Edexcel Economics (A) A-level

Theme 2: The UK Economy - Performance and Policies

2.6 Macroeconomic Objectives and Policies

Detailed Notes

2.6.1 Possible macroeconomic objectives

Possible macroeconomic objectives:

Governments intervene in the economy in an attempt to improve its economic performance. The government have four key macroeconomic objectives:

- **Economic growth:** In the UK, the long run trend of economic growth is about 2.5%. Governments aim to have sustainable economic growth for the long run. In emerging and developing economies, governments might aim to increase economic development before economic growth, which will improve living standards, increase life expectancy and improve literacy rates.

- **Low unemployment:** Governments aim to have as near to full employment as possible. They account for frictional unemployment by aiming for an unemployment rate of around 3%. The labour force should also be employed in productive work.

- **Low and stable inflation:** In the UK, the government target is 2%, measured by CPI. This aims to provide price stability for firms and consumers and will help them make decisions for the long run. If the inflation rate falls 1% outside the target, the Governor of the Bank of England has to write a letter to the Chancellor of the Exchequer to explain why this has happened and what the Bank intends to do about it.

- **Balance of payment equilibrium on the current account:** This is important to allow the country to sustainably finance the current account, which is important for long term growth.

They have some other macroeconomic objectives:

- **Balance government budget:** This ensures the government keeps control of state borrowing, so the national debt does not escalate. This allows governments to borrow cheaply in the future should they need to and makes repayments easier.

- **Protection of the environment:** This aims to provide long run environmental stability. It ensures resources used are not exploited, such as oil and natural gas, and that they are used sustainably, so future generations can access them too. Moreover, it means there is not excessive pollution.

- **Greater income equality:** This minimises the gap between the rich and poor. It is generally associated with a fairer society.

To achieve their macroeconomic objectives, governments are able to manage demand through monetary or fiscal policy. In times of recession, they often increase AD to increase employment and economic growth whilst in a boom, they will decrease AD to decrease

inflationary pressures. They may also use supply side policies, which aim to bring about long-term growth.

2.6.2 Demand-side policies

Demand side policies are policies designed to manipulate consumer demand. **Expansionary policy** is aimed at increasing AD to bring about growth, whilst **deflationary policy** attempts to decrease AD to control inflation.

Monetary policy is where the central bank or regulatory authority attempts to control the level of AD by altering base interest rates or the amount of money in the economy.

Fiscal policy is use of borrowing, government spending and taxation to manipulate the level of aggregate demand and improve macroeconomic performance.

Monetary policy:

Interest rates:

The interest rate is the price of money and the MPC are able to change the official base rate in order to tackle inflation. This is called the **repo rate**, the rate the Bank of England will charge for short-term loans to other banks or financial institutions. A change in the repo rate affects market rates offered by banks to consumers and businesses as the Bank of England is the lender of last resort. If they are short of money, they will have to borrow from the Bank at the repo rate and therefore they need to make sure that their interest rates are based on this rate so that they are able to make a reasonable return.

A rise in interest rates causes a fall in AD through four key mechanisms:

- The rise in interest rates will **increase the cost of borrowing** for firms and consumers. This will lead to a fall in investment and consumption, reducing AD. Two particular areas of consumption that will decrease are consumer durables and houses. Higher interest rates require higher rates of return for investment. It also makes **savings more attractive**, as the interest earnt on them will be higher.

- Since less people are borrowing and more are saving, there is a fall in demand for assets such as stocks, shares and government bonds. This leads to a **fall in prices for these assets**. Therefore, consumers will experience a negative wealth effect since the value of their assets fall, which will lead to a fall in consumption. Moreover, investment is less attractive since firms are likely to see lower profits if prices fall. AD falls because of the fall in consumption and investment.

- People will become **less confident** about borrowing and spending if interest rates rise. The fall in consumer and business confidence leads to a fall in consumption and investment, causing a fall in AD. On top of this, other loans, such as mortgages, will become more expensive to repay and so consumers have to dedicate more of their income to paying back these debts. This means they have less income to spend on goods and services, so consumption will fall, causing AD to fall.

