

Chapter 13: Fiscal policy and supply-side policies

Application of economics in the real world

Application of economics in the real world 13.1: Budget day

- 1 Parliament's website www.parliament.uk states that the budget, or financial statement, is a statement made to the House of Commons by the chancellor of the exchequer on the nation's finances and the government's proposals for changes to taxation. The budget also includes forecasts for the economy by the Office for Budget Responsibility (OBR).
- 2 The *Cambridge English Dictionary* defines a stealth tax as a new tax that is collected in a way that is not very obvious, so people may not realise that they are paying it. Most taxes are unpopular, though people accept them because they value the public services that the taxes pay for. However, some are more unpopular than others. It is these stealth taxes that governments try to hide when announcing their introduction. One way is to delay announcing the tax until a day when a national emergency or royal birth occurs, in which case the news is dominated by the latter event. The most famous case of this happening was the announcement of a tax increase on '9/11', the day of the 'Twin Towers' terrorist attack in New York. A second way is to announce the tax several months before it is first levied, hoping that people will have forgotten about the tax by the time they start paying it.
- 3 The details of the most recent budgets can be found on the government portal: www.gov.uk.
- 4 Fiscal policy is the part of a government's overall economic policy that aims to achieve the government's economic objectives through the use of the fiscal instruments of taxation, public spending and the government's budgetary position.

Application of economics in the real world 13.2: The OBR as a fiscal watchdog

- 1 Deficit bias is the tendency for governments which need to get re-elected to finance increases in government spending by borrowing, and thus by increasing the budget deficit, rather than by increasing taxes.

Pro-cyclicality refers to the tendency of financial variables to fluctuate around a trend during the economic cycle. Any quantity that tends to increase during an expansion and tends to decrease during a recession is classified as pro-cyclical. Gross domestic product (GDP) is an example of a pro-cyclical economic indicator.
- 2 Many economists, usually of a free-market persuasion, believe that elected governments are prone to deficit bias, which eventually harms economic performance. This logic was behind the setting up of agencies independent of the government, the Monetary Policy Committee to implement monetary policy and the Office for Budgetary Responsibility to advise the government on fiscal policy.
- 3 The *Collins English Dictionary* defines a watchdog as 'person or group of persons that acts as a protector or guardian against inefficiency, illegal practices etc.' and a lapdog as 'a person who attaches himself or herself to someone in admiration or infatuation'. A fiscal watchdog watches over fiscal policy whereas a fiscal lapdog would simply attempt to justify decisions that government has already made.
- 4 There is general agreement that by constraining central government, the OBR has improved the operations of fiscal policy in the UK. Professor Kevin Page, the former head of Canada's similar Parliamentary Budget Office, who undertook a review of how the Office for Budgetary Responsibility has implemented its remit, said the OBR 'has succeeded in imbuing its work

with a perception of independence and transparency'. He added that it had easily met its mandate. Professor Page said: 'The OBR is performing right at the top level compared with similar bodies in other countries.' Indeed, fiscal watchdogs in some other countries have performed less well. The OBR has, however, admitted to a poor forecasting record. Its early predictions about the recovery, for example, were too optimistic.

Application of economics in the real world 13.3: Have UK politicians been influenced by supply-side theory?

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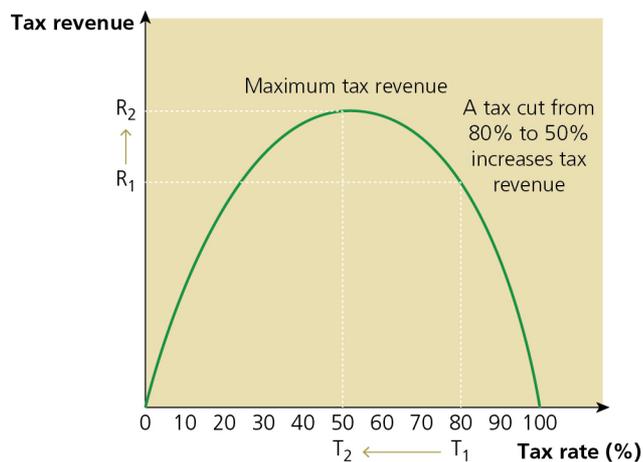


Figure AERW13.1 A Laffer curve

In Figure AERW13.1 we have drawn a Laffer curve which is similar to Figure 13.12 in Chapter 13, but with a few extra details added.

