Lesson Fourteen

Government Economic Policy Instruments (1)

Aims

The aims of this lesson are to enable you to:

- identify which policies are available to government to achieve the five macroeconomic objectives explored in recent lessons. We will look at policy instruments in two groups:
    - demand side
    - supply side

Context

In the last lesson we identified the five macroeconomic objectives of government. In this lesson we will look at the policy instruments available to government to implement these objectives.

The supporting reading for this lesson is as follows:

Rob Jones: *Edexcel International GCSE Economics,* Chapters 37-40 (continued in following lesson).

Oxford Open Learning

Macroeconomic Policies

In the previous lessons, we looked at the macroeconomic objectives of government – what the government would like to achieve in the economy. In this lesson, we will look at how government tries to achieve these objectives.

Broadly speaking, the government has two options: it can use demand side policy (which comprises fiscal policy and monetary policy); or it can use supply side policy. Demand side refers to the demand for goods and services in the economy, while supply side has to do with the production and supply to market of goods and services.

Demand side Policy

Demand side policy is aimed at achieving the government's macroeconomic objectives by altering the level of demand for goods and services in the economy.

Fiscal Policy

Fiscal policy concerns government revenue, expenditure and borrowing.

Revenue

Government revenue comes largely from taxation, both direct and indirect. Direct tax is tax that is applied to an individual or organisation, while an indirect tax is one that is levied on a good or service. Examples of direct taxes are income tax and corporation tax, while value added tax (VAT) and council tax are both indirect taxes.

A further distinction to be made is between proportional, progressive and regressive taxes. Progressive taxation means that the proportion of income paid in tax increases as income increases. In the UK (and many other countries) income tax is progressive: as income increases, the rate of tax increases from zero per cent of income up to around £6,000, to 20 per cent and then up to 40 per cent for income above £35,000. Proportional taxes are taxes where the same proportion of income is paid as income increases. Regressive taxation is a type of tax where the proportion of income paid as tax actually decreases as income increases. Council tax is one such tax, as people on low incomes pay a much higher proportion of their incomes as council tax than do high-earners.

Other sources of revenue or income for the government include national insurance, vehicle excise duty and interest payments.

Expenditure

Government spending takes many forms. Total public sector spending by government departments in the UK in 2016 was £591 billion. The table below gives a breakdown for that year of the five main components of government expenditure.

Department	Spending 2016	Main components of spending
Pensions	*£154.7bn*	State old age pensions, disability benefit, etc
Health care	*£135.3bn*	NHS, etc
Education	*£60.9bn*	Schools, universities, etc
Defence	*£44.8bn*	Army, Navy, Air Force; foreign aid, etc
Welfare	*£57.9bn*	Unemployment benefit, housing benefit, etc

Source: *http://www.ukpublicspending.co.uk*

If government spending is higher than its revenue, this is known as a budget deficit. A deficit can be dealt with by either increasing taxation or decreasing spending; if neither is possible or desirable, the government must borrow money.

Borrowing

The amount the government needs to borrow is called the public sector borrowing requirement or PSBR. If revenue is higher than taxation, there exists a budget surplus and the government can pay back debt. The amount it pays back is called the public sector debt repayment or PSDR.

When revenue and expenditure are equal, this is called a balanced budget. Whether the government decides to run a deficit, surplus or balanced budget depends upon what objective it is trying to achieve; the various ways government can use fiscal policy to achieve these aims is explored below.

Taxation and the Environment

Taxes are used by the government to raise revenue that can be spent in the areas shown in the table above, among others. Taxation can also be used to discourage certain activities and government can spend money on providing incentives for desirable activities. In Lesson 5 we saw that taxes could be used to deal with negative externalities. With regard to the environment, the government places taxes on the use of petrol and diesel, on emissions from factories and on putting waste into landfill. It also provides subsidies for householders installing cavity wall or loft insulation, businesses implementing greener practices and motorists using more fuel-efficient cars.

Activity 1

Have a look in the news for examples of "green taxes" announced by the government (or proposed by others). What can you find?

