competitiveness. The government could invest in youth apprentice schemes, for example, to make people more employable and productive from a young age. Education and training can mean higher value products can be made and productivity can be improved.
  Fiscal policy aims to stimulate economic growth and stabilise the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.
  However, many free market economists argue that government spending is wasteful and causes inefficiency. Thus, they prevent growth. They believe that funds would be better spent by the private sector.

- **Living standards**
  They can greatly improve living standards by correcting market failure, providing public goods and reducing absolute poverty. The political system means that funds should be spent where people want them to be, although this is not necessarily the case.
  Some argue that the government's inefficiency will reduce overall output and thus reduce living standards.

- **Crowding out**
  Governments might have to fund its spending using taxes or running a budget deficit. This leaves fewer funds in the private sector for firms to use, since the government is borrowing money, which crowds them out of the market.
  When the government borrows a lot of money, interest rates might increase. This discourages spending and investment among the private sector.
  This reduction in private sector investment is the ‘crowding out’ of investment.
  Sometimes, crowding out refers to the government provision of a good or service, which would otherwise be provided by the private sector.
  However, in times of high unemployment, government spending could lead to 'crowding in' as it encourages investment through the multiplier.

- **Level of taxation**

  The tax rate might increase if government debt gets too high. If confidence is lost in the government's ability to repay the debt, governments might have to raise interest rates to encourage investors to buy bonds, so that they can finance the debt. It could lead to higher taxes and austerity measures, especially if the debt becomes uncontrollable. In some countries, the government is able to finance spending through other means, for example oil revenues.

- **Equality**

  Redistributive policies and welfare payments, such as Income Support, could be used to help those on the lowest incomes.
  Also, government spending on housing and the provision of public services, such as education and healthcare, helps provide equal opportunities for people from all income backgrounds. This ensures that even those on low incomes can afford a good standard of healthcare and education.
  By providing these services, the government ensures that all members of society can achieve a minimum standard of living.

**Synoptic point:**

Government spending can have microeconomic objectives, for example subsidies in individual markets are able to reduce externalities. The impacts of spending on individuals, such as those who receive transfer payments, is a microeconomic impact.

# 4.5.2 Taxation

## Progressive, proportional and regressive taxes

A proportional tax has a fixed rate for all tax payers, regardless of income. It is also called a flat tax. For example, all tax payers might have to pay 20% income tax rate. The incidence of taxes is equal, regardless of the ability of the taxpayer to pay. It could encourage people to earn higher incomes, because the rate of tax paid does not increase.

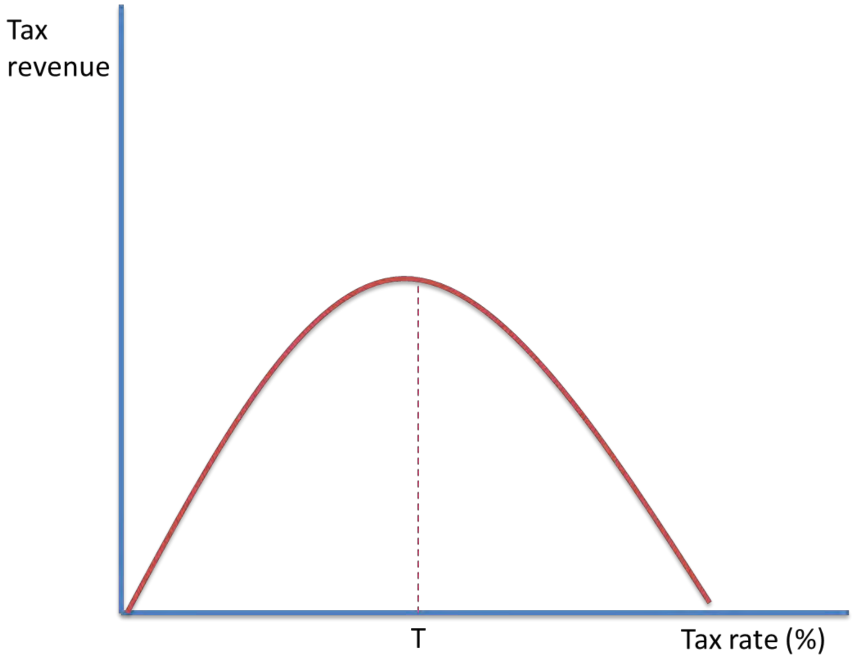
A progressive tax has an increase in the average rate of tax as income increases. As income increases, the proportion of income taxed increases. For example, in the UK income tax is progressive. This should help reduce inequality, because those on lower incomes pay less tax. The tax is based on the payer's ability to pay. Higher income households are more able to pay higher rates of tax than lower income households. Generally, direct taxes are more progressive.

