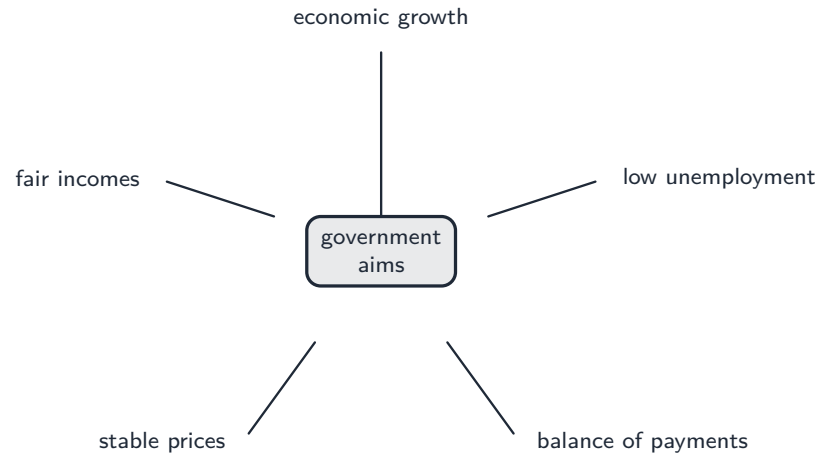


Government and the macroeconomy

IGCSE Economics

Government macroeconomic aims

Governments try to manage the whole economy – the **macroeconomy**. They have five main aims:



Five main aims: growth, low unemployment, stable prices, balance of payments stability, fair incomes

1. **economic growth** – the economy makes more goods and services each year.
2. **full employment** – almost everyone who wants a job has one, so **unemployment** is low.
3. **price stability** – prices rise only slowly, so **inflation** is low.
4. **balance of payments** stability – avoiding persistent external imbalances, including large current-account deficits. It does not mean exports must always equal imports.
5. **redistribution of income** – sharing income more fairly, so the gap between rich and poor is not too wide.

These aims can **conflict** (work against each other). For example, fast growth can pull prices up, causing inflation. Cutting unemployment can do the same. So a government must balance its aims.

Fiscal

government
spending & taxes

Monetary

interest rates, money
& exchange rates

Supply-side

raise capacity
& productivity

Exam: fiscal = G & T; monetary = interest rate / money; supply-side = capacity & productivity

The government's three sets of policy tools for managing the macroeconomy

Fiscal policy

Fiscal policy means the government changing two things to manage the economy:

- **government spending** – money the government spends, for example on schools, hospitals, and roads.
- **taxation** – money the government takes from people and firms.

The government **budget** sets spending against tax. There are three outcomes:

- a **budget deficit** – spending is more than the tax raised, so the deficit needs financing, often through borrowing.
- a **budget surplus** – the tax raised is more than spending.
- a balanced budget – the two are equal.

Official worked budget: June 2025, 0455/22 Q1(a). Government spending was 310million and tax revenue 292 million. Budget deficit = spending – tax revenue = 310million – 292 million = \$18 million. This is a one-period shortfall, not accumulated government debt.

Types of tax

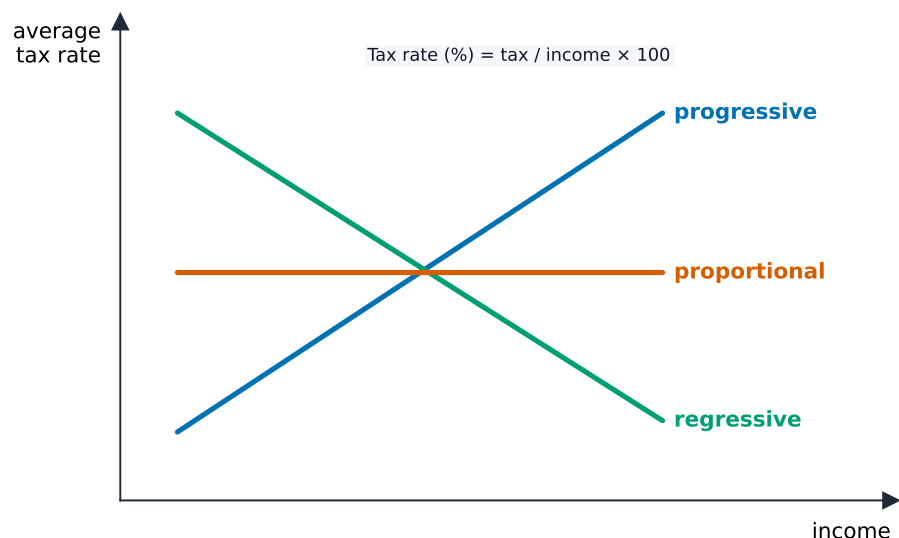
Taxes are grouped in two ways. By *what* is taxed:

- a **direct tax** is paid straight to the government from **income** or **profit** (income tax, corporation tax).
- an **indirect tax** is added to the price of goods and paid when you spend (a sales tax).

