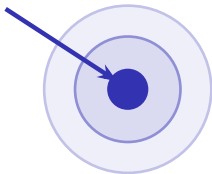


Government Macroeconomic Intervention

A-Level Economics ■ Topic 5

A-Level Economics



What we will cover

- 1 Policy objectives
- 2 Fiscal policy & the budget
- 3 Types of tax
- 4 Monetary policy
- 5 The transmission mechanism
- 6 Supply-side policy



the state steers the economy



Macroeconomic objectives

**price
stability**

**full
employment**

**economic
growth**

**balance of
payments**

**redistri-
bution**

Aims can **conflict**: fast growth can pull up inflation and worsen the balance of payments; cutting unemployment can raise inflation.

The five macroeconomic objectives

economic growth

a rising real output, sustained over time

low inflation

stable prices – usually a target around 2%, not zero

full employment

everyone who wants work at the going wage can find it

balance of payments

a sustainable current-account position

redistribution of income

narrowing the gap between rich and poor

and increasingly

environmental sustainability, added alongside the traditional four

These **conflict**: growth can raise inflation and worsen the current account, and redistribution can weaken the incentive to work. Naming the conflict is the evaluation.



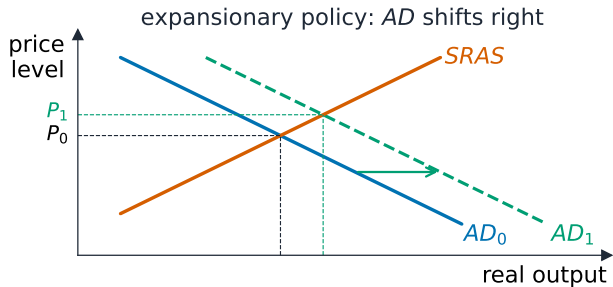
Fiscal policy and the budget

Fiscal policy uses government spending & taxation.

- **budget deficit** – spend > tax (borrow)
- **expansionary** – raises AD (fights recession)
- **contractionary** – lowers AD (fights inflation)

Risk: **crowding out** of private investment.

Fiscal policy and the budget, in detail



expansionary: $AD \rightarrow \cdot Y \uparrow, P \uparrow$

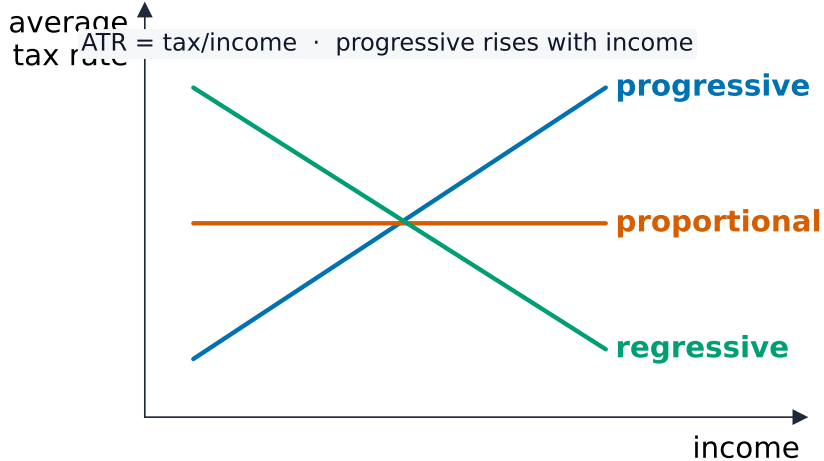
Expansionary fiscal or monetary policy shifts AD right, raising output and the price level; contractionary policy does the reverse.

Types of tax

By what is taxed: **direct** (income, profit) vs **indirect** (spending). By how the rate moves with income:

- **progressive** – rate rises
- **proportional** – rate flat
- **regressive** – rate falls

Types of tax, in detail



By what is taxed: **direct** (income, profit) vs **indirect** (spending).

Three tax structures, and the words around a budget

Progressive

The average rate *rises* with income – income tax with rising bands.

