

Should Fairness Matter in Economic Policy?

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1. Introduction

Governments have tough decisions to make when creating economic policy. Should fairness be included in the decision making process? Fairness can be defined as, “the quality of treating people equally or in a way that is right or reasonable.”¹ To achieve economic goals such as sustained economic growth, it may be argued that it is not possible to treat each and every citizen in a fair way.

In this assignment I will investigate how the government use economic policy, and analyse whether or not fairness has been considered. I will also attempt to answer the question of, “Should fairness matter in economic policy?” I will look into areas including a minimum wage, banker bonuses and the UK’s membership to the EU.

2. Minimum Wage

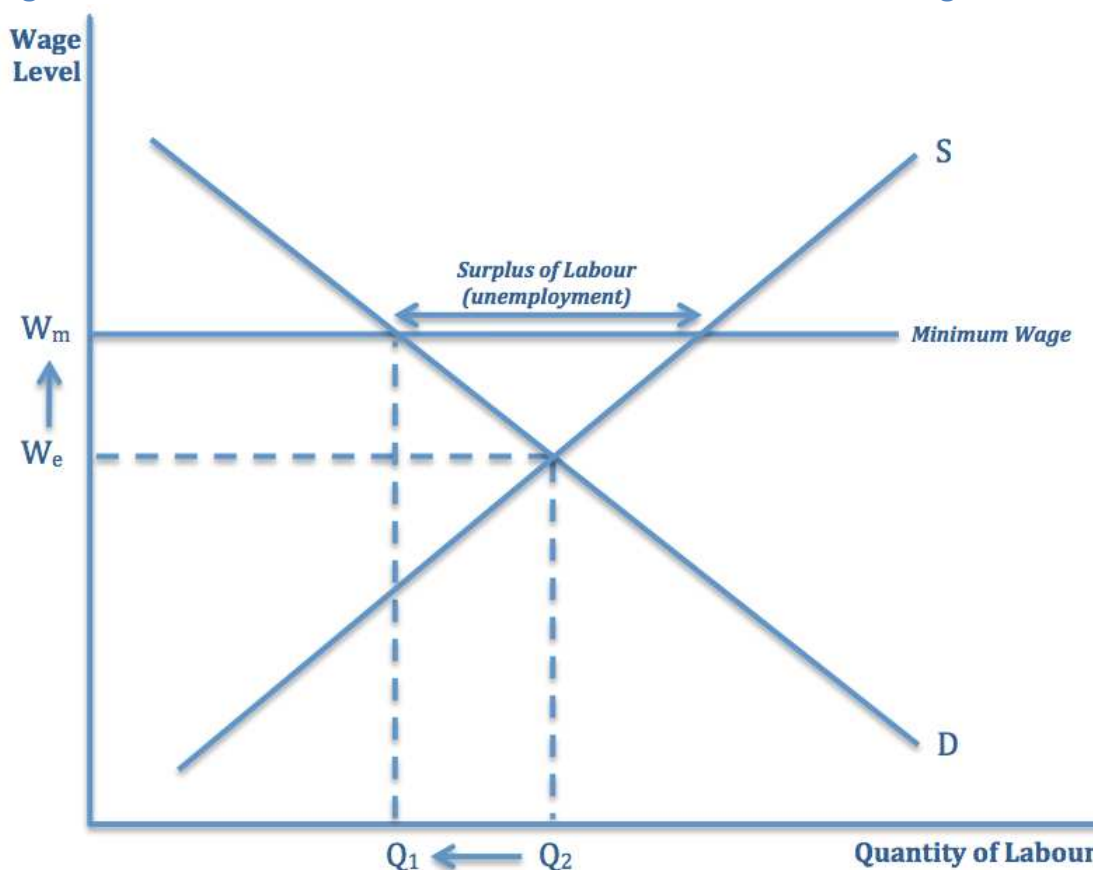
A minimum wage is an economic policy intervention into the labour market. The government set a floor for the price of wages, which does not allow the price of labour (per hour) to fall below a certain wage. Fairness is clearly a large influence for a government to set a minimum wage. It is usually implemented to stop employers taking advantage of their employees, especially in low skilled industries, and at times where unemployment is high. These are circumstances where the balance between worker and employer power, is heavily in favour of the employer. In the UK, the minimum wage was originally introduced in 1999 at £3.60 for workers over the age of 21. This was to protect many workers in industries such as cleaning and catering from being exploited. Before the introduction of the minimum wage they could often expect to receive a wage less than £2 per hour.²

