

Government & the Macroeconomy

IGCSE Economics ■ Topic 4

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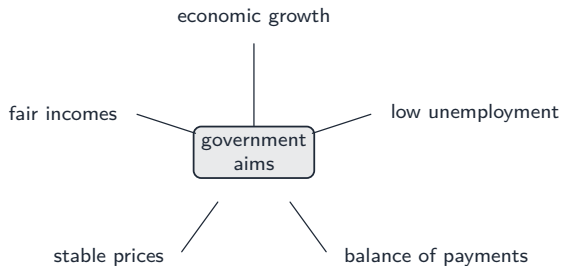


What we will cover

- 1 Government aims
- 2 Policy tools
- 3 Taxes
- 4 Inflation
- 5 Unemployment
- 6 The business cycle



Government aims



Five **macroeconomic** aims:

- **economic growth**
- **full employment**
- **price stability**
- **balanced trade & fair incomes**

Aims can **conflict**.

Policy tools

- **fiscal policy** – spending & tax
- **monetary policy** – interest rates
- **supply-side policy** – improving the economy's capacity



Central banks set the monetary tools

Policy tools – overview

Three sets of tools for the same aims:

- **fiscal policy** – government spending and tax
- **monetary policy** – interest rates (and the money supply)
- **supply-side policy** – raising what the economy can produce

Supply-side tools, by name

Privatisation

Privatisation : selling a state industry to private owners, in the hope that competition raises efficiency.

Deregulation

Deregulation : removing rules that keep new firms out, so incumbents face competition.

Incentives

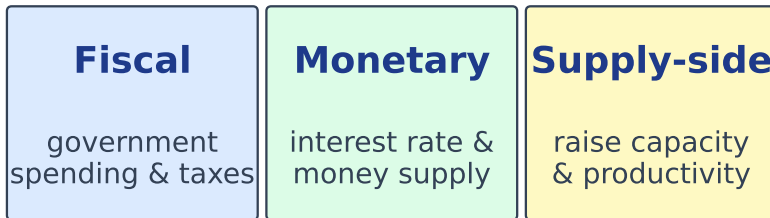
Lower marginal tax rates and targeted subsidies change the **incentives** to work, save and invest.

Training

Education and training raise **productivity** – the slowest tool, and the only one that lifts capacity permanently.

Supply-side policy shifts what the economy *can* produce. Demand-side policy only moves how much of it is bought.

Policy tools – overview, in detail



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

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

The budget, and the three outcomes

the budget

government **spending** set against **tax** raised

a budget deficit

spending exceeds tax, so the government must **borrow**

a budget surplus

tax exceeds spending

a balanced budget

the two are equal

expansionary fiscal policy

raise spending or cut tax – used to fight unemployment, and it widens the deficit

contractionary

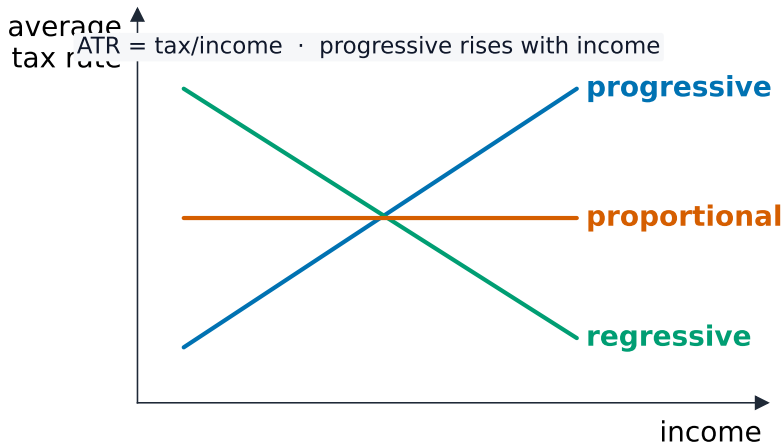
cut spending or raise tax – used to fight inflation

A deficit is not automatically bad: borrowing to invest in what raises future output is different from borrowing to fund today's spending.

Taxes

- **direct tax** (on income) vs **indirect tax** (on spending)
- **progressive** – higher % on the rich
- **regressive** – hits the poor harder

Taxes, in detail



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

How taxes are classified

by *what is taxed*

the first of the two groupings

a **direct tax**

paid **straight to the government** from **income** or **profit** – income tax, corporation tax

an indirect tax

paid on **spending**, collected by the seller – VAT, duties

by *who pays what share*

the second grouping

progressive

a **higher** percentage as income rises

regressive

a **lower** percentage as income rises – most indirect taxes are regressive

The two groupings are independent. An indirect tax is usually regressive, but that is a consequence, not a definition.



Inflation

Inflation is a general rise in prices, from:

- **demand-pull** – too much spending
- **cost-push** – rising costs

Demand-pull

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

Cost-push

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

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

Measuring inflation, and what it does

the CPI

pick a **basket** of goods a typical family buys, weight each by how much is spent on it, and track the total cost

what the number is

the **percentage change** in that cost over a year

purchasing power

money loses it – each unit buys **less**

savings

become worth less, unless interest exceeds inflation

exports

the country's goods become dearer than other countries', which **hurts exports**

and deindustrialisation

as a country develops, jobs shift **primary** → **secondary** → **tertiary**

The basket and the weights are what make the CPI meaningful – and both must be revised as spending habits change.

