Government and the macroeconomy

Macroeconomic aims and their conflicts, the government budget and fiscal policy, taxation, monetary policy, supply-side policy, economic growth and recession, employment and unemployment, and inflation.

Macroeconomics looks at the **whole economy**: total output, employment, prices and trade. This chapter covers what governments aim for and the **policies** they use.

4.1 The role of government

Macroeconomic aims

Aim	Meaning
Economic growth	an increase in the economy's output (real GDP) over time
Full employment / low unemployment	everyone who wants a job can find one
Stable prices / low inflation	prices rising slowly and predictably (many governments target about 2%)
Balance of payments stability	not a large, persistent deficit (or surplus) in trade with other countries
Redistribution of income	a fairer distribution between rich and poor
Environmental sustainability	growth that does not damage resources for the future

Why governments choose these aims: growth raises **living standards**; low unemployment avoids **waste of resources** and hardship; stable prices keep **savings and wages** from losing value and make planning easier; a stable balance of payments avoids **debt** and currency problems; redistribution reduces **poverty and inequality**; sustainability protects **future generations**.

Criteria governments may set (examples): growth of around 2–3% a year, unemployment below 4–5%, inflation of about 2%, a current account close to balance.

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Conflicts between aims

Conflict	Why
Full employment and stable prices	low unemployment means high demand, which can **pull prices up** (inflation)
Economic growth and environmental sustainability	more production may mean more **pollution** and resource use
Full employment and balance of payments stability	higher incomes mean more **imports**, worsening the trade balance
Economic growth and redistribution	high taxes to redistribute income may reduce **incentives** to work and invest

Governments must therefore **prioritise** between aims.

4.3 Fiscal policy

The government budget

- The **government budget** is the **plan of government spending and tax revenue** for the year.
- **Budget deficit**: government **spending is greater than** tax revenue (it must borrow).
- **Budget surplus**: tax revenue is **greater than** government spending.

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> A government plans spending of $90 billion and tax revenue of $80 billion. **Deficit = 90 – 80 = $10 billion.**

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Government spending

Main areas: **education**, **healthcare**, **defence**, **social security (benefits and pensions)**, **infrastructure** (roads, energy), **law and order**, **debt interest**.

Reasons and effects: to provide **merit and public goods**, to **redistribute income**, to **improve skills and health** (raising productivity), to **create jobs** and **boost demand**. **Effects**: higher spending raises demand and employment; but it must be **funded** by taxes or borrowing, which has an **opportunity cost**.

Taxation

Reasons for taxation: **raise revenue** for spending, **discourage consumption of demerit goods** (tobacco), **reduce imports** (tariffs), **redistribute income** (progressive taxes), **influence total demand** (higher taxes reduce spending), and **encourage environmental sustainability** (carbon or plastic taxes).

Classification of taxes:

	Meaning	Example
Direct tax	paid **directly** to the government by the person or firm on whom it is levied (on **income and wealth**)	income tax, corporation tax
Indirect tax	tax on **spending**, collected by sellers and passed on	VAT, sales tax, customs duties, excise duty
Progressive	takes a **higher percentage** of income as income **rises**	income tax with bands
Regressive	takes a **higher percentage from low-income** people	a flat charge on cigarettes (the poor spend a bigger share of their income on it)
Proportional	takes the **same percentage** from everyone	a flat 10% tax

Impact of taxation:

On	Effect
Consumers	less disposable income, so lower spending; indirect taxes raise prices
Workers	high income tax may reduce the **incentive to work**
Firms	**higher costs** or lower profit (corporation tax); lower consumer spending reduces sales
Government	gains **revenue** to spend on services
Economy	reduces total demand; can redistribute income; **very high taxes** may reduce growth

Fiscal policy

> **Fiscal policy is the use of government spending and taxation to influence the economy.**

Measures: change **taxes** (rates or types) and change **government spending**.