- Higher rates will increase the incentive for foreigners to hold their money in British banks as they can see a higher rate of return. As a result, there will be increased demand for pounds and the **value of the pound will rise**. This means that imports will be cheaper, and exports will be more expensive. This decreases net trade and therefore AD.

There are some **problems** with this method of demand management:

- Firstly, the exchange rate may be affected so much that exports fall significantly and imports rise significantly, causing a **balance of trade deficit**.
- Moreover, changes in interest rates take up to **2 years** to have their full effect and small changes in interest rates may not affect people's decisions.
- Sometimes, **interest rates are so low** that they cannot be decreased any further to stimulate demand. This is a particular issue for many countries today, and something most people never thought would be a problem.
- There are a range of different interest rates and **not all of them are affected by the Bank of England base rate.**
- A **lack of confidence** in the economy may mean that, no matter how low interest rates are, consumers and businesses do not want to borrow or banks do not want to lend to them.
- High interest rates over a long period of time will **discourage investment** and decrease LRAS.

Monetary supply:

Quantitative easing:

This is when the Bank of England **buys assets in exchange for money** in order to increase money supply and get money moving around the economy during times of very low demand. 'Quantitative' means a set amount of money is being created and 'easing' refers to reducing pressure on banks. It can prevent the **liquidity trap**, where even low interest rates cannot stimulate AD.

One way of buying assets is for the Bank of England to simply increase the size of banks' accounts at the Bank of England, called the 'reserves', which encourages them to lend money. Following the financial crisis, the Bank of England found that many banks preferred to keep their money in reserves rather than lending it out so buying assets from the bank did not have the effect they wanted. As a result, the Bank bought securities or bonds from private sector institutions such as insurance companies, pension funds and banks.

Quantitative easing has the effect of increasing consumption and investment, which increases AD and ensures the country meets its inflation target:

- Since the bank is buying assets, there is a rise in demand and so **asset prices rise**. This causes a positive wealth effect since shares, houses etc. are worth more so people will increase their consumption. Moreover, the cost of borrowing will decrease as higher asset prices mean lower yields (money earnt from assets), making it cheaper for households and businesses to finance spending.
- Moreover, the **money supply increases**. Private sector companies receive more money which they can spend on goods and services or other financial assets, which may increase investment or consumption and therefore increase AD. It may also push asset prices up further. Banks have higher reserves, meaning they can increase their lending to households and businesses so both consumption and investment increase as people can buy on credit.

- Commercial banks may **lower their interest rates** as they are receiving so much money from the Bank of England and so can offer very low interest deals to their customers. The increased money supply will mean that the price of money falls; interest rates are the price of money. This will encourage borrowing, and therefore increase investment and consumption so increase AD. If many banks decide to lower their interest rates, the same mechanisms will apply as those following a reduction in the base rate.

However, there are also **problems** with using quantitative easing:

- It is very risky and, if not controlled properly, could cause high inflation and even **hyperinflation.**
- Others say it would only lead to increased demand for **second hand goods** which pushes up prices but does not increase aggregate demand. For example, it would not lead to more new houses being built but only second hand houses becoming more expensive.
- There is **no guarantee that higher asset prices lead into higher consumption** through the wealth effect, especially if confidence remains low.
- It had a large effect on the **housing market** by stimulating demand and leading to rapid price rises since 2013, helping to worsen the issues of geographical mobility. It also led to rising **share prices** which increases inequality, since the rich grow richer whilst the poor see none of the gains.
- It was not meant to be permanent and there are concerns that banks and economies are **too dependent on quantitative easing**, particularly within the Eurozone.

Other methods:

- Open market operations: In order to reduce monetary supply, the central bank can sell more government securities on the open market. Securities are a promise by the government to pay a certain amount of money to the owner at a certain time and they are bought for less than their actual value; their price is determined by the demand for them. When people buy securities, they pay for them with money drawn from banks and so there is a fall in the bank balances. This means banks need to reduce their lending so monetary supply will fall. If they want to increase monetary supply, the central bank can buy government securities.

- The central bank can force banks to hold certain assets as a percentage of their total assets, known as monetary base or reserve assets. This means they can control the amount of money that is loaned out and therefore the money supply.

- Moreover, the central bank can restrict a bank's ability to lend money or who they are allowed to lend it to.

