Threats to the sustainability of economic growth

Exhaustion of resources

Resources are finite and increasing economic growth requires increasing consumption of resources. There are fears that world supplies of carbon based fuels are running out and the exhaustion of them, and the preceding bidding up of the price of them, will cripple economic growth. However microeconomic theory dictates that as the price of the goods go up, this will give people and firms the incentive to; change their consumption habits to save money, invest in alternative technologies to prolong or replace the use of fossil fuels or make the exploitation of previously financially unviable deposits viable. These would do both to increase supply as well as decrease demand. However the question is whether or not we can do this quick enough and whether or not the break neck industrialisation of India and China has not done too much to speed up the arrival of peak oil.

Global warming

There is some scientific evidence that suggests that world temperature levels are rising. This is likely to har economic growth as; more crops and other outputs are destroyed due extreme weather, there will be structural UE as certain climates change rendering some industries uncompetitive of redundant I.e. ski instructors in Scotland and there be increased government spending on flood defences and the preparation for natural disasters which could be utilised better in a different market. However as evidence inconclusive there has been no great rush to try and correct behaviour as of yet.

Environmental damage

As output increases more resources are used. This can have a detrimental impact on the environment as more resources are exploited and there is increased pollution. However the Kuznets curve dictates that the more economically developed a country is, the more it can afford to be environmentally friendly and less dependent on polluting "dirty industries such as manufacturing, so after a certain point, economic development can actually improve the environment

Reasons for the economic cycle

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Automatic stabilisers

Automatic stabilisers are processes that kick in without any policy implementation that smooth the fluctuations of the economic cycle.

When a country is in boom, increased consumption and the creation of a positive output gap leads to demand pull inflation and a increased level of imports being "sucked in" (as capacity does not allow any more expansion of domestic demand). This leads to real incomes being eroded and the balance of payments worsening. This has the effect of leading to a fall in AD, smoothing out the "peak" of a boom.

If an economy is falling into recession, government spending will automatically rise as more people start to claim benefits. This has the effect of raising AD as the government spending aspect of AD has risen, smoothing out the "trough" of a recession.

Exogenous demand and supply shocks

Exogenous shocks are occurences that have effect from outside the economy. The can be used as an explanation of what triggers booms or reccessions. They can be demand shocks which have an effect of demand or a supply shock which has an effect of aggregate supply. Many occurences are both demand and supply as they effect consumer and investor confidence. For example the war in oil producing Libya in 2011 led to a reduced supply of oil production as well as hitting investor confidence hard. Another example would be hurricane activity in the Gulf Of Mexico. Not only does a hurricane dampen the demand for goods in the area but will also destroy capital in the surrounding localities and reduce aggregate supply.

Demand and supply shocks can be good as well. Technological advance occurs exogenously and can vastly improve the economies level of productive capacity.

Speculative bubbles

Rapid economic growth can lead to a rapid rise in asset prices. This is because real incomes have risen and assets are a normal good; i.e. the demand for them rises as income rises. This can lead to a specualtive bubble as people buy asests which prices' are rising in the hope that they keep rising in value and make the investor a profit.

As long as investor confidence that the asset prices will keep rising in maintained, the bubble will become a self-fulfilling prophesy as greater demand for the assets lead to increased market prices. This leads to even greater speculative pressure and the bubble

Budget surplus – When gov. revenues exceed gov. spending

Structural deficit - A budget deficit resulting from fundamental changes in the structure of the economy.

Cyclical deficit - A budget deficit resulting from the fluctuations in the economic cycle.

Automatic stabilisers - Features of government spending and taxation that minimise the fluctuations of the economic cycle.

The principles of taxation

Economical

A tax should be simple so that revenue is max. compared to the cost of collection.

Equitable

Tax should be fair and based on the taxpayer's ability to pay. This is a large part of the argument for progressive taxation is based upon i.e. rich people are in a better position to pay a greater proportion of their income in tax so they should.

Convenient

The payment method and timing should be convenient to the tax payer

Certain

Taxpayers should understand how the system works and should be clear about what, when and how to pay. Taxes should also be difficult to evade.

Efficient

An efficient tax system meets its aims whilst minimising the distortions such as reducing individuals' incentives to work or for firms to invest.

Flexible

The structure and rates of taxation must be capable of easy alteration in response to changing economic conditions.

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Pros and cons of indirect taxation

Pros

Influences spending patterns

Indirect tax changes are arguably more effect in changing the overall patter of demand, in particular goods and services, by changing relative prices. In comparison direct taxation has no "relative" effect as a tax directly on income merely shifts the demand curve for goods in proportionally.