By setting a price floor on the labour market, there can be negative effects to some suppliers of labour; this is demonstrated in figure 1. The price floor shifts the price of labour above the equilibrium level from W_e to W_m . This causes there to be a surplus of labour in the market, otherwise known as unemployment. Only the employed benefit from a minimum wage, and therefore only those workers can be lifted out of poverty. The minimum wage can therefore create greater unemployment, as people who were originally willing to supply their labour below the minimum wage level are no longer legally allowed to.

¹ Cambridge Dictionaries Online: Fairness,
http://dictionary.cambridge.org/dictionary/british/fairness_1

² Sloman, J., Wride, A., 2009. *Economics*, Pearson Education. Page 287

Figure 1: A labour market with the introduction of a minimum wage



A minimum wage is an intervention into the labour market to ensure that workers are protected, by receiving a fair wage for their labour. This interference into the market can however have negative effects on workers with lower wage expectations. They are forced out of work as businesses employing unskilled workers reduce employment. This causes greater inequality amongst society and could be considered an unfair policy for those with low wage expectations.

3. Income Tax

The UK operates a progressive tax system on people's incomes. This means that the post-tax distribution of income is more equal. Governments tax people's earnings in order to raise revenue to fund government spending. People are taxed in proportion to their incomes in order to reduce inequality. An individual earning ten times the amount someone else is, is less than likely contributing ten times the effort and value to society. Therefore it may seem fair that people with higher earnings are taxed more, and part of this tax revenue is redistributed to poorer people in society through welfare payments.

It can be argued however that it is only fair to tax people at the same rate, irrelevant of their income. Students often study at University in order to improve their job prospects and increase the chance of achieving a higher salary. Some people may put in extra hours in order to secure a promotion or a pay rise. Is it therefore fair to penalise a worker by taxing their extra income at a higher rate?

Although effort can be linked to income, there is often an element of luck involved. Someone may be born into a wealthy family who can provide him or her with a private education or fast track them to a highly paid position within a family business. Somebody may have the talent to be successful, but without the right opportunities they may never be noticed by an employer willing to pay high salaries. People are born with different abilities and intelligence levels, so may be less productive and less able to contribute as much to society as someone else. But should they be penalised for being born with only one arm or learning difficulties, things out of the individual's control? Then again, should someone be penalised for being lucky?

People with higher incomes often have a higher propensity to save since they have a greater disposable income. When money in an economy is saved, it is not being circulated around the economy. The rich may not consider a progressive income tax fair, however it allows money otherwise hoarded in savings accounts, to be fed back into the economy. Greater consumption can lead to economic growth, as aggregate demand is shifted outwards. So from the perspective of a high earner, they may not consider the income tax system as fair. But it is necessary from an economics perspective in order to achieve a more efficient allocation of resources (in this case money).

4. Monetary Policy

Monetary policy is used as a method of stabilising the economy through the control of the money supply, often through adjustments to the base rate. The Bank of England cut the base rate to a historic low of 0.5% in March 2009, where it has remained at this level to date.³ Low interest rates stimulate the economy, as the cost of borrowing is cheaper which leads to increased consumption. There are members of society who are heavily reliant on savings, namely pensioners. They often rely on interest payments on their savings, and with the base rate at such a low level the return on savings is generally very small. Another problem with low interest rates for savers is when the economy is experiencing high levels of inflation. The current level of inflation is at 3.7% (CPI January 2011)⁴, which is above the Bank of England target. This means that with inflation higher than interest rates, the value of savings is depreciating. This could be regarded as terribly unfair on certain members of society, particularly pensioners.

