Public Expenditure

# Starter - Brainstorm

**Instructions:** Consider the question and note your ideas in the space provided

*‘What do Governments spend money on?’*

***Extension:*** *‘Why do they spend on these things?*

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| Note Space: |

# Presentation 1 - Intro to Public Expenditure

Complete the activities below so as to have a complete set of Notes:

**Definition:** *Public Expenditure*

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**Key Notes:** Three main types of Public Spending

**Definition:** *Transfer Payments*

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*Examples:*Jobseekers’ Allowance, Child Benefit, State Pension, Housing Benefit, Income Support and the Working Families Tax Credit

*Role:* The main aim of transfer payments is to provide a basic floor of income or minimum standard of living for low income households.

*N.B.* Transfer payments are payments where no good or service is received in return

**Definition:** *Current Spending*

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*Example:*The NHS is the UK’s biggest employer with over one million people working within it.

*Role:*Important in providing Public & Merit Goods to a society, as well as a stable component of AD

**Definition:** *Capital Spending*

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*Examples:* Spending on projects such as new motorways and roads, hospitals, schools and prisons.

*Role:* This government investment spending adds to the economy’s capital stock and can have important demand and supply side effects in the long term.

**Key Question:** Why do governments spend?

*Providing Important Goods:*

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*Expanding Economic Potential:*

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*Protecting Important Industries:*

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*Redistributing Income:*

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*Stimulating the Economy:*

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# Group Task: UK Government Spending post GFC

**Instructions:**

* Read, highlight and annotate the article
* In your group analyse the reasons for the changing size and composition of public expenditure in the UK.
* Fill the table with your analysis. Discuss at the end
* Discuss your answers as a class

**Article**

*What caused the deficit? - The mess in Britain's finances has three main causes.*

The first is that the crisis of 2007 arrived when the budget was in relatively poor shape. Tax receipts during the bubble years were weaker than the Treasury expected, which meant that even with the economy booming the deficit stood at close to £40bn.

The second factor was the depth and duration of the recession. Deficits tend to rise during downturns because tax receipts fall and spending on unemployment and other welfare payments rise. So part of a fiscal deficit may be the consequence of the automatic stabilisers at work. These are the tax and government spending changes that happen automatically at different stages of the business cycle. The governments of most developed countries are prepared to allow the automatic stabilisers to work through because, when their economy recovers, the cyclical component of a fiscal deficit will diminish, indeed in an economic boom, the government may run a budget surplus. In Britain's case, the economy contracted by more than 6% over six successive quarters from early 2008 to late 2009. By the time growth resumed national output was 10% lower than it would have been had the economy continued to expand at its normal rate of around 2.5% a year. That punched a hole in the public finances.

Finally, the VAT holiday and help for the unemployed, designed to mitigate the effects of the recession, cost around £25bn, or around 1.5% of GDP, much smaller in relation to the size of the UK economy than the packages used to support growth in the United States or China. Keynesian economists have long favoured the use of targeted and timely fiscal stimuli such as labour-intensive public works and other infrastructure investment projects, designed at kick-starting an economy suffering from a chronic lack of demand and income.

Part of the deficit is deemed to be cyclical – it will disappear once the economy grows strongly. The other part, the £70bn structural element, is what the government wants to eliminate during the current parliament. Demographic pressures can also affect the fiscal position too, for example an ageing population will cause an increase in government spending on the state pension; a fast-growing population (perhaps boosted by net inward migration) will also put more pressure on the government to fund essential public and merit goods. From 2004 to 2040, the number of people over 64 in Britain is expected to grow from 9.5 million to 15 million. In 2000 there were 11.2 million people under the age of 15 in the UK. By 2040, this will have decreased to 8.7 million. Over time, total government spending can rise because of the many competing demand placed upon politicians and the effects of lobbying by (often influential / powerful) pressure groups. In some countries, public spending is bloated by very generous systems of farm / food / energy subsidies that are politically hugely difficult to remove. The state might also get locked into providing financial support for loss-making businesses and industries such as airlines. THE UK Government will continue paying farm and other subsidies currently sent to from Brussels after Britain leaves the European Union, Chancellor Philip Hammond has announced.