Proportional

A **proportional tax** takes the same percentage from every income – a flat tax.

Regressive

A **regressive tax** takes a larger share from a low income. Most **indirect tax** is regressive, since the poor spend more of what they have.

Budget words

A **budget surplus** is revenue above spending; the **national debt** is the stock of past deficits, not this year's flow.

Progressive and regressive describe the *average rate as income rises* – not whether the tax is large.



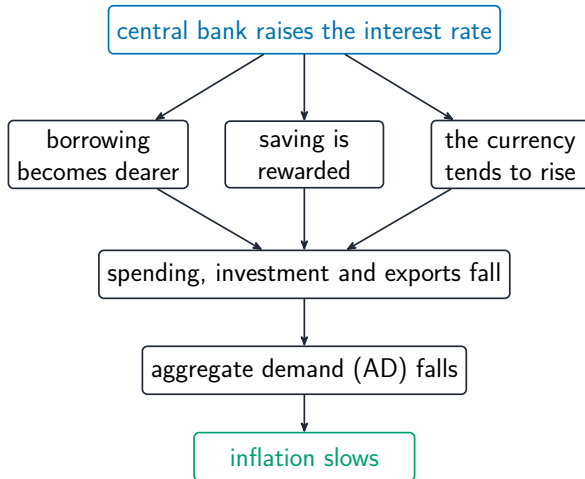
Monetary policy



Monetary policy is run by the **central bank** ; its main tool is the **interest rate** .

Flexible (the rate can change anytime), but works with a **lag** of a year or more – and in a slump, low rates may not revive borrowing.

The transmission mechanism



A **higher** interest rate works through three channels:

- borrowing dearer → less spending & investment
- saving rewarded → less spending
- currency rises → exports fall

All lower AD, slowing inflation.

How a policy reaches the economy

Demand-side policies **Demand-side policies** – fiscal and monetary – shift AD. Fast, and they cannot raise capacity.

The money supply Monetary policy works through the interest rate and the **money supply** : borrowing, saving, asset prices, and confidence.

The exchange rate A lower interest rate weakens the **exchange rate** , which raises net exports – the channel students most often forget.

Supply-side Supply-side policy raises **productivity** and capacity instead. Slow, and it is the only route to non-inflationary growth.

Every transmission channel has a lag. Naming the lag is usually worth an evaluation mark.

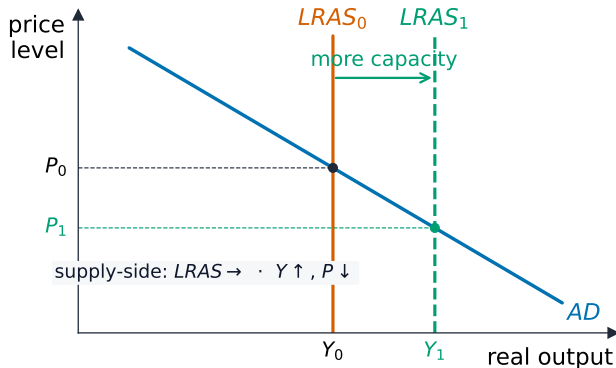


Supply-side policy

Supply-side policy raises **productive capacity** , shifting LRAS right.

Powerful – it can raise growth **and** cut inflation with no trade-off – but slow and costly.

Supply-side policy, in detail



Supply-side policy raises capacity, shifting LRAS right: real output rises and the price level falls – growth with lower inflation.

Worked example – which policy in a deep recession?

A deep recession, a large output gap, and interest rates . Which policy?

- **monetary** policy is nearly exhausted – rates cannot fall much further
- **supply-side** policy works on capacity, and acts far too slowly
- so **expansionary fiscal policy**: raise spending, cut tax
- with spare capacity the multiplier is large and crowding out minimal

Match the tool to the **diagnosis**. The same recession with rates at 5% would be a monetary-policy answer.