A Laffer curve shows how the government's total tax revenue changes as the average tax rate increases from 0% to 100%. Tax revenue must be zero when the average tax rate is 0%, but the diagram also shows that total tax revenue is assumed to be zero when the tax rate is 100%. With the average tax rate set at 100%, all income must be paid as tax to the government. In this situation, there is no incentive to produce output other than for subsistence, so with no output produced, the government ends up collecting no tax revenue. Between the limiting tax rates of 0% and 100%, the Laffer curve shows tax revenue first rising and then falling as the average rate of taxation increases. Tax revenue is maximised at the highest point on the Laffer curve, which in the figure occurs at an average tax rate of 50%.

The diagram shows that a cut in the tax rate from, say, 80% to 50% leads to a movement 'back up' the Laffer curve, causing the government's tax revenue to rise from R_1 to R_2 .

- 2 'Extreme' supply-side economists follow the message of the Laffer curve, believing that cuts in income tax rates lead to a growth in the government's tax revenue. By contrast, 'moderate' supply-side economists believe that, at best, this effect is quite limited, and is overridden by the fact that, through widening post-tax income differentials, cuts in the rate of income tax mainly reward the rich at the expense of the poor.
- 3 Large cuts in public spending generally reduce the provision of publicly provided social services on which the poor rely. The rich are more able than the poor to switch to privately provided schools, healthcare and retirement homes. The poor become locked into failing, underfunded and underprovided public sector social services which are not fit for purpose.
- 4 The national debt is the total stock of central government debt — the accumulated stock of central government borrowing which has built up over the years and which the government has not yet paid back.

In recent decades, UK governments have usually run budget deficits. In this situation, the *flow* of public-sector borrowing which finances the budget deficit builds up a *stock* of accumulated national debt.

In recent years — and related to the aim of trying to reduce the levels of both public spending and public-sector borrowing as proportions of national output — national debt reduction has become an important part of supply-side fiscal policy. Free-market supply-side economists are in favour of low levels of government spending and low levels of taxation, and are also, usually, in favour of the government running a balanced budget.

However, the growth of the national debt is only really a constraint on fiscal policy if it has become very large and if it is a growing proportion of GDP. If *nominal* GDP is growing faster than the *nominal* national debt, the *real* national debt (*nominal* debt as a proportion of *nominal* GDP) is actually falling. In this situation, national debt growth should not really constrain fiscal policy, unless of course the government is ideologically committed to balancing the budget and/or lowering the real national debt.

End-of-chapter questions

- 1 The budget deficit is an example of an economic flow. This means that even when the deficit is falling, provided it is still positive (that is, not a budget surplus), the *flow* of new borrowing that finances the budget deficit adds to the *stock* of the national debt.

The national debt is the total stock of central government debt — the accumulated stock of central government borrowing which has built up over the years and which the government has not yet paid back.

- 2 Supply-side fiscal policy is used to increase the economy's ability to produce and supply goods, through creating incentives to work, save, invest and be entrepreneurial. Interventionist supply-side fiscal policies, such as the financing of retraining schemes for unemployed workers, are also designed to improve supply-side performance.

Supply-side fiscal policy is arguably the most important type of supply-side policy, but there are also non-fiscal supply-side policies such as the removal of unnecessary regulations.