N.B. The bank bailouts have little impact: the Treasury does not count money used to buy bank shares because it assumes it will get it back.

Since 1993-94 the top three spending categories have been social protection, health and education. They all have a higher proportion of government spending than they did 20 years ago.

The coalition government began the triple lock in 2010. From April 2014, the basic state pension will be around £440 a year higher than it would have been if it had been increased in line with the increase in average earnings. In April 2013, the state pension increased by 2.5%, as this was higher than inflation or earnings, giving an extra £2.70 a week and raising the full basic state pension to £110.15 a week.

Health spending increased steadily and had the largest increase proportionally, increasing from 13.5% to 19.2% of all government spending in 2013-14.

Social protection (pensions and benefits) spending was the largest public spending category totalling £250.6 billion in 2013-14. Spending on social protection was 37.2% in 2013-14, up from 36.2% in 1993-94.

Education was the third largest area of government spending and proportionately, this has grown slightly over the last 20 years. Whereas spending on defence and public order and safety, which includes policing and crime prevention, has fallen as a share of all spending.

**Table**

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| --- | --- | --- |
| Factor:  | ↑ or ↓ G: | Causality: |
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# Presentation 2 - Causes of Changes to the Size and Composition of Public Expenditure

Complete the activities below so as to have a complete set of Notes:

**Elaborate:** Elaborate on the below factors influencing levels and the make-up of public spending

*Changes to Incomes:*

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*Changing age distributions:*

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*Changing expectations:*

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*The Great Financial Crisis:*

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# Case Studies Task: Changing size and composition of public expenditure

**Instructions:**

* Read, highlight and annotate the articles
* Answer the questions
* Discuss your answers as a class

**Articles**

**Source 1:** The Nordics cluster at the top of league tables of everything from economic competitiveness to social health to happiness. They have avoided both southern Europe’s economic sclerosis and America’s extreme inequality. Development theorists have taken to calling successful modernisation “getting to Denmark”. In the 1970s and 1980s the Nordics were indeed tax-and-spend countries. Sweden’s public spending reached 67% of GDP in 1993. Astrid Lindgren, the inventor of Pippi Longstocking, was forced to pay more than 100% of her income in taxes. On public services the Nordics have been similarly pragmatic. So long as public services work, they do not mind who provides them. Denmark and Norway allow private firms to run public hospitals. Sweden has a universal system of school vouchers, with private for-profit schools competing with public schools. Denmark also has vouchers—but ones that you can top up. Public services are arguable normal goods, meaning that as incomes rise so does demand for them and hence more taxation and spending is needed. This may sound like enhanced Thatcherism, but the Nordics also offer something for the progressive left by proving that it is possible to combine competitive capitalism with a large state: they employ 30% of their workforce in the public sector, compared with an OECD average of 15%.

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**Source 2:**  Africa is losing more than $50bn (£33bn) every year in illicit financial outflows as governments and multinational companies engage in fraudulent schemes aimed at avoiding tax payments to some of the world’s poorest countries, impeding development projects and denying poor people access to crucial services. Illegal transfers from African countries have tripled since 2001, when $20bn was siphoned off, according to a report released by the African Union’s (AU) high-level panel on illicit financial flows and the UN economic commission for Africa (Uneca). In total, the continent lost about $850bn between 1970 and 2008, the report said. An estimated $217.7bn was illegally transferred out of Nigeria over that period, while Egypt lost $105.2bn and South Africa more than $81.8bn.

SOMALIA is not only one of the world’s poorest and least developed countries, it is also one of the most dangerous for tax collectors. By one reckoning a fifth of tax collectors in the capital, Mogadishu, were killed in 2012-14. Armed guards now accompany the remainder on their rounds. That may be an extreme case, but most poor countries struggle to raise much revenue, and therefore to pay for basic infrastructure and services. There are many reasons why poor countries don’t collect as much tax as rich ones, the most obvious of which is that lots of their citizens are penniless. Another is that their economies are largely informal and thus beyond the reach of taxmen. The cost of tax collection in sparsely populated regions is often higher than the benefits, and around 60% of sub-Saharan Africans still live in rural areas, for example. Britain’s Department for International Development has been sending tax administrators abroad for more than ten years to advise revenue-starved governments. One such expert, Kieran Holmes, helped to increase annual tax revenue in Rwanda by 6.5 times after automating the collection process, which reduced errors and opportunities for fraud.