A regressive tax does not relate to income, but means those on lowest incomes have a higher average rate of tax. In other words, the proportion of income paid as tax is higher for those on lower incomes than those on higher incomes. For example, as a percentage of income, the London Congestion Charge and Council Taxes are higher for those on lower incomes. This leads to a less equitable distribution of income. Generally, indirect taxes are more regressive.

## The economic effects of changes in direct and indirect tax rates on other variables

- **Incentives to work:**
  Higher marginal rates of tax may discourage people from working as they will gain less of what they have earned. Free market economists believe lower taxes will lead to individuals working longer hours, accepting promotions and joining the workforce. High taxes will encourage the top earners to move abroad. Income taxes have the biggest effect on incentives.
  However, there is no strong evidence to suggest this. It can be argued people would work longer hours with higher taxes in order to maintain their income.

- **Tax revenues (the Laffer curve):**




The Laffer curve shows how much tax revenue the government receives at each level of tax. Up until the point 'T', as tax rates increase, government tax revenue increases. After point 'T', people do not think it is as worthwhile working, and the lack of incentive to work leads to falling tax revenue. 'T' is the optimum tax rate where the government can maximise their revenue. Laffer argued that if tax rates are too high, they provide a disincentive to work.

Revenue from indirect taxes are uncertain as they depend on consumer spending patterns.

- **Income redistribution**

  There can be income redistribution and wage equality through government intervention. For example, inheritance tax means rich families cannot keep their entire wealth. A progressive tax system will increase equality. Since direct taxes are more progressive than indirect taxes, a move from indirect to direct taxes will increase equality.

- **Real output and employment**

  Direct taxes affect AD; a fall in direct taxes will cause a rise in AD. Indirect taxes affect SRAS; a fall in indirect taxes will increase SRAS. Some taxes can affect LRAS because of their impact on work incentives or investment. The impact on output and employment therefore depends on which taxes are implemented and the impact they have.

- **The price level**

  Indirect taxes could cause cost push inflation. Indirect taxes could increase the cost of goods such as cigarettes or fuel, if producers choose to pass the costs onto the consumer. Since the demand for cigarettes and fuel is relatively price inelastic, producers are likely to pass the cost of the tax onto consumers. The price level will also be affected by the changes to AD and AS which affect output and employment.

- **The trade balance**

  Taxes could be imposed on imports into a country. These are tariffs and they make it more expensive to import goods, which should, in theory, improve the trade balance. However, other countries might retaliate, so exports might decrease as well.

- **FDI flows**

  Governments can provide a competitive tax environment to encourage FDI, so that the market is profitable, fair and has macroeconomic stability. Taxes should also be consistent and predictable, so they are business friendly. This would encourage FDI flows. High, fickle taxes are likely to discourage FDI flows, since investors will choose to invest elsewhere.

**Synoptic point:**

Indirect taxes tend to directly effect individual markets, and so have microeconomic objectives. The impact of direct taxes on the labour market is a microeconomic point. All taxes affect individuals and businesses, so have microeconomic impacts.

# 4.5.3 Public sector finances

## Distinction between automatic stabilisers and discretionary fiscal policy

- **Discretionary** fiscal policy is a policy which is implemented through one-off policy changes. Discretionary fiscal policy involves deliberate changes in government expenditure and taxes with the intention of influencing aggregate demand. Keynes believed that during recessions, governments should increase their spending, and finance this with more borrowing.
- **Automatic stabilisers** are policies which offset fluctuations in the economy. These include transfer payments and taxes. They are triggered without government intervention.

## Distinction between a fiscal deficit and the national debt

- A government has a **fiscal (budget) deficit** when expenditure exceeds tax receipts in a financial year.

- The **national debt** is the amount of money the government has borrowed at one time through issuing securities by the Treasury.

## Distinction between structural and cyclical deficits

### Cyclical deficit

This is a temporary deficit, which is related to the business cycle. A deficit might occur during recessions, when governments increase spending to stimulate the economy.

### Structural deficit

This is a deficit which is due to an imbalance in the revenue and expenditure of the government, so it exists at every point in the business cycle.

## Factors influencing the size of fiscal deficits

- **The business cycle**

  Governments are likely to spend more during recessions. This is to try and stimulate the economy. Spending might be increased on welfare payments, since more people will be unemployed and on low incomes. Moreover, tax revenues from income tax and VAT will be lower, since people will be earning and spending less.

