Unit 5 Role of government in an economy

Assessment: model answers

1 Public finances in Sweden

(a) To reduce a budget deficit a government can cut its public expenditure and/or raise taxes.

(b) Public expenditure is money sent by the public sector in an economy, notably government authorities. It can include current expenditures such as the wages of public sector employees, and capital expenditures on the construction of new roads, the purchase of new trains for a nationalized public railway or the purchase of new medical equipment for a public hospital.

In contrast, private expenditure is undertaken by private individuals and firms. For example, private individuals will tend to spend money on satisfying their needs and wants for food, housing, clothing, travel and entertainment. Firms will spend money on productive activity, for example by investing in new plant and machinery and the purchase of component parts and materials used to make finished products. Private firms also spend a significant amount of money advertising its products to create consumer awareness and demand.

(c) The Swedish government may cut taxes to help it reduce unemployment and boost economic growth.

A reduction in the general level of taxation in an economy can help to expand the aggregate demand for goods and services. A cut in income taxes will increase disposable incomes and in turn consumer spending may rise. As demand expands, firms may increase their output and employ additional resources including labour. This will help to reduce unemployment.

Boosting total demand in the economy may also encourage firms to invest in new production facilities and equipment. This will expand their productive scale and therefore the rate of growth in the economy. Cuts in taxes on profits may especially encourage investment in new capital and new firms to be created. Lowering income taxes can similarly motivate more people to seek employment and increase motivation and productivity among those already in work. These combined effects will also help to grow the total output and size of the economy.

(d) Governments will usually have four macroeconomic aims for their economies. These are for low and stable price inflation, a high level of employment, a healthy rate of economic growth and a stable balance of payments. However, achieving these policy aims at the same time can prove difficult and they can sometimes conflict. For example, during an economic boom unemployment will be low but there may be inflationary pressures as continued growth in consumer demand begins to outstrip growth in the aggregate supply of goods and services. The growth in demand may also suck in many imports, causing the balance of international trade to deteriorate.

To reduce inflationary pressures the government may cut its own expenditure and raise taxes. This will have the effect of reducing aggregate demand in the economy. The government may also raise interest rates to curb borrowing and increase the incentive for people to save. However, as demand contracts, firms may cut back their output and demand for labour in response. Employment is
likely to fall and more and more people may become unemployed over time as demand and output continue to contract. Firms are also likely to cut back their investment plans in response to falling demand and rising interest rates. If old and worn out plant and machinery are not replaced then the productive potential of the economy will also contract. However, while the fall in consumer demand may be beneficial to the balance of international trade as spending on imports falls, the deteriorating economic conditions may reduce flows of inward investment by overseas firms.

In contrast, during an economic recession when aggregate demand is falling and unemployment high and rising a government may attempt to reflate demand by boosting its own spending and by cutting taxes and interest rates. However, these policies could prove to be inflationary if the rise in demand is not matched by an increase in the aggregate supply of goods and services in the economy. Cutting taxes on profits and cutting interest rates can however encourage firms to borrow money to invest in additional productive capacity and boost economic growth.

However, some economists argue there need not be any policy conflicts because sound fiscal management combined with sensible supply-side policies can achieve low inflation high employment and healthy economic growth over the long term. It can also stabilize or improve the balance of international trade.

Supply-side policy instruments are designed to boost productivity and to improve the efficiency of different markets by removing barriers to competition. By expanding the supply side of the economy, employment an output will increase and this will help to reduce inflationary pressures on prices caused by rising demand. Keeping inflation low will also help to keep wage demands down and it reduces uncertainty for businesses seeking to invest in new capacity. It will also increase the competitiveness of goods and services on international markets.

(e) The Swedish government is clearly a major employer, consumer and producer of goods and services in Sweden. The article suggests it spends over 50% of the total expenditure of Sweden each year. This includes spending on an extensive welfare system to help people in the greatest need because free markets will not otherwise provide them with the goods and services they need.

For example, consumers with little or no money, for example because they are in low paid jobs or because they are single mothers or too old or disabled to work, may be unable to afford many basic goods and services. Private sector firms are unlikely to produce many of the goods and services they need because their spending power is too low. A government may therefore provide income support to people on low incomes so they can afford to buy the goods and services they need from private producers. A government can also employ resources to provide the same goods and services for free or for a small charge that people on low incomes can afford. For example, the article reports the Swedish government provides public day-care facilities for all young children. This will allow their parents to continue working during the day.