Should fairness be considered when the interest rate is set? If fairness was a consideration into the Monetary Policy Committee's (MPC) decisions, it may be reluctant to reduce the base rate to such a low level seen in recent years. However monetary policy is a valuable tool in sustaining economic stability and helped the economy to emerge out of recession in Q4 of 2009.⁵ Lowering the

³ BBC News, UK interest rates to stay at a record low 'until 2014', <http://www.bbc.co.uk/news/business-10756094>

⁴ Bank of England, <http://www.bankofengland.co.uk/>

⁵ Guardian, UK scrapes out of recession but growth figure disappoints City, <http://www.guardian.co.uk/business/2010/jan/26/uk-recession-over>

base rate to 0.5% was necessary to stimulate the economy when it was experiencing negative growth. If the MPC were reluctant to lower the base rate due to concerns of fairness on pensioners and other savers, then an even deeper recession would have been likely.

5. Banker Bonuses

Banker bonuses are highly topical at this moment in time, largely due to the economic climate. Leader of the Labour party Ed Miliband recently stated, "It cannot be right that, when workers face below-inflation pay increases . . . senior bankers keep raking in bonuses that are more in one year than most people can earn in a lifetime."⁶ He was speaking in context to the coalition's decision not to reapply the 50 percent tax on bankers' bonuses. During the financial crisis the UK government bailed out the banks RBS, Lloyds Banking Group and HBOS with taxpayer's money.⁷ There is anger over the reports that these banks will be paying their senior members of staff huge bonuses again this year. The majority of UK citizens consider this as incredibly unjust as the taxpayer is paying for their mistakes, and now they are being rewarded. Continuing to tax these large bonuses may seem the most simple and fair economic policy to implement, however the coalition have other concerns.

Labour's one-off bonus tax was intended to be just that, a one-off. It was not only British banks who were forced to pay the 50 percent tax on bonuses, but foreign banks too such as Goldman Sachs. The UK bonus tax reportedly cost Goldman Sachs \$600m.⁸ London is the world's leading financial centre,⁹ but this title could be threatened if the banks fear the British bonus tax is to become more permanent. If the large banks were to downsize or relocate in other countries in order to avoid the British bonus tax, it could have a detrimental effect on the British economy. Therefore although it may seem a fair policy to heavily tax the banker's bonuses, it may not be the greatest decision for the economy in the long-run.

6. Taxation of Demerit Goods

A demerit good is a good that often creates negative externalities. Examples include cigarettes and alcohol. The marginal social cost exceeds the marginal social benefit for these goods. Therefore society would be closer to the

⁶ World Economic News, Miliband calls for bank bonus tax to be extend,
<http://www.economiconlines.com/?p=2594>

⁷ BBC News, UK banks receive £37bn bail-out,
<http://news.bbc.co.uk/1/hi/business/7666570.stm>

⁸ The Telegraph, Goldman Sachs profits slide 82pc after UK bonus tax, record US fine,
<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7901573/Goldman-Sachs-profits-slide-82pc-after-UK-bonus-tax-record-US-fine.html>

⁹ The Telegraph, Britain overtakes US as top financial centre,
<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6272639/Britain-overtakes-US-as-top-financial-centre.html>

allocatively efficient output if production and consumption of these goods were reduced. Alcohol and tobacco are both subject to the British ad valorem tax VAT, but are also subject to a unit tax known as an excise duty. The current level of duty on spirits is £28.30 per litre of pure alcohol.¹⁰ The main externality alcohol and tobacco cause is a burden on the National Health Service (NHS), a publically funded healthcare organisation. This is due to the damage to health caused by the consumption of these goods. Tobacco can also damage the health of other members of society due to passive smoking, and alcohol consumption can lead to antisocial behaviour and violence through inebriation.

