Macroeconomic policy

Fiscal Policy

What is fiscal policy? Fiscal policy is the use of government spending and taxation to influence the level of aggregate demand and economic activity.

List the main types of fiscal policy instruments. The two main instruments of fiscal policy are:

- Government spending ($G$): on public services, infrastructure and benefits. The government can adjust the amount, timing and composition of government spending.
- Taxes ($T$): government can adjust the types of tax, rates of tax, coverage of tax ie who pays, and what is taxed eg children’s clothing is exempt from VAT.

How does fiscal policy affect the economy? Fiscal policy affects the:

- Aggregate demand: eg increasing government spending ($G$) and cutting taxes increases aggregate demand and moves the economy to a new level of GDP.
- Aggregate supply: eg tax cuts raise incentives to join the labour force or work overtime.

What is a government’s fiscal stance? Fiscal stance refers to the intended impact of public spending and taxation plans on the level of future economic activity and can be:

- Neutral: fiscal policy aims to have no impact on the future levels of AD.
- Reflationary/expansionary or loose: fiscal policy aims to increase the future level of AD.
- Deflationary/contractionary or tight: fiscal policy aims to lower the future level of AD.

Does the government have full control over the level of its spending and tax revenues? No. Tax receipts and job-related benefits depend on the level of GDP.

Explain automatic stabilisers. These are automatic fiscal changes brought about by the economic cycle. They impact quickly without any policy changes and smooth the economic cycle.

How do automatic stabilisers work in a recession? Automatic stabilisers trigger changes in AD that counter the economic cycle. In a slump public spending on unemployment related benefits automatically rise, stimulating AD. Automatic stabilisers are countercyclical.

Define discretionary fiscal policy. Deliberate changes in government spending and taxation.

Explain counter cyclical policies. Countercyclical policies aim to move demand in the opposite direction to the economic cycle eg increases in public spending in slumps.

List the strengths of fiscal policy. Fiscal policy has a multiplier effect and can be targeted at:

- specific products eg taxes on demerit goods or subsidies for merit goods;
- particular regions eg tax breaks for firms locating areas of high unemployment;
- given sections of the population eg benefits for vulnerable groups in society.

Identify fiscal policy implementation issues. Fiscal policy is made less effective if:

- there are long implementation time lags eg time taken to secure planning permission and build a new school or road.
- Uncertain multiplier. The multiplier value is uncertain. The multiplier effect has time lags.
- Tax changes affect incentives Increasing income and corporation tax rates diminishes the incentive to work, and so reduce aggregate supply. Fiscal policy affects supply side policy.
- Fiscal policy is inflexible. Budgets occur annually. Monthly budgets to adjust tax rates would confuse households and firms – uncertainty reduces investment.
- Crowding out. government borrowing reduces the funds available for private sector investment leading to higher interest rates.
- Contractionary fiscal policy involves politically unpopular spending cuts and tax increases. In practice it can be hard to cut spending on education and health.
Monetary Policy

What is monetary policy? Monetary policy is the use interest rates and other monetary policy instruments to influence the level of aggregate demand.

List monetary policy instruments. Interest rates, the money supply and exchange rates

What are debtors and creditors? A debtor is someone who owes money while a creditor is someone who is owed money

What is interest? Interest is the amount charged for borrowing. Interest is both the cost of borrowing and the reward for lending or saving

Explain interest rates. The interest rate is the amount charged each year for borrowing money, expressed as a percentage eg 12% pa means £12 interest is paid for every £100 borrowed

Who sets interest rates? The UK’s central bank, The Bank of England, uses its base rate (official rate) to influence interest rates set by commercial (high street) banks

What is a central bank? A central bank is a country’s main bank. It issues currency, enacts monetary policy, is banker to the government and lender of last resort to commercial banks

What is the Bank of England? The Bank of England is the UK’s central bank.

What is the base rate? The base rate is the official interest rate set by the Bank of England. Commercial banks set their own interest rates for mortgages and loans around the base rate.

Is there more than one interest rate? The rate of interest on savings accounts, overdrafts, credit cards and mortgages are set by high street banks usually in line with the official rate

Who carries out UK monetary policy? In 1997, the government gave the Bank of England (BOE) operational independence to set interest rates to help meet government inflation targets.

Explain the term operational independence. Operational independence means the Bank of England is responsible for taking monetary policy decisions about interest rates and the money supply to keep future inflation rates within an agreed target range set by the government.

