

9 Macroeconomic policy — answers

Test yourself

Test yourself 9.1

One reason why statements **A**, **C** and **D** are wrong is that they all contain dogmatic assertion. This means that to be correct, the statements have to be true in all circumstances. Thus while an increase in interest rates (statement **A**) *often* reduces inflation, it is not always the case. Similarly, interest rate changes (statement **C**) usually affect the money supply, and are unlikely to have no effect on the money supply. Statement **D** is simply wrong: an increase in interest rates will usually reduce, rather than increase, investment in new capital goods. This leaves statement **B** as the only correct statement. From a business's point of view, an interest rate rise increases the business's cost of servicing its debt or the amount of money it has borrowed. This raises costs of production and contributes to cost-push inflation.

Test yourself 9.2

The estimated percentage share of income tax in total government revenue in 2014/15 was 25.77% (£167bn divided by £648bn and then multiplied by 100.) The estimated percentage share of corporation tax in total government revenue in 2014/15 was 6.33% (£41bn divided by £648bn and then multiplied by 100).

Test yourself 9.3

Contractionary fiscal policy, which involves raising taxes and/or cutting government spending in order to reduce aggregate demand, is used to reduce demand-pull inflationary pressures. This is why statement **D** provides the correct answer. Statement **A** is wrong because an expansionary rather than a contractionary fiscal policy would be used to close or eliminate a negative output, which occurs when the economy is in recession. Contractionary fiscal policy relates to stabilising the economic cycle and not to changing the economy's long-run trend rate of growth or to reducing structural unemployment. Statements **B** and **C** do not, therefore, relate to contractionary fiscal policy.

Test yourself 9.4

Spending government money on infrastructure is part of interventionist supply-side policy — the government is intervening in the economy. It is not demand-side fiscal policy, which aims to change the level of aggregate demand in the economy. This is why policy **(b)** is consistent with the information in the question, and not policies **(a)** and **(c)**.

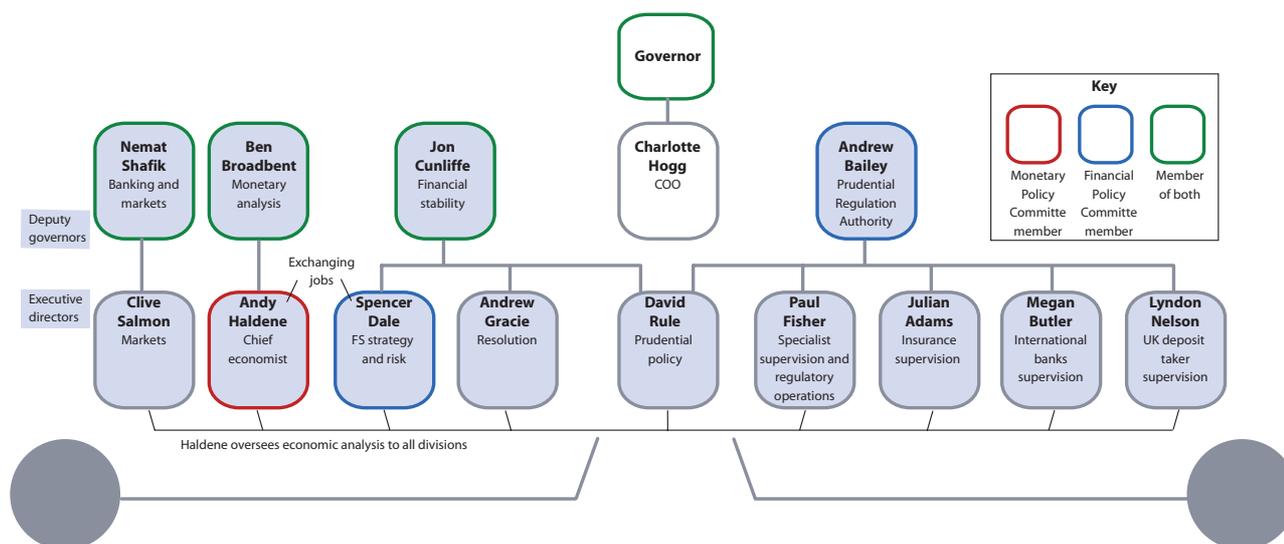
Case studies

Case study 9.1

- 1 Since taking over as governor of the Bank of England in 2013, with the introduction of 'unconventional' monetary policies such as *forward guidance* and the *Funding for Lending Scheme*, Mark Carney has moved UK monetary policy away from relying solely on Bank Rate changes to implement monetary policy. However, the governor has received criticism for the poor execution of this flagship policy, and for sending mixed signals on the likely timing of the first interest rate rise after/more than 6 years of holding Bank Rate at 0.5%. Mark Carney's big challenge has been to return long-term interest rates to more normal levels, namely somewhat above the 2.5% rate at which they have been stuck in the UK. However, by 2015 this challenge had not been met. On the wider front, monetary policy is

