Question #69263 Economics / Macroeconomics

3.1. Consolidated government expenditure is expected to grow by 7.1 percent over the medium term, reaching R1.69 trillion in 2018/19. At this rate, spending growth will outpace inflation by 0.8 per cent. (Source: www.treasury.gov.za)

3.1.1 Describe the main instruments of fiscal policy that are available to government.

Government of each country use policies influence macroeconomic conditions. One of them – fiscal policy. Fiscal policy designed to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy. Main instruments are tax rates and government spending.

To illustrate how the government could try to use fiscal policy to affect the economy, consider an economy that's experiencing a recession. The government might lower tax rates to try to fuel economic growth. If people are paying less in taxes, they have more money to spend or invest. Increased consumer spending or investment could improve economic growth. Regulators don't want to see too great of a spending increase though, as this could increase inflation.

Another possibility is that the government might decide to increase its own spending – say, by building more highways. The idea is that the additional government spending creates jobs and lowers the unemployment rate.

3.1.2 Drawing from the statement above, how can government finance increased expenditure?

Government spends money for a variety of ways, including:

- To supply goods and services that the private sector would fail to do, such as public goods, including defence, roads and bridges; merit goods, such as hospitals and schools; and welfare payments and benefits, including unemployment and disability benefit.
- To achieve supply-side improvements in the macro-economy, such as spending on education and training to improve labour productivity.
- To reduce the negative effects of externalities, such as pollution controls.
- To subsidise industries which may need financial support, and which is not available from the private sector. For example, transport infrastructure projects are unlikely to attract private finance, unless the public sector provides some of the high-risk finance, as in the case when government provided huge subsidies to the banking sector to help deal with the financial crisis.
- To help redistribute income and achieve more equity.
- To inject extra spending into the macro-economy, to help achieve increases in aggregate demand and economic activity. Such a stimulus is part of discretionary fiscal policy.

3.1.3 What are the possible negative effects of 3.1.2 above?

Economists will generally agree that government spending becomes a burden at some point, either because government becomes too large or because outlays are misallocated. In such cases, the cost of government exceeds the benefit. The downward sloping portion of the curve can exist for a number of reasons, including:

- The extraction cost. Government spending requires costly financing choices. The government cannot spend money without first taking that money from someone. All of the options used to finance government spending have adverse consequences. Borrowing consumes capital that otherwise would be available for private investment and, in extreme cases, may lead to higher interest rates. Inflation debases a nation's currency, causing widespread economic distortion.

- The displacement cost. Government spending displaces private-sector activity. Every dollar that the government spends necessarily means one less dollar in the productive sector of the economy. In general, however, governments do not use resources efficiently, resulting in less economic output.

- The negative multiplier cost. Portions of the federal budget are used to finance activities that generate a distinctly negative effect on economic activity. The direct expense to taxpayers of membership in organizations such as the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) is often trivial compared to the economic damage resulting from the anti-growth policies advocated by these multinational bureaucracies.

- The behavioral subsidy cost. Government spending encourages destructive choices. Welfare programs encourage people to choose leisure over work. Unemployment insurance programs provide an incentive to remain unemployed. Flood insurance programs encourage construction in flood plains.

- The behavioral penalty cost. Government spending discourages productive choices. Saving is important to help provide capital for new investment, yet the incentive to save has been undermined by government programs that subsidize retirement, housing, and education. Why should a person set aside income if government programs finance these big-ticket expenses?

- The market distortion cost. Government spending distorts resource allocation. Buyers and sellers in competitive markets determine prices in a process that ensures the most efficient allocation of resources, but some government programs interfere with competitive markets. When individuals use other people's money, they become less concerned about price.

- The inefficiency cost. Government spending is a less effective way to deliver services. Government directly provides many services and activities such as education, airports, and postal operations. However, there is evidence that the private sector could provide these important services at a higher quality and lower cost.

- The stagnation cost. Government spending inhibits innovation. Because of competition and the desire to increase income and wealth, individuals and entities in the private sector constantly search for new options and opportunities. Reducing government-or devolving federal programs to the state and local levels-can eliminate or mitigate this effect.

3.2 With the aid of a properly labelled diagram, explain the three main characteristics of the consumption function.

A study of the short run consumption function reveals the following four characteristics:

1. Most poor people find it difficult to save be-cause they spend the major portion of their income on consumption goods. So income must reach a min-imum level for any saving to occur. In other words, there is a break-even level of income. It is the level of income at which households spend all of their income on consumption goods, neither more nor less, i.e., at which saving is zero.