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	Expansionary (to boost the economy)	**Contractionary (to slow it down)**
Taxes	**lower** (more spending power)	**higher**
Government spending	**increase**	**cut**
Effect	demand rises: **growth and employment rise**, but **inflation** and a **budget deficit** may follow	demand falls: **inflation falls**, but **growth and jobs may fall**

Effects on aims: fiscal policy can reduce unemployment (more spending creates jobs), promote **growth**, **control inflation** (reduce demand), **redistribute income** (progressive taxes and benefits) and support **sustainability** (green taxes and spending).

4.4 Monetary policy

- **Money supply** is the **total amount of money** in an economy.
- **Monetary policy** is the use of **interest rates, the money supply and the exchange rate** by the **central bank** to influence the economy.

Measures:

Measure	**Effect**
Change in the interest rate	**higher rate**: borrowing and spending fall, saving is encouraged, the exchange rate tends to rise; **lower rate**: borrowing and spending rise
Change in the money supply	**less money** in circulation reduces spending; **more money** increases it
Change in the foreign exchange rate	a **higher** exchange rate makes exports dearer and imports cheaper; a **lower** rate does the reverse

Effects on aims: **raising interest rates** helps **control inflation** (lower demand), but may reduce **growth and employment**; **cutting interest rates** boosts **growth and employment**, may raise inflation and lower the exchange rate; a **lower exchange rate** can help **exports and the balance of payments**.

4.5 Supply-side policy

> **Supply-side policy is any policy that aims to increase the economy's productive capacity: the quantity and quality of resources: by improving efficiency, so the economy can produce more at lower cost.**

Measures:

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Measure	How it works
Education and training	more skilled, productive workers
Infrastructure spending	better roads, ports, energy and broadband lower firms' costs
Labour market reforms	reduce union power or **make hiring easier**, increase worker **mobility**
Lower direct taxes	**raise incentives** to work and to invest
Deregulation	removing unnecessary rules, so **competition** and efficiency increase
Improving incentives to work and invest	tax breaks, reducing benefits, grants for investment
Privatisation	selling state firms to increase competition and efficiency

Effects on aims: supply-side policy **shifts the PPC outward** (long-run growth), **lowers costs and inflation**, creates **jobs** (reducing structural unemployment) and improves the **balance of payments** (more competitive exports). **Drawbacks**: **slow** (long-term), **expensive**, effects uncertain, and some measures (deregulation) may harm workers or the environment.

4.6 Economic growth

> **Economic growth is an increase in the economy's output (real GDP) over a period.**

Measurement: **real GDP** is **GDP adjusted for inflation**; growth is the **percentage change in real GDP**. (GDP is the total value of goods and services produced in a country in a year.)

Causes of growth

- an **increase in total (aggregate) demand** (higher consumer spending, investment, government spending or net exports)
- an **increase in the quantity of resources** (more workers, new land or resources, more capital)
- an **increase in the quality of resources** (education, training, technology).

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Advantages and disadvantages

Advantages	Disadvantages
higher **incomes** and **living standards**	**pollution** and **resource depletion**
more **jobs**	may widen **inequality** (the rich gain more)
more **tax revenue** for health and education	may cause **inflation** if too fast
better **business confidence** and investment	**congestion**, loss of traditional ways of life

Recession

A **recession** is a **fall in real GDP for two or more consecutive quarters** (6 months).

Causes: a **fall in total demand** (less consumer spending or investment, a fall in exports), a **fall in the quantity or quality of resources** (a disaster, war, loss of skills).

Consequences:

For	Effect
Consumers	lower incomes and spending, less confidence
Workers	**unemployment**, lower wages, job insecurity
Firms	**falling sales and profits**, some go bankrupt
Government	**lower tax revenue** and **more spending on benefits**, so a bigger budget deficit

Policies to promote growth

Fiscal policy (**lower taxes, higher spending**), monetary policy (**lower interest rates**), **supply-side policy** (education, infrastructure), policies to **attract investment**, encouraging **exports**. Their **effectiveness** differs: demand-side policies work quickly but can cause inflation; supply-side policies are slow but give lasting growth.

