Victoria McAlister

Economics – fiscal policy questions- June 2002 2887

4)

a) Explain the factors that might affect the size of the UK government's budget deficit or surplus.

The government's annual budget sets out the planned income and expenditure of the government for forthcoming year, together with a statement of the revenue and expenditure for the past financial year. A government's budget deficit or surplus refers to either when its expenditures (the purchases of goods and services, plus its transfers (grants) to individuals and corporations) are greater than its tax revenues(; a deficit). Or when tax revenues exceed government purchases and transfer payments, the government has a budget surplus. there is also a neutral budget where government income and spending are the same and total demand in the economy remains constant. whether a budget is running a deficit or a surplus it is usually used deliberately as an instrument of economic policy, planned in order to bring about economic changes. This is known as fiscal policy.

For 2006-07 the UK government plans to raise total receipts of £518 billion through both direct and indirect tax, with the largest proportion of revenue coming from income tax (£146bn). Although it plans to have a total managed expenditure of £555 billion, with the highest section being spent on social protection (£153bn). So therefore the labour government through a greater amount of public spending than that of revenue raised by taxation is running a budget deficit. The expenditures are larger than the funds received by the government; this resulting deficit tends to stimulate the economy, as goods and services are produced for government purchase. In contrast, if a government runs a surplus by not spending all the funds it collects, economic growth will generally be curtailed, as the surplus funds are removed from circulation in the economy.

Government expenditure (G) is treated as being autonomously determined due to it being subject to political decision; it is therefore regarded as being independent of income. However taxation, unlike government spending, cannot be treated as autonomous since the revenue from taxation bears direct relationship to income, and tax revenue is a function of income. Therefore indirect taxes cause spending at market prices to increase the spending factor cost so that the whole of current spending does not go on to generate incomes; a leakage. Direct taxes are also leakages as they are a compulsory withdrawal of income from households and firms. These leakages are lessening the flow of money, and therefore affecting the equilibrium involved between taxation and spending and its affect on the governments budget.

One of the factors, which might affect the size of the UK government's budget deficit or surplus, is that of taxation. The government raises taxation for several reasons; to cover expenditure, to redistribute income, to reallocate resources, to change consumption patterns (on demerit goods such as cigarettes), and to control the economy. The changes in the rates of taxation therefore may be used as a means of influencing aggregate demand. Taxation can be altered in order to manipulate a budgets deficit or surplus, such as under the current Labour government taxation has been increased in various forms. E.g. Net taxes as % GDP from 33.3% to 37.7% in

2000-01, Higher real excise duties (fuel, cigarettes), and some newer taxes including airport passenger duty + windfall tax, Increase in national insurance contributions.

Cuts seen in income tax can lead to various other revenue raising activities for the government, by increased incentives to seek work, an expansion of active labour supply which would lead to increase in potential national output and possibly higher labour productivity. Whereas lower rates of corporation tax and other business taxes lead to higher profits can finance Research and Development and other investment projects, increase in rate of small business start-ups and greater inflow of foreign direct investment. All of which would through fiscal policy increase the size of the UK government's budget surplus, through an increase aggregate supply. Although the fall in taxes, causes increased disposable income for consumers, and higher post-tax profits for businesses; both of which usually lead to a higher level of aggregate demand for goods and services. However the danger of reducing the overall burden of taxation too much is that it might lead to excess demand and therefore lead to a build up of inflationary pressure. Such as under Thatcher's Conservative leadership, whereby after 1987, when she lowered the tax burden, excess demand was seen, which led to the high inflation in the turn of the decade.

Currently a higher proportion of state income comes from that of direct taxation. Direct taxes are those levied on income and wealth, and the burden of such taxes is borne by those of whom it is levied. However there has been a gradual shift away from direct towards indirect taxes in the UK over recent years. Also changes in direct taxation can have a negative affect upon investment, which could in turn overall lead to less economic activity and revenue for the government. Changes in indirect taxes; those taxes that are imposed on certain items that have high inelasticity, they can often appear regressive and so do not turn over as much revenue.

These changes in rates of taxation have multiplier effects, as they will cause changes in aggregate spending which are not related to changes in income. Therefore the government may alter the level of income by changing its own spending on goods and services; changing G in the equilibrium equation.

Through the use of fiscal policy as an automatic stabilizer for the economy, government spending on items such as unemployment benefits generally increases during a recession, whereas government receipts such as income taxes will fall during a recession, moderating the extremes of the business cycle.

Another factor that may affect the size of the UK government's budget is the equilibrium between government spending and tax revenue on the annual budget balance can be affected hugely by small percentage changes. Such as when the economy is strong, the budget position can improve very quickly. Equally, if there is an economic slowdown, there can be a rapid deterioration in the government's financial position.