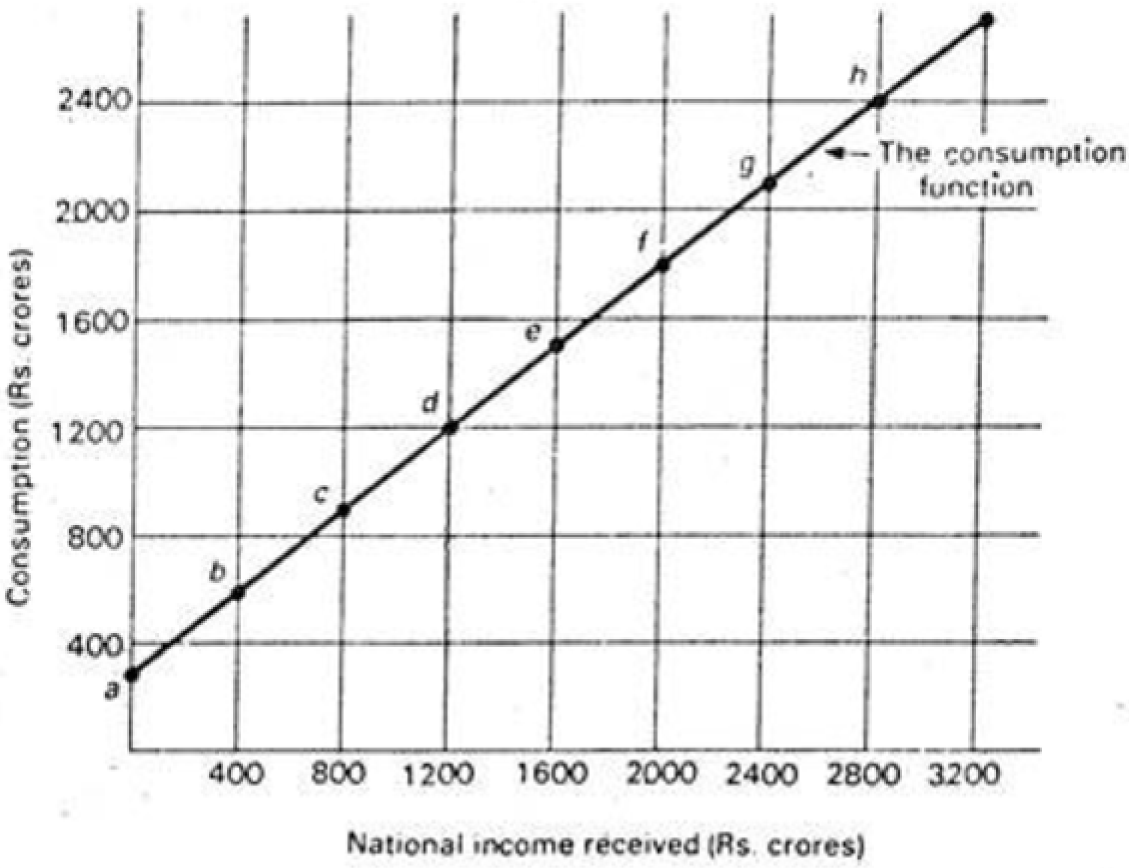
2. Below the critical (break-even) level people plan to spend in excess of their current income.

This can be done in two ways:

- Either by borrowing or
- By dissaving, i.e., by spending out of wealth accu-mulated in the past.

3. Once income crosses the break-even level, peo-ple plan to consume only a portion of their income and to save the remaining portion of it.

These basic assumptions about the dependence of consumption and saving on in-come. These are illustrated in Fig. The line plotted in Fig is a consumption function. Any point on the line shows planned consumption at each level of income.



Firstly Fig shows that the graph of the consumption function is upward sloping, implying that as income increases consumption spending also increases. This makes it clear that consumption chan-ges are induced by income changes. However, total consumption has an autonomous (income-independent) component.

1. In Fig. when national income is zero consumption spending is Rs. 300 crores. When income increases by Rs. 400 crores consumption increases by Rs. 300 crores. This part of total consumption at higher level of income is called autonomous (subsistence) consumption. This is the minimum amount people must consume, irrespective of income, in order to survive.

2. The second point to observe is that when na-tional income is Rs. 1200 crores, consumption expen-diture is also Rs. 1200 implying that saving is zero. This is the break-even level of income and is shown by point d in Fig.