The UK government has to pay for the cost of these externalities. In 2008 it was predicted that smoking costs the NHS £2.7 billion per year. However at the same time the pro-smoking group Forest estimated that smokers pay over £9 billion in tobacco tax.¹¹ The government imposes unit taxes on these goods to discourage consumption. Generally as the price of a good increases, less of it is consumed. Yet this depends on the price elasticity of demand of a good. Tobacco is highly addictive meaning demand for tobacco is fairly inelastic. The figures above could suggest that the government is unfairly taking advantage of smokers by imposing taxes at a far greater level than the costs of the externalities smokers cause.

It can be argued that economic policy that imposes sanctions on people consuming demerit goods should be encouraged. Tax revenue generated from demerit goods not only allows the costs of externalities to be dealt with, but surplus revenue can be distributed throughout other areas of the economy. Even if only by a small amount, decreasing the consumption of a demerit good is a positive thing. Since the economy would be more efficient if demerit goods were not consumed, fairness should not be important when creating economic policy that governs these goods.

7. EU Membership

Since the UK's initial membership to the European Economic Community (EEC) on January 1st 1973, there have been many changes. The Maastricht Treaty in 1993 saw the creation of the European Union (EU), which replaced the EEC. The EU is now an economic and political union consisting of 27 member states. The question of whether or not the UK should remain a member of the EU is constantly under debate.

The issue is that the UK is a net contributor to the EU, the second largest behind Germany. Between the 2007-2013 period it is estimated that the UK will make a net contribution of €57bn.¹² This is the case because the UK is one of the richer

¹⁰ HMRC Budget 2010, Alcohol Duty: Rates, Page 2,
<http://www.hmrc.gov.uk/budget2010/march/bn61.pdf>

¹¹ BBC News, Smoking 'costs the NHS billions',
<http://news.bbc.co.uk/1/hi/health/7654153.stm>

¹² Open Europe, Briefing note: European Communities (Finance) Bill, Page 3,
<http://www.openeurope.org.uk/research/budget07.pdf>

members of the EU. Although the UK is financially worse off, the funds are redistributed throughout the EU mainly to the poorer member states who are in need of funding the most. These members include Slovakia and Romania. This can be viewed as a fair economic policy where greater equality is achieved.

Many British citizens would like UK to negotiate an exit deal. It may be possible to negotiate an exit deal where some of the EU benefits are retained, whilst the costs are eliminated. Iceland, Liechtenstein and Norway are all members of the EEA whilst non-EU members. This means they enjoy benefits such as free trade of goods and services along with the free movement of people between EU countries, without contributing the EU membership fees. A deal like this could make the UK financially better off, but may not be considered a fair decision by fellow Europeans.

8. Conclusion

Fairness is subjective, as it can be perceived in many ways. Individuals often have different opinions on what is fair, and these opinions are often influenced by the individual's circumstances. The rich are more likely to be in favour of inequality, whereas the poor are likely to be strictly against it. This means that if the government are to consider fairness when adopting new policy, they will often have to take into account conflicting opinions of what is fair. Attempting to satisfy everyone can often be inefficient in itself, and it could be argued that economic policy should concentrate purely on the health of the economy.

I believe that where possible fairness should of course be considered when policymaking. However as I have explained in this assignment, for the goals of certain economic policies to be achieved and in some cases to preserve the health of an economy, it may not be practical to adopt what may be viewed as the fairest policy.

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Abbreviations

EEA	European Economic Area
EEC	European Economic Community
EU	European Union
HBOS	Halifax Bank of Scotland
MPC	Monetary Policy Committee
NHS	National Health Service
RBS	Royal Bank of Scotland
UK	United Kingdom
VAT	Value Added Tax