UNE202C2

MACROECONOMICS

ASSIGNMENT 2

BY

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'The decision to cut income tax in the 1987 budget had no effect other than to destabilise the economy'. Discuss.

The problem presented to us with the title above is a simple one. After the Chancellor of the Exchequer cut income tax in 1987, what state was the economy in? This problem can be addressed by doing a number of things. Firstly, by looking at and assessing a number of variables such as inflation, unemployment, economic growth and the U.K governments deficit at the time in question. The government's economic policies, their objectives and if those objectives were achieved are also key issues that should be considered when trying to evaluate the economy.

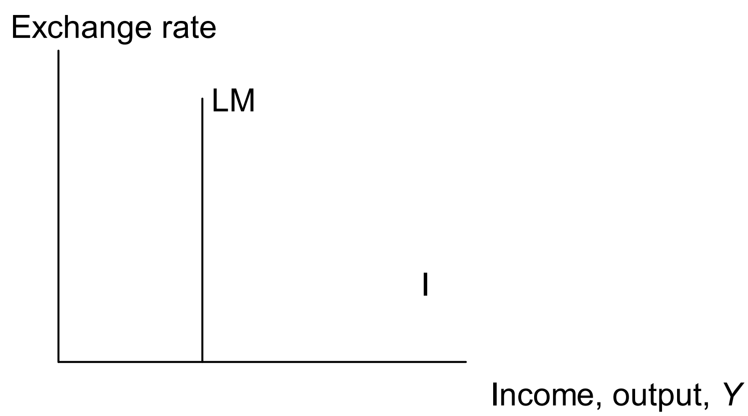
To asses how destabilising cutting income tax was, I will compare the economy from the previous year (1986) to what happened in 1987. I will discuss macroeconomic as well as microeconomic objectives that the government may have been looking to achieve. I will be looking to find out if the policies of the government were effective or if they backfired.

So what can be considered as a destabilising economy? In my opinion, a destabilising economy is characterised by high inflation, high unemployment, low aggregate demand and supply. Hopefully, I will be able to show that none of these were completely achieved after the 1987 budget.

So why cut income tax? Firstly, lower income tax allows individuals to keep a greater proportion of their income. This means that individuals will work harder knowing that any extra income they earn will not be going to the taxman. From a business perspective, businesses will be able to flourish as a result of reductions in higher rates of tax. This is because those who want to set up a business will not worry about the fact that the more successful they become, the more money they would have to give to the taxman. A reduction in income tax also means it is likely for individuals to evade or avoid taxation, which is illegal.
If a government reduces incomes tax, it helps avoid or at least lessen the chances of confrontation with workers union representatives looking to get higher wages for the people they represent.

The poverty trap can also be alleviated by the reduction. The poverty trap exists for those individuals on relatively low incomes whose income is made up from the work they do as well as benefits received through the social services. As their earnings increase from work, they receive less benefit as the amount received is related to your income. If an individual is losing benefit and then having to pay tax on their income, they would rather stay unemployed and receive benefits. But with a low rate of income tax, more people would seek active employment rather than depend on benefits. This situation is closely linked to what is known as the unemployment trap, which is a situation where individual's income drop after taking up a job and paying income tax so they do not see an incentive to work.

The British economy is considered a small open economy, with a floating exchange rate. The aim of the tax cut was to give the public a higher level of disposable income; so aggregate demand would have increased in the economy. According to fiscal policy though, when this happens, there is an increase in planned expenditure and the exchange rate appreciates. This however proves to be an impossible position to be in as the foreign exchange market and not the domestic government determine the exchange rate for such an economy and so the rate cannot be above world rates. In a closed economy, when there is an increase in income, there is a higher demand for money, which then increases interest rates, and so there is an inflow of capital into the economy, which helps to maintain an economy's balance of payments. So fiscal policy should ideally be ineffective in an economy like that of the U.K. The graph on page 4 illustrates this.



(Source: Mankiw 2002, page 318)

The graph shows a fiscal expansion under a floating exchange rate. A cut in taxes will shift the IS curve to the right. This shift raises the exchange rate but has no effect on income.*

So what was so destabilising about the new income tax rate? The chancellor, Nigel Lawson cut income tax from 29 percent to 27 percent. The level of unemployment was relatively high at just over 3 million but still lower than the level of the previous year, real incomes were steadily rising and the level of inflation was 4.1 percent. I think that as a result of this cut, money supply was in effect increased and there was a downward pressure on the interest rates in the United Kingdom. Interest rates in a small open economy like that of the U.K are set by world interest rates so if there is downward pressure on the domestic interest rate, there would be a huge outflow of capital as investors look to invest their money somewhere else to get a better return. This would be a shock to the domestic economy as it means that domestic prices would increase to make up for the loss of capital and hence driving up the rate of inflation.

The money supply has increased as a result of reducing income tax; the previous year income tax was also reduced so people build this into their rational expectations about future earnings. The possible consequence to this is that the level of tax will continue to go down and so people would expect to be having a higher income in the future. This could result in what is known as the leisure-income trade-off, where people would substitute working hard now and less in the future knowing that the level of their income will not be affected and if anything could possibly increase.

Expectations play a key part in the economy in sense people expectations about the future of the economy will determine their present economic activity. And sometimes mistakes are made, not only by consumers but also by economic experts. The reduction in income tax ultimately led the economy to a position where enterprise was booming and there were many new small businesses starting. Interest rates were between 8 and 10 per cent and this was attracting foreign investment into Britain. Nigel Lawson, saw this boom occurring at great speed but was not fazed and so kept interest rates at a rate of 10 per cent, the economy was doing well.

Although people always have their expectations about the economy, they seem to leave very little room for shocks, as was the case towards the end of 1987. In October 1987, when all seem to be going well and the British government was in the process of increasing the level of privatisation by selling a third of its share in the oil company British Petroleum. At the time of this sale was when an event referred to as ‘Black Monday’ occurred. Trading on the stock market was suspended one weekend as a result of a hurricane that brought about great destruction and prevented traders from getting to work. The Monday after brought its own shock to the economy as world stock markets went into free fall and a total of about £50 billion was wiped off the value of London shares and prices dropped by about £40 billion. At this point, interest rates would have been reduced and the result of this was that there would be a significant slowdown in consumer spending, while business investment would have reduced considerably due to the difficulties of raising finances on the stock market.

When the chancellor of the exchequer cut income taxes, the objective was to put more money in the pockets of workers who would then go out and spend this money, putting back into the economy. However, the events that followed were unexpected. The economy was in a good position; the rate of inflation was not too high at 4.2 per cent although the previous year it was only 3.4 per cent. The level of unemployment was also low. Businesses in the country were booming with corporate revenues being at high levels. The government as well as individuals were satisfied with the position they found themselves but then came the shock. With shocks, the effects are not always noticed straight away and sometimes take months. These shocks did not affect unemployment but did eventually affect the rate of inflation. All of a sudden, people had to change their spending habits and this is where the issue of the leisure-income trade-off becomes important. When people make expectations, they always assume that the best will happen and not the worse but as the market crash proves, we never know what may happen.

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Lecture notes.

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