By *how the rate changes with income*:

- a **progressive tax** takes a *bigger* % from higher incomes. This helps redistribute income.

- a **regressive tax** takes a *smaller* % from higher incomes, so it hits the poor harder.
- a **proportional tax** takes the *same* % from everyone.



Under a progressive tax the average rate rises with income; under a regressive tax it falls; under a proportional tax it stays the same.

Original tax calculation. A earns £10,000 and pays £1,000; B earns £30,000 and pays £6,000. Average tax rate = tax paid ÷ income × 100. A: £1,000 ÷ £10,000 × 100 = 10%. B: £6,000 ÷ £30,000 × 100 = 20%. The average rate rises with income, so this is progressive. Direct/indirect is a separate classification. A fixed spending-tax payment can take a larger income share from a poorer household; indirect does not mean regressive by definition.

■ What fiscal policy does

To boost the economy (raise growth and jobs), the government can spend more or cut taxes. This raises total **demand** – but if demand grows too fast, it can cause inflation.

To slow the economy (fight inflation), the government can spend less or raise taxes. This lowers demand, but can raise unemployment.

Exam reasoning: June 2025, 0455/22 Q4(c). Higher personal income tax can reduce disposable income, then consumer spending, firms' orders and demand for workers. Cyclical unemployment may rise. This chain assumes spending falls and is not offset elsewhere; government use of extra tax revenue also matters.

Monetary policy

Monetary policy is the **central bank** changing **interest rates** (and the **money supply**) to manage the economy. The interest rate is the cost of borrowing and the reward for saving.

- **Lower** interest rates: borrowing is cheaper, which may encourage people and firms to spend and **invest** more. Demand rises, potentially increasing output and jobs if there is spare capacity; inflationary pressure may rise.
- **Higher** interest rates: borrowing is dearer, so spending falls. Demand falls, giving less inflation – but maybe more unemployment.



Central banks use monetary-policy instruments to influence demand, inflation and growth; they do not set every loan rate

Supply-side policy

Supply-side policy tries to raise the amount the economy *can* produce. It improves the quantity and quality of the **factors of production**. Methods include:

- **education and training** – relevant skills can raise **productivity** when firms can use them.
- **privatisation** – selling state-owned firms to private owners, who may run them better.
- **deregulation** – removing rules that hold firms back.
- **incentives** – lower taxes on income and profit may improve incentives to work and invest; the response varies.

Supply-side policy can raise growth and jobs *and* lower inflation at the same time. It

can take time, costs money and depends on the cause of the constraint; outcomes are not guaranteed.

Original policy comparison. Cutting income tax during weak spending is fiscal policy: more income may be spent, but households may save it. Lowering a policy interest rate is monetary policy: borrowing may be cheaper, but firms with few orders may not invest. Training mechanics for new jobs is supply-side policy: relevant skills may improve employability and capacity, but suitable vacancies must exist. Private ownership alone does not guarantee competition, and education is not the only policy that can improve capacity.

Economic growth

Economic growth is a rise in **real GDP**.

GDP (gross domestic product) measures the value of final goods and services produced within a country over a period, usually a year. Counting final output avoids counting inputs again. **Real** GDP is GDP after the effect of rising prices is removed, so it shows the *true* change in output.

Worked example. A country's real GDP was £500 billion last year and £515 billion this year. Find the rate of economic growth.

- $\text{economic growth} = (515 - 500) \div 500 \times 100 = 3\%$.

Because this uses *real* GDP (with the effect of rising prices taken out), the 3% is a true rise in output, not just higher prices. If prices had risen but output had not, real GDP would be unchanged and its growth rate would be zero; the level of GDP would not be zero.