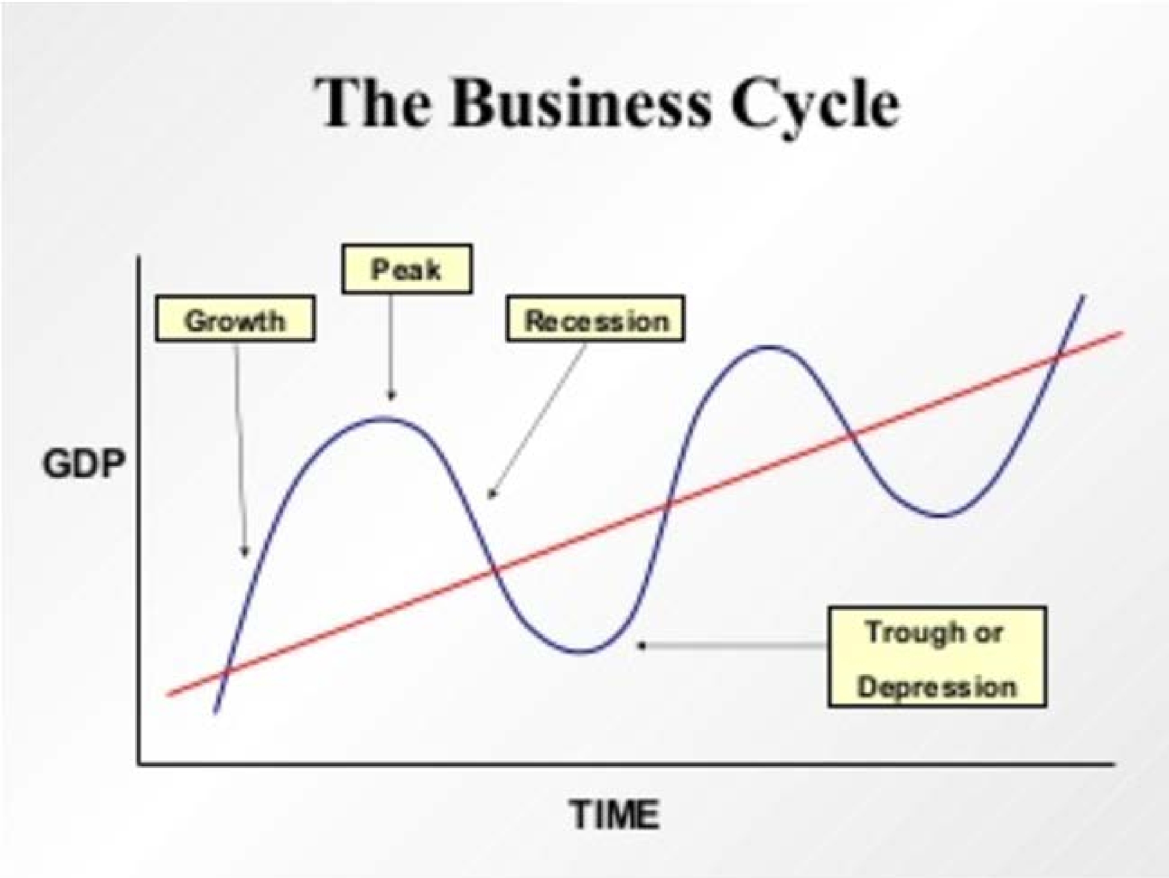
3. The third point to observe is that when national income is Rs. 800 crores consumption spending is Rs. 900 crores. Thus at this level of income there is dis-saving of Rs. 100 crores, implying that consumption expenditure exceeds income. This excess of consump-tion spending over income is financed by borrowing or reducing past saving. Point c in Fig. illustrates the point.

4. The fourth point is that if income crosses a Critical level (i.e., the break-even level) saving will be posItive. This is illustrated by point f in Fig.. Point f shows that when national income is Rs. 2000 crores, desired consumption spending is Rs. 1800 crores.

3.3 With the aid of a fully labelled diagram explain the general business cycle in the South African economy.

The business cycle is the fluctuation in economic activity that an economy experiences over a period of time. A business cycle is basically defined in terms of periods of expansion or recession.

During expansions, the economy is growing in real terms (i.e. excluding inflation), as evidenced by increases in indicators like employment, industrial production, sales and personal incomes.



South Africa is on Growth period during 2018-19. It is accompanied by a line of activities:

Source:

http://www.investopedia.com/terms/d/deficit-spending.asp
http://www.investopedia.com/articles/04/051904.asp
http://www.heritage.org/budget-and-spending/report/the-impact-government-spending-economic-growth
http://www.economicsonline.co.uk/Global_economics/Fiscal_policy_government_spending.html
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