Two kinds of supply-side policy

market-based

let markets work more freely

deregulation

removing rules that block competition

lower direct tax

strengthening the incentive to work and invest

interventionist

the state supplies what markets under-provide

infrastructure

spending on roads, ports and broadband

education and R&D

training, and support for research and new technology

Supply-side policy is the **only** tool that can raise growth and lower inflation at once – but it is slow, costly, and its effects arrive years after the government that paid for it.

Two supply-side approaches

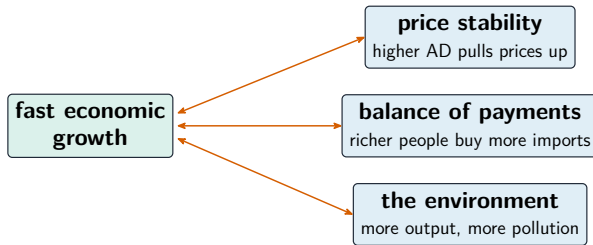
market-based

cut tax & benefits,
privatisation ,
deregulation

interventionist

training ,
infrastructure ,
research support

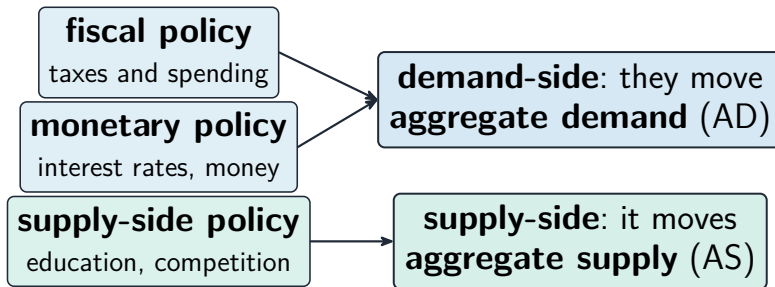
Conflicts between objectives



the same tension links **full employment** and **price stability**:
cutting unemployment by raising demand can cause more inflation

Chasing fast growth can pull against price stability, the balance of payments and the environment

Conflicts between objectives, continued



Fiscal and monetary policy work on aggregate demand; supply-side policy works on aggregate supply

Exam tips

- Match a **policy to an objective**: fiscal and monetary policy act on demand; supply-side policy raises long-run capacity.
- Explain how a change in **interest rates** works through AD, and fiscal policy through G and T .
- Evaluate policy with **time lags, side effects and conflicts** between objectives.
- **Supply-side** measures (education, tax incentives) are long-run and slow to work.



Worked example – fiscal or monetary?

An economy is in recession with a large output gap. Compare using fiscal and monetary policy.

- **Fiscal**: cut tax or raise spending $\Rightarrow$ AD rises, and the **multiplier** amplifies it.
- But it is slow to legislate and worsens the **budget deficit**.
- **Monetary**: cut rates $\Rightarrow$ cheaper borrowing, less saving, weaker currency $\Rightarrow$ AD rises.
- But confidence is low and rates may be near zero $\Rightarrow$ **a liquidity trap**.

Judge any policy on **time lag**, **size of effect** and **side effects**. Monetary is quicker to change; fiscal is more certain to work when confidence is broken.

Topic 5 – key takeaways

1

Objectives

stability, jobs, growth, trade,
fairness – they conflict

2

Fiscal

spending & tax move AD; risk of
crowding out

3

Monetary

the interest rate works via
transmission

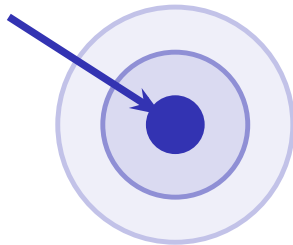
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Supply-side

lifts LRAS – growth with low
inflation

Check yourself

- 1 A budget deficit means spending is how vs tax?
- 2 A progressive tax rate does what as income rises?
- 3 Who sets monetary policy?
- 4 Which policy shifts LRAS to the right?



Answers 1. greater than tax 2. rises 3. the central bank 4. supply-side policy