4.7 Employment and unemployment

- **Employment**: people who have a job. **Unemployment**: people who are **able, available and actively looking for work but without a job**. **Full employment**: everyone who wants a job has one (some frictional unemployment still exists).

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Measuring unemployment

Unemployment is measured by the **labour force survey** (a sample of households asked about their work situation) and sometimes by counting those claiming benefits (which may miss some).

> **Unemployment rate = (number unemployed ÷ labour force) × 100. The labour force is the employed plus the unemployed.**

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> 2 million unemployed, 38 million employed. Labour force = 40 million. **Unemployment rate = 2 ÷ 40 × 100 = 5%.**

Types of unemployment

Type	Cause
Frictional	people **between jobs** or entering the labour market (short-term)
Structural	**decline of an industry** or change in skills needed: **long-term**, caused by technology or competition (workers' skills no longer match)
Cyclical	a **fall in total demand** in a recession
Seasonal	work is available only in **certain seasons** (farming, tourism, construction)

Consequences of unemployment

For	Effect
Individuals	loss of income, stress, loss of skills, poverty
Firms	lower demand for their products; but a larger pool of workers
Government	**lower tax revenue** and **higher spending on benefits**
Economy	wasted resources (output below the PPC), lower GDP, more inequality and social problems

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Policies to reduce unemployment

- **Fiscal policy** (cut taxes, spend more) and **monetary policy** (lower interest rates) for **cyclical** unemployment.
- **Supply-side policies** (education and retraining, labour market reforms, better information about jobs, **help with relocation**) for **structural and frictional** unemployment.
- **Regional policy** (grants for firms in high-unemployment areas).

Effectiveness: demand policies can cause **inflation**; retraining is slow; policy must fit the **type** of unemployment.

4.8 Inflation and deflation

> **Inflation is a sustained rise in the general price level. Deflation is a sustained fall in the general price level.**

Measuring inflation

Inflation is measured by the **Consumer Prices Index (CPI)**:

1. Surveys find what a **typical household** buys (a "basket" of goods and services).
2. Each item is **weighted** by the share of spending on it.
3. The **cost of the basket** is tracked over time: the **percentage change** is the inflation rate.

Causes of inflation

Cause	Explanation
Demand-pull	**total demand rises faster than supply**: "too much money chasing too few goods" (for example a boom, tax cuts, low interest rates)
Cost-push	**costs of production rise** (wages, raw materials, energy, imports from a weaker currency), so firms **raise prices**

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Consequences of inflation

Group	Effect
Savers	lose out if interest rates are lower than inflation (real value of savings falls)
Borrowers	gain (the real value of what they owe falls)
Lenders	lose, if interest is below inflation
Consumers	purchasing power falls, especially for those on **fixed incomes**
Workers	real wages fall unless pay rises with prices; may demand higher wages (a **wage-price spiral**)
Firms	higher costs, uncertainty, **menu costs**; exports become less competitive
Economy	lower competitiveness, **balance of payments** worsens, uncertainty reduces investment

Policies to control inflation

- **Monetary policy**: **raise interest rates** to reduce demand (the central bank's usual tool).
- **Fiscal policy**: **raise taxes or cut government spending** to reduce demand.
- **Supply-side policy**: **lower costs and raise productivity** (long-term).
- A **higher exchange rate** lowers import prices.

Effectiveness: policies that reduce demand work for **demand-pull** inflation but can **reduce growth and raise unemployment**; supply-side policies deal with **cost-push** but are slow.

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Explain how an increase in household spending could cause inflation. Household spending is part of total demand, so an increase raises it. If total demand exceeds the economy's ability to supply goods (total supply), firms can raise prices: **demand-pull inflation**. Higher demand may also lead firms to hire more workers, pushing up wages and costs: **cost-push** pressure, and perhaps a wage-price spiral.

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