- 3 Macroeconomic performance can be assessed by judging how well the economy is doing in terms of achieving:
 - sustained economic growth at an acceptable rate of growth
 - full employment
 - control of inflation
 - a satisfactory balance on the current account of the balance of payments

Between 2011 and 2019 the UK economy achieved sustained economic growth — though at a lower rate than in the previous decade — which matched growth rates in other major European economies. Unemployment peaked around 2011 and fell for most of the following 8 years, reaching very low levels by recent historic standards. Inflation rose initially but then was more or less on target until 2022.

The various shocks caused by Brexit, the pandemic and the war in Ukraine have significantly affected UK economic performance. Since 2020, economic growth has fluctuated due initially to the pandemic and then, later, due to the shocks caused by eventual departure from the EU and a rise in energy and food prices. Inflation rose significantly, reaching over 10% in 2022 and 2023 — for the first time in around 40 years. Unemployment has remained low despite these shocks (it did rise to around 5% but has fallen back — which may be seen as surprising given the low economic growth and possible recession in 2023).

The balance of payments position has been unsatisfactory, but this has seldom been seen as an important problem.

The issue is the extent to which recent UK macroeconomic performance results from supply-side policies. Some commentators argue that the economy would have performed much better if ‘austerity’ policies had not been implemented. The economy had begun to recover from recession in 2010 largely because of a demand-side stimulus which was nipped in the bud by public spending cuts. These policies were implemented by politicians such as George Osborne, but was ‘austerity’ really a supply-side objective?

- 4 The cyclical budget deficit is the part of the budget deficit which rises in the downswing of the economic cycle and falls in the upswing of the cycle.

The structural budget deficit is the part of the budget deficit which is not affected by the economic cycle but results from structural change in the economy affecting the government’s finances, and also from long-term government policy decisions.

- 5 Automatic stabilisers are fiscal policy instruments such as progressive taxes and income-related welfare benefits that automatically stimulate aggregate demand in an economic downswing and depress aggregate demand in an upswing, thereby ‘smoothing’ the economic cycle.
- 6 The election of the Conservative/Lib Dem coalition government in 2010 led to public spending cuts, and to a lesser extent tax increases, aimed at reducing the size of the budget deficit. These changes were part of the ‘austerity’ programme, aimed at reducing the size of the state as well as the size of the budget deficit, introduced by the then chancellor, George Osborne.

Osborne was successful in achieving both these aims, but arguably at a cost. The economy grew more slowly than it would have done without these policies and the public spending cuts led to a significant increase in poverty and in inequality in the distributions of income and wealth.

In autumn 2022, the new chancellor unveiled measures to reduce the budget deficit. Jeremy Hunt became chancellor in autumn 2022 in part to ‘clean up’ the effects of the poorly received mini-budget of September 2022 by his predecessor, Kwasi Kwarteng. This involved the cancellation of previously announced tax cuts and the introduction of extra tax rises with adjustments to government spending totals. These measures were announced by Chancellor Hunt to try to reduce the budget deficit but also to restore confidence to financial markets (which had reacted badly to the earlier mini-budget).

- 7 There is a good case for disagreeing with this statement. Assuming they are successful, supply-side policies shift the *LRAS* curve to the right. However, to avoid a damaging deflation brought about by a lack of demand in the economy, aggregate demand needs to be stimulated to ‘absorb’ the extra output that the successful supply-side policies are producing. It is true that economic policy can shift the thrust of policy so that supply-side policies are *dominant* (although they need to be backed up by demand-side policies), but the extreme supply-side argument that such policies on their own can achieve a stable, sustainable and satisfactory rate of economic growth can be disputed.

Test yourself answers

TEST YOURSELF 13.1

‘Demand-side’ fiscal policy, which is generally favoured by Keynesian economists, uses changes in tax rates and levels of government spending to manage the level of aggregate demand in the economy. ‘Supply-side’ fiscal policy, which is favoured by anti-Keynesian or pro-free-market economists, is used to increase the economy’s ability to produce and supply goods, through creating incentives to work, save, invest and be entrepreneurial.

TEST YOURSELF 13.2

Figure 13.1 and pages 467–68 of the textbook illustrates how a government can use fiscal policy to stimulate an economy in a recession.