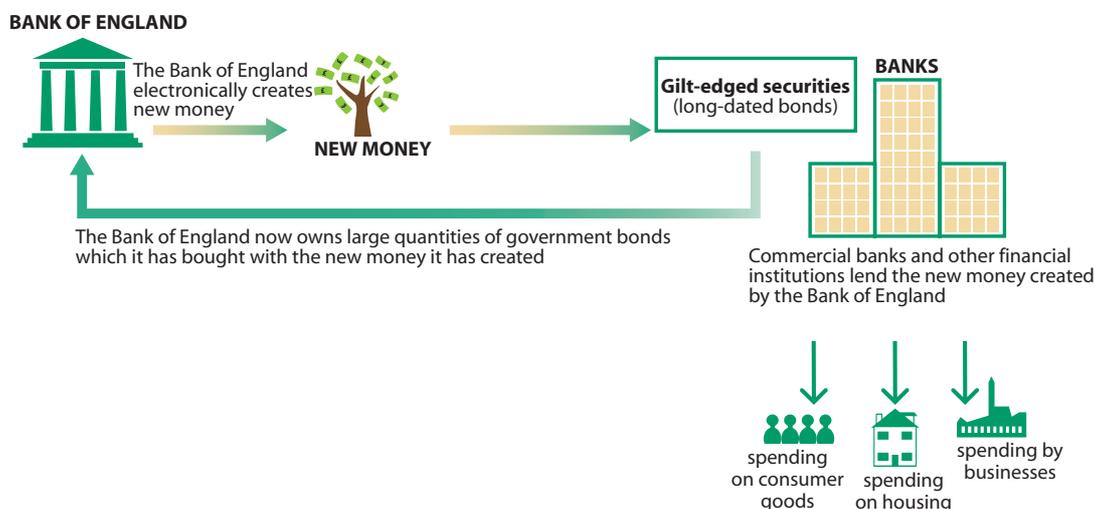
still aimed at controlling inflation, but in practice Carney's current policy of holding Bank Rate at 0.5% has meant that trying to maintain the recovery from the 2008 recession has been central to UK monetary policy. In 2014 and 2015, the fear of deflation had replaced the traditional worry about the rate of inflation being too high. This justified keeping Bank Rate low and indulging in 'unconventional' monetary policy in order to stimulate aggregate demand in the economy. Nevertheless, evidence was beginning to emerge which indicated that the economy was overheating, such as growing skill shortages in labour markets.

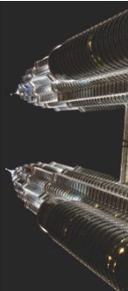
- The chart below shows the composition of the Bank of England's Monetary Policy Committee (MPC) and also another important Bank of England committee, the Financial Policy Committee. The MPC is made up of four internal Bank of England officials, plus Mark Carney who chairs the committee and in the event of disagreement has the casting vote on MPC Bank Rate decisions, together with four external members. The external members are appointed for 3 years, so look out for the appointment of new members in future years.



Case study 9.2

- The best-known monetary policy instrument additional to Bank Rate is quantitative easing (QE). The way quantitative easing operated between its UK introduction in 2009 and its eventual suspension (though not abolition) in 2012, is shown in the following chart.





- Higher interest rates increase the cost of borrowing. Firms and individuals who have borrowed to finance the purchase of capital goods and consumer goods reduce or pay back their borrowing, with the result that they invest and consume less. Investment and consumption are components of aggregate demand. A fall in investment and consumption shifts the aggregate demand curve to the left, which reduces demand-pull inflationary pressures. Additionally, by attracting capital flows into the pound, higher interest rates raise the exchange rate, and with it overseas demand for UK exports, which are another component of aggregate demand.