What is inflation targeting? Inflation targeting is a monetary policy strategy where interest rate changes and other monetary tools are used to try to maintain price stability

What is price stability? Price stability occurs when there is low and stable inflation

What is a low inflation rate? In the UK the central inflation target is 2% pa based on the CPI measure. The acceptable inflation target range is 1% to 3%. If the actual annual CPI inflation rate is at or near (+/-1%) the target rate of 2% the aim of price stability is achieved.

Why is price stability important? Price stability preserves the purchasing power of savers, maintains international price competitiveness and reduces uncertainty which encourages private sector investment, which in turn supports sustainable economic growth

What is the Monetary Policy Committee (MPC)? The Monetary Policy Committee MPC is a Bank of England group that meets monthly to set the official interest rate

Why are interest rates important? Interest rates changes affect future levels of consumption, investment, the price of assets such as houses, expectations, the exchange rate and net exports.

What is the transmissions mechanism? The transmissions mechanism is the process by which a change in interest rates affects the future levels of economic activity and inflation.

How do interest rates changes affect the economy? Interest rates affect key components of aggregate demand. Eg lower interest rates increase aggregate demand because they

- lower the reward for saving and the cost of borrowing. Households with variable interest loans eg mortgages have more money available to spend. Consumption rises.
reduce costs for firms with overdrafts and encourage new investment. Firms expect increased sales as households are encouraged to increase spending. Investment rises.

- cause hot money to leave the UK, leading to a depreciation of sterling. Next exports \( X - M \) increase if demand is elastic

**Outline how expansionary monetary policy can be implemented.** A central bank can cut the base interest rate to encourage increased consumption and investment or create new money to buy debt from commercial banks, increasing their capacity to lend: so called *quantitative easing*.

**What factors determine the impact of an interest rate change?** The impact of interest rate changes depends on the size of the change, and overall consumer and business confidence.

**How effective is monetary policy?** Most nations now use monetary policy as the main means of influencing the level of aggregate demand to achieve a macro objective. Interest rates are:

- *Highly flexible* eg rates are set monthly by the MPC
- *Influence consumption* – the largest component of AD, and investment
- *A blunt instrument*. Eg higher interest rates to dampen demand in a booming house market have an adverse impact on firms struggling to compete on price in overseas markets. Savers benefit while borrowers with variable rate loans face higher interest payments.
- Subject to *time lags*. Interest rate changes takes around a year to affect the output and a further 12 months to impact on the price level - the ‘1+1’ rule.
- *Affects other variables* in the economy eg hot money flows impact on the exchange rate
- *Depends on consumer and business confidence*. Cutting interest rates to stimulate aggregate demand is ineffective if low confidence means economic agents postpone spending plans
Supply side policy

What is supply side policy? Government measures designed to increase long run aggregate supply by improving the efficiency of markets eg labour, energy and transport.

What is the impact of successful supply side policy? Successful supply side policies raise potential GDP and so shifts the AS curve to the right.

Link supply side policies and microeconomics. Supply side policies are often targeted at improving the performance of individual markets eg deregulating buses.

Are government policies the only reason for improvements in the supply side of the economy? Private sector investment in latest capital and training to improve productivity and remain competitive contributes to increases in potential output.

Identify approaches to supply side policy. There are two main approaches

- **Interventionist** to correct market failures eg public spending on education, training; investment in infrastructure eg High Speed Rail; trade union reform
- **Laissez faire** advocates reducing the role of the state by cutting government spending to allow lower taxes. This gives economic agents the incentive to work harder and invest. Governments support the private sector by minimising regulations and privatisation

What is the labour market? The places where human resources are traded

What is the unemployment (poverty) trap? Individuals calculate that lost benefits and extra tax means there is a disincentive to get a job or work extra hours and earn extra income.

Give examples of supply side policies targeted at labour markets. Policies include:

- **Cutting income tax rates** encourages the unemployed to join the labour force. Existing workers have an extra financial incentive to undertake overtime or accept promotion.
- **Reducing benefit levels and tightening eligibility rules** encourages/forces the unemployed to take paid work. The impact of any unemployment trap is reduced
- **Subsidising education and training courses** eventually increases labour productivity and helps improve the occupational mobility of labour.
- **Reduce worker rights** by making it easier for firms to 'hire and fire' or reduce pensions, and trade union reform that reduce the ability of workers to strike to protect wages.