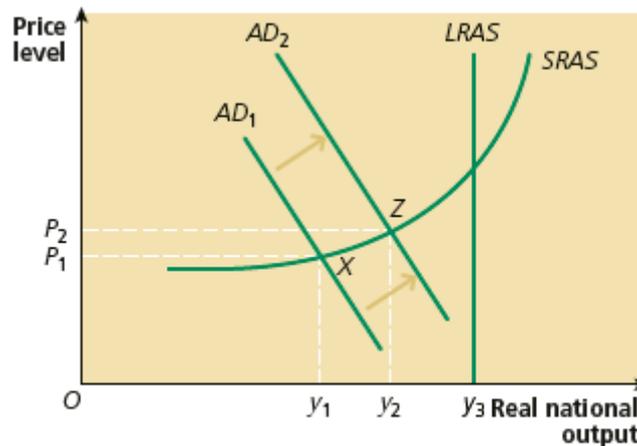
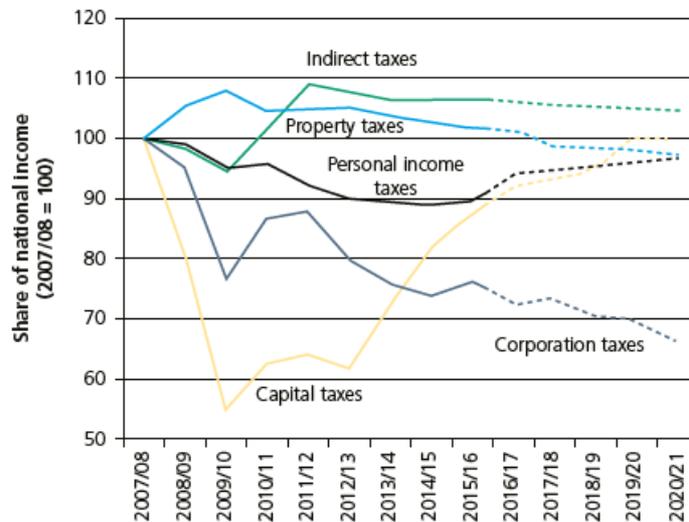


Figure 13.1 Keynesian or demand-side fiscal policy

Initially, with the aggregate demand curve in position AD_1 , equilibrium national income occurs at point X . Real income or output is y_1 , and the price level is P_1 . To eliminate demand-deficient (cyclical or Keynesian) unemployment, the government increases the budget deficit by raising the level of government spending and/or by cutting taxes. The expansionary fiscal policy shifts the AD curve to the right, from AD_1 to AD_2 , and the economy moves to a new equilibrium national income at point Z .