Monetary Policy

Monetary policy concerns the money supply – how much money there is in the economy. This includes not only notes and coins: also included are bank and building society deposits and credit created by banks. There is no one definition of the money supply and so it is difficult to measure precisely, but for our purposes it is enough to examine the effects of an increase or decrease in the money supply.

The government could affect the money supply through altering the amount of notes and coins in circulation but since this is a very small part of the money supply, it is much more effective for the government to use the interest rate to increase or decrease the money supply; indeed, this is exactly what it does. Interest is the money that lenders or savers receive as compensation or a 'fee' for lending money. It is also the 'price' that borrowers pay for borrowing money. For this reason, an increase in the interest rate will provide an incentive for individuals and firms to save more and borrow less. Conversely, a lower interest rate will encourage more borrowing and less saving. It is therefore a powerful tool for changing the money supply.

Supply Side Policy

Supply side policy is aimed at allowing markets to function more effectively by attempting to increase the quantity and productivity of factor inputs (land, labour, capital and enterprise) and reduce distortions and disincentives, particularly in the labour market. Distortions occur when something is preventing the market from producing an efficient outcome. When unemployment is high, for example, there is pressure for wages to fall to bring the labour market back into equilibrium (see Lesson Four). If there is something preventing wages from falling however (such as trade union power) unemployment may remain high while those in work are paid an above-market level wage.

Incentives are very important in economics since people and organisations make decisions based upon the rewards available for various courses of action. Disincentives discourage particular courses of action and this is of course good when the course of action is harmful (as discussed in relation to environmental damage above); but if disincentives mean that people choose not to do something beneficial for society then this is clearly undesirable. Incentives are discussed below in relation to the tax and benefit system.

Supply side policy can take several forms:

Education and Training

As we explored in earlier lessons, increasing the level of human capital in an economy has a large impact on productivity and the level of output. Education is extremely important and allows countries to progress from depending on agriculture to industries that generate higher levels of wealth. Training gives workers new skills and knowledge, which allow them to become more productive. Training also allows the labour market to become more flexible: if one industry is declining, training workers leaving that industry will allow them to find work in new industries.

As jobs in the automotive industry have been declining in the UK, the government has announced plans to provide training for workers to produce ‘green’ cars in the northeast of England, which has been designated as a low carbon economic area. As part of this, in 2009 Nissan said that it would produce lithium-ion batteries for electric cars in Sunderland. The government provided grants to set up the plant and provide training.

Incentives for Investment

Increasing the level of capital can have an even larger effect. An increase in the capital stock in the economy will lead to higher levels of output and productivity. Decreasing the interest rate, in addition to affecting the money supply, will lead to an increase in investment. The government may also offer tax reductions to encourage firms to invest in new capital and to encourage foreign firms to invest in the UK.

Case study

Taxes play an important role in the location and investment decisions of multinationals, according to new research.

Papers, published by the European Tax Policy Forum (ETPF), were presented at a joint conference of the ETPF and the Institute for Fiscal Studies on 24 April 2009.

One study, by Michael Devereux and Ben Lockwood of the University of Warwick, examines the impact of corporation tax on the investment behaviour of US multinationals. Based on data from a number of OECD countries, they found that taxation has a substantial impact. Specifically, they find that a ten percentage point fall in the effective average corporation tax rate in a host country (such as the UK) would increase inward investment by US multinationals by 60% in the short run. Ultimately this would increase the capital stock owned by US multinationals in the host country by 15%.

Adapted from: *Taxes play an important role in multinationals' location and investment decisions*, IFS Press Release, www.ool.co.uk/1406ei.

Reforming the Tax and Benefits System

To the extent that voluntary unemployment exists (see Lesson Eight), decreasing the level of benefits available to unemployed people and reducing the disincentive effects of income tax will lead to an increase in the labour supply. Someone moving from unemployment into work may find that, as benefits are withdrawn and tax and national insurance payments increase, disposable income (money left for spending as one chooses) is only slightly higher than before.

