CIE Economics A-level

Topic 5: Government Macro Intervention

c) Effectiveness of policy options to meet all macroeconomic objectives

Notes

Problems arising from conflicts between policy objectives

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.

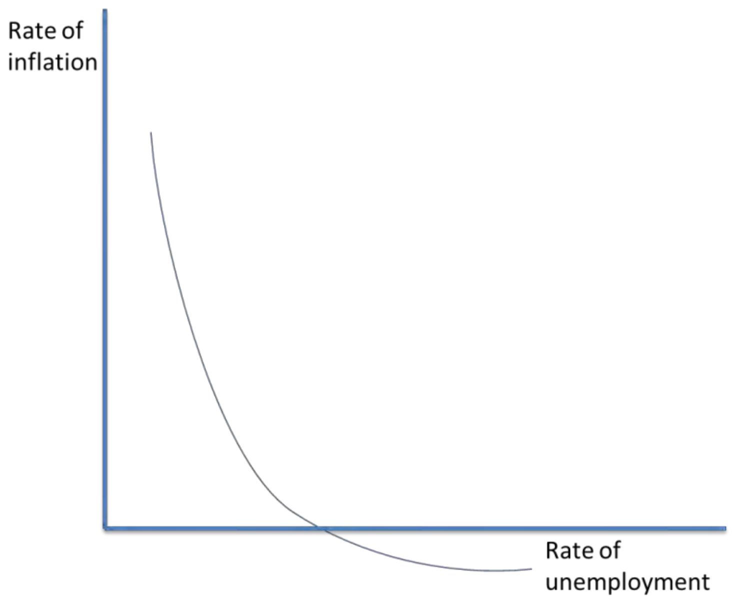
Economic growth vs the environment:

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.

- **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.

Existence of government failure in macroeconomic policies

- Governments can fail when they intervene in markets. They could worsen the market failure already present or a new failure might occur.
- This results in a **net welfare loss** to society.
- The loss could be from having ineffective intervention or when harm is caused.

Causes of government failure:

- **Unintended consequences**

- This is when the actions of producers and consumers have unexpected, or unintended, 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.

- **Excessive administrative costs**

- The social benefits of a policy might not be worth the financial cost of administering the policy. It might cost more than the government anticipated. The government has to consider whether the policy is good value for money.

- **Information gaps**

- Some policies might be decided without perfect information. This might require a full cost-benefit analysis, and it could be time-consuming and expensive.
- For example, government housing policies are long term, and have failed several times in the past.
- However, it is impractical for governments to gain every bit of information they need, so assumptions are made.

- **Distortions of price signals in markets:**

- Government subsidies could distort price signals by distorting the free market mechanism. A free market economist would argue that this could lead to government failure. There could be an inefficient allocation of resources because the market mechanism is not able to act freely.
- For example, the government might end up subsidising an industry which is failing or has few prospects.

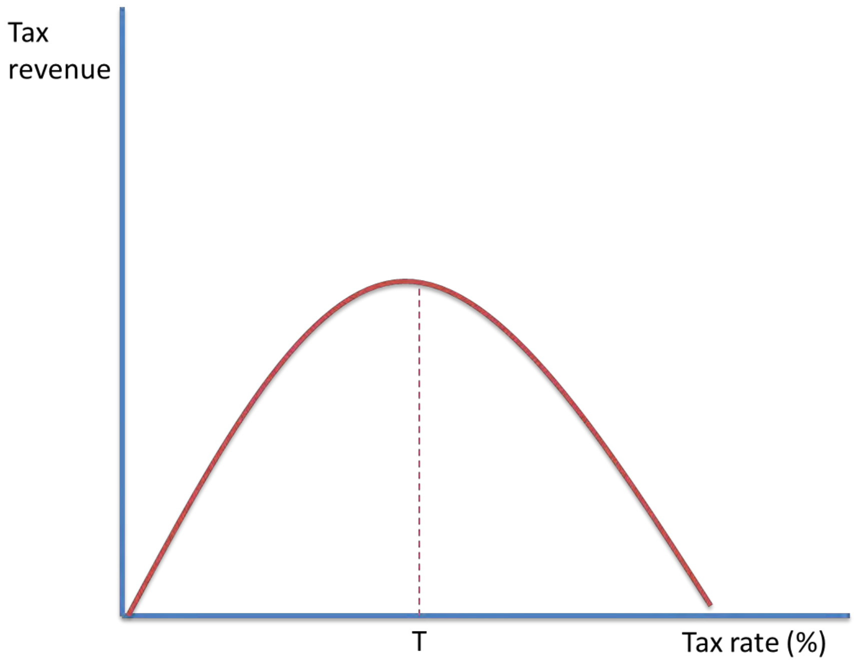
- In the agriculture market, governments might intervene with a buffer stock system to reduce price volatility. However, historically, these have been unsuccessful.
- Governments buy up harvests during surpluses, then sell the goods onto the market when supplies are low.
- **Advantages:**
  Farmer incomes remain stable, because fluctuations in the market are reduced.

This will be particularly beneficial in rural areas, where farming is a main source of income.
It also increases consumer welfare by ensuring prices are not in excess.

- **Disadvantages:**
  Governments might not have the financial resources to buy up the stock.
  By guaranteeing farmers a minimum price, they might overproduce. This could be expensive and damaging to the environment.
  Storage is difficult and expensive, since agricultural goods do not last long, and there are administrative costs.

- In the labour market, market failure is caused by immobility, skills gaps and discrimination within the market. The government might intervene by implementing a National Minimum Wage or having an Equal Pay Act. There is also a minimum school leaving age, to ensure workers have a sufficient basic education.
- The NMW could lead to government failure if instead of raising living standards, people become unemployed. However, there has been no evidence of this in the UK.

Laffer curve analysis



The Laffer curve shows how much tax revenue the government receives at each level of tax. Up until the point ‘T’, as tax rates increase, government tax revenue increases. After point ‘T’, people do not think it is as worthwhile working, and the lack of incentive to work leads to falling tax revenue. 'T' is the optimum tax rate where the government can maximise their revenue. Laffer argued that tax rates are too high, so they provide a disincentive to work. To encourage people to work harder, Laffer argued, tax rates should be reduced.