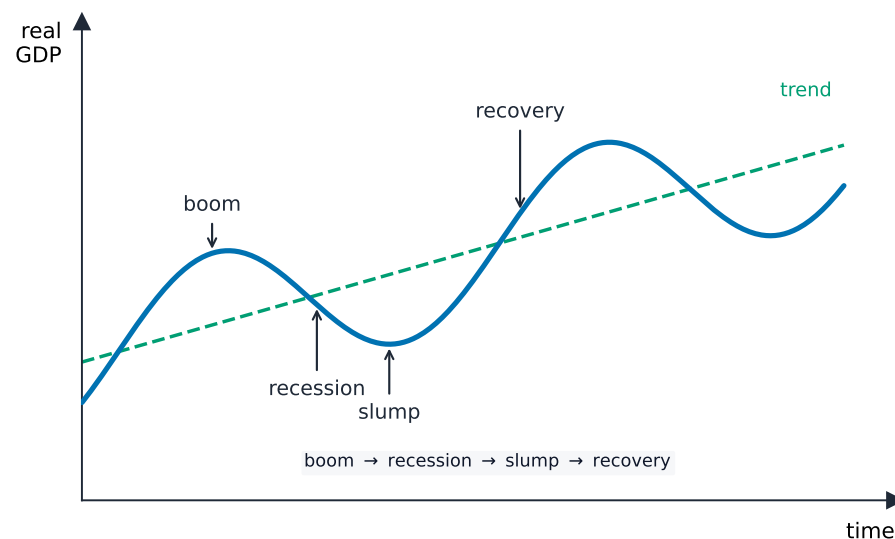


Investment can expand capacity; the skyline alone cannot establish a growth rate

■ The business cycle

Real GDP does not rise smoothly. It moves through a **business cycle** with four stages:

- **boom** – fast growth; output and jobs are high; pressure on prices may increase if capacity is stretched.
- **recession** – output falls and jobs are lost. (A recession is often defined as falling real GDP for six months.)
- **slump** – the bottom of the cycle; very low output and high unemployment.
- **recovery** – output starts to rise again.



Real GDP moves through boom, recession, slump and recovery around its rising trend.

■ Causes and effects

Growth comes from more or better factors of production: investment in new machines, a bigger or more skilled workforce, and new technology.

Good effects: higher incomes, more jobs, better **living standards**, and more tax for the government to spend.

Bad effects: prices may rise (inflation); the gap between rich and poor may grow; and there may be more pollution and use of scarce resources.

A recession can reduce incomes and employment and increase business failures; the effects differ between groups.

Employment and unemployment

■ Measuring unemployment

Unemployment is people who can work and want to work, but cannot find a job. There are two ways to measure it:

- the **claimant count** – it counts people who claim **unemployment benefit**. It misses those who want work but cannot claim.
- the **labour force survey** – a survey that counts people who are not working but are looking for work and are ready to start.

The **labour force** is everyone who is working plus everyone who is unemployed (and looking for work).

Worked example. A country has 24 million people in work and 2 million people who are unemployed and looking for work. Find the labour force and the unemployment rate.

- labour force = $24 + 2 = 26$ million.
- unemployment rate = $2 \div 26 \times 100 = 7.7\%$.

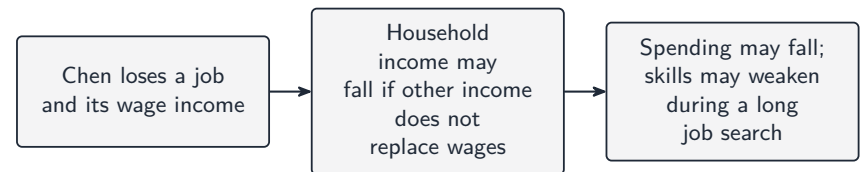
People with neither a job nor active job search are usually outside the labour force. A student with a paid job is employed; a student who is jobless, searching and available may be unemployed. A falling rate alone does not show that new jobs were created.

Original survey check. Dana is jobless, actively seeking work and available: unemployed. Eli studies full time and neither works nor seeks work: outside the labour force. Farah studies full time and has a paid part-time job: employed. Classify by activity, not the label “student”.

Original rate comparison. From the initial 24 million employed and 2 million unemployed, 0.5 million unemployed people stop seeking work. Employment stays 24 million. New labour force = $24 + 1.5 = 25.5$ million. New unemployment rate = $1.5 \div 25.5 \times 100 = 5.9\%$ (rounded). No new jobs were created, despite the fall from 7.7%. Claimant counts record benefit claims; surveys can include unemployed non-claimants.

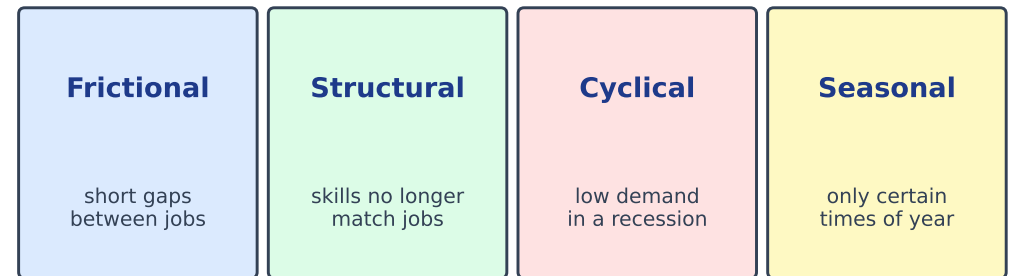
■ Types of unemployment

- **frictional unemployment** – short-term unemployment between jobs (a worker who just left one job and is looking for the next).
- **structural unemployment** – a whole industry shrinks and workers’ skills are no longer wanted (for example, coal miners after the mines close).
- **cyclical unemployment** – caused by a recession, when total demand is low so firms need fewer workers. (It is also called demand-deficient unemployment.)



