

OCR Economics A-level

Macroeconomics

Topic 3: Implementing Policy

3.1 Fiscal Policy

Notes

Types of government expenditure:

1. **Current spending** - this is expenditure on public services, e.g. paying wages for NHS employees or maintaining public roads.
2. **Capital spending** - this is spending money on new infrastructure, e.g. new bridges across the UK or R&D in the pharmaceutical industry.
3. **Welfare spending** - this is money spent on transfer payments, e.g. universal credit or public pensions.

Direct/Indirect tax:

- Taxes can either be direct or indirect:

Direct taxes: these are taxes paid directly from an individual to their government, e.g. income tax, corporation tax, stamp duty.

Indirect taxes: these are taxes levied on goods and services, and therefore passed onto consumers in the form of higher prices. However, the firm can choose how much of the tax they wish to pass on, e.g. VAT, excise duty, climate change levy. There are *two* types of indirect taxes.

- **Ad valorem tax:** these taxes are set as a percentage of the price of the good/service, e.g. VAT at 20%.
- **Specific tax:** this is a fixed amount of tax on a particular good, e.g. a tax of £1.25 per 1 litre of petrol.

Progressive, Regressive and Proportional tax:

- Taxes can also be progressive, regressive or proportional:

Progressive taxes: these are taxes that increase in value as the taxpayers income increases, e.g. UK income tax.

Proportional taxes: taxes that take the same proportion of income from taxpayers regardless of their level of income, e.g. National Insurance Contributions (NICs).

Regressive taxes: taxes that take a larger proportion of income from taxpayers as their income decreases, e.g. excise duties.

Canons of taxation

- In Adam Smith's (the 'father of economics') publication of the "Wealth of Nations" in 1776, he mentions how taxes should follow the following characteristics:
 - The cost of collecting the tax must be low.
 - The way of paying should be convenient for the taxpayer.
 - The amount paid should be based on the taxpayers ability to pay (i.e. equitable).
 - The tax should be efficient in correcting the externality.

Examples of tax in the UK:

- Council tax - in the UK, council tax is considered highly regressive, because after the value of the property in question exceeds £320,000 the tax rate remains constant. This means that a property worth £25 million pays the same amount of tax as a property worth £400,000. This is clearly regressive as the owner of the first property is much more able to pay this tax than the owner of the second property, which goes against Adam Smith's 'canons of taxation'.
- Income tax - this is considered progressive in the UK, as the tax rate increases as annual income increases.

The government budget surplus and deficit:

- A government experiences a **budget deficit** when expenditure exceeds tax revenue in a fiscal year.
- A government experiences a **budget surplus** when tax revenue exceeds expenditure in a fiscal year.
- A government experiences a **balanced budget** when expenditure is equal to tax revenue in a fiscal year.

Budget deficits/surpluses can be split into two different categories:

- Cyclical budget deficit - this is a **temporary** deficit, which varies depending on the state of the economy. For example, during a recession the cyclical deficit will be high as governments will increase spending and reduce tax to stimulate the economy, whereas in an economic boom the cyclical deficit will be low as governments raise taxes and cut back on spending.
- Structural budget deficit - this does not depend on the stages of the **economic cycle**, and is simply the difference between taxation revenue and government expenditure.

National debt:

- This is the total amount of money which the government has borrowed, and therefore owes to third-party members (regardless of the fiscal year).

Relationship between the national debt and budget balance:

- The difference between the two terms is that the national debt is the total amount of money the government owes, whereas a budget deficit is simply the difference between what the government owes and what it is owed (in tax revenue) in a single fiscal year.

Consequences of budget deficits:

- ◆ As the budget deficit widens (which in the UK it currently is, given the covid-19 pandemic), governments are borrowing excessively which could potentially lead to **demand-pull inflation**. If this exceeds the Monetary Policy Committee's (MPC) target of 2.0% CPI, this represents a conflict between two key macroeconomic objectives.
- ◆ When the government borrows excessively, it can signify a weak economy, and therefore lower the **credit rating** of that country - this being an independent assessment of the credit worthiness of an economy, giving investors insights to the level of risk from investing in that country.

