

5. Government Macroeconomic Intervention

5.1 Government Macroeconomic Policy Objectives

Syllabus 5.1

- Use of government policy to achieve macroeconomic objectives: price stability, low unemployment, economic growth (policy conflicts and trade-offs are not required)

Government Aims

1. **Price Stability** → **Low and stable** inflation rate
 - not **zero rates**: 1) any measure of inflation tends to overstate any rise in prices; 2) to aim for zero inflation may result in deflation; 3) inflation encourages consumption due to price rises
2. **Low Unemployment** → Unemployment is a waste of the society
3. **Economic Growth** → **Most fundamental** of all the policies, e.g., maintaining stability for price is to encourage firms to undertake investment to stimulate economic growth

5.2 Fiscal Policy

Syllabus 5.2

- meaning of government budget
- government budget deficit and surplus
- meaning and significance of national debt
- taxation
 - types of taxes: direct/indirect, progressive/regressive/proportional
 - rates of tax: marginal and average rates of taxation (mrt, art)
 - reasons for taxation
- government spending
 - types of spending: capital and current
 - reasons for government spending
- expansionary and contractionary fiscal policy
- AD/AS analysis of the policy's impact on the equilibrium level of national income and the level of real output, the price level and employment

Fiscal Policy and the Budget

- **Fiscal Policy**: the use of **taxation** and **government spending** to manage **aggregate demand** in order to **achieve the government's macroeconomic aims**
- Put forward by the **government**
- **Budget**: a **statement of its fiscal policy**
 - **Budget surplus**: tax revenue > government spending
 - increase in government spending & decrease in tax rate might increase surplus as the level of economic activity increases
 - **Budget deficit**: government spending > tax revenue
 - **Balanced budget**: government spending = tax revenue

The National Debt

- **National Debt:** the **total** amount of government debt, based on **accumulated previous deficits and surpluses**, represented as **a percentage of GDP**
- **Disadvantages:** 1) opportunity cost of interest payments; 2) decrease government's borrowing power; 3) limit the government's economic activity

Taxation

- **Indirect taxes:** taxes on the **sale of goods and services**
 - **Sin tax:** discouraging people from buying harmful products
 - normally **regressive**
 - **Advantages:** 1) they do not discourage effort, innovation and saving; 2) less tax avoidance and tax evasion
 - **Disadvantages:** great reliance makes income less evenly distributed
- **Direct taxes:** taxes on **income and wealth**
 - normally **progressive**, tax brackets
- **Marginal rate of taxation (mrt):** the proportion of **extra income** taken in tax
- **Average rate of taxation (art):** the proportion of **a person's total income** taken in tax
- **Proportional tax:** marginal rate of taxation = average rate of taxation
- **Reasons for taxation:** 1) government revenue; 2) market failures; 3) control demand & income distribution

Automatic Stabilizers

- **Automatic Stabilizers:** mechanisms in fiscal policy that automatically adjust revenues and expenditures to economic fluctuations, without the need for explicit government intervention
 1. **Progressive tax system:** the tax rate increases as the taxable amount increases; during downturns, people have less income, and therefore they pay less taxes, and vice versa
 2. **Government transfer programs:** during downturns, more people qualify for these benefits, and vice versa

Government Spending

- **Current expenditure:** spending on **goods and services** for immediate use
 - e.g., transfer payments,
- **Capital expenditure:** spending on **infrastructure projects**
 - e.g., transport and communications
- **Reasons for government spending:** increase **aggregate demand** and **aggregate supply**; transfer payment → level of poverty and security; market failures; earning **political popularity**

Expansionary and Contractionary Fiscal Policy

- **Expansionary fiscal policy:** increase aggregate demand → increase government spending + decrease tax rates
 - shifting the AD curve to the right
- **Contractionary fiscal policy:** lower the growth of aggregate demand → decrease government spending + increase tax rates
 - shifting the AD curve to the left

Effectiveness Evaluations

- **Timing and Lag Effects:** recognition lags, decision lags, and impact lags

- **Automatic Stabilizers v.s. Discretionary Fiscal Policy:** the effect can be hardly distinguished, leading to misinterpretation of policy effectiveness
- **Ricardian Equivalence:** increased government borrowing and spending might not stimulate demand if consumers anticipate a future tax rise
- **Sustainability Concerns:** large national debt burdens future generations

5.3 Monetary Policy

Syllabus 5.3

- definition of monetary policy
- tools of monetary policy: interest rates, money supply and credit regulations
- expansionary and contractionary monetary policy
- AD/AS analysis of the policy's impact on the equilibrium level of national income and the level of real output, the price level and employment

Monetary Policy

- Any policy tools that affect the **price or quantity of money**
- A **demand-side** policy seeking to influence **aggregated demand**, put forward by the **central bank**

Monetary Policy Tools

- **Interest Rates** (bank, base, repo): affects the saving and borrowing, hence the liquidation of money in the market
- **Money Supply:** the main cause of changing money supply is lending by commercial banks
- **Credit Regulations:** maintain financial stability and influence bank lending

Expansionary and Contractionary Monetary Policy

- **Expansionary:** increase AD → lower interest rate, more money supply, less regulations
- **Contractionary:** decrease AD → higher interest rate, less money supply, more regulations

Effectiveness Evaluations

- **Timing and Lag Effects:** recognition lags, decision lags, and impact lags
- **Liquidity Trap:** even if the interest rate is low, people might still not spend and invest because they anticipate that the price would fall
- **Supply-side Factors:** contractionary monetary policy might lower investment and hence decrease supply potential and cause cost-push inflation
- **Uneven Beneficiaries:** lenders earn when borrowers lose; borrowers earn when lenders lose

5.4 Supply-side Policy

Syllabus 5.4

- meaning of supply-side policy, in terms of its effect on LRAS curves
- objectives of supply-side policy: increasing productivity and productive capacity
- tools of supply-side policy, for example, training, infrastructure development, support for technological improvement
- AD/AS analysis of the policy's impact on the equilibrium level of national income and the level of real output, the price level and employment

Supply-side Policy

- Any policy tools that intended to have a **direct impact** on **long-run aggregate supply** by **improving the workings of product and factor markets**
- **Objectives:** increase productivity and productive capacity

Supply-side Policy Tools

- **Education and Training:** better quality, higher productivity, more skilled labors
- **Infrastructure Development:** lower transportation costs, increase mobility
- **Support for Technological Improvement:** improve productivity
- **Cuts in corporate/income tax:** more investment & working incentives
- **Trade Union Reform:** increase workers flexibility and mobility, decrease strikes
- **Privatisation and Deregulation:** less control, more competition, and growth
- **Immigration:** more skilled and productive labors
- **Subsidies:** increase output, cut cost, more profit hence investment

Effectiveness Evaluations

- **Time Lags:** often, in the long run, in the short run, government spending might lead to inflation; also, deregulation in the short run might cause job losses and disruptions
 - Infrastructure development might take a long time, and by the time it is finished, the demand for it might have changed
- **Measurement Difficulties:** several factors can influence productivity at the same time, and it is hard to measure which one is the contributor
- **Uneven Beneficiaries:** technological development might cause some jobs to emerge while causing others to lose their jobs
- **Spare Capacity:** any supply-side policy tool which increases AS may not raise output if the economy is initially operating with spare capacity