The BIG ideas!

webnote 240

Syllabus 2.4

I.b Syllabus 2.4: Macroeconomic Objectives: Unemployment

Syllabus 113-119

- 240: Powerpoint summary
- 241: Laffer
- 242: Fiscal policy overview
- 243: Crowding out
- Sample Exam Question – see slide 2
- 244: Exam Questions

Big Idea 1

Big Idea 2

Big Idea 3

Big Idea 4

Big Idea 5

key syllabus items 119 + 117

- 119 (weight = 5)
- 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.

- 117
- 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.

IBQ Nov 2016- SP1

Macroeconomics

- 4. (a) Explain what effect an increase in interest rates might have on unemployment. [10 marks]
- (b) Evaluate the effectiveness of fiscal policy as a tool to reduce unemployment [15 marks]

IBQ May 2014 - SP1

Macroeconomics

- 4. (a) Using an appropriate diagram, explain why a country might experience a deflationary gap? [10 marks]
- (b) "Fiscal policy is the most effective way of bringing an economy out of recession." To what extent s this statement valid ? [15 marks]

2.4 Key terms

- **2.4 - Fiscal Policy**
- 1. automatic tax stabilizer
- 2. balanced budget
- 3. budget deficit
- 4. budget surplus
- 5. contractionary fiscal policy
- 6. crowding out
- 7. expansionary fiscal policy
- 8. time lag
- 9. transfer payments

Syllabus 2.4 Item 115

Big Idea 1

Know why fiscal policy and how it can be used to manage a macro economy in the form of direct intervention using government spending or by using direct tax changes to increase incentive in markets

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Fiscal Policy is a key policy to manage a macroeconomy for the main government objectives e.g. stable inflation, growth and jobs

1. **Key government policy to reallocate wealth e.g progressive taxation or using 'deficit budgeting'**
2. **Key government policy to improve spending in the short run and therefore a key anti recession policy because it can have immediate short term effects**
3. **Typically described as a 'Keynesian' policy tool but it is of key importance for supply siders also. Remember demand and supply side economists do not "own" fiscal and monetary policy. They share the use of these policies to manage the macroeconomy in order to achieve their objectives**

Syllabus
2.4 Item 115

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How does G use fiscal policy to grow the economy?

Taxes:

1. Reduce direct taxes
2. Adjust size of tax bands at lower rates of tax in order to increase consumption spending
3. Adjust corporation tax rates. Trump is proposing to lower US corporation taxes in an effort to attract MNC into the US
4. This may bring abour a 'Laffer Cuve' effect by promoting growth with lower tax rates
5. Determining the 'best rates' of tax may be difficult and comsumers and firms must be confident if they are to spend
6. See syllabus item 117 for progressive taxation as an economic stabilizer i.e. booming economy has a greater tax leakage

G spending:

