Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

2.6 Introduction to Macroeconomic Policy

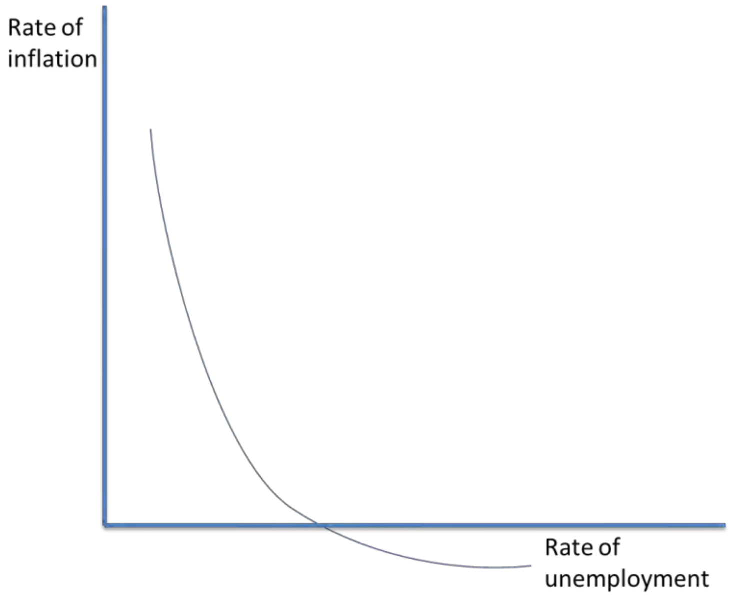
2.6.3 Potential policy conflicts and trade-offs

Notes

Unemployment vs inflation:

In the short run, there is a trade-off between the level of unemployment and the inflation rate. This is illustrated with a **Phillips curve.**

As economic growth increases, unemployment falls due to more jobs being created. However, this causes wages to increase, which can lead to more consumer spending and an increase in the average price level.



The extent of this trade off can be limited if supply side policies are used to reduce structural unemployment, which will not increase average wages.

Economic growth vs inflation:

A growing economy is likely to experience inflationary pressures on the average price level. This is especially true when there is a positive output gap and AD increases faster than AS.

A **negative output gap** occurs when the actual level of output is less than the potential level of output. This puts downward pressure on inflation. It usually means there is the unemployment of resources in an economy, so labour and capital are not used to their full productive potential. This means there is a lot of spare capacity in the economy.

A **positive output gap** occurs when the actual level of output is greater than the potential level of output. It could be due to resources being used beyond the normal capacity, such as if labour works overtime. If productivity is growing, the output gap becomes positive. It puts upwards pressure on inflation. Countries, such as China and India, which have high rates of inflation due to fast and increasing demand, are associated with positive output gaps.

Economic growth vs the current account:

During periods of economic growth, consumers have high levels of spending. In the UK, consumers have a high marginal propensity to import, so there is likely to be more spending on imports. This leads to a worsening of the current account deficit. However, export-led growth, such as that of China and Germany, means a country can run a current account surplus and have high levels of economic growth.

Economic growth vs the government budget deficit:

Reducing a budget deficit requires less expenditure and more tax revenue. This would lead to a fall in AD, however, and as a result there will be less economic growth.

Economic growth vs the environment:

High rates of economic growth are likely to result in high levels of negative externalities, such as pollution and the usage of non-renewable resources. This is because of more manufacturing, which is associated with higher levels of carbon dioxide emissions.

The issues governments face in managing the macro-economy

The government might face some issues when managing the macro-economy.

- **Potential policy conflicts and trade-offs:**

  This occurs when one macroeconomic policy has a larger impact than another, which conflicts with the other policy or reduces its effectiveness.

- **Environment vs competitiveness:** If 'green taxes' are implemented, such as carbon taxes, or if there are minimum prices on pollution permits, the competitiveness of domestic firms could be compromised. This is because they are limited in their production.

- **Progressive taxes vs inflation:** Taxes to reduce inequality could lead to higher rates of inflation. For example, a higher VAT rate increases the price of goods for firms and consumers.

- **Fiscal vs monetary policy:** Expansionary fiscal policies involve more government borrowing, which could cause interest rates and the inflation rate to rise.

- **Interest rate vs inequality:** The low interest rate could affect the distribution of income. Savers only receive a small return on their savings.