Can tax cuts increase productive capacity? There are two opposing arguments:

- **Cutting income tax rates** encourages the economically inactive to join the labour force and the unemployed to take jobs. Workers are more willing to undertake overtime
- **Workers may have target income and use higher disposable incomes brought about by tax cuts to work fewer hours**
- **Cutting capital gains taxes** encourages entrepreneurs to risk capital and organise more production. Owners who sell on their successful business keep more of any capital gain
- **Corporation tax cuts leaves firms with more profit to invest in R&D, new plant buildings & machinery, or distribute to shareholders to reward their risk taking.**

Can benefit cuts increase productive capacity? Cutting unemployment benefits gives the jobless a bigger incentive to find work, reducing frictional unemployment. Workers are more likely to accept the first job, even if it is below their skills level, or accept part time work. Tighter eligibility rules reduce the numbers able to claim benefits. Eg paying benefits for only a fixed period of time; requiring attendance at training schemes or community projects. The Coalition
Government is tightening eligibility rules for receiving long term sickness benefits. However cutting benefits can reduce aggregate demand causing a lower level of GDP.

**How can government grants affect the supply-side? Grants**

- support the development of new firms and encourage *foreign direct investment*
- aid for relocating firms can help regenerate depressed areas. *Regional aid* also generates a local multiplier effect.
- Some economists argue that government subsidies that enable firms to retain staff during a recession and so maintain long-term productive capacity

**How can trade unions restrict markets?** Trade unions may use their labour market power to resist new working practices that aim to improve productivity or insist on over-manning. They may use their power to raise wages above the market equilibrium.

**How can trade union reform increase productive potential?**

- Laws which reduce minimum redundancy payments and make it easier for firms to dismiss unwanted workers make labour markets more flexible but at a significant social cost.
- Labour market imperfections hinder economies moving to long run macroeconomic equilibrium. Trade union reforms that reduce the ability of workers to strike to protect wages means short run aggregate supply can adjust quickly and fully to economic shocks.

**How does enterprise affect productive capacity?** Supply side measures that increase the potential reward from setting up or expansion increase business activity hence potential output.

**What are product markets?** The place where all kinds of goods of services are traded.

**Give examples of supply side policies aimed at product markets.** Government policies that aim to improve the working of product markets and so increase aggregate supply include:

- *Deregulation*: fewer rules and regulations for private sector firms cut compliance costs. Reducing barriers to entry encourages competition.
- *Privatisation*: private sector firms motivated by profit have an incentive to cut costs and increase productivity.
- *Competition*: enforcing competition rules forces firms to improve productivity to maintain their market share.
- *Trade liberalisation*: removing tariffs and quotas exposes domestic firms to competition.

**What is privatisation?** Privatisation is where state owned firms are sold to the private sector.

**How can privatisation increase potential output?** Some economists argue state run firms are productively inefficient. The profit motive gives privatised firms the incentive to increase the productivity of labour which, in turn, raises productive capacity.

**Why do governments regulate firms?** Unregulated production can endanger workers and generate negative externalities eg pollution. Monopolies can exploit their market power. Firms incur higher costs in ensuring government laws, rules and regulations are observed.

**What is deregulation?** Deregulation occurs when government removes or simplifies ‘unnecessary’ restrictions on the operations of an industry or a firm.

**Why do governments deregulate?** Deregulation can reduce costs and increase competition.

**What is the impact of deregulation on competition?** Deregulation opens up markets to new firms resulting in an increase in supply, lower prices and more choice for consumers. Existing firms strive to reduce costs and maintain competitive prices to retain their customers.

**How can deregulation increase the supply of labour?** Visa controls restrict the ability of skilled labour to enter the UK. Relaxing visa controls allows inward migration of skilled workers.
Link fiscal and supply side policies. Fiscal policy can impact the supply side of the economy:

- **Incentives**: Direct taxes affect incentives eg Income tax and income related benefits influence decisions to work or remain unemployed. Corporation tax affects the amount of profit owners receive for enterprise.
- **Government spending** on education and training improves skills hence labour productivity. Public investment in infrastructure, eg roads, cut transport costs.

**Link supply side polices and macro objectives.** To meet macro objectives, supply side policy must be supported by demand side management.

Successful supply side policy shifts AS curve to AS2. Matching management of AD results in non-inflationary growth, making full use of resources.

If supply side measures increase productivity, improved international competitiveness improves the balance of payments.

The four main macro objectives of low inflation, unemployment, sustainable growth and balance of payments are met, without conflict.