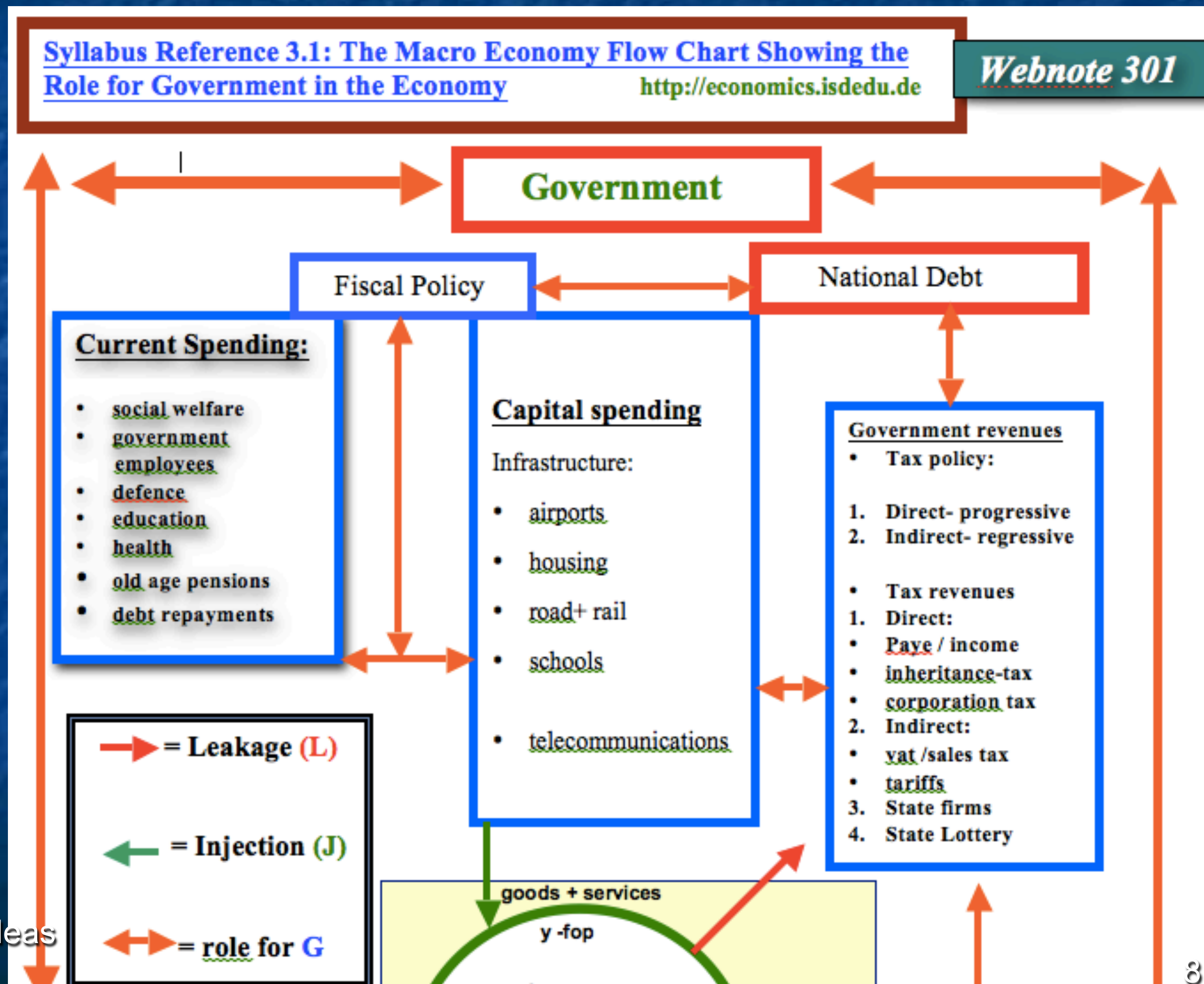
1. Increase government spending in areas of the economy that will promote higher output e.g. education and training or infrastructure
2. The policies outline in 1 are likley to be long run and expensive

