OCR Economics A-level

Macroeconomics

Topic 3: Implementing Policy

3.1 Fiscal Policy

Notes

The government budget:

The government budget is comprised of tax revenues and government expenditure.

Proportional, progressive 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. People have a personal allowance of £10,600 where tax is not paid. For incomes below £31,785, people only pay the basic rate of 20%. For incomes between £31,786 and £150,000, people pay the higher rate of 40%. Above this, a 45% rate is paid. 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.

Direct and indirect taxes:

Direct taxes are imposed on income and are paid directly to the government from the tax payer. Examples include income tax, corporation tax, NICs and inheritance tax. Consumers and firms are responsible for paying the whole tax to the government.

Indirect taxes are imposed on expenditure on goods and services, and they increase production costs for producers. This increases market price and demand contracts.

There are two types of indirect taxes:

- **Ad valorem** taxes are percentages, such as VAT, which adds 20% of the unit price. This is the main indirect tax in the UK.
- **Specific taxes** are a set tax per unit, such as the 58p per litre fuel duty on unleaded petrol.

The features of a good tax

- These 'Canons of Taxation' were first developed by Adam Smith. They are essentially the criteria taxes are judged by. They are:

1) The cost of collecting the tax must be low relative to the yield
2) The timing and quantity paid must be obvious to the tax payer
3) The timing and way of paying should be convenient for the tax payer
4) Taxes should be imposed depending on the ability to pay

- These have been updated to include:

5) The tax should not limit efficiency, and there should only be a minimum loss of efficiency.
6) Tax should be compatible with tax systems of other countries. For the UK, taxes should be compatible with the rest of Europe.
7) Taxes should adjust with inflation.

The advantages and disadvantages of a flat rate tax system:

A flat tax is a uniform tax rate on income, regardless of the level of income.

Advantages:

- The system is simple, which makes payments straightforward and easy to understand.
- It saves taxpayers the costs of using accountants and lawyers to calculate tax from various sources of income. For example, consumers will not have to calculate or pay tax on dividends or interest.

Disadvantages:

- Low income households have to purchase the same necessities as higher income households. If all taxpayers pay the same rate, low income households will have significantly less disposable income than high income households.
- Income tax is a significant source of revenue for the government. If all tax payers pay the same rate, it could disproportionately benefit the rich. It could also meant the government receives significantly less revenue than if they charged high income households a higher tax rate.

Government expenditure:

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.

The budget position/fiscal stance:

- The fiscal stance is the impact that taxes and government spending has on the future economy.

- The budget position refers to whether the government has a deficit, surplus, or if the budget is balanced.

- A government has a **budget surplus** when tax receipts exceed expenditure.

- The government has a **balanced budget** when expenditure is equal to revenue.

- A government has a **budget deficit** when expenditure exceeds tax receipts in a financial year.
- It is important to distinguish between the government **debt** and the government **deficit.** The debt is the accumulation of the government deficit over time. It is the amount the government owes. The deficit (or surplus) is the difference between expenditure and revenue at any one point.

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

Different budget positions:

Cyclical budget position

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

Structural budget position

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

Overall budget position

This is an accumulation of deficits and surpluses over time to give the overall budget.

Budget position on current expenditure

This is the flow of cash at during one period of time.

How budget deficits can be financed:

- Budget deficits are usually financed by borrowing.

- Deficits can be reduced using austerity measures, such as cutting government spending on local authorities.

- Taxes could be increased. For example, the UK government increased the rate of VAT to 20%.

- There could be caps to the amount of welfare benefits someone can claim. In the UK, there is a £26,000 cap per annum.

Policies to correct a budget surplus or deficit:

- 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 could choose to default on their debt if it is no longer manageable. However, this can make accessing credit in the future difficult.

Consequences of government debt:

- 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.

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.

  For example, during periods of high economic growth, governments receive more tax revenue and they spend less on unemployment benefits. During a recession, automatic stabilisers limit the extent of negative economic growth. Consumers pay less tax since they are earning less income and the government has to spend more on unemployment benefits.