Other problems the government might face include:

- When reducing the size of the government deficit, the government might need to reduce their spending and increase the tax rate. However, these are politically unpopular.
- Some policies might take a long time to show an effect. This is particularly true of supply-side policies. For example, the effects of education cannot be seen until the education has been given and acted upon. This could take several years. Changes in taxes have an effect more quickly.
- Some events are beyond the control of the government, and this could limit how well policies work. For example, the financial crisis and global interest rates can affect the domestic economy, and this influences and limits the effectiveness of government policy.

How different macroeconomic perspectives influence policy decisions

- **Free market economies:**
  - Also known as ***laissez-faire economies,*** where governments leave markets to their own devices, so the market forces of supply and demand allocate scarce resources.
  - Economic decisions are taken by private individuals and firms, and private individuals own everything. There is no government intervention.
  - In reality, governments usually intervene by implementing laws and public services, such as property rights and national defence.
  - Adam Smith and Friedrich Hayek were famous free market economists. Adam Smith's famous theory of the invisible hand of the market can be applied to free market economies and the price mechanism, which describes how prices are determined by the 'spending votes' of consumers and businesses. Smith recognised some of the issues with monopoly power that could arise from a free market, however. Hayek argued that government intervention makes the market worse. For example, shortly after the 1930s crash, he argued that

the Fed caused the crash by keeping interest rates low, and encouraging investments which were not economically worthwhile: ‘malinvestments’.

- **What to produce:** determined by what the consumer prefers
- **How to produce it:** producers seek profits
- **For whom to produce it:** whoever has the greatest purchasing power in the economy, and is therefore able to buy the good

- **Advantages:**
- Firms are likely to be efficient because they have to provide goods and services demanded by consumers. They are also likely to lower their average costs and make better use of scarce resources. Therefore, overall output of the economy increases.
- The bureaucracy from government intervention is avoided.
- Some economists might argue the freedom gained from having a free economy leads to more personal freedom.

- **Disadvantages:**
- The free market ignores inequality, and tends to benefit those who hold most of the wealth. There are no social security payments for those on low incomes.
- There could be monopolies, which could exploit the market by charging higher prices.
- There could be the overconsumption of demerit goods, which have large negative externalities, such as tobacco.
- Public goods are not provided in a free market, such as national defence. Merit goods, such as education, are underprovided.

Command economy:

- This is where the government allocates all of the scarce resources in an economy to where they think there is a greater need. It is also referred to as central planning.
- Karl Marx saw the free market as unstable. He saw profits created in the free market as coming from the exploitation of labour, and by not paying workers to cover the value of their work. He argued for the “common ownership of the means of production”.

- **What to produce:** determined by what the government prefers
- **How to produce it:** governments and their employees
- **For whom to produce it:** who the government prefers

- **Advantages:**
- It might be easier to coordinate resources in times of crises, such as wars.
- The government can compensate for market failure, by reallocating resources. They might ensure everyone can access basic necessities.
- Inequality in society could be reduced, and society might maximise welfare rather than profit.
- The abuse of monopoly power could be prevented.

- **Disadvantages:**
- Governments fail, as do markets, and they may not be fully informed for what to produce.
- They may not necessarily meet consumer preferences.
- It limits democracy and personal freedom.

- **Mixed economy:**
  - This has features of both command and free economies and is the most common economic system today. There are different balances between command and free economies in reality, though. The UK is generally considered quite central, whilst the US is slightly more free (although the government spends around 35% of GDP) and Cuba is more centrally planned.
  - The market is controlled by both the government and the forces of supply and demand.
  - Governments often provide public goods such as street lights, roads and the police, and merit goods, such as healthcare and education.

  - **What to produce:** determined by both consumer and government preferences
  - **How to produce it:** determined by producers making profits and the government
  - **For whom to produce it:** both who the government prefers and the purchasing power of private individuals.

The likely effects of individual policy instruments on specific problems; possible unintended consequences

When governments employ a policy, there could be unintended consequences. This is when the actions of producers and consumers have unexpected consequences.

With government policies, consumers react in unexpected ways. A policy could be undermined, which could make government policies expensive to implement, since it is harder to achieve their original goals.

For example, the government could increase in the minimum wage with the intention of raising living standards. However, this could make it unaffordable for employers to employ so many workers, so it could lead to workers being sacked.