Evaluate Fiscal Policy syllabus 119

Webnote 240

Know your vocab: eg

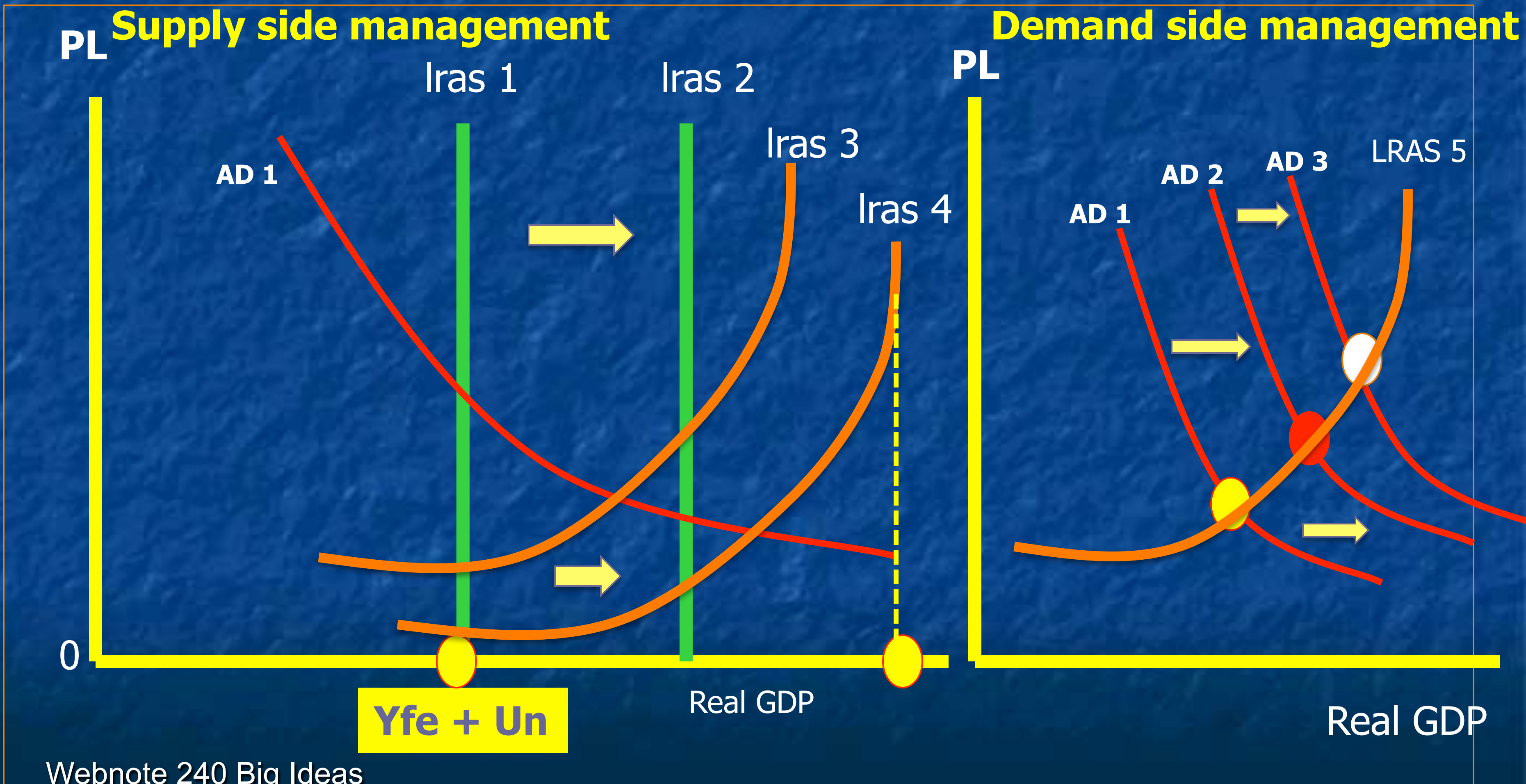
- **Deficit**
- **Surplus**
- **Transfer payments**
- **Current account**
- **Capital account**
- **Expansionary fiscal**
- **Contractionary fiscal**
- **Automatic stabilizers**
- **Time lags**
- **Crowding out**



Webnote 240 Big Ideas for 2.4

Diagram D: Fiscal Policy uses supply side and demand side managment

Fiscal policy can be used by both schools of economics (keynes and classical) to achieve macro objectives : keynes use of G spending or classical using tax cuts to grow the economy



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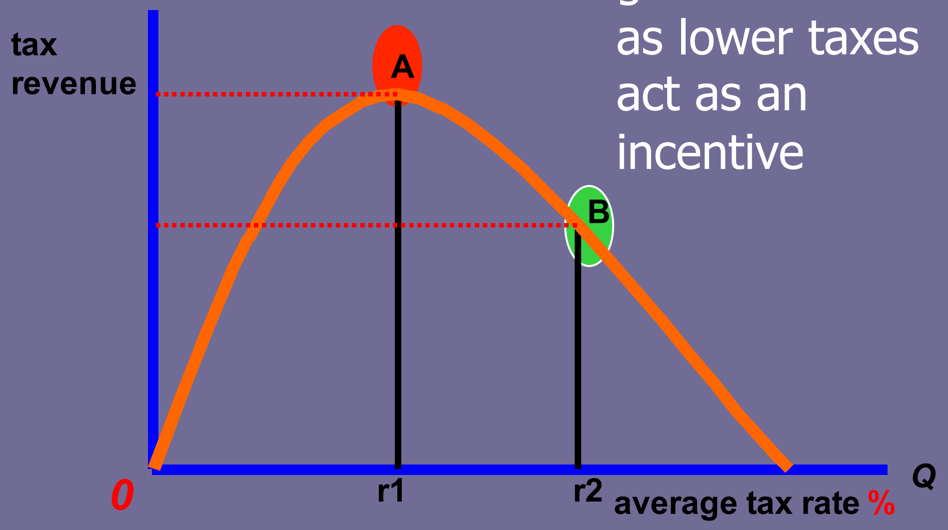
Laffer Curve

Big Idea 2

Laffer Curve argues for Lower 'incentive' based direct taxation

- **A tax rate of 0r1 maximises tax revenue (A) with 0r1 tax rate because more people want to work and firms will be inclined to expand**

Diagram 1: Laffer Curve



A implies more growth than B as lower taxes act as an incentive

Laffer Curve Note:

A = tax system **optimality** where r1 results in a mazimisation of tax revenue. Note that this represents the highest possible level of macroeconomic activity possible in the economy in terms of fiscal policy tax rates. This means that the economy is producing at a higher level of economic activity and resource allocation due to the optimal tax rates.