TEST YOURSELF 13.3



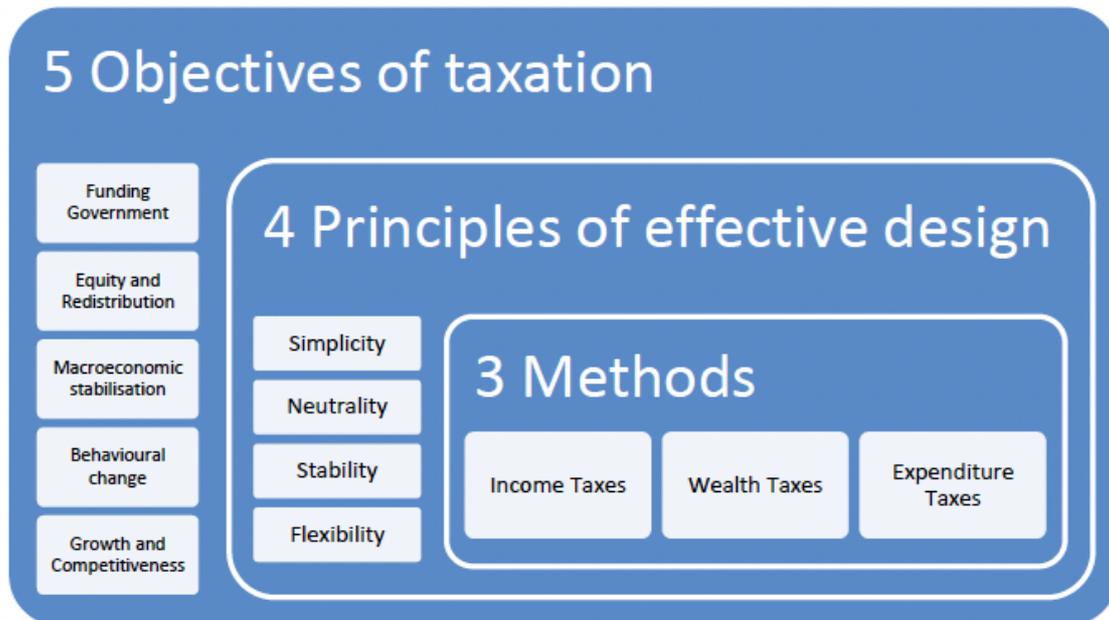
Source: Institute for Fiscal Studies

Figure 13.7 Composition of UK government tax receipts, 2007/08 to 2020/21 (forecast)

Figure 13.7 shows data for five different types of tax in the UK from 2007/08 to 2020/21. The data are presented in index numbers, with a different index for each of the five types of tax. The base year for all five of the indices is 2007/08, with the 2007/08 index number being 100 for each of the five types of tax. While it is possible to read from the graph whether the share of a particular type of tax, like personal income taxes, has risen or fallen since 2007/08, as well as to calculate the percentage change, it is impossible to say by how much, and whether indirect taxes are more important than income taxes.

TEST YOURSELF 13.4

In 2013, the Scottish government published a document titled ‘Principles for a modern and efficient tax system in an independent Scotland’. The following chart is taken from the document:



Five of the Scottish government’s objectives of taxation are listed in the left-hand column. Four of the government’s principles or canons of taxation are then listed in the next column.

A principle of taxation is a criterion used for judging whether a tax is good or bad. Back in the eighteenth century, Adam Smith suggested that taxation should be equitable, economical, convenient and certain, and to these we might add the principles of efficiency and flexibility. A ‘good’ tax meets as many of these principles as possible, although because of conflicts and trade-offs, it is usually impossible for a tax to meet them all.

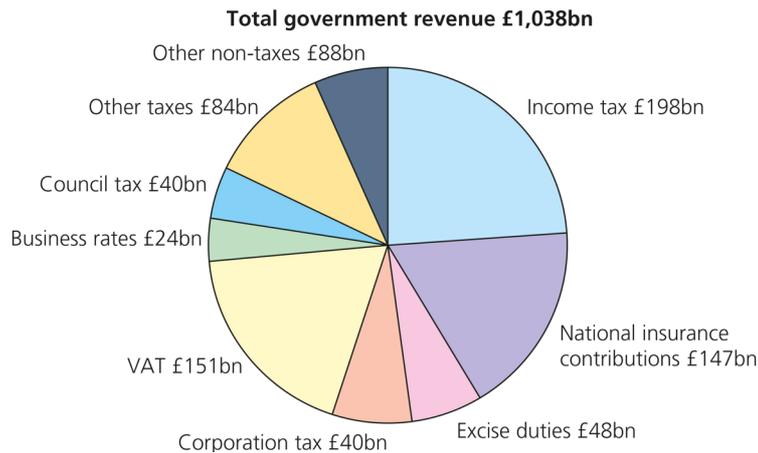
TEST YOURSELF 13.5

Chloé’s average or mean score for her first five tests is 90.6. This means that the minimum score Chloé needs on her sixth test to reach her target of achieving a mean score of 90 is 89.

TEST YOURSELF 13.6

Income tax is a progressive tax, while indirect taxes are regressive. This means that a cut in income tax rates accompanied by an increase in indirect taxes will make the tax system more regressive. The tax system will be more unequal and less equitable or fair.