Similarly, other goods or services such as street lighting, a legal system and defence may not be provided in free market economies because it will be difficult for private firms to identify and collect money from the individual consumers who will benefit from them. This is because once provided it is difficult to exclude consumers from the benefit of, say, street lighting, whether they have paid for it or not. In all these cases a government can use resources to produce goods and services that are in the public and economic interest, and distribute them to people in the most need regardless of their
ability to pay. A government can pay for the provision of such goods and services from the tax revenues it collect.

In a free market economy, resources including labour may remain unemployed if it is not profitable for private firms to employ them. However, in a mixed economy like Sweden, government organizations can provide employment for many people to produce goods and services the market may not otherwise provide, such as free or low-cost education and health care for people on low incomes.

In many countries water and electricity supplies are also provided by government organizations because they are essential for public and economic welfare. In this way a government can more easily regulate service quality, provision and prices charged to different groups in society than it may be able to if these services were provided by profit seeking private firms.

(f) Governments will attempt to influence the behaviour of producers to achieve economic outcomes they desire but that markets will not otherwise deliver. They can do this by using regulations and selective taxes and subsidies.

Regulations can directly control firm behaviour by outlawing certain activities or stating how producers are legally required to behave. For example, in a market economy private firms and individuals may fail to take account of the impact their production and consumption decisions can have on the natural environment. A government may therefore introduce regulations to protect the environment. For example, anti-pollution and dumping laws can make it illegal to burn waste or dump untreated waste into rivers and seas. Similarly, competition laws can be used to outlaw anti-competitive behaviours used by large powerful firms to restrict competition and force up market prices. Large firms found to be actively restricting competition and acting against the public interest may be fined, be subject to price controls or, in the case of monopolies, broken up into smaller, competing firms.

Indirect taxes, such as excise duties, can be imposed on products that are considered harmful in order to reduce their consumption and therefore production. For example, high taxes on cigarettes and alcohol can reduce consumer demand for these products. Consumer demand for these products will tend to fall as their after tax prices rise. Similarly, a government may change the total amount of taxation in the economy to affect the total or aggregate demand of goods and services. If prices are rising rapidly in an economy because total demand is rising faster than supply, a government may increase direct taxes on personal incomes to reduce consumer spending. It may also raise interest rates to reduce borrowing and encourage saving.

Selective subsidies can be used to influence production decisions by offsetting costs. For example, many governments are encouraging the development of new technologies such as renewable energy generation, bio-fuels and electric vehicles that will help to boost economic growth but in a more sustainable way. By reducing the costs of production, subsidies can increase output and employment, and help to reduce market prices, thereby expanding demand for new products and technologies.

2

(a) Direct taxes are levied directly on an individual person’s or company’s income and wealth. They include personal income tax, corporation tax on profits and capital gains taxes on the appreciation in value of various assets.
In contrast, indirect taxes are those that are paid from incomes only when they are spent on the purchase or use of various goods and services. Indirect taxes are added to the price of goods and services, either as a percentage of the selling price such as sales tax and value added tax, or as a fixed tax sum. For example, excise duties include duties on alcohol and tobacco, motor vehicles, petroleum and air travel.

(a) ii A progressive tax takes proportionally more tax from higher levels of income than from lower incomes. For example, a tax that is levied at 0% on any income up to $5,000 per year, 10% on each dollar of income over $5,001 to $40,000 per year, and 20% on each dollar of income over $40,001, is an example of a progressive tax. Many income tax systems are progressive in nature and can be used to reduce inequalities in income.

A regressive tax, however, takes proportionally less from a higher income than a lower income. Many indirect taxes tend to be regressive in nature. For example, consider an excise duty of $5 on the price of a good. If a person earning $100 per week buys this good then the excise duty will take 5% of his or her income while the same duty will take only 0.5 per cent from the income of a person earning $1,000 per week. Because of this many people argue that regressive taxes are unfair.

(b) A government imposes direct and indirect taxes for many reasons. A primary reason is to raise revenue to pay for government spending such as wages of public sector workers and investments in infrastructure including new schools and roads. In this way a government can direct spending at goods and services that can help increase economic growth and economic welfare. For example, tax revenues can finance welfare benefits paid to the old, sick and unemployed. In this way, taxes, particularly those levied on incomes and wealth, can be used to help alleviate poverty and reduce inequalities in wealth and incomes between people.