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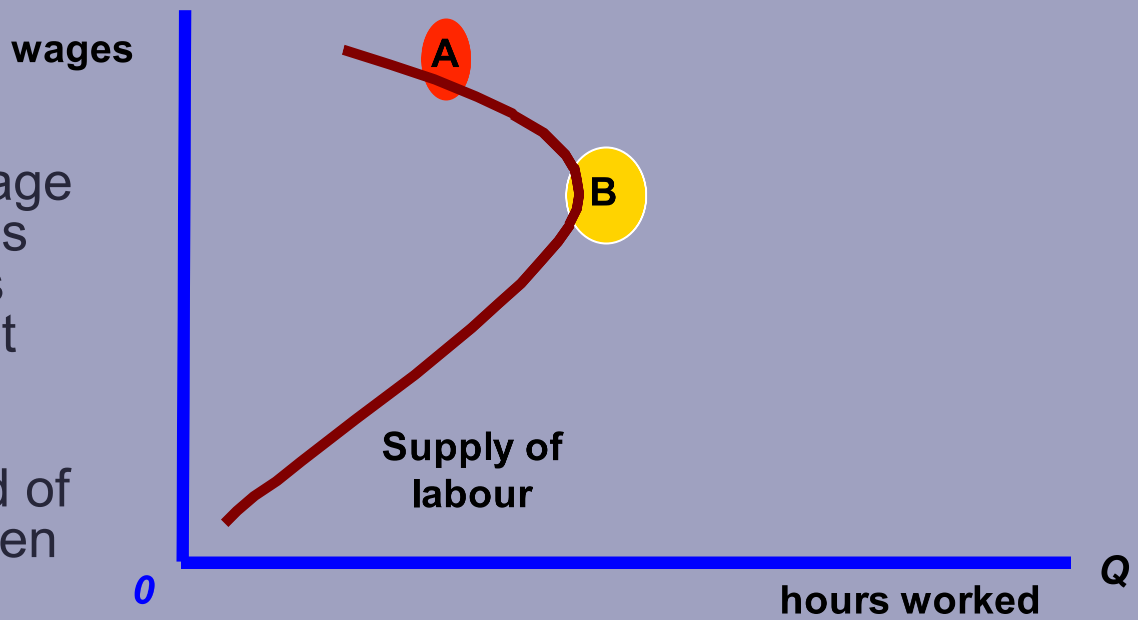
Laffer Curve

- Critics of the Laffer curve argue that a cut in tax rates would in all probability lead to a fall in tax revenue.
- Idea here is based on backward bending supply curve whereby at higher wage rates workers may offer less hours of labour i.e. workers value leisure time more that additional hours at work subject of course to some minimum required standard of living so lower taxes will even

Diagram 2: Backward bending supply curve for Labour



Syllabus 2.4
Item 117

Webnote 240

Big Idea
3

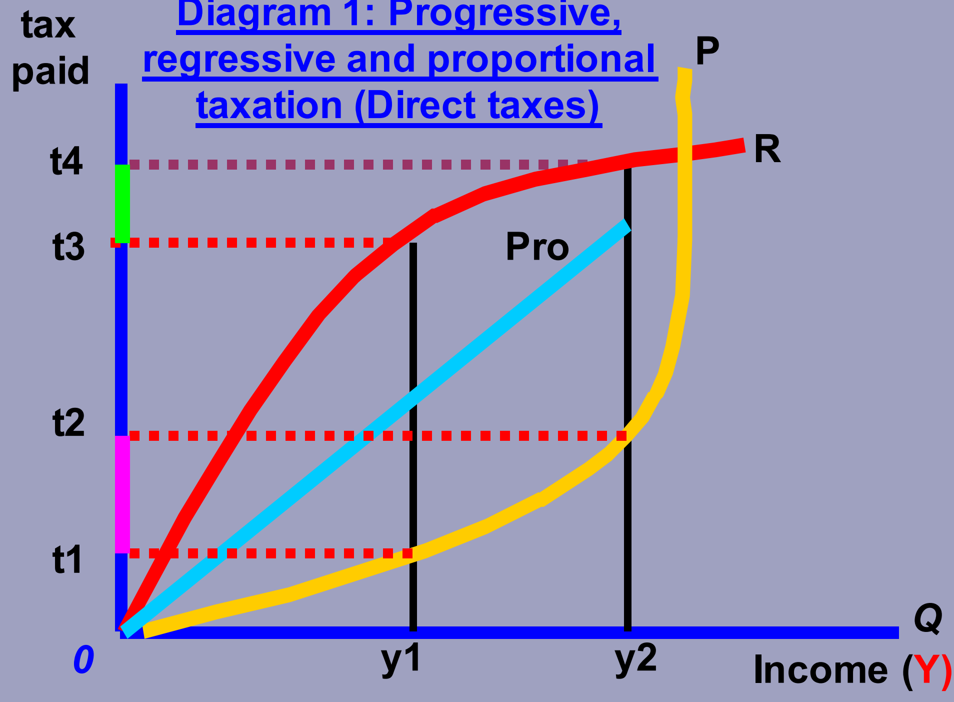
Governments can control distribution of income with progressive and regressive taxation. Progressive taxation acts as an automatic stabilizer in a booming economy and visa versa