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**Source 3:** The question of market-oriented governance or planned economy have lots of historical context and are of the upmost importance to the world leaders of today. In China from 1999 to 2009 the state's share of industrial output by value fell from 49% to 27%, according to a recent report by Unirule Institute of Economics, an independent think-tank in Beijing. In 1999 government-controlled firms owned 67% of industrial capital; a decade later their share had fallen to 41%. But in the industries that pay the highest salaries, state firms dominate. A huge change is underway in China. Over the next 10 years, the country plans to move 250 million people — the equivalent of Indonesia's entire population — into the country's rapidly-growing megacities. To accommodate that enormous migration, the country has invested billions of dollars in massive infrastructure projects. Some are already complete, while others are still in the works. From highways that span the continent, to the largest wind power base in the world, to enormously popular airports, to new cities in the desert, China is showing what it really means to do big things.

* $473 MILLION: The Qinling Tunnel is the longest highway tunnel in China, measuring more than 11 miles underneath Zhongnan Mountain.
* $532 MILLION: The Hainan power grid project will get a second underwater cable that runs between the southern island of Hainan to mainland China. It's slated to be completed in 2017.
* $717 MILLION: The Kashgar-Hotan Railway connects all the cities and towns of the southwestern Tarim Basin.
* $900 MILLION: The Tianhuangping hydroelectric project is the biggest in Asia and plays a vital role in supplying power to eastern China.

Western countries will hit the limits of big government, as Sweden did. When Angela Merkel worries that the European Union has 7% of the world’s population but half of its social spending, the Nordics are part of the answer. They also show that EU countries can be genuine economic successes. And as the Asians introduce welfare states they too will look to the Nordics: Norway is a particular focus of the Chinese.

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**Source 4:** A new report from Aon Hewitt, the global talent, retirement and health solutions business of Aon plc (NYSE: AON), estimates that the average cost increases for employer-sponsored medical plans globally will be 9.1 percent in 2016. This is 5.5 percentage points higher than the global average projected inflation rate of 3.6 percent. In the UK, the increase in the costs of employer-sponsored plans is expected to rise by 9.3 percent. "We expect medical costs to continue to escalate around the world due to global population aging, overall declining health, poor lifestyle habits particularly in emerging countries, continued cost shifting from social programmes and an increase in utilisation of employer-sponsored health plans. Regardless of the underlying medical insurance system, employers around the world are continuing to experience added organisational cost and lost workforce productivity as a result of these factors." Aon Hewitt's report found that cardiovascular issues, cancer and gastrointestinal issues were the most prevalent health conditions driving health care claims around the world. Prevailing issues in Europe are cardiovascular, cancer and diabetes. The global risk factors expected to drive future claims and to contribute to the adverse experience driving high medical cost increases, were primarily non-communicable diseases, such as high blood pressure, obesity and high cholesterol, followed by physical inactivity. In Europe, the top reported conditions are high blood pressure, smoking and poor stress management.

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**Source 5:** When Spanish business consultant Alejandro Macarrón started crunching the numbers behind Spain’s changing demographics, he couldn’t believe what he was seeing. “I was astonished,” said Macarrón. “We have provinces in Spain where for every baby born, more than two people die. And the ratio is moving closer to one to three.” Spain has one of the lowest fertility rates in the EU, with an average of 1.27 children born for every woman of childbearing age, compared to the EU average of 1.55. Its crippling economic crisis has seen a net exodus of people from the country, as hundreds of thousands of Spaniards and migrants leave in the hope of finding jobs abroad. The result is that, since 2012, Spain’s population has been shrinking. A political knock-on effect is the overwhelming political power of the grey vote. Macarrón points to the crippling austerity measure put in place during the economic crisis: “During the same time frame, expenditures on pensions rose by more than 40%. We’re moving closer to being a gerontocratic society – it’s a government of the old.”