Can be used to correct market failures

Indirect taxes can be useful in correcting the spill over effect of economic transactions where the total costs of the good are not represented by the market price. Because the price of the good is lower than the true cost of the good the good is over-consumer and therefore a demerit good; this leads to a loss of social welfare as resources are not being allocated efficiently. Indirect taxes on these demerit goods can help internalise the costs and achieve a more socially optimal allocation of resources which maximises social welfare.

Incentive effects

Indirect taxes have less of an impact upon individual work versus leisure choices as economic agents have the aspect of choice in their decision to pay as they could just forgo the good that has the indirect tax levied on it. (Laffer curve)

Flexibility

Indirect taxes are more flexible than direct taxes and therefore are more suitable given they can be altered in response to changing macroeconomic conditions. Direct taxes on the other hand are very inflexible and can only be changed once a year when the Budget is announced.

Cons

Regressive

Many indirect taxes are regressive as the proportion of income spent on that good, and therefore by extension the proportion of income spent on taxes, is higher for those in the bottom percentiles of the income distribution than those in the top percentiles. A big example of this is with petrol duties. If the petrol duty is 2p a litre this represents a much larger proportion of income to some one on £500 a month to someone on £50,000 a month. Therefore the tax is regressive. The choice aspect of indirect taxes is also overridden in certain cases as those goods, such as petrol, are necessity goods. The government attempts to get around this problem by exempting many necessity goods such as food, books and children's' clothing from VAT.

Inflationary

Indirect taxation leads to a direct increase in cost push inflation as prices of all goods in the production chain rise and this rise in costs can lead to increased prices for consumers. Also indirect taxation may alter workers expectations for inflation and therefore they may bargain for higher wages to maintain the purchasing power of their pay packets. This subsequently will lead to higher cost push inflation in the economy.

May lead to an increase in tax avoidance

High levels of indirect taxation create incentives to avoid them. This represents a welfare loss due to the negative externalities associated with crime as well as representing a loss of revenue for the government.

Lack of an "announcement effect"

Because indirect taxes can be changed more readily economic agents may not be entirely sure exactly how much they are ought to pay. This goes against the "certain" principle of Adam Smith's Canons of Taxation.

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Pros and cons of a budget deficit

Dependent on whether or not the deficit is a cyclical one or a structural one and what the money is being spent on.

Pros

Can be used to stimulate AD

Keynesian economists would advocate the running of budget deficit to boost AD in order to avoid a large negative output gap in a recession. If factors of production are left unemployed for too long their capital (be it human or physical) will start to erode and the productive potential of the economy will deteriorate. This is called the hysteresis effect; when a variable does not return back to its initial equilibrium. If AD is injected into the economy by the government this can avoid wide spread UE and factors of production will stay employed so the hysteresis effect does not take place.

Can be used to stimulate supply-side growth

If a budget deficit is used to finance additional capital spending such as roads, hospitals and schools this will improve the long run potential growth of the economy which can lead to higher levels of growth in the future and possibly increased tax takes for the government hopefully balancing out the deficit. This concept; that government spending pays for itself is called the fiscal dividend.

Cons

Increased government borrowing to finance the debt and increased national debt

Each year there is a budget deficit it adds to the national debt and the government has to sell interest incurring gov. bonds to finance the debt. If the debt keeps growing then interest payments will rise. This represents not only a leakage from the circular flow of income which will depress AD but an opportunity cost as the government is forgoing spending government revenues on welfare deriving goods and services such a schools, hospitals and roads to finance the national debt.

Having a high national debt also puts the government at increased risk of default. If investors start to lose confidence in the govs. ability to pay back the national debt the yields on bonds will rise as govs. have to offer greater rates of interest to entice investors to buy the bonds. This however increases the governments borrowing costs and increases the likelihood that it will default. Increased borrowing costs mean there is an even greater leakage from the circular flow of income and OC on paying interest.

If the lack of confidence in the govs. solvency grows yields rise and rise and a government can quickly become insolvent and must default on its debt. This can have very severe economic ramifications as government spending will be cut back on sharply as austerity must take place. Deep recessions and price deflation are usual consequences.

We have in Greece over the pass year the damage a sovereign debt crisis can do to an economy and also the damage it can do to surrounding economies. The lack of confidence in Greek gov. bonds spread to the surrounding Eurozone economies especially those with very high levels of sovereign debt dubbed the PIIGs (Portugal, Ireland, Italy and Greece). This spread of investor panic is called a "contagion". The resulting high bond yields and falling investor and consumer confidence is a major determinant of the EU's and by extension the rest of the Western World's (especially the UK with its high dependency on trade with the EU) poor economic performance over the last year.