Unemployment

Unemployment : people who want a job cannot find one. Types:

- frictional , structural
- cyclical , seasonal



Unemployment wastes labour resources

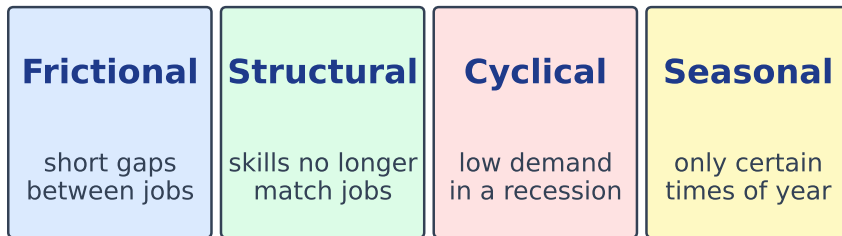
Sectors and the changing pattern of employment

- 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).

Unemployment – types

- **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, so workers' skills are no longer wanted.
- **cyclical unemployment** – a recession cuts total demand, so firms need fewer workers.

Unemployment – types, in detail



Exam: name the type + cause — cyclical needs demand stimulus; structural needs retraining

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

The two ways unemployment is measured

the claimant count

counts people claiming **unemployment benefit**

what it misses

those who want work but do not claim, or are not eligible – so it **understates**

the labour force survey

a survey counting people not working, **looking for work**, and ready to start

why it is preferred

internationally comparable, and it captures non-claimants

counted in neither

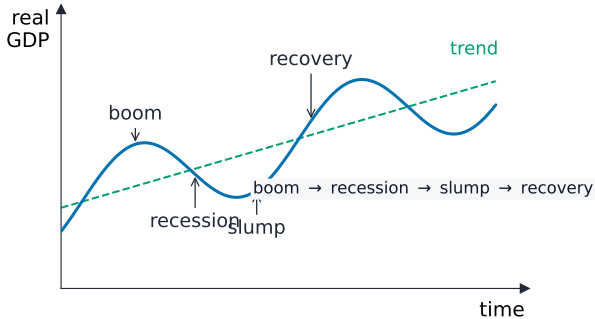
people not looking for work – retired, or full-time students

so

a fall in the rate is good news only if those people found jobs, not if they stopped looking

That last point is the standard evaluation mark: a falling rate can mean discouraged workers leaving the labour force.

The business cycle



The **business cycle** swings between **boom** & **recession**. In a recession the government can boost spending or cut interest rates.

Around the business cycle

Boom

Output above trend, unemployment low, inflation rising.

Slump

A deep **slump** : output falling, unemployment high, and investment postponed.

Recovery

Recovery : output rising again, confidence returning, and unemployment falling last.

How it is measured

By **gross domestic product** , and by the **consumer prices index** for the inflation that accompanies each phase.

Government policy is counter-cyclical: expand in the slump, tighten in the boom. **Redistribution of income** runs through both.

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.

Types of unemployment

frictional
short-term,
between
jobs

structural
skills no longer
match the jobs

cyclical
low demand in
a recession

Unemployment means people who want a job cannot find one

Economic growth



Investment in new buildings and capital, seen in Shanghai's Pudong skyline, drives economic growth

Exam tips

- Learn the government's five aims (growth, low unemployment, low inflation, balance of payments, fair incomes) – they can **conflict**, e.g. fast growth can pull up inflation.
- **Fiscal policy** = government spending and taxes; **monetary policy** = the central bank changing interest rates; **supply-side policy** = raising what the economy *can* produce.
- Key rates: unemployment rate = $\text{unemployed} \div \text{labour force} \times 100$; inflation rate = $\text{change in CPI} \div \text{old CPI} \times 100$; growth = $\text{change in real GDP} \div \text{old real GDP} \times 100$.
- **Deflation** (falling prices) can be harmful, because people delay buying, so demand and jobs fall.



Worked example – economic growth

Real GDP was £500bn last year and £515bn this year. Find the growth rate.

- $\text{Growth} = \frac{\text{change in real GDP}}{\text{original real GDP}} \times 100$
- $= \frac{515 - 500}{500} \times 100$
- $= \frac{15}{500} \times 100 = 3\%$
- **Real** GDP already has inflation removed, so this is a genuine rise in output.

Always use **real**, not nominal, GDP – nominal rises with prices alone. Two quarters of **negative** growth is the usual definition of a recession.

Topic 4 – key takeaways

1

Aims

growth, jobs, stable prices, fair incomes

2

Tools

fiscal, monetary & supply-side policy

3

Taxes

direct vs indirect; progressive vs regressive

4

Problems

inflation & unemployment

Check yourself

- 1 What does fiscal policy change?
- 2 Which policy uses interest rates?
- 3 Which tax takes a bigger % from the rich?
- 4 Name one cause of inflation.



Answers 1. government spending & taxation 2. monetary policy 3. a progressive tax 4. demand-pull or cost-push