Furthermore a governments budget surplus can rise is through sustained economic growth, such as whereby real GDP rose by over 20% between 1993 and 2000, and until 2000 levels of employment were rising, there is also strong consumer spending and fiscal drag effects lead to sharp rise in tax receipts. Also if a government under spends, as was the case of 1999-00, it can lead to a greater budget surplus.

The government can also borrow in the short term in the form of selling its debt to the public in the form of national savings certificates, having introduced the 'Golden Rule', whereby he as Chancellor of the Exquecher can only borrow for long term investment, rather than to cover short term spending. So the Public Sector Borrowing Requirement no longer covers budget deficits.

However Keynes and others view that a deficit Budget will create demand, but, where the economy is operating at less than full employment, this extra demand will call forth extra output rather than increase prices.

Also the government in power, in conjunction with the political demand of the electorate may influence public expenditure, such as if the electorate and media are calling for higher pensions, or unemployment pay, or family benefits, then it is likely to increase public expenditure, and therefore more likely to incur a deficit. Under a more socialist political party such as the Labour Party, then it is more likely that through nationalization, and other such socialist policies that public expenditure will increase. However under a more conservative government, such as the monetarist policies and the 'New Right' of Thatcher (and Reagan) there is more likely to be a budget surplus, as wealth creation is an economic objective priority, and as a result tax cuts ensued from 1987 onwards, eight years after she came to power.

It could also be simply that the deficit or surplus is in part of the trade cycle in, e.g. in a boom; so government revenues would be high and so social security Benefits lower and so a surplus would happen.
Furthermore government spending tends to increase over time, such as New Labour spent £555bn this year, (£9200 per every person in the UK), next year it plans to spend £585bn (2007-08).

A budget surplus can then be used for various things such as increases in government spending in key sectors, cuts in taxation, or repayment of government debt thereby reducing tax burdens for future generations and decreasing annual interest payments on the national debt.

Therefore in conclusion the factors which affect the UK government's budget deficit or surplus are often the deliberate manipulation by the government in order to regulate income and expenditure, which is broadly known as fiscal policy, often used in conjunction with monetary policy. Furthermore the factors, which affect the size of the budgets deficit or surplus, are also usually controlled by various mechanisms in which the government uses to do so. However there are several criticisms of these methods such as the time lag of implementing the measures, and them taking effect.

b) Discuss the impact of changes in UK fiscal policy on income distribution and on the performance of the economy as a whole.

Fiscal policy is manifested in government's policies of the deliberate manipulation of government income and expenditure with the aim of regulating economic activity. Also it determines the distribution of resources between the public sector and the private sector and influences the distribution of wealth, and affects people's incomes and consumption, investment and savings. This policy stems essentially from the work of John Maynard Keynes during the great depression.

Keynes also believes a government should use fiscal policy to stimulate an economy slowed by a recession by running a deficit, that is, by spending more than it takes from the economy in taxes. Conversely he also believes that in order to slow down an economy that is threatened by inflationary pressures, he urged increasing taxes or cutting spending to create a budget surplus that would act as a drag on the economy.

There have been two types of fiscal measures have been identified, that of automatic and discretionary. An automatic stabiliser acts independently of any direct political intervention, when playing its compensatory role in regulating some propensities in government spending and income. The use of forms of progressive taxing are used as an automatic stabilising influence, by slowing down the growth of aggregate demand when income is rising, and reducing the fall in aggregate demand when income is falling. Automatic stabilisers can also lead to an increase in GDP, which would benefit all socio economic groups in the UK. Furthermore as this measure of the policy is built into the economic system and thus responds automatically to changes in economic activity, such as in a recession government spending on items such as unemployment benefits generally increases, whereas government receipts such as income taxes will fall during a recession, which would moderate the extremes of the business cycle. This done and needs no legislation to implement the policies, as they are automatic. A discretionary fiscal policy is an economic manipulation intentionally carried out be the government, such as tax changes, or changes in government spending.

For the budget year of 2006-07 the tax on income was £146bn, although when the inclusion of such other taxes that are automatically deducted directly from income the total tax receipt on the UK was £258bn from a total tax receipt of £518bn. That makes up more than half of the tax burden resting directly on the individual. However of a total of £555bn of total managed expenditure, £153bn alone of that figure was spent on social protection. Consequently a greater amount is being spent on the redistribution of income as far as a higher percentage of the budget is being spent on 'benefits' to those who are of lower socio- economic groups (D and E), than is being spent else where in the public sector, such as defence; with only £32bn being spent on that section. Also income related taxation has the highest percentage of taxation. It can therefore be deduced as a priority of the current Labour government, who through the use of a progressive tax system, and raising of social security benefits compared proportionately to the previous Conservative government (who although introduced it did not fund it to the extent that New Labour have), have the intention of greater income redistribution, although not to the extent of such Labour leaderships as under Michael Foot, or Clement Atlee, who were both much more socialist in their approach to governing. But as with the 're-branding' of Labour to 'New' Labour, and the abolishing of the clause four, post Neil Kinnock and Tony Blair there has actually been a decrease in social mobility between classes, compared with that under the Thatcher government. However through the introduction of the minimum wage, and the pledge to end child poverty the current government has managed to increase expenditure on the members of the public who most need it. These fiscal policies of the introduction of the minimum wage, becoming legislation has improved living stands for the UK. Also the use of lower starting rates of income tax, through the progressive taxation system, provides a greater incentive for low-paid workers to enter the active labour market. Such as whereby the Labour Party introduced the working families tax credit as part of a strategy to boost the post-tax incomes of families in poorly paid jobs.

