Lab 6:

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Part 1: Quiz Questions

Quiz 7 Question 17: The country of Sylvania has a GDP of $4000, investment of $500, government purchases of $400, and net financial outflow of negative $300. What is consumption? Show your work.

Y = 4000, I = 500, G= 400
Y= C + I + G + (X-M)

Therefore, C is Y-G-I-(X-M) = 4000-400-500-(-300) = **3400$**

Quiz 7 Question 28: Imagine that Canada finds itself in the following situation: we have a government budget surplus of $200 billion, total private savings of $2100 billion, and total domestic investment of $1200 billion. According to the national saving and investment identity, what will be the current account balance? What would the current account balance be if investment rises by $50 billion while the budget deficit and domestic savings remains the same. Show your work.

GOVERNMENT BUDGET SURPLUS = PUBLIC SAVING = T – G = 200

S = 2100, I = 1200

Balance of Trade = FA = CA

S + (T-G) = I + CA

CA = S + (T-G) – I = 2100 + 200 – 1200 = 1100$

I = 1200 + 50 = 1250$

CA = 2100 + 200 – 1250 = 1050$

Part 2: Video Questions

Step 1: Read the Instructions Document and Watch the Video

Question 1: How has leaving the EU affect trade? Why has it led to lower investment in the UK?

Leaving the EU has had a significant impact on the UK's trade. According to the data, overall, UK trade volumes fell in the year following the end of the transition period. Specifically, goods imports from the EU were down 18% on 2019 levels, double the 9% fall in goods exports to the EU. This suggests that there have been tighter restrictions on the EU side of the border, leading to a decrease in trade volumes. Additionally, there is little sign to date of UK goods exports to non-EU countries making up for lower exports to the EU.

The decrease in trade can be attributed to new border frictions and higher transport costs that pose new barriers to trade. Furthermore, under a hard Brexit scenario, whereby the UK reverts to World Trade Organization rules, only one-third of UK exports to the EU would be tariff-free, while one-quarter would face high trade barriers.

The impact on investment in the UK is also significant. Brexit has reduced foreign direct investment (FDI) inflows into the UK. The new trade barriers and uncertainty surrounding the UK's future relationship with the EU have made the UK a less attractive destination for investment. Businesses have remained wary of the outlook for the economy, leading to a stall in investment. If investment had continued its pre-referendum trend, the UK economy could have been in a stronger position.

Question 2: Why might lower investment lead to lower government tax revenue?

Lower investment can lead to lower government tax revenue in several ways. Firstly, when businesses invest less, they typically generate less profit, which in turn means they pay less in corporate taxes. Secondly, lower investment can lead to fewer jobs being created, which means less income tax revenue for the government. Additionally, when there are fewer jobs, consumer spending tends to decrease, leading to lower sales tax revenue.

Furthermore, lower investment can slow down economic growth, which can have a broader impact on tax revenue. When the economy is not growing, businesses and individuals tend to earn less, and therefore, they pay less in taxes. This can lead to a decrease in government tax revenue.

In summary, the impact of Brexit on the UK's trade and investment has been significant, leading to lower trade volumes and reduced investment. This has potential implications for government tax revenue, as lower investment can lead to less corporate, income, and sales tax revenue.

Question 3 (Optional): Let us link this to our discussion from the previous chapter. With lower expected tax revenue, the British government already expected a budget deficit. However, it published a mini budget in September 2022, proposing using a tax cut to solve the situation. (You can read https://www-economist-com.ezproxy.library.uvic.ca/britain/2022/10/12/britains-government-is-yet-to-deal-with-a-mess-of-its-own-making and more from the extended reading of "introduction to financial system.") How would it work (in theory)? (You can search "trickle-down economics". If you are interested, you can further read https://www-economist-com.ezproxy.library.uvic.ca/leaders/2022/09/22/liz-trusss-selective-reaganomics-wont-work to see the counterargument for such policy. We may come back if we have time to discuss fiscal policy.)

Understanding the Theory

The British government's proposal to use a tax cut to address a budget deficit is rooted in the theory of trickle-down economics. This theory posits that reducing taxes on businesses and the wealthy in society will stimulate business investment in the short term and benefit society at large in the long term.

The idea is that when taxes are cut, businesses and individuals have more disposable income. Businesses, in turn, can invest in capital, create jobs, and drive economic growth. Wealthy individuals, having more income, can also invest and spend more, further stimulating the economy. This increased economic activity can potentially lead to higher tax revenues, even with lower tax rates, which could help to reduce the budget deficit.

Applying the Theory to the British Government's Situation

In the context of the British government's situation, a tax cut could theoretically stimulate economic activity and increase tax revenues. If businesses respond to the tax cut by investing more in the UK, creating more jobs, and increasing wages, this could lead to higher income tax and sales tax revenues. Similarly, if wealthy individuals respond by spending more, this could also increase sales tax revenues.

However, it's important to note that the effectiveness of this approach is a subject of ongoing debate among economists. Some argue that the benefits of tax cuts largely accrue to the wealthy and may not necessarily trickle down to the rest of the economy in the form of increased jobs and wages. Others argue that tax cuts can lead to increased economic inequality.

Moreover, the impact of a tax cut on the budget deficit is not guaranteed. The increase in tax revenues resulting from increased economic activity may not be sufficient to offset the initial loss of revenue from the tax cut. If this is the case, the budget deficit could increase because of the tax cut.

Counterarguments and Further Discussion

The article mentioned from The Economist provides a counterargument to the policy of using tax cuts to address budget deficits. It suggests that selective Reaganomics, a term often associated with trickle-down economics, may not work in the current context. This is a complex issue with many factors to consider, and it would be interesting to delve deeper into this topic if we have time to discuss fiscal policy in more detail.