Activity 2

What difficulties does the government face when making decisions about altering the levels of income tax and benefits? Why is it not simply a case of reducing the levels of both taxes and benefits to encourage people to work?

Promoting Competition

Restricting market power (see Lesson Six) can often lead to greater efficiency, increased international competitiveness and lower prices.

During the 1920s and 1930s, it was widely accepted that there was a lack of competition in British industry, which could have operated against the interests of the consumer. In 1948, the government passed the Monopolies and Restrictive Practices Act, designed to curb anti-competitive practices. It established the Competition Commission (formerly known as the Monopolies and Mergers Commission). Current competition policy is set out in the Competition Act 1998.

A Director-General of Fair Trading is appointed by the government. The Director-General is responsible for co-ordinating competition and consumer protection policy and advising the Secretary of State for Trade and Industry. The Director-General can refer monopolies to the Competition Commission.

The Competition Commission investigates potential monopolies. A firm or group of firms acting together, is defined as having a 'dominant position', if it has a market share of 40%. It has a monopoly if it has a market share of at least 25%. The result of any enquiry is given in a report.

The Secretary of State for Trade and Industry is the minister responsible for competition policy. The Secretary of State will decide what action to take. Prior to 1998, this was by voluntary agreement. Since 1998, the Office of Fair Trading has had the power to fine firms up to 10% of their turnover for anti-competitive practices. The Competition Act was designed to make UK practice conform to EU law. The European Commission also has the power to investigate monopolies but is more concerned with mergers and restrictive trade practices.

Reducing Trade Union Power

As we saw in Lesson 4, trade unions can have the effect of restricting the supply of labour, or increasing its price (the wage rate) above the market level. As this often serves to restrict output and increase costs, legislation made to restrict the power of unions can have the opposite effect.

In the 1980s and 1990s, the Conservative government reduced the power of unions to use collective bargaining. During the 1960s and 1970s, unions had wielded considerable power – over half of all workers were union members at by the end of the seventies. This reduction in union power is held by many to be one of the factors contributing to the increase in the economic performance of the UK economy.

Privatisation

In Lesson Seven we looked at how privatisation can lead to an increase in efficiency and competitiveness. In privatising many parts of the economy, successive governments have aimed to bring these positive effects about and produce benefits for the whole of society. Much of the privatisation that has happened had taken place by the end of the 1990s but some types of privatisation have continued to be implemented more recently, such as the private sector involvement in building schools, constructing and operating motorways and providing services for the NHS.

Deregulation

Deregulation is the removal by the government of rules and regulations from businesses in order to promote competition.

Until 1986, local bus services were local monopolies – there was no competition as only one bus company was allowed to operate on a given route and rivals could not offer a competing service. In 1986, deregulation took place and bus services were opened up to competition. The aim was for better services to be provided with a greater level of efficiency. Other industries that have been deregulated include air travel and utilities such as gas, water and electricity services.

Suggested Answer to Activity One

Some more-or-less recent green taxes that have been implemented include the landfill tax; relating the level of vehicle excise duty (road tax) and company car tax to the level of emissions produced by the vehicle; congestion charging in London; reductions in VAT for energy-saving building materials; and exemption of new carbon-neutral homes from stamp duty (a tax paid by house-buyers).

The Environmental Change Institute at Oxford University has recommended an increase in air passenger duty, which is now £5 for short-haul flights and £20 for long-haul flights; another policy it recommends is the application of VAT to domestic air tickets. You may find many more proposals!

Suggested Answers to Activity Two

The problem is that benefits such as Jobseekers Allowance and Disability Living Allowance allow people who are not able to work to have enough money to live on. Reducing the levels of these benefits will encourage those who are receiving them and are able to work to do so, but it will also reduce the standard of living of those who cannot work.

Progressive income tax is used to distribute income from higher to lower earners, which is seen by many as desirable. Making income tax less progressive (a flat tax, for example, charges the same tax rate to all earners) reduces the disincentive effect, but also means less distribution, potentially increasing inequality of wealth in society. These are very tricky issues and governments must tread a fine line to avoid upsetting too many voters.