Fiscal crowding out

Another consequence of higher government spending is that it may "crowd out" private sector investment. Increased government borrowing to finance a deficit will drive up interest rates for the private sector as well as more than likely lead to increased taxation for them. This will diminish the amount of private sector investment in the economy. This can be extremely detrimental for the economy as this will damage the long run growth prospects of the economy and possibly lead to slower growth rates in the future. Also common consensus says that private sector investment is more effective and efficient than government investment due to the discipline of the profit incentive. This means that government investment at the expense of private investment represents an inefficient allocation of resources and a loss in social welfare.

Limitations of fiscal policy

Although it still brings benefits, fiscal policy nowadays is seen as a less precise demand management tool than monetary policy. Previously governments used to try and "fine tune" the macroeconomy by using fiscal policy almost exclusively. This led to very destabilising boom bust cycles which were detrimental to everyone. Since the primacy of monetary techniques has been for certain although fiscal policy is still important albeit in a "back up" long term role with its impacts on the supply side of the economy being especially noted.

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Fiscal policy has numerous drawbacks:

Public choice theory

The choice of suitable fiscal policy is very susceptible to being distorted for non-economic means. Public choice theory states that politicians have the incentive to win votes therefore their incentive is to pick economic policies not to maximise social welfare or achieve the MEPOs but the economic policies that will increase the likelihood of them staying in power. For example increased benefits and reduced taxation is likely to win popularity for the party in power but it is at the detriment of the gov. finances MEPO. This is a drawback for the use of fiscal policy as the wrong policy may be chosen in order to keep the politicians in office, not to achieve the MEPOS.

Time lags

In addition to the time recognising the problems, the process of implementing policy and having it followed out (correctly or not is another issue) is also very lengthy so fiscal policy is accompanied by quite lengthy time lags. This can make the use of fiscal policy to influence the economy limited as policy makers may chose the right policy at the time but events between them implementing and the effects of the policy being felt may have made their policy choice redundant and possibly detrimental to the macroeconomic performance of the country.

Government revenues

Fiscal policy is also determined by the resources the government has at its disposal. If the economy is in need of a tax cut and an increase in benefits the government may not be able to do this as it may not have the revenues or it can't borrow any more without causing a reaction on the bond markets and threatening investor confidence. This means that fiscal policy has limits to what it can do determined by what resources the government have at their disposal.

Information failure

Exchange rates

Important definitions:

Floating rate - when the exchange rate is determined solely by the demand and supply of the currency on the FX markets.

A fixed exchange rate - when a gov. tries to maintain a fixed value or a "peg" of a currency compared to another currency or commodity

A "crawling peg" - when the peg of a fixed exchange rate is periodically revised

A managed float - when an exchange rate is allowed to fluctuate between two undisclosed levels

Advantages and disadvantages of a floating exchange rate:

Advantages

Constant adjustment of the exchange rate

Thanks to the invisible hand, the exchange rate will be constantly changing in relation to the demand and supply of pounds. This means that BoP deficits are less likely to happen for if UK exports become to expensive the demand for UK exports fall, so too does the demand for UK pounds, which means the value of the pound falls and then UK exports become more price competitive.

Reduced speculative pressure

Speculative investors do not know how low the gov. will let the exchange rate fall so there will be more risk, therefore less incentive, in speculating on sterling.

No need for government or central bank to hold currency reserve

Lower opportunity cost as asset reserves can be invested or employed doing something more productive.

Disadvantages

Does not guarantee a neutral BoP

UK exports could be structurally uncompetitive which would lead to a persistent disequilibrium in the BoP which any fall in the value of pound still could not fix.

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Currency uncertainty may have adverse effect on investment

Currency fluctuations, which are likely to occur with a floating exchange rate, may have an adverse impact on levels of FDI and trade flowing into the UK as foreign firms are unsure if the value of the pound will stay constant. Also it leads to greater "shoe leather" costs internationally as MNCs have to "shop around" to see which currency gets them the most value for money in regards to their investments. It also makes price comparisons less transparent and this can have a detrimental impact on UK trade.

Possibly detrimental to inflation

In an economy that is so dependent on imports such as the UK's, fluctuation in the exchange rate can have massive effects of the price level in the economy. If the value of the £ falls then M are more expensive driving up cost push pressure.

Lack of capital controls may lead to destabilising capital flows

A floating exchange rate system means that all capital controls on the country's currency are removed. This means that money can flow in and out freely as it likes. However hot money flows are extremely large and if there is a large scale inflow or outflow, caused by rises or falls in the int. rates, this can have destabilising effects on the exchange rate and by extension the macroeconomic performance of the country.

Factors affecting the exchange rate:

Relative interest rates