- **Interest payments**

  If interest rates increase on government debt, the amount the government pays in interest payments increases, so the deficit might increase.

- **Privatisation**

  An industry is privatised when the government sells the industry to the private sector. This provides them with a one-off payment, which could improve the budget deficit.

## Factors influencing the size of national debts

- The national debt is the accumulation of the government deficit over time. It is the total amount the government owes.
- If the government is continuously running a deficit, the size of the debt increases.
- If the government reduces the size of their deficit, the rate of increase of the total debt is slower, but the debt is still increasing.
- It is only when the government runs a budget surplus that the size of the national debt decreases. Currently, the UK government is trying to reduce the size of the deficit and eventually run a budget surplus by 2019-2020, at which point they will start paying off the debt.

## The significance of the size of fiscal deficits and national debts

- The cost of borrowing could increase, since by borrowing money, the government is increasing demand for credit in the economy.
- If confidence is lost in the government's ability to repay the debt, governments might have to raise interest rates to encourage investors to buy bonds, so that they can finance the debt.
- It could lead to higher taxes and austerity measures, especially if the debt becomes uncontrollable.
- A fiscal deficit could be inflationary if it increases AD.

- More government spending could lead to crowding out of the private sector. This leaves fewer funds in the private sector for firms to use, since the government is borrowing money, which crowds them out of the market.

# 4.5.4 Macroeconomic policies in a global context

## Use of fiscal policy, monetary policy, exchange rate policy, supply-side policies and direct controls in different countries

### Measures to reduce fiscal deficits and national debts

Budget deficits could be reduced with less government spending and higher taxes. However, this could lead to lower economic growth, which might cause government finances to worsen since tax revenue falls. Moreover, if taxes are too high, people could be discouraged from working, since they are not keeping much of their income.

Economic growth could be promoted to help reduce a deficit. This would increase revenue from taxes without needing to raise the rate of tax. For example, consumers would spend more, which raises revenue from VAT. However, this is not effective is the government has a structural deficit.

Governments can issue bonds to raise finance. This is not considered to be an effective long term solution to eliminate the government debt. However, it can help the government avoid raising taxes in the short run. The government has to pay interest to the investors who buy the debt, which has to be repaid at some point.

Governments could choose to default on their debt if it is no longer manageable. However, this can make accessing credit in the future difficult. For example, Russia and Argentina have defaulted on their debts in the past.

Sweden managed to use spending cuts and tax increases to balance their budget between 1994 and the late 1990s. Saudi Arabia used the sale of oil to reduce the debt burden from 80% of GDP to 10.2% of GDP between 2003 and 2010.

### Measures to reduce poverty and inequality

There can be income redistribution and wage equality through government intervention. For example, inheritance tax means rich families cannot keep their entire wealth.

Over the past century, sustained economic growth has helped reduced pre-War poverty in Britain, since wealth was redistributed to the poorest.

China's rapid economic growth between 1985 and 2001 helped 450 million people be lifted out of poverty. Similarly, India had strong economic growth in the 1980s and 1990s, and has had significant falls in poverty rates.

Governments could employ progressive taxes, such as higher rates of income tax for the richest earners. This puts most of the tax burden on high income earners, and it allows the government to reduce regressive taxes and raise welfare payments. However, this could reduce incentives to work harder and earn more, and it could result in a fall in government revenue, as shown by the Laffer curve.

The US has a progressive tax system, but the welfare state is not effective at redistributing income. In countries such as Finland and Scandinavia, the tax system is less progressive, but the government collects a lot more tax revenue, which they are effective at redistributing.

The UK has a National Minimum Wage which ensures all workers can access a minimum standard of living. This aims to prevent employees exploiting their workers by paying them low wages, and it prevents people falling into extreme poverty.

In developing countries, governments might improve human capital by making education more widely available. Moreover, they might try and diversify the economy in order to stimulate economic growth and job creation. For example, countries such as Sri Lanka and tried to develop their tourism industry.

- **Changes in interest rates and the supply of money**

Governments could use monetary policy to stimulate the economy and raise government revenue. For example, governments in the UK, the US and the EU have used low interest rates. This can encourage spending and investment, in order to try and boost economic growth.

Central banks can also pump money into the economy electronically to try and stimulate the economy. This is quantitative easing (QE). QE is usually used where inflation is low and it is not possible to lower interest rates further.