Role of the Bank of England:

- Monetary policy is controlled by the Bank of England rather than the government. The **Monetary Policy Committee** (MPC) makes the most important decisions, including the Bank of England base rate and the actions over quantitative easing.

- Their main aim is **keep inflation at 2%** and if it goes below 1% or above 3% the governor of the Bank of England has to write a letter to the Chancellor of the Exchequer explaining why this is happened and what the Bank of England is doing to bring it back to the target. They use CPI in order to see whether this target has been met.

- Since 2009, the MPC has kept the bank rate at 0.5% and policy has become focussed on boosting economic growth and employment. It was reduced to 0.25% following the Brexit vote but rose again in November 2017 due to the inflation that the weak pound brought about. They plan to raise the interest rate once the negative output gap has been eliminated and the economy is growing strongly.

- The Committee is made up of **nine people**: five are from of the Bank of England, including the Governor of the Bank of England, and the other four are independent outside experts, mainly economists.

Fiscal policy:

There are two main ways the government can increase AD through fiscal policy:

- A rise in income **tax** will cause a fall in disposable income. This will lead to a reduction in consumption and thus decrease AD. Alternatively, a rise in corporation tax will decrease a firm's post-tax profits. This will lead to a reduction in investment and thus decrease AD.

- A rise in **government spending** will increase AD since it is one component.

Government budgets:

The government's fiscal (spending, borrowing and taxation) plans are outlined in the budget. A **budget deficit** is when the government spends more money than they receive. A **budget surplus** is when the government receives more money than they spend.

Indirect and direct taxation:

Direct taxes are paid directly to the government by the individual taxpayer. An **indirect tax** is where the person charged with paying the money to the government is able to pass on the cost to someone else i.e. the supplier can pass on the burden to indirect tax to the consumer. The four highest revenue raising taxes are income tax, national insurance, VAT and corporation tax. Other taxes include council tax, excise duties, capital gains tax, inheritance taxes and stamp duty land tax.

It is a good idea to have an understanding of the different rates of tax in the UK. For example:

- Income tax is a direct tax and is the biggest source of revenue for the government, around 25% of all taxation revenue. It is paid as a percentage of income and all income earned below a certain threshold is not taxed (£11,850 as of Summer 2018). The basic rate is 20%, the higher rate is 40% and 45% is the additional rate for incomes over £150,000.
- VAT is an indirect tax and the standard rate of VAT is 20%. Not all goods pay the standard rate, for example food and children clothes aren't charged and domestic fuel/power are charged 5%.

There are **problems** which need to be considered when evaluating fiscal policy:

- Government spending also **impacts LRAS**. For example, by cutting government spending to reduce AD, the government may be reducing the quality of education or spending on research and technology.
- Taxes and spending have an impact on **inequality**, so some decisions aimed to reduce/increase demand may increase income inequality. They also have an impact on **incentives**, for example high taxes reduce incentives.

- The government also has to worry about **political issues**, for example they may be unwilling to raise taxes in order to reduce demand as this may lead to them being voted out of government
- Expansionary fiscal policy is difficult to undertake during a period of **austerity**. The government needs to consider the effect of policies on the budget.
- The impact of fiscal policy **depends on the multiplier**: the bigger the multiplier, the bigger the impact on AD. Classical economists argue that the multiplier is almost zero whilst Keynesian economists argue that it can be large if targeted correctly.

The impact of changes in government spending and taxation is looked at in more detail in A2. For A2 questions on fiscal policy, it is important to also bring in some of these points.

Evaluation of demand-side policies:

It is clear there are some issues with the individual policies, for example the effect on the budget following fiscal policy or hyperinflation risks with quantitative easing. However, demand-side policies on the whole have some issues:

- Classical economists argue that any demand management, whether fiscal or monetary, will have **no effect on long-run output** so supply side policies should be used. They believe that increasing AD during a depression will have no effect other than to increase prices. If the economy is in short-run disequilibrium, it will quickly return to long run equilibrium, whilst Keynesians argue that it can be in long-run equilibrium for years.

- On a Keynesian LRAS, the impact of changes in AD d**epend on where the economy is operating**: if the economy is at full employment then a rise in AD will only lead to higher prices. However, if unemployment is very high, then a rise in AD will only lead to higher output.