Office for budget Responsibility (OBR):

- This is an independent public advisory body that produces 5-year forecasts for the economy, including the impact of tax and expenditure changes that are announced in the Budget.
- They also analyse the effectiveness of policies in achieving macroeconomic objectives, by scrutinising tax and welfare spending measures.

Fiscal policy is a demand and supply-side policy that attempts to smooth out fluctuations in the economic cycle, whilst having both macroeconomic and microeconomic implications.

The government takes action to change:

- The level of government spending
- The level of taxation

Expansionary Fiscal Policy

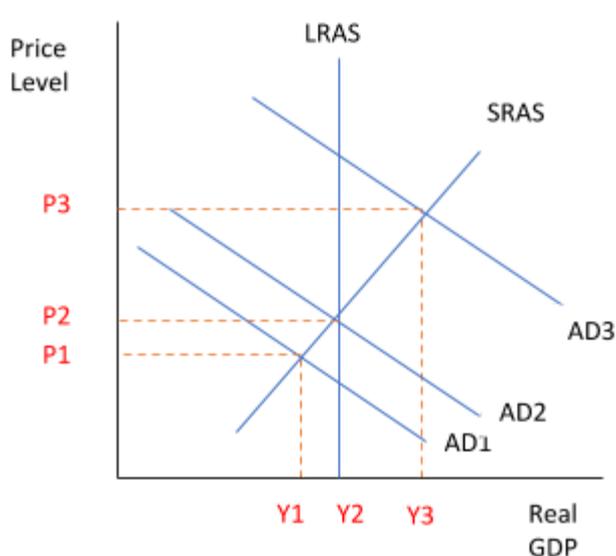
- A **reduction in taxes** and **increase in government spending** affects each determinant of aggregate demand (C+I+G+X-M):

Consumer spending (C)

Lower income tax leaves households with more **disposable income**, and so will spend more. This particularly applies to low income earners as they have a higher **marginal propensity to consume** than high income households. This injection into the circular flow of income triggers the 'multiplier effect' (see notes), whereby an initial increase in AD leads to an even larger increase in national output.

However, this depends on which type of tax is being reduced. For example, income tax is the UK government's biggest source of revenue, so a decrease in this must make up for the loss in taxation revenue. Although decreasing income tax increases the standard of living (as consumers are able to obtain more needs and wants), high income earners are much better off, and this therefore adds to the severity of income inequality in the UK.

In addition, if the multiplier effect was greater than anticipated, this could lead to a positive output gap as shown on the graph below. The graph accurately represents the multiplier effect in play because the shift from AD2-AD3 is larger than the shift from AD1-AD2.

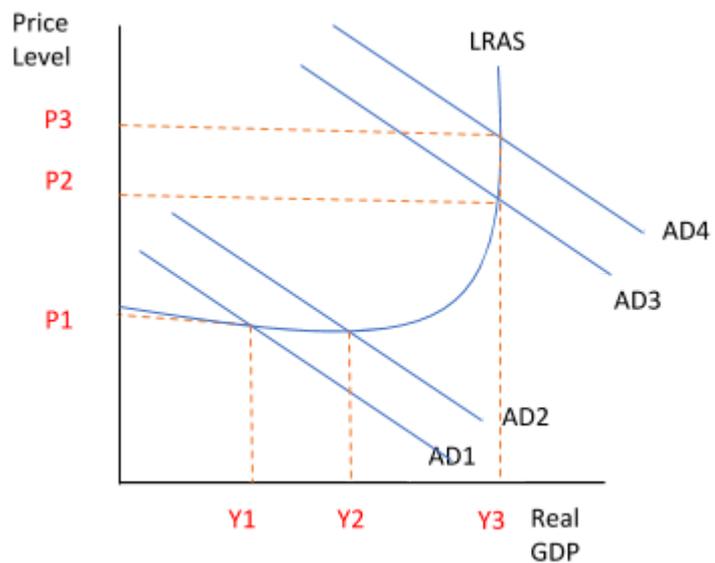


With the initial injection into the circular flow of income, the shift to AD2 led to an equilibrium of P2Y2, and we can assume the inflation rate is at 2%. However, when the multiplier effect is taken into account, the AD curve is now at AD3, with the new equilibrium at P3Y3, and this has exceeded the target of 2.0% inflation, thus posing a conflict between macroeconomic objectives.