- **For full details please see webnote 331 in section 2.4**

- ***P = progressive as average rate of tax increases as income Y increases Oy1 to Oy2 the tax paid increases from 0t1 to 0t2***

- ***R = average rate of tax decreases as income Y increases. As income increases Oy1 to Oy2 the total tax paid increases from 0t3 to 0t4.***

Diagram 1: Progressive, regressive and proportional taxation (Direct taxes)



'Automatic stabilizer' item 116

Fiscal policy can act as an automatic stabilizer in times of macroeconomic fluctuation: inflationary or recessionary (deflationary) gaps

- Fiscal policy
  - Progressive taxation can using tax rates on 4 factors of production reduce the rate of increase in the APL. This is done by adjusting tax rates and tax bands when spending is high causing inflationary pressure
  - Fiscal policy can then act to increase the leakage as economic activity increases
  - As income increases then households will move into higher tax bands with higher tax rates. This stabilizes macroeconomy

- Fiscal Policy
- Unemployment benefits
- Unemployment benefits and transfer payments can act as a buffer against poverty during times of recession supporting poorer households. This stabilizes macroeconomy

The BIG ideas!

"crowding out"

Webnote 240

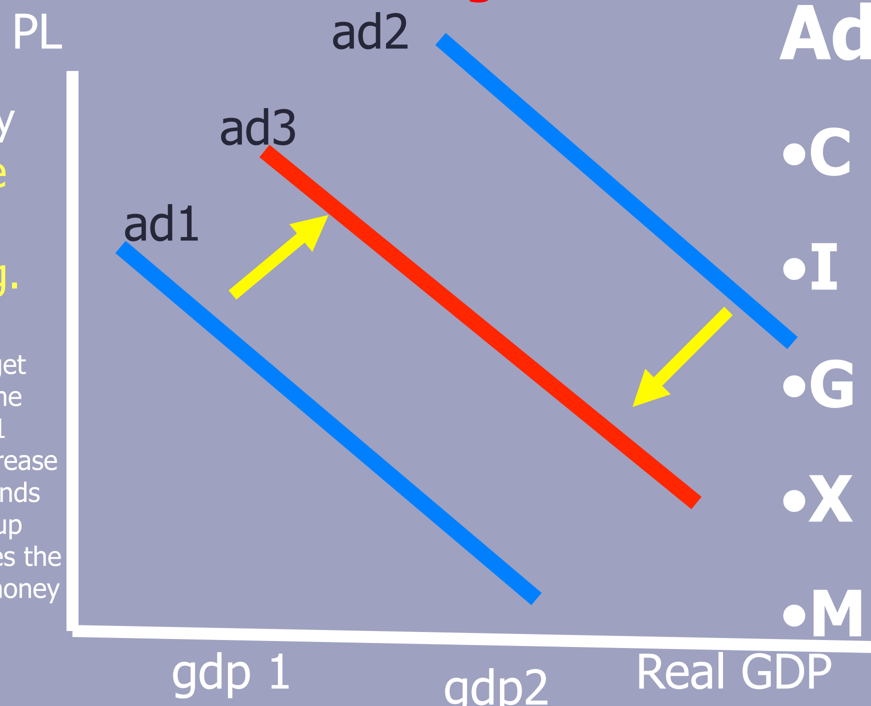
Big Idea 4

Public sector (G) spending can "crowd out" private sector (F+H)

What is crowding out? → **'anti Keynesian…anti demand side management'**

As a result of "crowding out" (spending by public sector) the private sector reduces spending.

