113. Sources of government revenue

IB Question

• Explain that the government earns revenue primarily from taxes (direct and indirect), as well as from the sale of goods and services and the sale of state-owned (government owned) enterprises.

➢ ***Fiscal policy*** → ***Demand-side policy***

→ An attempt to increase or decrease AD in order to affect real output, growth, employment and inflation

→ Manipulation of the level of government expenditures (G) and/or government revenues (T)

➢ The government budget

Government earn most revenues from:

- Direct taxation → Taxation on income and wealth.
- Indirect taxation → A tax on goods or on expenditure on a 'per unit' basis or as a percentage of the price.
- Sale of goods and services → ex.) revenues from the sale and export oil are major source of government revenues for countries producing and exporting oil.

114. Types of government expenditures

IB Question

• Explain that government spending can be classified into current expenditures, capital expenditures and transfer payments, providing examples of each.

➢ ***Government spending***

1) Current expenditures → include wages and salaries of public sector employees as well as spending on consumables (day-to-day-items) such as stationery
2) Capital expenditures → refer to public investment spending, including all spending on infrastructure, construction roads, harbors, hospitals and schools
3) Transfer payments → represent transfers of money from one group to another and as such are not included in the calculation of GDP but are part of income redistribution policies

   Ex.) social security (welfare) expenditures, for example pensions, unemployment benefits, disability payments and scholarship grants

115. The budget outcome

IB Question

- Distinguish between a budget deficit, a budget surplus and a balanced budget.
- Explain the relationship between budget deficits/ surpluses and the public (government) debt.

➢ ***The budget outcome***:

G – Government expenditures (spending), T – government revenues or income

If:	Then:	And:
G > T	A budget deficit is recorded	The national debt grows
T > G	A budget surplus is recorded	The national debt shrinks
G = T	The budget is balanced	The national debt is unchanged

116. Fiscal policy and short-term demand management

IB Question

- Explain how changes in the level of government expenditure and/or taxes can influence the level of aggregate demand in an economy.
- Describe the mechanism through which expansionary fiscal policy can help an economy close a deflationary (recessionary) gap.
- Construct a diagram to show the potential effects of expansionary fiscal policy, outlining the importance of the shape of the aggregate supply curve.

➢ ***Expansionary (or reflationary) fiscal policy***

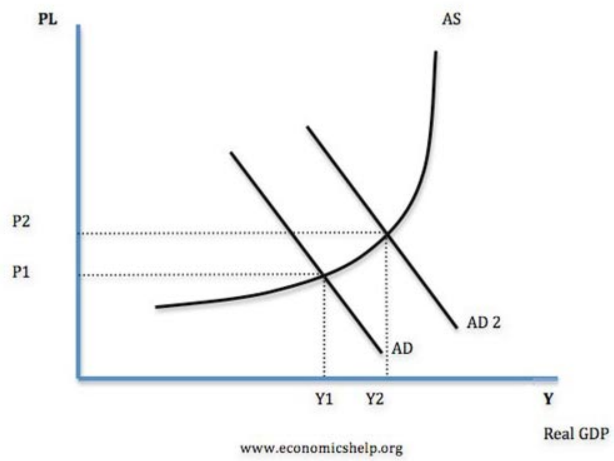
→ Keynes' idea that the equilibrium level of output was demand-driven.

→ The level of AD determines the level of overall activity

→ Aims at increasing AD in order to increase national income (real output) and employment and so close a deflationary gap

★ Requires an increase in government spending (G) and/ or a decrease in taxation (G)

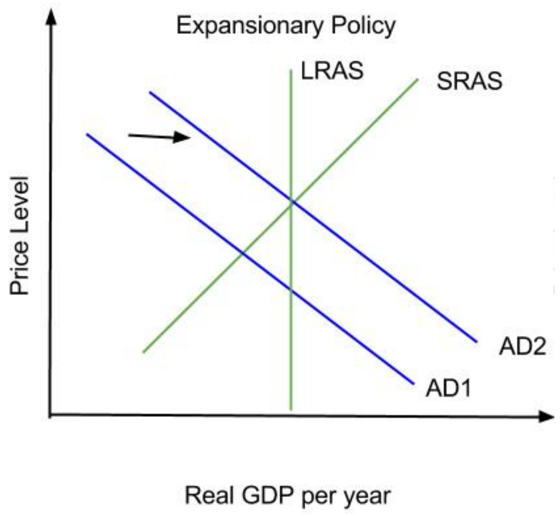
Expansionary fiscal policy (Keynesian)



- In order to close the deflationary gap, government decides to employ expansionary fiscal policy
- (The ↑ in G and ↓ in T will increase AD)

  → Though there is a risk of inflation towards Yf

<u>Expansionary fiscal policy (Monetarist/ New classical)</u>



- If AD goes beyond AD2, then no lasting increase in real output will result. Any increase in real output will be temporary. In the long-run, real output will return at its potential rate at the cost of high inflation. Expansionary fiscal policy will not have succeeded in increasing real output.