N.b. The negative output gap is the small triangle with the positive output gap being the larger triangle.

Another way there would be a conflict between macroeconomic objectives depends on the state of the economy, i.e. whether there is a little of a lot of **spare capacity**. For example, the AD1 curve on the graph below represents an economy with a lot of spare capacity. So a reduction in taxes and increase in government spending shifts the curve to AD2, but even though GDP increases to Y2, the price level remains at P1. If we assume P1 represents 2.0% inflation, then we have now achieved a higher rate of GDP whilst ensuring price stability (on the macroeconomic objectives). However, if we have an economy that has little

spare capacity, i.e. at AD3, the outcome is different. According to **Keynesian** theory - with a curved LRAS curve as opposed to a straight **Classical** one - a shift outwards to AD4 will bring an increase in GDP so small it can be regarded as negligible and so GDP remains at Y3. However the price level experiences a big jump to P3, which exceeds the 2.0% target rate set by the **Monetary Policy Committee** (see notes). This clearly represents a **trade-off** between the two objectives.



Investment (I)

Lower corporation tax means firms are left with more **retained profits**, which gives them more of an incentive to invest in **R&D**, cumulatively shifting the LRAS curve to the right. However for this to be true, the **Monetary Policy Committee** must set lower interest rates to ensure loans are cheap. If interest rates are high (so loans are expensive for firms to take out), firms won't invest and there may be an overall loss to the economy, because the reduction in corporation tax made no effect on the levels of investment and has now diminished the government's ability to spend in the economy without further worsening the state of their budget deficit.

Furthermore, it depends on the source of investment, i.e. whether it's from domestic or overseas investors. If the latter applies, and there is a surge of **Foreign Direct Investment (FDI)**, then these investors will need to pay for labour and capital in sterling (£). On the one hand, this is beneficial to the economy as more jobs are created so demand increases. However, by having to pay workers in sterling, it increases the demand for the £, which strengthens the currency against others, but makes exports more expensive in the process. Depending on how much more expensive exports were made, this could cancel out the effects of the increase in FDI into the economy.

Finally, now that climate change is becoming an increasingly worrying issue, more investment plans are being scrutinised by the public, for example Heathrow Airport's plans for a third runway were rejected by the court of appeal after the adverse environmental effects were assessed, even though it would have boosted economic growth by creating more jobs.

Government Spending (G)

Additional Content:

The theory of **Ricardian Equivalence** states that when governments engage in expansionary fiscal policy, **rational economic agents** see that it can only be maintained for

a small period of time, and that any increase in government expenditure will most likely be paid for by future increases in taxes to reduce the **budget deficit**. Therefore, if governments plan to increase spending, consumption may not actually rise as anticipated, and because consumer spending is the largest component of Aggregate Demand, this doesn't significantly rise either. But this assumes that all economic agents are rational.

Reducing welfare payments:

- In theory, reducing welfare payments (i.e. benefits and Universal Credit) would increase the **opportunity cost** of not working, so if more people are now in work the LRAS curve shifts outwards, thus improving the productive capacity of the economy. As welfare payments are the UK government's biggest source of spending, reducing this would also improve the state of the budget deficit, which is already at record highs as a result of the covid-19 pandemic.
- However, this is arguably **inequitable**, because those people on welfare payments may be out of work due to physical disabilities, i.e. **economically inactive**. So reducing their income would simply worsen the level of inequality in the UK as these people are unable to work.
- Another way of reducing welfare payments to improve the budget deficit is by reducing pensions. But this would reduce Aggregate Demand, as households would start saving up more for retirement. However, nowadays most households in the UK are on private pensions through their work schemes.