Government fiscal policy involves changing the overall level of tax collected and public expenditure to vary the total level of demand in an economy. Raising taxes and lowering public spending can help reduce a demand-pull inflation caused by an excess of aggregate demand for goods and services in an economy. In contrast, lowering taxes and increasing public expenditure can help boost total demand during an economic recession when unemployment may be high and rising due to low demand for goods and services. Taxes can therefore be used to influence the level of economic activity in an economy and help a government to achieve its overall macroeconomic aims.

Individual taxes on specific goods or services can also be used to influence the level of consumer demand for those products. For example, indirect taxes on tobacco products, such as cigarettes, can help to discourage their consumption and therefore reduce the incidence of health problems, lung cancers and deaths that may be caused by smoking. Similarly, by helping to reduce demand for car use, excise duties on petroleum can help conserve oil and reduce harmful exhaust emissions that can pollute the natural environment and contribute to harmful climate change.

(c) Raising income tax rates may have a number of different economic impacts. Disposable income will fall and will tend to reduce consumer expenditure as a result unless consumers instead run down their savings. Falling demand in the economy may help to reduce any demand-pull inflationary pressure on prices; however, it may also result in higher levels of unemployment if firms cut back production as demand for their products falls. Further, firms may
reduce their investments in new plant and machinery. This will reduce the productive potential of the economy in the future and will tend therefore to slow down economic growth. However, the overall impact on aggregate demand and growth in the economy will depend on how the additional tax revenue is used and/or whether other taxes have at the same time been lowered to offset the impact of the increased income tax rates. For example, the government may use the additional tax revenue to increase spending on employment and training programmes, grants to firms’ new research and development, or an expanded road network, all of which will help create jobs and stimulate economic growth.

However, increased taxes on income may reduce people’s incentives to work. This may reduce their productivity and slow down economic growth. Workers may demand higher wages from their employers to help compensate for the income tax increase. Higher wages will tend to reduce firms’ demand for labour and may contribute to cost-push inflation as firms attempt to pass on their higher wage costs to their consumers.

Finally, higher income tax rates may increase tax avoidance. For example, instead of receiving higher wages workers may ask to be paid in other ways instead, such as receiving more non-taxable gifts or holiday entitlement. Some workers may even illegally evade income tax altogether by working for unreported cash payments only. Tax avoidance and evasion will tend to reduce tax revenues that the government may have hoped for following their policy to increase income tax rates.

3

(a) Direct taxes are taxes on the incomes, profits and wealth of individuals and organizations. For example, payroll taxes are taken directly from wages and salaries. Corporation tax is a tax on company profits and property taxes are levied on the value of homes or commercial buildings.

Indirect taxes include tariffs and excise duties added to the prices of goods and services. They are normally imposed on producers who will then pass on as much of the tax as they can to their consumers in higher prices. Value added tax is levied as a percentage of the retail price of many products. Excise duties are fixed amounts of tax added to the retail price of goods such as cigarettes, alcohol and petrol.

(b) Frictional unemployment occurs when workers change jobs and spend some time looking for new ones. This type of unemployment is usually short term and can be caused by people leaving jobs they dislike, moving to a different town or looking for higher paid work.

Seasonal unemployment occurs because consumer demand for some goods and services is seasonal. For example, employment in fruit picking will peak in the summer when fruit such as strawberries are in demand and crops need to be harvested. When the harvest is over, workers employed for fruit picking are no longer required. Frictional and seasonal unemployment are not a big problem for the economy as they are predictable and can be short term.

Technological unemployment refers to the loss of jobs resulting from the substitution of capital for labour. For example, industrial robots and computerized machinery and equipment have been substituted for labour in many modern production processes. The growth of online shopping has also resulted in many jobs being lost from retail outlets as some firms have rationalized the number of outlets they maintain.
(c) The macroeconomics objectives of most governments include achieving and maintaining low and stable price inflation, a high level of employment, healthy long-term economic growth and a stable balance of international payments.

Low inflation is an objective because high inflation erodes the purchasing power of incomes and causes people hardship, especially those on low fixed incomes. It also increases production costs for many firms and can damage confidence in an economy as a good place to invest.