Case study 9.3

- The Budget is the government's annual financial statement and review of levels of taxation. It also includes the government's future financial strategy and economic forecast. The Budget is presented to parliament by the chancellor of the exchequer usually on a day in March just before the end of the current financial year and before the beginning of the next financial year on 6 April. The Budget occurs at this time in the year because certain taxes, such as income tax, are annual taxes rather than permanent taxes and the government must get the permission of parliament to use these taxes to collect revenue in the next financial year. Parliament gives the chancellor permission to use a motion, announced after the budget speech, to make tax changes that can come into effect immediately. Shortly after the budget debate which starts on budget day, the government introduces an annual Finance Bill in parliament. Once agreed by parliament, the Finance Bill becomes the Finance Act, which brings the tax proposals announced in the budget into law.

You should think of the budget speech as resembling a head teacher's report on school speech day, containing a review of how the economy has performed in the year since the last Budget, commentary on the current position of the economy, and announcements of the economy's future progress. Much of the budget speech is a précis of a document published on budget day called the Financial Statement and Budget Report (FSBR). This is also known as the 'Red Book', named after the traditional colour of its cover. The 'Red Book' contains an analysis of the economy and a summary of the Budget's tax measures.

- Taxes are generally unpopular, though most of the general public accept that taxes are necessary to pay for the government running the country and providing vital services. A stealth tax is a tax levied in such a way that it is largely unnoticed, or not recognised as a tax. One way of doing this is by announcing a tax increase or the introduction of a new tax several months before it happens, say in the autumn statement in November or December, and then keeping quiet about the tax increase when it is introduced in the March budget in the following year. Although all taxes are unpopular for at least some in the population, stealth taxes are especially unpopular, first because the government knows in advance that the general public is not going to like the tax increase, and second because the general public in their turn feel that they have been conned.

Case study 9.4

- Supply-side economists, being of a free-market and anti-government persuasion, believe in the virtues of tax cuts. They argue that people should be left free to spend their own money, knowing better what to do with it than the government. 'Moderate' supply-side economists accept that governments must provide vital services, and that taxes are therefore necessary to pay for these services. In the words of George Osborne quoted in the case study: 'I'm a low-tax Conservative, I want to reduce taxes, but I basically think you have to do the hard work of reducing government spending to pay for those lower taxes.' By contrast, 'extreme' supply-side economists, whom George Osborne apparently claims not to support, adopt libertarian views on the role of government and the state in the economy. Libertarians wish to restrict the role of the state to a night-watchman function. This is a minimal state whose

only legitimate function is the protection of individuals from assault, theft, breach of contract, and fraud, and where the only legitimate governmental institutions are the military, police and courts, together possibly with a minimum civil service and emergency-rescue departments such as the fire departments and prisons, though even these can be privatised.

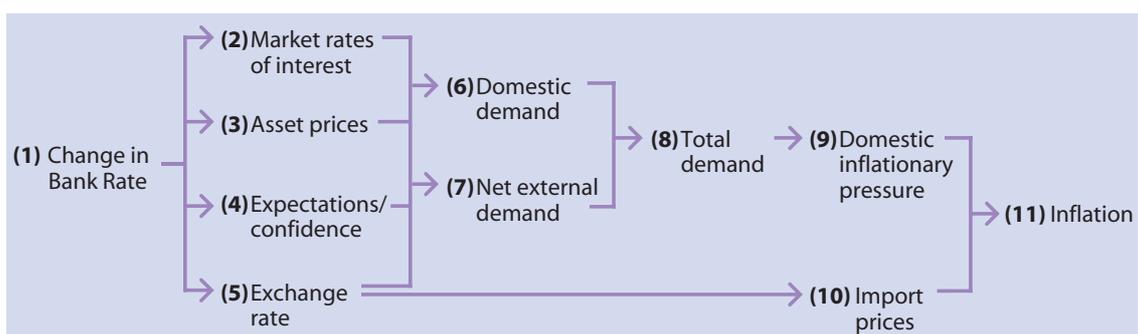
‘Extreme’ and ‘moderate’ supply-side economists share some common ground in their acceptance to a greater or lesser degree of the implications of the Laffer curve. They believe that the higher rate of income tax has in the past been set too high and that the 2012 cut in the highest rate of tax from 50% to 45% has increased tax revenues and incentivised both workers and entrepreneurs. ‘Moderate’ supply-side economists support a further cut, but ‘extreme’ supply-side economists want to go further and replace the current mildly progressive structure of income tax with a ‘flat’ tax in which all income earners would pay the same rate of income tax, say at 15%.