- Both policies see significant **time lags** between their introduction and their full effect.

- The biggest issue of demand-side policies is that, in most cases, an expansionary policy is **inflationary** whilst a deflationary policy brings **unemployment**. This depends on the elasticity of the curve and the curve which you perceive to be correct (Keynesian or classical), but holds in most scenarios. Thus, through demand management, the government cannot bring about both low and stable inflation and high economic growth/low unemployment.

Monetary vs fiscal policy:

- Monetary policy is useful as the government is able to increase demand without having to increase their spending, which would result in a larger fiscal deficit. Classicists argue that if demand management is going to be done only monetary policy should be used.

- Fiscal policy can have significant impacts on the supply side of the economy, for example increases in spending on education to increase AD will also increase LRAS. Moreover, it is more effective at targeting specific groups and reduce poverty, for example by increasing benefits it can increase AD and reduce inequality.

A range of demand-side policies should be used alongside other policies, such as supply-side policies, in order to achieve all the government's goals.

Synoptic point:

Any government decision will also have microeconomic impacts. For example, a government decision to reduce tax will allow firms to have higher post tax profits. This may increase investment and therefore increase efficiency.

Great Depression:

In the 1930s, the world experienced a severe depression known as the Great Depression- in the UK, unemployment was over 15% and in the US it was almost 25%. The areas most affected in the UK were the primary industry and the manufacturing industry which relied on exports and so were impacted by the collapse of world trade.

Causes of the Great Depression:

The Great Depression was set off by the **Wall Street Crash of 1929** when there was a sharp fall in share prices on the New York Stock Exchange, but economists have different views in what they believed caused the following depression:

- Firstly, it may have been caused by the **loss of consumer and business confidence**: shareholders lost money in the crash, others became worried about what would happen, and firms cut back investment which led to a downward spiral in AD.

- Moreover, it could have been caused by the **US banking system**. Banks had lent too much during the 1920s, which had created an unsustainable boom and the system was unable to deal with issues following the crash. The government allowed banks to fail after the crash, which decreased confidence further and reduced loans to businesses and consumers, causing a fall in AD.

- **Protectionism** may also have been another cause of the Great Depression. It reduced world trade which decreased AD and lowered confidence. Firms involved in exports were no longer able to pay bank their loans, which caused bank failures in the USA. America introduced the Smoot-Hawley Tariff Act in 1930 which decreased

imports to the USA. Countries which traded with America saw a reduction in exports which decreased in AD in their countries. American also suffered from a fall in exports as other countries retaliated.

- The UK was also affected by its commitment to the **gold standard,** in which its currency was fixed to the value of gold and therefore fixed to other currencies. It left the gold standard in 1914 but re-joined in 1925 at the 1914 level and value, despite the fact the value of the pound had fallen. The rejoining of the gold standard meant the pound was appreciated rapidly and exports fell as they became more expensive. The UK went into the Great Depression with an overvalued exchange rate.

Policy responses in the UK:

- The UK government believed that **balancing the government budget** was key to recovery and that borrowing money would prevent the private sector from doing so. They introduced an emergency budget which **cut public sector wages and unemployment benefit** by 10% and **raised income tax** from 22.5% to 25%. This reduced AD at a time when it needed to be increased.

- The pound came under attack from speculators and needed to be defended to prevent the UK being forced out of the gold standard. A balanced budget meant the UK didn't have to borrow from abroad, which helped the exchange rate as did the high interest rates used to defend the high exchange rate. However, the **high interest rates** also decreased demand.

- The UK was forced to **leave the gold standard** on 21st September 1931 due to continued speculation against it. This caused the value of the pound to fall by 25% compared to other currencies and allowed the Bank of England to **cut interest rates** by 2.5%, both of which helped the increase AD by increasing exports or increasing consumption/investment.

- There was recovery in London and the South East but Wales, the north and Scotland did not reach full employment until 1941.

Policy responses in the USA:

- The US government originally had the same view over a balanced budget as the UK.

- However, Franklin Roosevelt was elected in 1932 with **his New Deal** which promised public sector investment, work schemes for the unemployed and fiscal stimulus.