It has been used by the European Central Bank to help stimulate the economy. Since the interest rates are already very low, it is not possible to lower them much more. The bank bought assets in the form of government bonds using the money they have created. This is then used to buy bonds from investors, which increases the amount of cash flowing in the financial system. This encourages more lending to firms and individuals, since it makes the cost of borrowing lower. The theory is that this encourages more investment, more spending, and hopefully higher growth. A possible effect of this is that there could be higher inflation.

- **Measures to increase international competitiveness**

International competitiveness is the ability of a nation to compete successfully overseas and sustain improvements in real output and living standards.

Generally, the cheaper the relative unit labour costs, the more competitive the country in manufacturing. For example, countries such as China, India and Bangladesh have lower labour costs than countries such as the UK and US, which means that a lot of production requiring manufacturing, such as textiles, clothes and technology, has moved abroad.

However, countries such as Germany are famous for producing high quality engineered goods, such as cars, so consumers might be willing to pay more for them.

China has previously used currency manipulation in order to increase their international competitiveness. They devalued the Renminbi in order to make their relative export price lower. However, this is not a policy relevant for countries with floating exchange rates, such as the UK.

Unit labour costs rise when wages increase at a faster rate than productivity. China's large population means wages are generally low, but the rise of the middle class and consumer spending is pushing wages up.

The UK government has tried to increase competitiveness by lowering the corporation tax rate from 21% to 20% in 2015. This is the joint lowest in the G20 and should help increase inward investment. Moreover, the UK government has established the 'Red Tape Challenge', which aims to simplify regulation for businesses, so it is cheaper and easier to meet environmental targets and create new jobs. It should help to encourage investment and innovation, so domestic firms can become more internationally competitive.

## Use and impact of macroeconomic policies to respond to external shocks to the global economy

Due to globalisation, the world's economies are increasingly interdependent. This means that economic shocks in one part of the world affect many countries.

It is estimated that shocks in the global economy accounted for about 2/3 of weaknesses in UK output after the financial crisis.

For example, economic decline in the Eurozone negatively affected the UK's exports, since Eurozone countries form a large proportion of UK trading partners.

The UK MPC reacted to this by lowering interest rates to 0.5%, the historic low, in order to encourage economic growth. Since this was the lowest that interest rates could realistically go, the bank started using QE to try and stimulate economic activity.

Moreover, worsening conditions in the Euro area meant that UK banks faced higher funding costs. In order to support them, the government introduced the Funding for Lending Scheme, which aimed to lower these costs and provide cheap funding to banks and building societies.

Following the vote for Brexit, the chancellor has set aside around £3bn (as of 2018) to deal with the effects. Interest rates were originally lowered to improve confidence. They have been raised slightly in order to deal with the inflation following the fall in the pound.

**Synoptic point:**

> The government may have to respond to microeconomic shocks, such as a commodity price shock, which wold have effects on the whole economy.

## Measures to control global companies' (transnationals') operations

- **The regulation of transfer pricing**

Transactions between companies in the same multinational group form up a significant proportion of global trade. The price of these transactions is known as transfer pricing.

This price is set up in accordance with tax rules that determine the rate of tax on profits in different countries.

Transnational companies have to calculate their taxable profits, but the rules are complex and difficult to apply. They can allocate their profits to different countries with different tax rates.

Sometimes, transnational companies exploit these rules so they can reduce the amount of tax they have to pay. They could say that their activities have been in countries with low tax rates, for example, to reduce how much tax they pay. Companies can relocate parts of their company such as financial assets and intellectual property to low tax rate countries. This means that profits are taxed at a low rate.

In the UK, companies which do not allocate sufficient profits to the UK, in accordance to rules, are challenged by HMRC. This means they have managed to earn billions of pounds in tax.

- **Limits to government ability to control global companies**

The tax rules are complex and difficult to apply and regulate. There could be costs to HMRC to challenge firms which do not declare their profits truthfully. Although HMRC managed to secure £4.1 billion in tax revenue for the UK Exchequer, this might have taken a long time to sort out.

## Problems facing policymakers when applying policies

- **Inaccurate information**

Some policies might be decided without perfect information. This might require a full cost-benefit analysis, and it could be time-consuming and expensive. For example, government housing policies are long term, and have failed several times in the past. However, it is impractical for governments to gain every bit of information they need, so assumptions are made.

- **Risks and uncertainties**

With government policies, consumers react in unexpected ways. A policy could be undermined, which could make government policies expensive to implement, since it is harder to achieve their original goals.

- **Inability to control external shocks**

For example, the financial crisis was unexpected and uncontrollable, and meant policies employed by policy makers did not have the intended effects.