Crowding out and crowding in

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.

Crowding in is when government spending which is financed by debt and borrowing leads to an increase in private investment. The government spending leads to an increase in AD, which causes firms to spend more on capital, such as factories.

Average and marginal rates of taxation

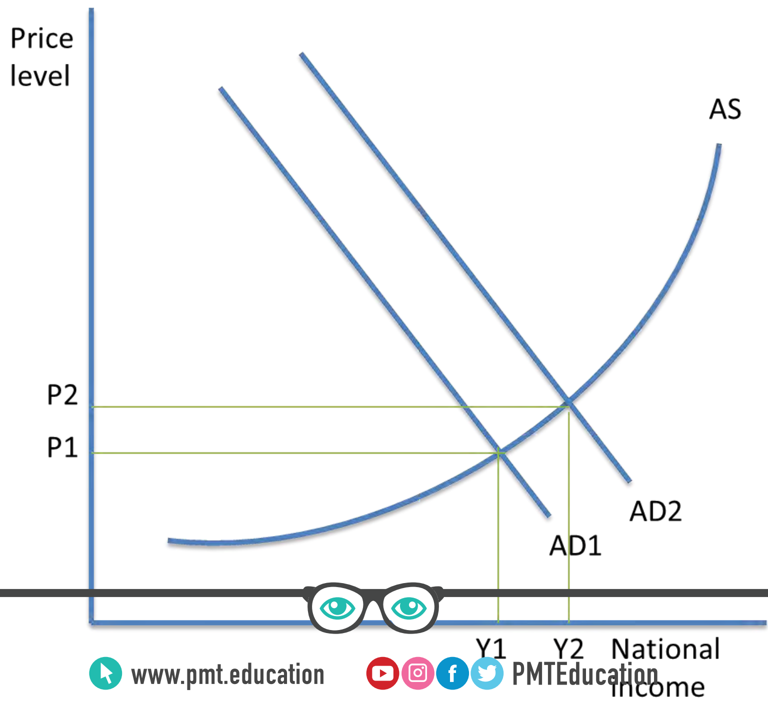
- The marginal rate of tax is the rate of tax applied to the next unit of currency of the income. For example, in the UK, the marginal rate of tax is the rate of tax each extra pound added to any taxable income.
- The average rate of tax is the total tax paid divided by total income. It is a proportion of income.
- Increasing the average rate of tax as income rises means the tax is progressive.

How discretionary fiscal policy could be used to improve macroeconomic performance:

- Discretionary fiscal policy involves deliberate changes in government expenditure and taxes with the intention of influencing aggregate demand.
- Governments can change the amount of spending and taxation to stimulate 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. Fiscal policy aims to stimulate economic growth and stabilise the economy.
- In the UK, the government spends most of their budget on pensions and welfare benefits, followed by health and education. Income tax is the biggest source of tax revenue in the UK.