- The USA reached full employment in 1943 (two years after joining the war- the same as Britain). Roosevelt's New Deal is an example of **Keynesian expansionary fiscal policy** but can be argued it was not large enough to be successful, although it did have a large impact as the US unemployment figure was so high.

Global Financial Crisis (2008/9):

There are many parallels between the Great Depression and the Global Financial Crisis: both were started in the US and spread throughout the world and both had large, long term effects on the economy. However, the Global Financial Crisis was much less severe than the Great Depression.

Causes of the Global Financial Crisis:

- The 2008 crisis was started by issues in **mortgage lending** in the USA. In the early 2000s, relatively poor people were encouraged by the government and banks to take out mortgages to buy their own homes. This was an example of moral hazard, as the bank workers saw higher bonuses for selling more mortgages. They were given low interest rates on the loan for the first few years, but many were no longer able to continue paying with the higher repayments. Houses were repossessed, demand fell, and prices fell meaning the value of the houses was now less than the mortgage of the house. This is known as negative equity.

- At the same time, banks had been **grouping 'prime' mortgages** (people who were likely to pay back their loans) **and 'sub-prime' mortgages** (those who weren't) and selling packages to other banks and investors as if they were all prime mortgages. The aim was to reduce risk since it meant no bank was highly dependent on risky mortgages. However, it increased risk as many were now holding assets worth less than they had paid for them; it spread the effects of the housing crash and the unpaid loans.

- When this was revealed, there was a **fall in confidence** and banks stopped lending between each other, fearing that they would lose money if the other bank were to collapse. Similar events occurred in the UK, Ireland, Spain and Portugal. Northern Rock Building Society was the first affected in the UK in 2007 with too many loans not being repaid, and savers beginning to withdraw their money. In 2008, Lehman Brothers, an investment bank, was allowed to fail. This caused panic as people believed bank after bank would be allowed to collapse, leading to losses for savers.

Policy responses in the UK and the USA:

- Both governments were forced to **nationalise banks and building societies** and **guarantee savers** their money in order to prevent the chaos of a collapsed banking system. For example, the British government bought Northern Rock and most of Royal Bank of Scotland and Lloyds Bank.

- They used **expansionary monetary policies** with record low interest rates and quantitative easing. The Bank of England said the QE led to lower unemployment and higher growth than would otherwise have been the case.

- However, the USA government had a more **expansionary fiscal policy** and this is perhaps why it recovered faster. In 2010, the UK prioritised reducing **National Debt** over providing a fiscal stimulus, but the USA did not make this decision until 2013.

2.6.3 Supply-side policies

Supply side policies are government policies aimed at **increasing the productive potential of the economy** and moving the supply curve to the right. Over time, there tend to be supply-side improvements independent of the government, through actions of the private sector such as investment. However, the government is able to use supply-side policies in order to increase and speed up these improvements. They may be across the whole economy or in certain markets to target economic growth in that sector.

Market based and interventionist methods:

- **Market based policies** are policies which are designed to remove anything that prevents the free market system working efficiently, causing lower output and higher prices. These barriers include those which reduce willingness of workers to take jobs or lead to inefficient production, high prices or a lack of risk-taking.

- **Interventionist policies** are policies designed to correct market failure, for example the free market under provides education and so the government provides it. Also, firms may only look into the short term and look to maximise short run profits to give to shareholders instead of investing, so governments may take actions to encourage investment.

- Free market economists tend to argue for market-based policies as they want the government to have as small a role as possible. Economists who support interventionist policies suggest the free market is not as efficient as people believe and so the government needs to intervene to improve it.

Policies:

Increase incentives:

- By increasing the incentive for people to go to work or firms to employ people, the government will increase the **size of the workforce** and this would mean more goods and services would be produced.
    - A **reduction in benefits/taxes** will increase the opportunity cost of being out of work and mean that people are always better off within work than on benefits. This is why the government have introduced Universal Credit, which helps to ease the transition into and out of work.
    - A reduction in benefits may prevent the **poverty/unemployment trap**, where low income workers end up in the same or an even worse position after they gain a new job because of the benefits they lose. The unemployment/poverty trap can also be solved by subsiding workers i.e. lower income workers receive income tax credits instead of paying income tax.
    - Moreover, they could encourage parts of the workforce back to work, for example women could be offered free childcare and flexible hours.
    - Taxes on firms when they take on new staff, such as **National Insurance Contributions,** decrease the incentive for businesses to employ. Reducing these taxes would increase incentives for firms to employ.
    - A **reduction/removal of the minimum wage** would increase the incentive for firms to employ.

