Government macroeconomic intervention (AS)

Government macroeconomic policy objectives and conflicts between them, fiscal policy, monetary policy and supply-side policy, with their effects and limitations.

5.1 Government macroeconomic policy objectives

Objective	Meaning
Economic growth	steady **real GDP growth**
Low unemployment	**full employment** (no demand-deficient unemployment)
Price stability	**low and stable inflation**
Balance of payments stability	**no persistent current-account deficit**
Redistribution of income	**reduce inequality**
Protection of the environment	**sustainable** development

> **Objectives can conflict. Faster growth may raise inflation and imports, worsening the balance of payments; cutting inflation with higher interest rates may raise unemployment in the short run (a trade-off).**

Policies use **demand-side** tools (fiscal and monetary) to influence **AD** and **supply-side** tools to raise **AS**. Their success is judged against the **objectives**, **time lags** and **side effects**.

5.2 Fiscal policy

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

- **Government spending (G):** on **current** items (wages, benefits), **capital** (roads, schools) and **transfers**.
- **Taxation: direct** (income, profit) and **indirect** (VAT, duties).
- **Budget deficit:** spending **exceeds** tax revenue; funded by **borrowing** (adding to **national debt**). **Budget surplus:** the reverse.

Expansionary fiscal policy (**higher G**, **lower taxes**) **raises AD**, increasing **growth and employment** but risking **inflation** and a **larger deficit**. **Contractionary** policy (**lower G**, **higher taxes**) **reduces AD** to **lower inflation** or **cut the deficit**.

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The multiplier: an initial change in spending causes a larger change in national income. Multiplier = 1 ÷ marginal propensity to withdraw = 1 ÷ (1 − MPC). If the MPC is 0.8, the multiplier is 1 ÷ 0.2 = 5, so a $10bn rise in government spending raises income by up to $50bn.

Evaluation of fiscal policy:

- **Time lags** (recognition, decision, impact).
- **Crowding out:** borrowing may **raise interest rates** and **reduce private investment**.
- **Size of the multiplier** depends on **MPC**, **spare capacity** and **leakages**.
- **Political pressure**, **limited accuracy**, **debt burden**, **effects on incentives**.
- It can **target specific groups or regions**.

Automatic stabilisers (income tax and benefits) **rise or fall with the cycle** without new decisions, **dampening** fluctuations.

Types of tax: direct taxes are paid **straight to the government by the person or firm** that bears them (income tax, corporation tax) and **indirect** taxes are **charged on spending** (VAT, excise duties). **Progressive** (average rate rises with income), **regressive** (average rate falls) and **proportional** (flat rate).

The **national debt** is the **total accumulated borrowing** of the government. Its **significance** depends on its size relative to **GDP**, the **interest** cost (which crowds out other spending), who **holds** it (domestic or foreign) and whether it funded **productive investment**; a high debt may force **tax rises or spending cuts** and **reduce confidence**.

5.3 Monetary policy

Monetary policy uses the **interest rate**, the **money supply** and the **exchange rate** to influence **AD**, usually run by the **central bank**.

- **Interest rates:** a **fall** reduces the **cost of borrowing** and the **reward for saving**, **raising consumption and investment** (and **AD**), and often **weakening the currency**, which **helps exports**. A **rise** does the reverse and **reduces inflationary pressure**.
- **Money supply and quantitative easing (QE):** the central bank **creates money to buy assets**, raising the **money supply** and **lowering long-term rates**.
- **Exchange rate policy: buying or selling** currency (intervention).

Evaluation: time lags, **people may not respond** (confidence, **liquidity trap**), **banks may not lend**, **savers lose**, impact on **different groups** differs, **conflicts** between **inflation** and **growth** objectives, and **international** capital flows. The **independence** of central banks aims to remove political bias.

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Note Academy

> The central bank raises the interest rate. Name two effects on AD.
>
> **Consumption falls** (higher cost of credit and a better return on saving) and **investment falls**. **The currency may appreciate**, **reducing exports**.

Expansionary monetary policy (lower interest rates, higher money supply) **increases AD**: in AD/AS, **AD shifts right**, raising **real output and employment** (and the price level, if near full employment). **Contractionary** monetary policy (higher rates, lower money supply) **shifts AD left**, **reducing inflationary pressure** but also **output and employment**.

5.4 Supply-side policy

Supply-side policies aim to **increase the economy's productive capacity** (**LRAS**), improving **growth** and **reducing inflation** without extra demand.

Policy	How it works
Education and training	raises **labour productivity** and **mobility**
Tax cuts (income, corporation)	**incentives** to **work, invest** and take risks
Labour market reform	reduce **union power**, make **hiring** easier, **cut benefits** to encourage work
Deregulation and competition policy	more **competition**, lower **costs**
Privatisation	**efficiency** from the profit motive
Investment in infrastructure	lowers **business costs**
Research and innovation (subsidies, patents)	**technology** and new products
Trade liberalisation	more **competition** and **specialisation**

Evaluation: long time lags, **expensive**, outcomes **uncertain**, effects may be **unequal** (job losses), and some policies (tax cuts) **widen inequality**. **Market-based** supply-side policies use **incentives**; **interventionist** policies use **government spending**.

Policy mix

Governments use a **combination** of fiscal, monetary and supply-side policy, judging **trade-offs** and the **state of the economy** (recession, boom). **Demand-side** policies work **faster** but may be **inflationary**; **supply-side** policies work **slowly** but can raise growth **sustainably**.

Supply-side policy shifts **LRAS to the right** (and often SRAS), so **real output and employment rise** while the **price level falls or rises less**: this is the **AD/AS** effect of a successful policy, giving **growth**

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without inflation.

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