TEST YOURSELF 13.7



The percentage share of income tax is: $\frac{£198\text{bn}}{£1,038\text{bn}} \times 100 = 19.1\%$

The percentage share of corporation tax is: $\frac{£40\text{bn}}{£1,038\text{bn}} \times 100 = 3.9\%$

TEST YOURSELF 13.8

The answer to this question depends largely on the size of the budget deficit and the amount of borrowing undertaken to finance the deficit. If both the deficit and the accompanying increase in government borrowing are small, then there should be no cause for concern. In these circumstances, Keynesian economists would probably argue that both are a part of demand management policies used in a counter-cyclical way to stabilise the economic cycle. If interest rates are very low, as has been the case in recent years, financial markets are only too willing to lend to the government at a very low cost to the taxpayer. However, if public spending has got out of control, this will not be the case. Rapidly growing debt could well lead to a situation in which financial markets refuse to finance the budget deficit except at very high interest rates, which the country cannot really afford. The government may be forced into massive cuts in public spending which will be severely deflationary. This would be a cause for concern.

TEST YOURSELF 13.9

If strong economic growth is consumer-led growth caused by strong consumer spending, this will lead to higher consumer incomes, with buoyant tax revenues from both consumer incomes and consumer taxes. The government's fiscal position should improve. However, if the strong economic growth results from a larger government budget deficit, this could lead to a deteriorating fiscal position, at least in the short run.

TEST YOURSELF 13.10

We can again use Figure 13.1 on page 468 of the textbook to illustrate a Keynesian view of the effect of an increase in aggregate demand. Initially, with the aggregate demand curve in position AD_1 , equilibrium national income occurs at point X . Real income or output is y_1 , and the price level is P_1 . To eliminate demand-deficient unemployment, the government increases the budget deficit by raising the level of government spending and/or by cutting taxes. This expansionary fiscal policy shifts the AD curve right, from AD_1 to AD_2 , and the economy moves to a new equilibrium national income at point Z .

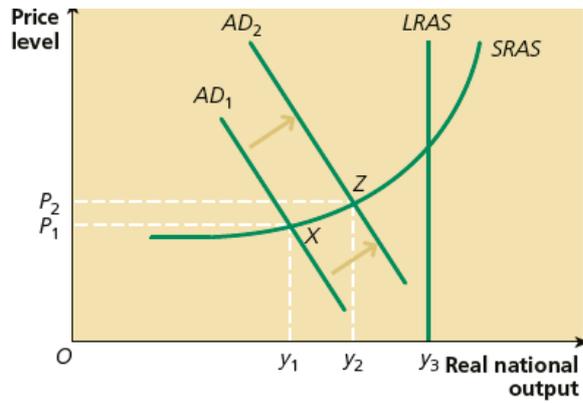


Figure 13.1 Keynesian or demand-side fiscal policy

Figure 13.3 on page 470 of the textbook illustrates the possible effects of supply-side fiscal policy resulting from an increase in aggregate demand.

Along with other supply-side policies, supply-side fiscal policy is used to try and shift the economy's *LRAS* curve to the right, thereby increasing the economy's potential level of output. The economy's *LRAS* curve shifts rightward from *LRAS*₁ to *LRAS*₂, which means that the 'normal capacity' level of output has increased (due to long-run economic growth) from *y*_{N1} to *y*_{N2}. The improvements in the supply-side performance of the economy are accompanied by rising aggregate demand, which means that the effect is to moderate inflation.

