Edexcel (A) Economics A-level

Theme 4: A Global Perspective

4.5 Role of the State in the Macroeconomy

4.5.4 Macroeconomic policies in a global context

Notes

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.

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.