Increasing and maintaining a high level of employment will maintain high levels of output, incomes, consumer demand and living standards. Unemployment causes hardship or those who are without paid employment and total output will be lower than it could otherwise be. As a result, a government may have to spend more on welfare payments to support the unemployed and their families. This means taxes may have to rise.

Growing the economy means expanding the national output and income. These in turn mean more employment opportunities and higher living standards. In contrast, if there is negative growth, output, employment and incomes will shrink, government tax revenue will fall, public spending will have to be cut and the profits of firms will fall. In response firms will cut their investment spending and this will further damage the productive potential of the economy.

Most countries seek to balance their inflows and outflows of income from international transactions. Sudden changes in the amount of money flowing into or out of an economy can be very disruptive to the banking system, firms and government. For example, if the balance of payments plunges into deficit as a result of consumers buying more imports and more firms moving their production overseas, a country will run out of foreign currency to buy the imported products it needs and the value of its currency may fall against other currencies and make imports more expensive, resulting in an imported inflation.

(d) Raising income taxes will reduce disposable incomes and as a result consumer spending is likely to fall. This policy might be used to reduce aggregate demand at a time when an economy is overheating and there is demand-push inflation. The reduction in consumer spending may also reduce demand for imported items, thereby improving the balance of trade.

Raising indirect taxes will however be inflationary by increasing the after-tax prices of many goods and services, while raising taxes on profits will dull incentives to start new businesses and invest in existing ones to increase their scale and efficiency. This will harm future growth prospects. However, if much of the capital equipment firms would buy is imported from overseas this too will help improve the balance of trade. High taxes on profits in a country are likely though to reduce flows of inward investment from overseas firms looking to expand their operations to that country. The balance of payments and also future economic growth will both be less favourable as a result.

Raising taxes may therefore help to reduce inflationary pressures and a balance of payments deficit but may do so only by reducing growth and employment. However, this does not consider how the government may use the increased revenue to boost jobs and investment at the same time.

For example, the additional revenue raised from increased taxes may be used by the government to invest in new infrastructure, such as new roads, ports and modern power and communications networks, creating many new jobs and increasing the productive capacity of the economy. It may also be used to fund selective subsidies aimed at growth industries to reduce their costs and thereby increase their output and demand for labour. Similarly, increasing
spending on education and training will increase the employment prospects of many people and also make them more productive in work.

Raising income tax rates on the highest incomes and using the revenue to fund increases in welfare payments or income support for people on the lowest incomes may also increase overall consume spending in the economy. This is because people on high incomes tend to save a large proportion of their incomes so as the tax on their incomes rises, they may reduce their saving. In contrast, people on low incomes tend to spend all the money they receive. Raising taxes on interest paid on savings at the same time will reduce the attractiveness of saving and people may spend more as a result. These measures could help to boost demand during an economic downturn and therefore help to reduce unemployment.

4

(a) Income tax is an example of a direct tax. Direct taxes are taken directly from individuals or firms and their incomes or wealth. That is, the burden of a direct tax falls on the person or firm responsible for paying it. In contrast, an indirect tax is taken only indirectly from incomes when they are spent on goods and services. Indirect taxes are therefore sometimes called expenditure or outlay taxes. An example of an indirect tax is value added tax. This is applied as a percentage of the price of a good or service. Firms are therefore responsible for collecting and paying to the government the money collected from value added tax.

(b)

(c) Price elasticity of demand is the responsiveness of consumer demand to a change in the price of a product. If a small percentage reduction in the price of a product results in proportionately larger expansion in demand, then demand is said to be price elastic. If, however, the quantity demanded of a product is not very responsive to a change in price then demand is price inelastic.

Demand for a product such as a Toyota car is likely to be relatively price elastic. This is because there are many different makes and types of car a consumer can choose from such that a rise in the price of the Toyota vehicle relative to other models will cause some consumers to switch their demand to one of these many substitutes. Cars are also expensive items such that even small percentage changes in prices can result in the loss or gain of many hundreds of dollars so it pays to spend time shopping around to find the best offers.

In contrast, bread is an essential source of food for many people. Demand is therefore likely to be relatively price inelastic, also because there are very few alternatives and it is a relatively low-cost item in most countries.