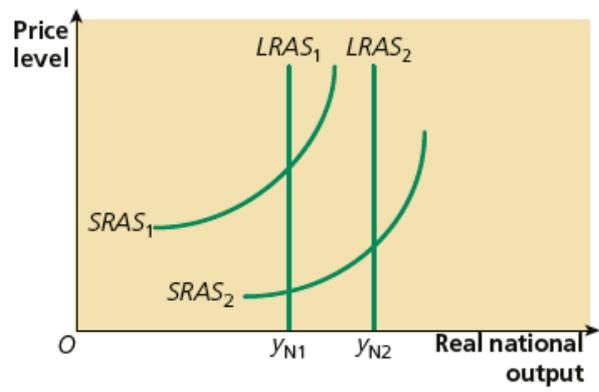


Figure 13.3 Supply-side fiscal policy shifting the *LRAS* curve to the right

TEST YOURSELF 13.11

First, the tax revenue the government raises from the budget deficit may be used to invest in infrastructure projects, such as roads and port facilities, which directly increase productive capacity. External economies are obtained which lower the costs of private-sector firms.

Second, the budget deficit triggers a positive multiplier effect that increases business confidence, which makes private-sector businesses more willing to invest in new productive capacity.

TEST YOURSELF 13.12

A negative output gap occurs when the economy is in recession. This would require an expansionary fiscal policy in order to increase aggregate demand. Therefore, statement A is clearly wrong, as a contractionary fiscal policy would make matters worse. Statement B would be correct if the short-run rate of economic growth were too high, but not the long-run rate of growth. Contractionary fiscal policy relates to stabilising the economic cycle by reducing excess demand. A low level of structural unemployment is irrelevant to this, so statement C fails to provide the correct answer. Statement D is the correct answer as inflationary pressures require a dampening of aggregate demand, and a contractionary fiscal policy will do this.

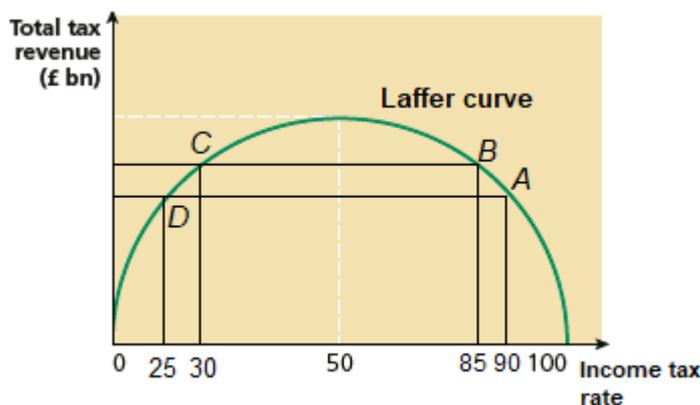
TEST YOURSELF 13.13

The cyclical budget deficit is the part of the budget deficit which rises in the downswing of the economic cycle and falls in the upswing of the cycle. By contrast, the structural budget deficit is the part of the budget deficit which is not affected by the economic cycle but results from structural change in the economy affecting the government's finances — for example, an ageing population increasing government spending on healthcare and reducing taxes paid by the old.

TEST YOURSELF 13.14

The key word in this question is 'inevitably'. The question assumes that the Laffer curve accurately depicts the relationship between income tax rates and tax revenue. It also assumes that the economy is initially at a particular point on the Laffer curve.

The diagram below is adapted from Figure 13.12 on page 499 of the textbook. Suppose the economy is initially at point *A* on the downward-sloping section of the Laffer curve. The income tax rate is 90%, which means that 90% of income is taxed. If the tax rate is cut from 90% to 85%, the economy moves to point *B* on the graph and total tax revenue increases. However, if the economy were initially at point *C* on the graph, with the income tax rate at 30%, a cut in the tax rate to 25% would reduce total tax revenue, with the economy moving to point *D*. Therefore, a cut in income tax rates does not inevitably lead to an increase in total tax revenue. It all depends on where the economy initially is on the Laffer curve.



TEST YOURSELF 13.15

By creating incentives for businesses and workers, successful supply-side policies increase the potential output of the economy and the underlying rate of economic growth improves. By liberating markets, such policies produce conditions in which domestically produced goods are both price competitive and quality competitive in overseas markets. Successful supply-side policies also attract inward investment from foreign-based multinational companies, such as Toyota and Goldman Sachs, which produce goods and services that are exported.