- 2 Arguably, the sovereign debt problem has prevented, or at least deterred, governments from continuing to increase public sector borrowing and the size of their countries’ national debts. George Osborne certainly used the sovereign debt problem as a reason for cutting UK public spending so as to reduce UK government borrowing and eventually the size of the UK national debt.

However, recent research published in June 2015 by the IMF (though not necessarily representing the views of the Fund) has questioned the existence of a sovereign debt problem in the UK. According to the research, countries with ‘fiscal space’ have no need to reduce government debt at all, and should not therefore undertake fiscal consolidation to reduce debt — not today or tomorrow. ‘Fiscal space’ means that financial markets are perfectly happy buying government debt, and that the borrowing countries therefore do not suffer any kind of significant default premium that raises the interest on their debt. The IMF paper suggests that most countries, including the UK, now have this ‘fiscal space’ and that ‘fiscal space’ existed in the UK at the time of George Osborne’s first austerity cuts in 2010.

Questions

- 1 The following flow chart presents the Bank of England’s view of how changes in Bank Rate (item 1 in the flowchart) affect aggregate demand (item 8), and then the rate of inflation (item 11):



Official Bank Rate decisions (item 1) affect market interest rates (item 2), such as mortgage rates and bank deposit rates set by commercial banks and financial institutions. At the same time, policy actions and announcements affect expectations about the future course of the economy and the confidence with which these expectations are held (item 4). They also affect asset prices (item 3) and the exchange rate (item 5). These changes in turn affect domestic demand within the UK economy (item 6) and net external demand for UK exports (item 7) and thence aggregate demand (item 8).

- 2 Monetary policy is best suited for dealing with demand-pull inflation since it can to a large extent control aggregate demand in the economy. It is less suited to controlling an increase in business costs which is the cause of cost-push inflation, especially business costs related to the prices of imported goods. However, monetary policy does have some effect on these, partly as a result of higher interest rates causing the exchange rate to rise, which in turn puts downward pressure on import costs. However, higher interest rates are themselves a cost of production for businesses that borrow, so they also contribute to cost-push inflation.
- 3 The chart below shows changes in the UK's inflation rate, measured by changes in the CPI and in the RPI, over the period from February 2005 to February 2015. Given that the Bank of England's remit is to keep the rate of CPI inflation between an upper limit of 3% and a lower limit of 1% (centring on a central target of 2%), the figures indicate that since 2008 the Bank has been only partially successful.

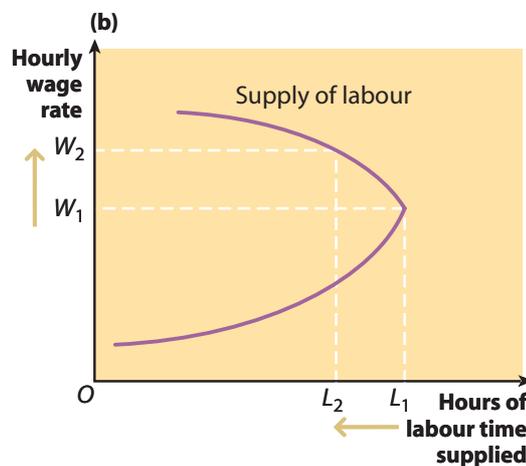
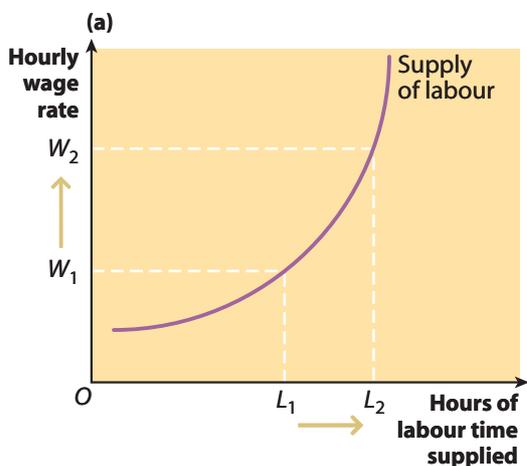
Inflation (2005-2015)

Percentage change over 12 months



Source: ONS

- 4 A budget deficit is a *flow*, whereas a national debt is a *stock*. The deficit, being the difference between the larger flows of government spending and revenue (mostly tax revenue), has to be financed by a flow of borrowing. The flow of government or public sector borrowing adds to the stock of national debt.
- 5 This statement is part of a supply-side view of how the economy works. To evaluate the view, consider the two following graphs which show the supply of labour at the microeconomic level.



