Edexcel (A) Economics A-level

A-level Paper 2: National and Global Economy

Example answers

Evaluate the case for cutting public expenditure rather than raising taxes as a means of reducing fiscal deficits.

A fiscal deficit is when government revenues are lower than their spending, and so they have to borrow money to fund their spending. Thus, to reduce this, they can either reduce their spending or increase their tax revenues.

One benefit of cutting public expenditure as opposed to raising taxes is that the Laffer curve shows raising tax does not always raise tax revenue. It shows that beyond a certain point, tax revenues will not rise when the tax rate rises. A rise in taxes will decrease incentives as people gain less of their income to spend. As a result, less people will be working or they will work less hours (assuming the tax is income tax) or people will buy less of their good (if it is indirect). This will reduce tax revenues. Therefore, raising taxes may not mean that tax revenue increases and so the deficit may not fall. By cutting expenditure, the deficit will certainly fall (ceteris paribus) as less will be going out of the budget. Similarly, raising taxes may negatively impact on incentives and this will reduce the output of the economy. High corporation taxes will make MNCs less likely to establish within a country and therefore there may be less jobs. Income taxes may mean that high earners may leave the country to work elsewhere, or low income earners may simply decide that it is better to be on benefits. On the whole, this will reduce output and decrease LRAS, meaning that economic growth is inhibited in the long run. Therefore, it can be better to reduce spending as this is less likely to impact on incentives. However, it is also possible for reducing spending to reduce LRAS because less spending on education will reduce the skills of the workforce and therefore decrease productivity and lower output. The impact of tax changes will depend on which taxes are changed; higher indirect taxes will have less impact on incentives than indirect taxes would.

Moreover, cutting expenditure may help to reduce inefficiency. It is argued that it is better for the private sector to spend money. This is because the market mechanism is used to ensure resources are spent where consumers value them rather than where the government wants to be spent. Similarly, some say that the government wastes money on bureaucracy and administration. Therefore, it may be easy to cut back on expenditure and the spending will have no impact on output nor on quality of life. However, there is only a certain extent to which inefficiencies can be cut.

One problem with cutting expenditure is that it will have a negative impact on quality of life and equality. Reduced spending will mean that less money is spent on the NHS, pensions, welfare or education. This will have a more than proportionate impact on the poor because they receive a larger percentage of government spending than the rich. This will cause an increase in inequality. Raising taxes may be more progressive because it can be targeted at the richest in society or equally across all income groups. This would require increase in direct taxes, but increases in indirect taxes would likely to be regressive so therefore it depends on taxes. In general, raising taxes will be less negative on income equality than spending.

Additionally, cutting public expenditure may cause increased market failure. The government provides public goods, such as education or healthcare and so a reduction in public expenditure will mean that services are worsened, or their availability reduced. This increases market failure.
Overall, the government should raise taxes rather than cut public expenditure. This is because reduced spending is likely to have a negative impact on equality and reduce quality of life in the country. It is difficult for the government to find more areas to cut spending. After years of austerity in the UK, there is still a deficit which would suggest that raising tax may be the way to go. It

depends mainly on the levels in a country. If taxes are already very high, the best way would be to reduce expenditure. However, if like the UK, spending has been cut almost as much as possible so there is a need to raise taxes.

Teacher's comments: 21/25

Could talk about view that you could attempt to grow out of the deficit if you encourage economic growth- would see higher tax revenues without need to increase tax rates.