G can often operate a budget deficit and this is often done with borrowed money. AD 1 shifts to AD 2. This can increase the demand for loanable funds (savings) and this can put up interest rates. This increases the costs for firms borrowing money for investment. See item 1 below:



Ad 1 to ad 2

- **C** ↑
- **I** ↑
- **G** ↑
- **X** ↑
- **M** ↓

Syllabus 2.4 Item 119

See also webnote 243 for additional examples of 'crowding out'

Key importance: As a result of "crowding out" (by public sector) the private sector reduces spending.

Government spending (G) rises but how is it paid for?Governments often borrow money in the bond markets and as a result:

1. Increased demand for borrowing → Interest rates will rise thus affecting the household spending and investment by firms and therefore AD 2 shifts back to AD 3 due to higher interest rates. This is the 'crowding out' effect.
2. Economists (keynesian and classical) disagree as to how 'crowding out' is significant in terms of affecting government objectives.

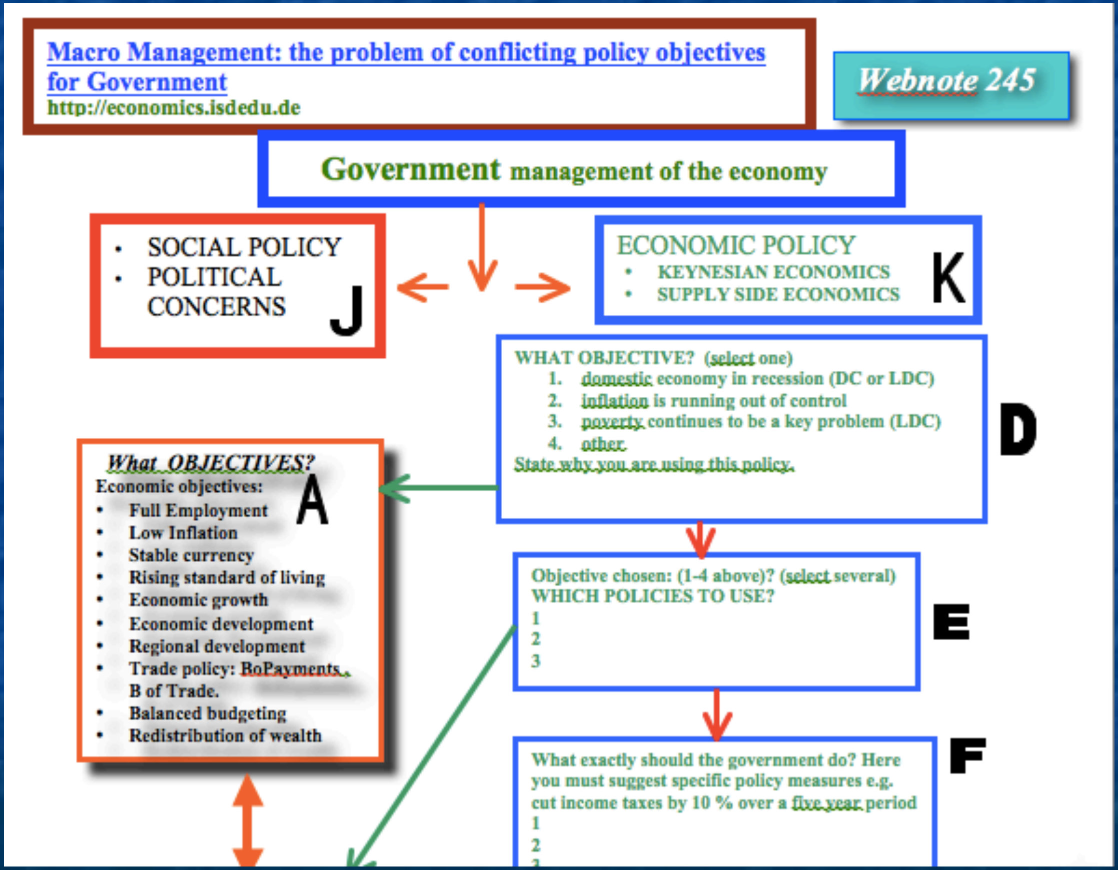
Big Idea 5

Know how one government policy can conflict with another

Webnote 240

Policy Conflict

See webnote 245



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Laffer Curve

- Reading:
- See Blink p.334 and McGee 'The Good, the bad and the economist' p.455
- End