The two panels of the diagram have been taken from Figure 9.14 in Chapter 9. The chapter argues that since a cut in the rate at which income tax rates are levied is equivalent to an increase in the wage rate, the upward-sloping supply curve implies that workers respond to cuts in the marginal rate of income tax by working harder. (The marginal rate of income tax is the percentage of the last pound of income paid in tax.) If this is the case, a reduction in income tax rates creates the incentive for workers to supply more labour (and for entrepreneurs to become more enterprising), while an increase in income tax rates has a disincentive effect on effort and the supply of labour.

The chapter goes on to argue that the supply curve of labour need not necessarily slope upwards throughout its length. If the labour supply curve slopes backward, as in the right-hand panel of the diagram, above the hourly wage rate W_1 , any further wage rate increase (or income tax decrease) causes workers to supply *less* rather than *more* labour. In this situation, workers prefer to enjoy extra leisure time rather than to work. Following an increase in the hourly wage rate from W_1 to W_2 , the hours of labour time supplied fall from L_1 to L_2 .

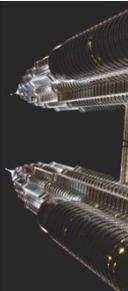
It is important to note that, if supply curves of labour bend backward, the supply-side argument, that tax reductions increase national output and efficiency through their effect on labour market incentives, becomes much weaker. Far from encouraging people to work harder, a wage rise or income tax cut might have the opposite effect, causing people to work fewer hours and to enjoy more leisure time instead.

- 6 Chapter 9 explains how, in demand-side fiscal policy, income tax cuts stimulate aggregate demand through shifting the *AD* curve to the right. In supply-side fiscal policy, by contrast, income tax cuts increase aggregate supply via their effects on economic incentives. Supply-side fiscal policy aims to increase the economy's ability to produce and supply goods, through creating incentives to work, save, invest and to be entrepreneurial. Along with other supply-side policies, supply-side fiscal policy is used to try and shift the economy's long-run aggregate supply curve (*LRAS*) curve to the right, thereby increasing the economy's potential level of output.

Arguably, supply-side fiscal policy is the most important type of supply-side policy. However, there are many other supply-side policies, some interventionist, but mostly anti-interventionist, aimed at freeing up markets, promoting competition and greater efficiency, and reducing the economic role of the state. Taken together, these supply-side policies include industrial policy measures such as privatisation, labour market measures such as reducing the power of trade unions, and financial market measures focusing on market deregulation.

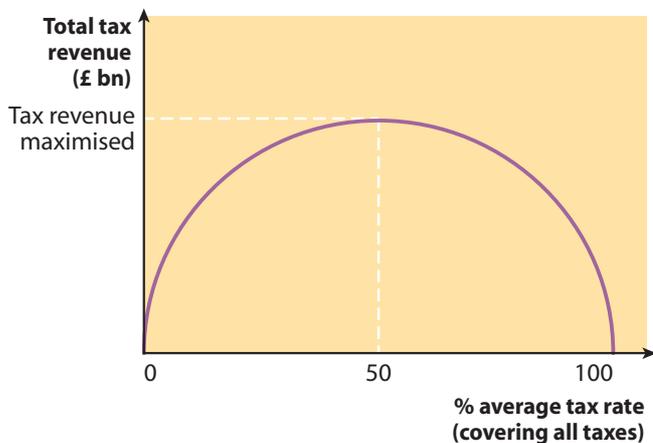
- 7 This question requires that answers include value judgements, and these will vary from person to person. It is also important for the answer to consider the meaning of 'UK macroeconomic performance'. This can be considered by drawing on the five standard main objectives of macroeconomic policy: economic growth, low unemployment, control of inflation, fairness in the distributions of income and wealth, and a balance of payments position which reflects the international competitiveness of the country's exporting industries. Is the rate of economic growth satisfactory and sustainable? Likewise, have low unemployment and a satisfactorily low rate of inflation been achieved? Are the distributions of income and wealth judged to be fair? And finally, how competitive in world markets are the country's exporting industries?