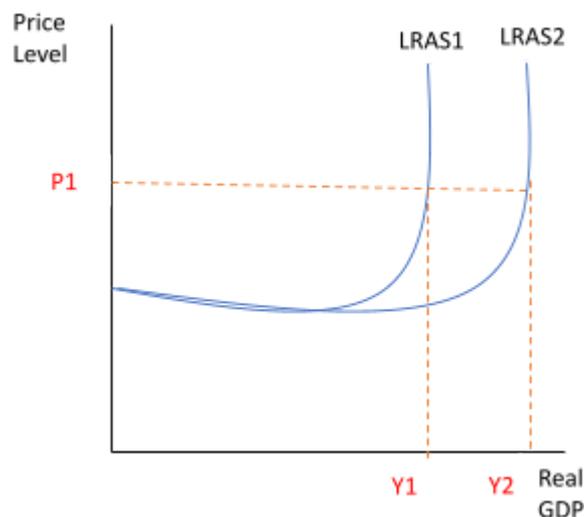
Raising the National Minimum Wage (NMW):

- The NMW is the lowest hourly wage rate employers must pay their workers under UK law.
- By raising the NMW, it increases the **opportunity cost** of not working, so reduces the **natural rate of unemployment** (see notes), which shifts the LRAS curve outwards. It also boosts consumer spending, as households have more income to obtain needs and wants, so the AD curve shifts to the right and there is an overall increase in GDP.
- However an increase in the NMW would fall hardest on small firms and low-income bosses, as these are the people most likely to be paying their workers the minimum wage in the first place. So raising the **floor** would increase cost of production for these firms, which could potentially lead to redundancies as firms find ways to cut costs. Therefore the overall effect on unemployment could be neutral.

Supply-side effects of expansionary fiscal policy:

- Income tax - as explained above, reducing this means the **opportunity cost** of not working is higher so more individuals are incentivised to find work. By providing the economy with more **labour**, the LRAS curve shifts outwards. As shown on the right,

an outward shift boosts GDP to Y2, but the price level remains at P1 and, if we assume P1 represents 2.0% inflation, coincides with the macroeconomic objective of **price stability**.



- Corporation tax - less tax for businesses means they have more **retained profit**, which gives them more of an incentive to **invest**. This shifts out the LRAS curve as there is an increase in the **productive capacity** of an economy, however there is also an outward shift in AD, as investment is a determinant of demand. However, there is no guarantee firms will use the increased profits to invest, as they may simply use it to reward shareholders. However, if combined with expansionary monetary policy (i.e. low interest rates), it means loans would be cheaper to take out.

Limitations of expansionary fiscal policy:

- ***Crowding out*** - this occurs when high levels of government expenditure doesn't in fact revive the economy, because it results in an equivalent fall in public sector spending an investment.
 - *Resource crowding out* occurs when the government asks the private sector for money in order to fund their fiscal stimulus packages. If private sector firms are channeling their funds to the government, they have no money to spend on their own projects, and private firms are naturally more efficient at spending than the government anyway due to the presence of a **profit-motive**.
 - *Financial crowding out* occurs when the government increases interest rates on bonds to attract more people to buy them. As a result, interest rates elsewhere in the economy rise with it, making it more expensive for firms to invest.

Deflationary Fiscal Policy

- An **increase in taxes** and **decrease in government spending** affects each determinant of aggregate demand ($C+I+G+X-M$). Most of the effects of **fiscal austerity** will simply be the opposite to what is explained above, however there are a few extra things to know:
- Fiscal austerity is politically difficult, as it has adverse impacts on the reputation of those in charge. Therefore, most leaders would choose to avoid this route, and unlike monetary policy where the central bank is independent from the government, fiscal policies are much more prone to political influences.
- The government may decide to sell some of its state-owned enterprises. Transferring ownership to the private sector increases the overall efficiency of these firms, due to the presence of a **profit-motive**. This shifts the LRAS curve to the right which increases the productive capacity of the economy.
- The government may also decide to reduce regulation in certain industries, as this involves high **administrative costs**.

The Laffer Curve

- The Laffer curve depicts how an increase in the level of taxes may not actually result in a rise in **tax revenue**:
- As shown on the diagram, to begin with tax revenue rises with the tax rate. However, after a certain point on the curve passes, the level of tax and tax revenue forms an inverse relationship.
- This can be explained by 3 possible reasons:
 - High tax rates incentivises tax avoidance - this is legal.
 - High tax rates incentives tax evasion - this is illegal
 - Households fall victims of the **unemployment trap**, whereby they are better off not working due to generous unemployment benefits.