Government may collect less income tax and spend more on support.
Unused labour can mean lost potential output.

Job loss can affect household income, spending, public finances and potential output; replacement income can change the result.



Exam: name the type + cause — match policy to cause; results depend on vacancies and spare capacity

The four types of unemployment: frictional (between jobs), structural (skills no longer match), cyclical (low demand in a recession) and seasonal

Original worker cases. Asha left a job and is searching for another: frictional unemployment; better vacancy information may shorten the search. Ben’s factory closed and vacancies need skills he lacks: structural unemployment; relevant retraining may help. Chen lost work because falling spending reduced orders across the economy: cyclical unemployment; demand support may help if spare capacity exists. Choose a policy from the cause; extra spending alone does not give Ben missing skills.

■ Effects of unemployment

- workers lose income and may lose their skills.
- the country loses the output those workers could have made.
- the government pays more in benefits and collects less in tax.
- crime and poor health may rise.

■ Sectors and the changing pattern of employment

The economy has three **sectors**:

- the **primary sector** extracts raw materials (farming, fishing, mining);
- the **secondary sector** makes things (manufacturing, construction);
- the **tertiary sector** provides services (banking, tourism, retail, transport).

A common development pattern is a shift in employment shares **primary** → **secondary** → **tertiary**; it is not inevitable in every economy. Early on most work is farming; industrialisation moves workers into factories; then **deindustrialisation** and rising incomes grow the service sector, so most jobs end up tertiary. Modern economies also see more **part-time and flexible** work.



Museum visitors illustrate demand for tourism services, not unemployment. This is not a photograph of jobseekers.

Original sector check. Growing vegetables is primary activity; canning them is secondary; serving them in a museum café is tertiary. Classify the activity, not simply the business name.

Inflation

Inflation is a rise in the *average* level of prices over time. The opposite – falling prices – is **deflation**.

■ Measuring inflation

Inflation is measured by the **Consumer Prices Index** (CPI). We pick a “basket” of goods a typical family buys, give each good a **weight** (a bigger weight for things people spend more on), and track how the price of the whole basket changes each year.

Worked example. A country’s Consumer Prices Index (CPI) was 100 last year and 104 this year. Find the rate of inflation.

- inflation rate = $(104 - 100) \div 100 \times 100 = 4\%$.

Prices rose by 4% on average. If next year the index reaches 107, the inflation rate is $(107 - 104) \div 104 \times 100 = 2.9\%$. Prices are still rising, but more slowly – a smaller inflation rate is *not* the same as deflation, because for deflation the index itself would have to fall.

■ Causes

- **demand-pull** inflation – total demand grows faster than the economy can supply, so prices are pulled up.
- **cost-push** inflation – firms’ costs rise (wages, materials), so they may raise prices to cover them.

Demand-pull

total demand grows faster than supply →
"too much money chasing too few goods"

Cost-push

firms' costs rise (wages, materials) →
may raise prices to cover them

Exam: demand-pull = excess total demand; cost-push = rising costs (wages, oil, imported inputs)

The two causes of inflation: demand-pull (excess demand) and cost-push (rising costs)

■ Effects of inflation

- money loses **purchasing power** – each unit of money buys less.
- unchanged money savings lose purchasing power; interest received also matters.
- firms must keep changing prices on labels and lists, which costs time and money.
- if domestic prices rise faster than competitors’ and the exchange rate does not offset this, exports may become less competitive.

■ Deflation

Weaker demand or lower costs can cause deflation; expected falls may delay purchases.

Exam discussion: June 2025, 0455/22 Q1(h). Original A: confidence and spending fall, lowering output and jobs. Fixed debts become harder to repay if income falls. Original B: better technology lowers costs while output rises, potentially improving purchasing power. Judge the cause, affected groups and whether savings reach customers.

Exam tips

Name the equation, use the correct denominator and give units. Explain causal chains; judge causes, constraints and affected groups.

Vocabulary card meanings

macroeconomy: The economy considered as one whole. redistribution of income: Using tax and payments to shift income between groups. regressive tax: A tax that takes a larger fraction of a small income than of a large one. proportional tax: A tax that takes the same fraction of every income. invest: To commit money to assets expected to earn more later. Real: A figure with the effect of rising prices removed. unemployment benefit: State money paid to people who are out of work. deindustrialisation: A shrinking share of factory jobs in the economy. Consumer Prices Index: An index tracking the cost of a typical household basket. purchasing power: The quantity of goods a sum of money can buy.