Few economists would disagree with the view that supply-side improvements are needed if UK macroeconomic performance is to improve. However, supply-side improvement is not the only requirement. Supply-side improvement, resulting from both supply-side reform in the private sector and wisely chosen government supply-side policies, requires that aggregate demand must also grow to enable the economy to absorb the extra output that the supply side



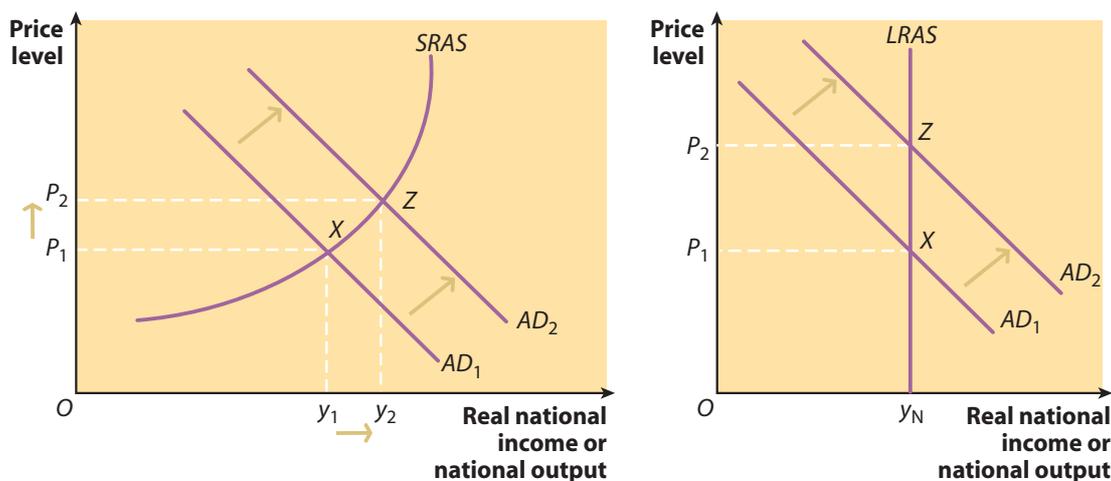
becomes capable of producing. Appropriate demand-side policies, for example interest rate policies, are needed as well as appropriate supply-side policies.

- 8 This question can be answered with the aid of the Laffer curve, though not all economists agree that the relationship between tax rates and tax revenue shown by the Laffer curve is correct. The diagram drawn below, which is the same as Figure 9.13 in Chapter 9, shows a Laffer curve.



The message of the diagram is that if the average tax rate is initially above 50%, a tax cut back toward the rate of 50% can indeed increase the government's total tax revenue. However, if the initial tax rate is at or below 50%, a cut in the rate of tax would also cut total government tax revenue. If we accept that the Laffer curve relationship is correct, much of the economic debate that follows centres on the issue of exactly what is the rate of tax at the 'peak' of the Laffer curve. Is the Laffer curve 'skewed' to the left, in which case the supply-side argument in favour of tax cuts is strongest, or is it 'skewed' to the right, in which case there may be considerable scope for increasing tax rates without adverse effects on tax revenue?

- 9 The answer to this question depends on the slope of the *SRAS* curve, and also on whether the economy is on the vertical *LRAS* curve, producing the 'normal capacity' level of output. The possibilities are shown in the following pair of *AD/AS* diagrams.



The left-hand diagram shows an *AD* curve 'sliding' up an *SRAS* curve which becomes increasingly steep as the *AD* curve moves up the *SRAS* curve. The extent to which the price level or real national income increases as a result of the shift of the *AD* curve from *AD*₁ to

AD_2 depends on the slope of the $SRAS$ curve between point X and point Z . As the $SRAS$ curve becomes steeper, moving from point to point up the curve, the increase in real output gives way to an increase in the price level.

The right-hand diagram shows that if the economy is initially producing the ‘normal capacity’ level of output, y_N , located on the vertical $LRAS$ curve, an increase in aggregate demand, and the movement from point X to point Z , results only in the price level rising — though there could also be a temporary increase in real national income.