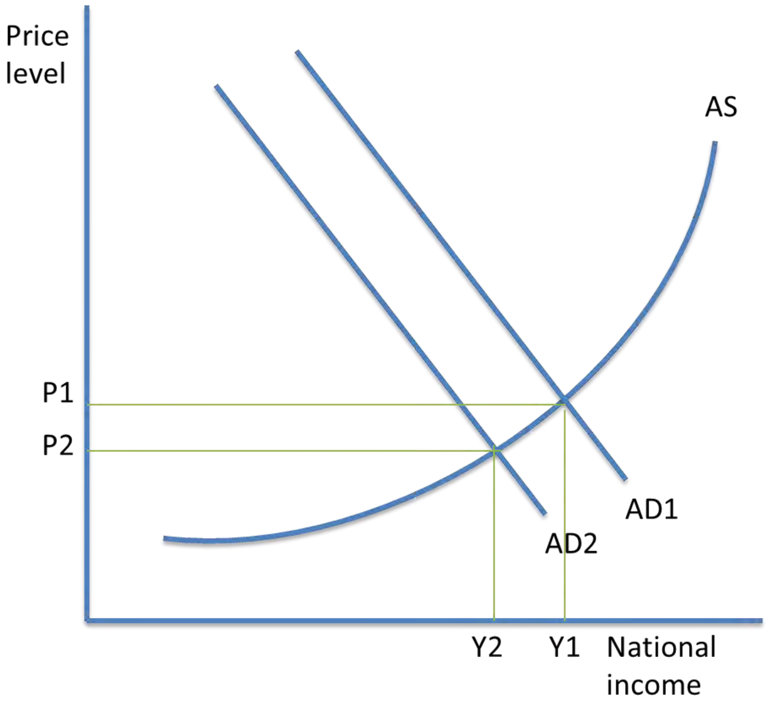
Expansionary fiscal policy

This aims to increase AD. Governments increase spending or reduce taxes to do this. It leads to a worsening of the government budget deficit, and it may mean governments have to borrow more to finance this.



Deflationary fiscal policy

This aims to decrease AD. Governments cut spending or raise taxes, which reduces consumer spending. It leads to an improvement of the government budget deficit.



Limitations of fiscal policy:

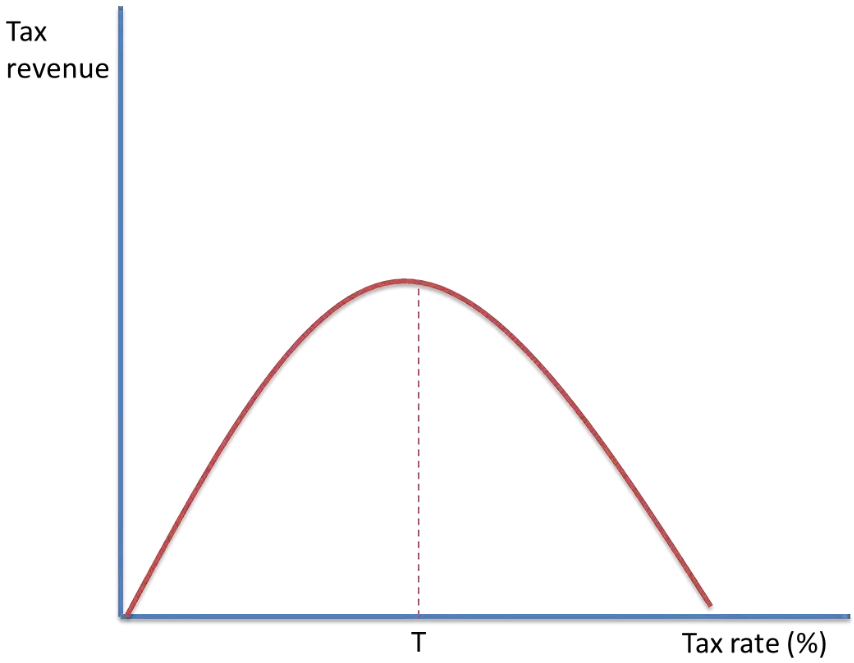
- Governments might have imperfect information about the economy. It could lead to inefficient spending.
- There is a significant time lag involved with employing fiscal policy. It could take months or years to have an effect.
- If the government borrows from the private sector, there are fewer funds available for the private sector, which could lead to crowding out.
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy.
- If interest rates are high, fiscal policy might not be effective for increasing demand.

- If the government spends too much, there could be difficulties paying back the debt, which could make it difficult to borrow in the future.

Fiscal rules:

A fiscal rule is a long term constraint on fiscal policy by putting numerical limits on the budget.
A fiscal rule was established in the UK for the first time in 1997. This was with the aim to balance the government's books by only borrowing to fund capital projects.
Another rule was established to ensure the ratio of investment to GDP should not be above 40%.
However, by 2010, the coalition government decided these rules were no longer feasible, since public debt was increasing and they needed to control it.

Laffer curve analysis



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 tax rates are too high, so they provide a disincentive to work. To encourage people to work harder, Laffer argued, tax rates should be reduced.