- Moreover, they could increase incentives for people to **take risks** or for firms to invest. One way they could do this would be lowering taxes, which will mean people see a bigger return on their investment.

- The **problem** with this method is that many people will argue a small change in any tax, for example from 25% to 20%, will have little impact on people's incentive to work. Reductions of tax on high income earners will lead to more income inequality and any reduction will mean governments have less revenue so have to decrease spending or borrow more. Reducing benefits will also worsen equality.

Promote competition:

- **Privatisation,** selling nationalised companies to private sectors, or **deregulation**, reducing restriction on businesses which restrict entry to the market, makes firms more competitive.

- **Competition** policy is used to prevent monopolies in the market and make cartels and price fixing agreements illegal. The CMA is the body in the UK which ensures markets are competitive and the Competition Act (1998) and Enterprise Act (2002) were passed with the same aim. These are looked at in more detail in Theme 3.

- The belief is that competition is necessary to make firms **efficient** as they have to offer a cheaper or better service if there is competition. Free market economists argue that governments have little incentive to cut costs or innovate so nationalised industries are inefficient and causes government failure.

- **However,** deregulation and privatisation may lead to a poorer quality service. It could also cause environmental issues if deregulation is seen in environmental regulations.

Reform the labour market:

- By **increasing the retirement age**, there will be more people working and so more goods and services could be produced.

- Moreover, the labour market could become **more flexible** in order to make it more efficient as it can respond to external changes, such as changes in demand for a product or population changes.
  - One way to do this is through **weakening of unions**. For example, the government has introduced postal ballots, banned secondary picketing and reduced the picket line to only 7 people. Unions now have to give 14 days' notice before strikes and have a higher turnout and support for strikes in ballots. Trade unions push up wages which can lead to businesses laying off some workers and reducing production, which limits AS, and so therefore reducing their power will hope to prevent this.
  - Also, businesses have attempted to be more flexible by **changing employment contracts,** for example zero-hour contracts.
  - Flexibility could also be in the form of making it easier to change jobs, through **higher mobility of labour**: improved information about job vacancies, improved flexibility of pensions and improved geographical mobility; or in making it easier to sack people from jobs which would encourage more firms to employ people. In order to improve geographical mobility, the government is trying to improve the affordability of housing. To do this, they have cut VAT and relaxed planning laws.

- If the **minimum wage** is set above the equilibrium level it will cause increased unemployment, so some people argue the minimum wage should be scrapped to prevent real-wage inflexibility unemployment.

- The **reduction of benefits** will also increase incentive to work and help to reform the labour market. Universal Credit is helping to reform the labour market, although it is currently experiencing problems in setting it up.

- On the whole, all of these methods would **reduce unemployment**, which represents a waste of resources, and mean that more goods and services can be produced as the labour force is bigger.

- **On the other hand**, trade unions are already very weak in the UK so reducing their power further may have little effect. Similarly, reducing benefits will lower AD if these people are unable to get jobs and this will cause a further fall in employment. The reduction in benefits is likely to have a multiplied effect as the poor have a very high MPC and so a reduction in their income will cause a large fall in spending, meaning AD falls by a lot. It may also mean there is increased income inequality. Making the labour force more flexible will lead to decreased quality of life as people are less secure in their jobs and may have to work odd hours. It will also mean some people receive very low pay, which will increase income inequality and may reduce AD.

Improve skills and quality of the labour force:

- They could **increase spending on education and training** to create a more educated workforce who will be more efficient and be able to do more skilled jobs, increasing the number of goods and services produced. This could be in terms of academic education, such as free university tuition, more spending on secondary school etc., or improving the quality of on the job training, such as apprenticeships. T-Levels have been introduced by the government as an A Level equivalent which focuses on technical education. The government are also working with trade unions and firms to improve the skills of the long term unemployed.