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**Source 6:** In 2008 the United States Congress passed—and then-President George W. Bush signed—the Economic Stimulus Act of 2008, a $152 billion stimulus designed to help stave off a recession. The bill primarily consisted of $600 tax rebates to low and middle income Americans. The United States combined many stimulus measures into the American Recovery and Reinvestment Act of 2009, a $787 billion bill covering a variety of expenditures from rebates on taxes to business investment. $184.9 billion was to be spent in 2009, and $399.4 billion was to be spent in 2010 with the remainder of the bill's appropriations spread over the rest of the decade. Announcements of rescue plans were associated with positive returns whereas a public intervention in favor of a specific bank showed negative impacts. A statement on the government's website said the State Council had approved a plan to invest 4 trillion yuan in infrastructure and social welfare by the end of 2010. This stimulus, equivalent to US$586 billion, represented a pledge comparable to that subsequently announced by the United States, but which came from an economy only one third the size. The stimulus package will be invested in key areas such as housing, rural infrastructure, transportation, health and education, environment, industry, disaster rebuilding, income-building, tax cuts, and finance. China's export driven economy started to feel the impact of the economic slowdown in the United States and Europe, and the government had already cut key interest rates three times in less than two months in a bid to spur economic expansion. The stimulus package was welcomed by world leaders and analysts as larger than expected and a sign that by boosting its own economy, China is helping to stabilize the world economy. World Bank President Robert Zoellick declared that he was ‘delighted’ and believed that China was ‘well positioned given its current account surplus and budget position to have fiscal expansion.' News of the announcement of the stimulus package sent markets up across the world. Compared to other European nations, Germany is in a unique position: It has low debt, a high balance of trade, and an export driven economy. The recession has led to a decline in German exports, but Germany has the capacity to replace some of the export demand with domestic stimulus. The Germans were initially hesitant to pass a large stimulus bill; however, in 2009, the Germans passed a 50bn euro stimulus bill that focused on taxes, a child tax credit, and spending on transportation and education. Prior to the 2009 stimulus, one of Germany's largest stimulus efforts had been a scrappage program. The German stimulus program includes a "cash for clunkers" program that offers rebates of $3,172 to Germans who scrap their old cars for new, more efficient models. The program totals about 5 billion euros.

**Questions**

What causes different levels of spending as a % in GDP in different countries?

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What causes different proportions of spending in different countries?

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What is the impact of economic development on public expenditure?

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**Extension:** which elasticity is relevant for the use of public services?

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Presentation 3 - Impacts of Changes in Public Expenditure

Complete the activities below so as to have a complete set of Notes:

**Key Notes:** Impacts

*Productivity and growth:* Increased government spending can promote economic growth

Capital spending provides the infrastructure, such as roads, needed for the economy to run smoothly.

Current spending improves the quality of labour (Education creates the human capital, healthcare reduces the number of days workers lose from serious illness).

Furthermore, sufficient spending on R&D may not be done by the private sector, so the government will undertake it to give businesses a long term competitive edge.

*However:*

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*Living Standards:*Government spending can drive large improvements in living standards.

The government corrects market failure and provides public goods, which boost social welfare.

They also act to reduce absolute poverty by providing benefits and basic goods.

In developing countries, governments are unable to do this, leading to malnutrition, poor water etc.

*However (1):*

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*However (2):*

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*National Debt:*Successive years of budget deficit will increase the size of the national debt.

In turn, this would result in increased interest payments on the national debt in the future which may mean that less public expenditure is available for spending on public services such as new schools and hospitals.

Taxes would need to be increased as well to pay the debt off, reducing consumption and investment, further constraining economic output.

*However:*

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# Table Task: Causes and Impacts

**Instructions:** With reference to the previously seen case studies, complete the table to explain the causes and impacts of changes in the size or composition of public.