**How effective is supply side policy?** Some supply side policies such as education and training are expensive and have long implementation time lags eg it can take years for education and training to generate higher productivity. Outcomes are uncertain eg:

- Extra education spending may fail to raise standards or equip workers with relevant skills.
- Companies may use corporation tax cuts to raise dividends, not investment. Workers may use tax cuts to work less hours and maintain the same income.

By itself supply side policy does not guarantee sustainable non-inflationary growth – there must be complementary demand management. For instance, supply side policies have no impact if there is significant spare capacity in the economy.

If spending on education improves labour productivity, lower costs improve UK price competitiveness resulting in higher exports, lower imports, and an improved balance of trade.

**Conflicting Macro Policies**

**Give examples of how fiscal and supply side polices can work together.** Some fiscal policies also improve the supply side eg if tax cuts to stimulate AD also encourage the unemployed to take jobs. Government spending on infrastructure also reduces firms costs eg transport.

**Give examples of how fiscal and supply side polices can conflict.** The crowding out theory argues that government borrowing to finance its spending reduces the funds available for private sector investment leading to higher interest rates. Reflationary fiscal policy resulting in crowding out also raises interest rates – a contractionary monetary policy.

**Give examples of how monetary and fiscal policy can work together.** An increase in interest rates to reduce AD may have the effect of attracting hot money flows into the economy. The resultant exchange rate appreciation makes exports less price competitive and imports relatively cheaper.

**How can monetary and fiscal policies conflict?** Higher interest rates usually reduce private sector investment in eg capital and training, weakening the supply side of the economy.

**Give other examples of potential policy conflicts.** Environmental policies to increase sustainability generally raise short run costs of production, weakening the supply side. International competitiveness may be harmed if measures are not mandatory in other countries leading to a loss of price competitiveness. However investment in green technologies may raise competiveness in the long run.
Macro policies in action

How can government reduce unemployment? Government can opt for policy instruments designed to tackle the causes of unemployment. Potential measures include:

- *Fictional unemployment* arises through normal labour turnover and the resultant delays in applying for interviewing and accepting jobs. Job searches take time. Policies: improve job information, eg better job centres. Reduce amount and duration of unemployment benefits to give the unemployed an incentive to find work quicker.

- *Structural unemployment* arises when workers in declining industries lose their job but have inappropriate skills or mobility to fill vacancies. Policies: Offer retaining to improve occupational immobility and relocation grants to improve geographical immobility.

- *Demand deficient unemployment* occurs when the economy is operating below potential GDP. Keynesian economists argue that market failure means only expansionary demand management can increase GDP and so lower cyclical unemployment.

How can government control inflation? Policies focus on the cause of price instability:

- Cost push inflation requires government action to lower costs. For example the state can restrict wage increases (incomes policy); cap council tax increases; or encourage an appreciation of sterling to reduce the price of imports.

- Demand pull inflation requires contractionary demand management. The state can raise income tax; lower its own spending or increase interest rates.

- Inflation targeting where an independent central bank can use monetary policy to keep inflation target rate eg 2.5%. Inflation expectations are lowered.

How can government promote economic growth?

- If the economy is operating below potential output, reflationary demand management increases AD resulting in actual economic growth.

- If the economy is at potential GDP, potential growth requires an increase in productive capacity eg supply-side policies that increase quantity and quality of resources.

How can fiscal policies affect economic growth? Sustained economic growth requires an increase in long run aggregate supply. Specific types of spending and tax cuts can boost growth:

- Increased government spending on education and training increases productivity.

- Income tax cuts encourage economically inactive people to join the labour force.

- Lower corporation taxes and capital gains taxes increases the rewards of enterprise.

How can a government correct balance of payments difficulties? Policies focus on the cause of balance of payments disequilibrium. Two fiscal measures can be taken:

- *Expenditure reducing* policies lowers domestic aggregate demand hence the demand for import eg raising income tax and cutting government spending reduces domestic expenditure on all products, including imports.

- *Expenditure switching*. Expenditure switching policies change the relative prices of imports and exports eg tariffs raise import prices. UK membership of the EU and the threat of retaliation limit use.

- *Exchange rate* intervention to engineer a depreciation of sterling lowers the price of exports while increasing the price of imports improving UK price competitiveness.

- *Supply side policies* focus on improving UK competitiveness eg measures to increase productivity or R&D grants to improve the quality of UK products.