IB Question

• Describe the mechanism through which contractionary fiscal policy can help an economy close an inflationary gap.

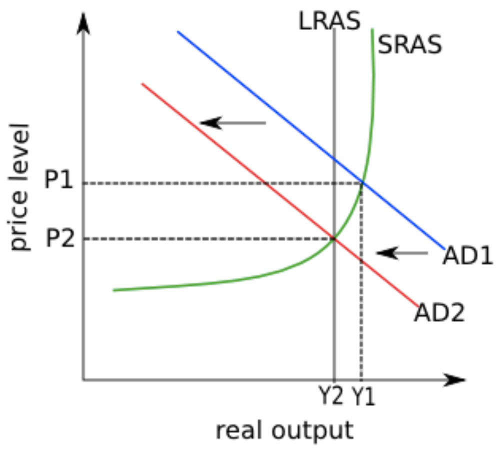
• Construct a diagram to show the potential effects of contractionary fiscal policy, outlining the importance of the shape of the aggregate supply curve.

➢ ***Contradictionary (deflationary) fiscal policy***

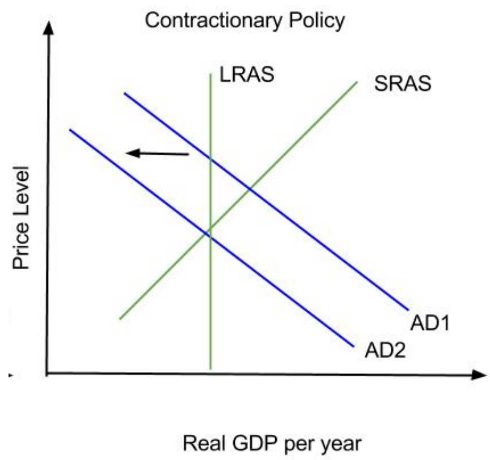
→ An overheating economy, defined as an economy where AD is rapidly increasing, creating inflationary pressures, requires contractionary fiscal policy.

★ The government must decrease government expenditures (G) and increase taxes so that AD decreases

Contractionary fiscal policy (Keynesian)



Contractionary fiscal policy (New classical)



- The risk of contraction differ between the two

IB Question

• Explain how factors including the progressive tax system and unemployment benefits, which are influenced by the level of economic activity and national income, automatically help stabilize short-term fluctuations.

- ***Automatic fiscal stabilizers***

→ Both tax revenue and government expenditures change automatically as the level of national income changes without government intervention

→ Makes the business cycle smoother

- How automatic stabilizers mitigate an economic downturn

- Assume an economy entering recession
- The economy enters recession at time t1. Real GDP starts to decrease. At time t2, as a result of automatic stabilizing effect of unemployment benefits and progressive taxes, real output falls only to Y whereas it would have decreased to Y' without their existence

  → The downturn is milder

- How automatic stabilizers cool-off an overheating economy

IB Question

• Explain that fiscal policy can be used to promote long-term economic growth (increases in potential output) indirectly by creating an economic environment that is favourable to private investment, and directly through government spending on physical capital goods and human capital formation, as well as provision of incentives for firms to invest.

- Government expenditures on infrastructure (physical capital) create significant positive externalities in lowering the overall cost of economic activity asn so potentially having a high social rate of return → Can increase an economy's potential output and shift its vertical LRAS to the right
- Government expenditure on schools and health care can increase and improve the stock of human capital an economy has available → increase labour productivity translates to faster long-run growth so a higher level of potential output
- Decrease in tax rates may unleash more work and investments as incentives could be positively affected which enable potential output to increase

IB Question

• Evaluate the effectiveness of fiscal policy through consideration of factors including the ability to target sectors of the economy, the direct impact on aggregate demand, the effectiveness of promoting economic activity in a recession, time lags, political constraints, crowding out, and the inability to deal with supply-side causes of instability.

➢ *Effectiveness of fiscal policy*

Strengths

- ***Ability to target sectors of the economy***
- ***The direct impact on aggregate demand*** → any increase in government spending will automatically increase national income by at least as much, as it is a component of AD
- ***The effectiveness of promoting economic act in a recession***

  → In an economy in deep recession interest rates may be at or close to zero, so monetary policy is totally ineffective; in such a case policy makers have only fiscal policy to turn to

Weaknesses

- ***Political constraints*** → Fiscal policy suffers form an 'expansionay bias' because politicians are often irresponsible and prefer to spend more and tax less than spending less and taxing more because the former maximizes their short term re-election chances
- ***Inability to deal with supply-side causes of instability***
- ***Time lags*** → they may even end up destabilizing instead of stabilizing an economy
- ***Crowding out*** → expansionary fiscal policy and deficit spending may end up crowding out private investment and therefore be less effective. The resulting budget deficit must somehow be financed. Government borrowing from financial markets may drive interest rates up and, as a result, private investment will decrease (and so will consumption expenditures) If this decrease in private spending matches the increased government spending, the crowding out is totally ineffective.