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| **Factor**  | **Why has this caused a change in the size or composition of public expenditure & examples:** | **Impacts** (productivity, growth, living standards, crowding out, level of taxation, equality) |
| Source 1 & 3: Role of government & political ideology: market- oriented or planned economy  |  |  |
| Source 2: Ability to raise tax improves with development  |  |  |
| Source 3 & 4: Positive YED of public services  |  |  |
| Source 4: Importance and cost of healthcare grows with development  |  |  |
| Source 5: Population change: total and distribution  |  |  |
| Source 6: Response to external shocks e.g. Financial Crisis 08/09  |  |  |

Presentation 4 – Crowding Out

Complete the activities below so as to have a complete set of Notes:

**Definition:** *Crowding out*

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**Key Notes:** Workings

If a gov. runs a budget deficit, it must finance its spending by selling bonds to the private sector.

This leads to an increase in the demand for ‘loanable funds’

I.e. the demand for borrowing money

To tempt lenders, a government will need to offer higher returns on its bonds.

In the diagram this is seen in the rise in real interest rates

This rise in interest rates may then ‘crowd-out’ private investment and consumption, as there is greater reward for buying gov. debt (i.e. saving), offsetting the fiscal stimulus

Eventually higher government spending must be funded by higher taxes, which again squeezes private sector spending and investment. Thus, fiscal stimulus is less effective in an expansion as at full capacity, an increase in public demand crowds out private demand, leaving output unchanged, but with higher prices!

**Key Notes:** Evaluating the Crowding Out Theory

The probability of 100% crowding-out is remote, especially if the economy is operating below its capacity and if there is a plentiful supply of saving available to purchase newly issued state debt

Keynesian economists such as Paul Krugman argue that fiscal deficits crowd-in private sector investment.

Well-targeted, timely and temporary increases in government spending can absorb under-utilized capacity and provide a strong multiplier effect that generates extra tax revenue.

Another criticism of the basic theory is that the available supply of loanable funds Is not limited to domestic sources, external finance is available from other countries

Presentation 5 – The Fiscal Multiplier

Complete the activities below so as to have a complete set of Notes:

**Definition:** *The Fiscal Multiplier*

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The fiscal multiplier measures the effect of a £1 change in spending or a £1 change in tax revenue on the level of GDP

**Key Notes:** *In Context*

According to an IMF research report published in 2014, “the literature finds that (government) spending multipliers tend to be larger than (tax) revenue multipliers.”

This would be supported by Keynesian theory, which argues that tax cuts are less effective than spending increases in stimulating the economy since households may save a significant portion of the additional after-tax income.

The IMF also found that fiscal multipliers are generally larger in downturns than in expansions – this supports the Keynesian view of using fiscal stimulus when conventional monetary policy is found to be ineffective

***Evaluation:***

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e.g. financial stress - uncertainty about job prospects, future income and inflation levels might make people save tax cuts or openness of the economy the more open an economy is (i.e. the higher is the ratio of imports and exports to GDP) the greater the extent to which higher government spending or tax cuts will feed into rising demand for imports, lowering the impact on domestic GDP.

# Assignment

**Section C (Essay)**

"In 2016 the UK Chancellor of the Exchequer announced that the government would spend an extra £23 billion on innovation and infrastructure over the following five years.”

Evaluate the likely economic effects of this planned increase in government expenditure.

[25]

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| **Planning Grid: Aim = 5 paragraphs - 2 KAA points (16); 2 Eval points (9) with a conclusion**  |
| **KAA Point 1 = signpost key point** |  |
| Application |  |
| Main concept & diagram |  |
| **Eval Point 1 = relate to your earlier point & re-read the title** |  |
| Context / evidence |  |
| **KAA Point 2 = signpost key point** |  |
| Application |  |
| Main concept & diagram |  |
| **Eval Point 2 = relate to your earlier point & re-read the title** |  |
| Context / evidence |  |
| **Conclusion = judgement** |  |
| Context; what does it depend on? |  |

**Question:** Evaluate the likely economic effects of this planned increase in government expenditure. [25]