(d) i If a government increases tax or duty on a product it may end up losing revenue if demand for that product is price elastic because demand for it may fall significantly. However, if demand for a product is price inelastic the increased tax or duty on the product will raise revenue for the government because demand is relatively unresponsive to changes in price. For example, imagine demand for a product is currently 1,000 units per week at a price of $10 inclusive of a $2 tax. Revenues are therefore split $8,000 for the producers and $2,000 for the government. If the government increases the tax to $3 this will increase the after tax price to $11 – an increase of 10%. If demand falls by only 5% to 950 units total revenues will now be split $9,500 for producers and $2,850 for the government (i.e. 950 × $3).
(d) ii In the same way the government can use its knowledge of the price elasticity of demand for imported items to target increases in tariffs that will reduce overall spending on imports. Increasing tariffs on those imported products for which demand is price elastic will cause the largest contraction in demand and therefore spending on imports.

5

(a) In a mixed economy there is a private sector and a public, or government owned and controlled, sector. Both will own and hire resources to produce goods and services.

In a market economy, in order to earn a profit private sector producers supply consumers with the goods and services they want. Changes in market prices provide signals to producers about what consumers want and what is profitable. If consumer demand for a product is increasing the market price of that product will tend to rise. As price rises, profits will rise and firms will respond by expanding their supply of the product.

However, resources will only be employed in a market economy if it is profitable for firms to do so. This means there could be higher levels of unemployment and some goods and services may be underprovided or not provided at all, especially to those consumers least able to pay for them. Private firms may also fail to take account of the impact of their production on the natural environment and will also supply harmful products, such as hard drugs and guns, if it is profitable to do so.

In a mixed economy, a government can intervene to correct failures of the market system, for example by banning the sale of guns, taxing other harmful products to reduce their consumption, and providing goods and services that people need and the economy will benefit from despite these products being unprofitable for private firms to supply.

(b) The macroeconomics objectives of most governments include achieving and maintaining low and stable price inflation, a high level of employment and healthy economic growth.

High inflation erodes the purchasing power of incomes and causes people hardship, especially those on low fixed incomes. It also increases production costs for many firms and can damage confidence in an economy as a good place to invest.

Unemployment is a waste of productive resources. Increasing employment will therefore help to boost output, incomes, consumer demand and living standards. However, when unemployment is high, many people will suffer hardship from a loss of income and total output will be lower than it could otherwise be. In addition, a government may have to spend more on welfare payments to support the unemployed and their families. This means the government may have to raise taxes on businesses and working people. This will reduce their incomes and spending on goods and services. High levels of employment therefore help to increase output, incomes, consumer demand and living standards.

Governments also aim to grow the size of their economies over time. Fulfilling an objective to achieve long-term economic growth will help to expand employment opportunities, increase the availability of goods and services, lower inflation and improve living standards. Private and public investments in new products, processes, equipment, factories, education and training, and economic infrastructure can all help to boost the long-term productive potential of an economy.
Another example of a macro-economic aim is achieving a stable balance of payments.

(c) In a government’s budget it will set out its plans or forecasts for public spending and tax revenues for the next financial year.

In the budget a government may change tax rates, announce new taxes or even abolish old ones. The budget is also used to announce how the government intends to spend public revenues on different current and capital expenditure items.

A government that budgets for a deficit plans to spend more than it expects to earn from tax revenues. A budget deficit is normally associated with an expansionary fiscal policy whereby a government seeks to increase aggregate demand during an economic downturn to boost employment and output. There will be an actual budget deficit if actual spending exceeds actual tax revenues. In contrast, if total tax revenue exceeds public expenditure there will be a budget surplus.

(d) A government can finance its expenditure in a number of ways but by far the most important is from direct taxes on personal and corporate incomes and wealth, and indirect taxes on expenditures.

A government may also earn some rents from publicly owned buildings and land rented to the private sector and admission charges, for example from public museums and national monuments. Some government agencies and public corporations will also earn revenue from the sale of the goods or services they supply, such as nationalized postal services, public transport and electricity supplies.

Periodically a government may also be able to sell off land and other assets it owns, including nationalized industries. The sale of nationalized industries to the private sector is known as privatization.

If, however, a government fails to raise sufficient revenue from all the above ways to finance its expenditure it will need to borrow the shortfall from the private sector, from banks or through the sale of government loans stocks, or from overseas governments.