Taxation is sought and raised by the government for several reasons; to cover expenditure, to redistribute income, to reallocate resources, to change consumption patterns (on demerit goods such as cigarettes), and to control the economy. The changes in the rates of taxation therefore may be used as a means of influencing aggregate demand or supply. The use of taxation as a fiscal policy to control income distribution depends upon whether the tax is progressive whereby the percentage of income taken in tax rises as income rises. An example of this is income tax. Or regressive taxation that refers to the tax where the percentage of income taken in tax system falls as income rises. An example of this is business rates. A progressive tax is used to aid the redistribution of income in 'Robin Hood' style of taxing the rich and subsidizing the poor.

The economy as a whole, with the use of direct taxes may create disincentives to postpone consumption through saving, also for firms to invest in new capital inputs. Indirect taxes however generally do not encourage saving to the same level as a rise in direct taxes, however one of the ways to avoid high levels of excise duties is to reduce consumption, but as the products usually have relatively high inelasticity of demand, consumption is unlikely to be reduced.

There are however two effects from a tax change; the substitution and the income effect. The substitution effect occurs when income tax rates are cut the return to working extra hours rises. This means the opportunity cost of leisure time is higher than previously. And the income effect whereby when the tax rate is reduced, people can earn a particular amount post-tax income with fewer working hours than before the tax cut. If they regard leisure as a normal good, they may prefer to switch out of work and enjoy more leisure time whilst still earning the same income.

The use of increased indirect taxation has allowed the government to reduce the overall tax burden on income and capital. Both income tax and corporation tax rates in recent years have been allowed to proportionally continue to be lowered. Thus supply-side economists believe that indirect taxes are preferable to direct taxes because they create less of a disincentive to work since employees retain more of what they earn. The argument being that workers should respond to lower marginal tax rates, by expanding the hours they work and therefore raising their productivity. If correct, then the long-run output potential of the economy should rise through an expansion of aggregate supply would expand, generating a downward pressure on the general price level.

Although indirect tax increases will push up prices, decrease consumption and consequently reduce the effects of negative externalities such as damage to the environment. Such as is the case of the high rate of taxation on alcohol sold in the UK, as opposed to Europe, which has affected the UK drinks industry. Also a trade in importing alcohol has arisen.

Also a significant point against indirect taxes is that they tend to be regressive. As each individual pays the same rate on their purchases, 'at the point of delivery', the poor as a result pays a larger proportion of their incomes in indirect taxes. In comparison with direct taxes that tend to be progressive and are seen as more equitable – the proportion of income paid in taxes rises as income rises when a tax is progressive. An example of this in the UK is the high level of duty on tobacco products. Those in socio economic groups D and E tend to pay a much larger percentage of the disposable incomes on duty on tobacco.

Conversely, indirect taxes can be used explicitly to correct for market failure caused by environment damage. These externalities occur when the social costs of production or consumption exceed the private costs, implying that the price does not reflect the true costs of production and will result in over consumption of the good or service. The use of indirect taxation is one solution to the problem of externality: the producer or consumer is charged the full social cost and demand will respond accordingly. Environmental economists argue that the most effective way to protect the environment from carbon dioxide is to tax the polluter.

In conclusion changes in UK fiscal policy impact income distribution as far as providing economic mechanisms to change the effects and market mechanisms of a totally free market, through majoratively a progressive tax system and high expenditure on social protection to alter the natural circular flow of income, which assumes that prices and money wages do not move towards their equilibrium level. The Keynesian analysts predict that these changes in fiscal policy change national income through the multiplier process. In the absence of an 'inflationary' spiral trade-off will occur between unemployment and inflation, and it will be 'manageable' by the government. This sequence however can break down whereby if workers and unions can increase money wages in line with increases in prices, and if firms can increase prices in line with increases in money wages and other costs, the inflation rate increases more readily than it. Keynes also says that persistent unemployment is possible above its natural rate, because markets do not move towards equilibrium and that persistent unemployment will persist in the presence of an inflationary spiral even with reductions in the government deficit, with inflation decreasing very little. So there will always be market imperfections in the economy as a whole, because economic variables are hard to predict