- Alternatively, they could introduce **regulation** which forces businesses to continuously train their own staff, to keep them up with developments etc. The Apprenticeship Levy is effectively a tax on salaries in large companies where the money is held online for them to spend on training. However, it has not been very effective as there has been a fall in the quality and number of apprenticeships.

- An **increase in high skilled migrants** would also improve the quality of the workforce. The government have introduced more lax rules for skilled immigration. It is hoped this will improve the skills shortages in the UK, where there are 800,000 unfilled vacancies due to incorrect skills.

- Overall, improvements in skills will mean that workers are **more efficient** and so can produce more goods and services as well as being more skilled so be able to develop new technology etc.

- **However,** improving education may have no effect if it is in skills not relevant to the workforce. Increasing education will incur an opportunity cost as it means government money will be lost in other sectors. It will also take time to see the effects of increased education and more investment may not necessarily increase the quality of education

Improve infrastructure:

- This could be done through offering **tax incentives or subsidies** on investment. For example, businesses who invest their profits could see lower tax rates.. Investment in the UK is just 17% of GDP compared to 35% in South Korea. In order to improve this, the government plans to reduce corporation tax to 18% in 2020. Moreover, the Enterprise Investment Scheme provides tax relief for people who buy shares in a small company when the finance raised is used for investment purposes.

- Alternatively, the **government could spend money** to improve infrastructure themselves. Some government action includes building new roads, HS2, CrossRail and the Transforming Cities Fund.

- This will mean new technology will be developed and more will be invested in buying new technology. Improvements in technology will mean that production is **more efficient** so less resources are needed to produce the same amount of goods whilst more technology will mean more goods and services can be produced. The UK is 24th in the world for infrastructure and so it is clear that more action needs to be taken.

- However, there are **some issues**. Offering tax breaks/subsidies could have adverse effects on the government budget as it will mean they lose tax revenue or incur an opportunity cost as they have to spend money on subsidies. Some businesses may not actually invest this money and instead used it as a method of tax evasion. Moreover, not all investment will be successful in improving supply as it may not achieve its aim or it may not be aimed at increasing supply.

Evaluation of supply-side policies:

- Unlike demand-side policies, supply side policies are able to both **increase output and decrease prices**.

- They are more **long-term policies** and lead to long term economic growth, rather than small changes in economic growth following changes in AD.

- Moreover, they can be directed at increasing exports which will also **improve the balance of payments.**

- Supply side policies allow **two different types of approaches**: market based and interventionist, and this will mean that both free market economists and more interventionist economists will accept and use supply side policies.

- However, the Keynesian LRAS curve shows that they have **no impact when LRAS is elastic**, and so demand-side policies are needed to fix the problem in the short run.

- Moreover, **not all supply side policies work** at actually increasing supply, whilst others cause conflicts and both these issues vary depending on which policies are used.

- Often, the government has to spend more money (for example on education) or decrease taxes, which will decrease their revenue and lead to a **budget deficit**.

- These actions may also have **undesirable impacts on AD** and could cause higher unemployment or higher inflation.

- Supply side policies can also take a **long time** to have any effect on output and this makes them less useful.

Synoptic point:

Some of these policies are aimed at solving microeconomic issues, for example under-performing monopolies, in order to improve a macroeconomic concept. If the economy is not successful at a microeconomic level, it will be unable to meet macroeconomic objectives.

2.6.4 Conflicts and trade-offs between objectives and policies

Conflicts and trade-offs between objectives:

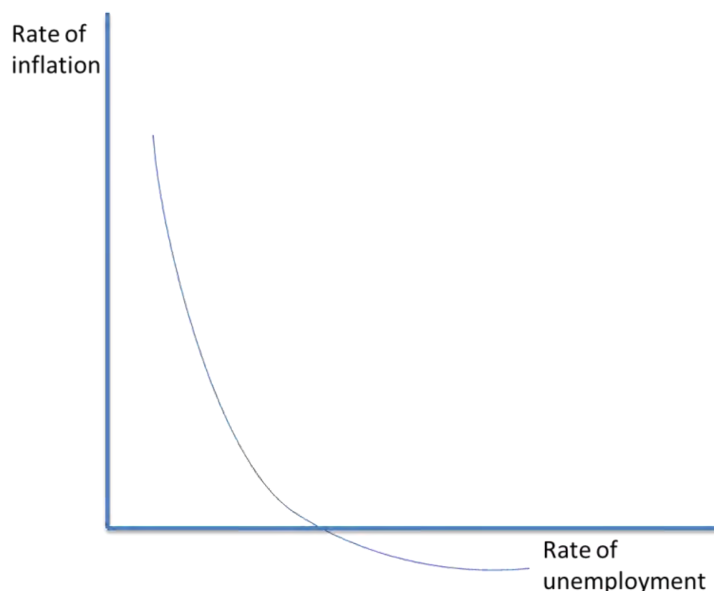
There are many different trade-offs between the macroeconomic objectives. Two objectives which tend to go hand in hand are economic growth and unemployment, but the rest tend to be achieved at the expense of another.

Economic growth vs. protection of the environment: As the economy grows, we expect more resources to be used. As we use resources and produce goods, we produce pollution and noise and destroy habitats. Economic growth in China has been rapid but it has

led to serious levels of pollution. Economic growth can be achieved without damaging the environment, but the growth is likely to be slower and have higher costs.

Economic growth vs. Balance of Payments: Some countries such as India have seen rapid economic growth leading to balance of payments problems. The country is so large that its industry is largely producing goods for its own people and the wealth of the people has led to increased demand for imported goods. In comparison, China has seen massive growth but that has been largely been by producing goods for exports and therefore their balance of payments is in a surplus.

Unemployment vs Inflation- Short run Phillips curve: A. W. Phillips found a trade-off between inflation and unemployment, called the Phillips curve. He found the existence of an empirical regularity, which said that the rate of change in money wages increased as the rate of unemployment fell. This was then generalised into a relationship between unemployment and inflation, by arguing that firms pass on increases in wages to the customer in increased prices. The reason for this connection is that businesses know that if there is a high level of unemployment, they can attract the workers they want with low wages. If there is high employment, firms are competing for the best workers and the way to obtain the best is by offering higher wages. Initially, the Phillips curve seemed to accurately show the relationship well. However, during the 1970s, we saw high levels of unemployment and low inflation, called stagflation.



Conflict and trade-offs between policies:

Expansionary and deflationary fiscal and monetary policies: Expansionary policies will increase AD, to increase output, employment and economic growth but will lead to increased inflation and may worsen the balance of payments as some of the increased demand for goods and services will be met by imports. On the other hand, deflationary

policies will decrease AD to improve inflation but will decrease employment and economic growth.

Changes in interest rates: An increase in interest rates will be used to decrease inflation. However, continuously high rates will damage long-term investment as less businesses will want to invest, and this will decrease long-term growth. Moreover, they will raise the value of the pound which will decrease exports and increase imports, worsening the balance of payments. Also, the interest rate will affect distribution of wealth: high interest rates benefit savers and lenders, tending to be older people as they are more likely to have savings. Low interest rates tend to increase income inequality, as the richest people hold a larger proportion of their wealth in non-money assets, such as stocks, shares and belongings and so aren't affected much by interest rates, whilst middle and working-class people are more likely to have savings in the bank.

Supply-side policies: Supply side policies intend to increase aggregate supply, and therefore improve long term economic growth. They are also able to decrease long term inflation but may increase it in the short term if they encourage investment as this will increase AD. Moreover, policies which decrease trade union power, reduce wages, lower benefits, change taxation etc. may increase income equality as these will negatively affect the poorest in the country. Some supply-side policies have adverse effects on the budget or on the environment.

Fiscal deficits: In order to reduce fiscal deficits, the government may decide to reduce government spending and increase taxes. Firstly, this will reduce AD and decrease short term economic growth and higher unemployment. Also, the higher the fall in output as a result of these measures, the higher the fall in tax revenues will be and so therefore the more ineffective the policy. Moreover, it is likely to affect income equality as the poor are the ones who use the government services most and so will be worst affected.

Synoptic point:

Some microeconomic policies could have adverse macroeconomic impacts and vice versa. For example, indirect taxes to fix market failure could fix market failure could reduce competitiveness and decrease SRAS.