4.1 THE ROLE OF GOVERNMENT

The role of government locally, nationally and internationally

The following are the roles of government locally:

- **State owned industries:**
- **Local governments:**

The following are the roles of nationally:

- **The government may act as a producer of goods , where it feels essential that such goods should be accessible to all. It might choose to produce such goods if it feels that such goods are under-produced, or not being produced at all.**
- **The government may choose to run its key industries. This may be done by completely managing such key industries or by providing them with favoured loans from banks.**
- **Such key industries are prevented from mergers or foreign takeovers.**
- **It may also produce essential products on the grounds of equity and merit and public goods.**
- **Government may get into partnerships with private sector firms**
- **The government provides employment in the state-owned enterprises. It thus moves towards reducing unemployment. It limits wage rises and thus prevents rises in prices of goods and services. It serves as a role model for ideal work place by providing staff training, appraisals and pension schemes.**

The following are the roles of internationally:

- **Free international trade is allowed by some countries.**
- **Certain countries impose trade restrictions**
- **Government policies play a key role in the establishment of MNC’s**
- **The government might choose to be a member of trade blocks and thus would further decide on the countries that can get into business with it.**

4.2 THE MACROECONOMIC AIMS OF GOVERNMENT

The following are the macroeconomic aims of the government:

- **Economic growth**
- **full employment/low unemployment**
- **stable prices/low inflation**
- **balance of payments stability**
- **redistribution of income**

Economic growth

Meaning of economic growth:

- **It is an increase in real output over a period of time**
- **It leads to improved production possibilities**
- **It leads to increased incomes**
- **It is measured through changes in GDP, GNP or NNP.**

Reasons for the "economic-growth-aim" of the government:

- **Higher economic growth, means higher living standards because people can now enjoy more goods and services**
- **An economics growth would lead to a higher employment as more workers will be needed to produce the higher output**
- **This will decrease government spending on benefits and the government may be able to spend more on e.g. education and healthcare**
- **There will be more tax revenue allowing more spending on e.g. health**
- **.Current account position will improve if there is the demand for exports**
- **Incomes will rise which may allow more people to enjoy basic necessities, thus reducing poverty**
- **Government will be able to attract investment from abroad/MNCs as foreign firms will now have the potential to earn high revenues/make high profits**

Full employment/Low unemployment

Meaning of full employment:

- Full employment exists when all those willing and able to work at a given wage are working. In other words, all unemployment is voluntary. It is thus the level of employment at which all those who wish to work have found jobs, exception of those who are frictionally employed. This will decrease government spending

Calculating Employment rate:

Employment rate=(Unemployment/Labour force) x 100

Benefits to a country from full employment [Why a government would want to achieve full employment?]

It may be due to the following reasons:

- There is and efficient use of resources, working at full capacity/producing on the production possibility curve , making as much output as possible/increase output, resulting in high living standards and low poverty
- low spending on unemployment benefits and a high tax revenue . Government spending on other areas e.g. healthcare and education can increase becomes possible
- Government policy measures do not have to be used to lower unemployment and they can concentrate on other areas e.g. a balance on the current account of the balance of payments
- It may reduce crime rates and result in lower government spending on prisons etc.

A country might not benefit from full employment:

- Productivity may fall as the last people employed may not be as skilled.
- Inflation may occur . Shortage of workers can raise wages and cause cost-push inflation
- High incomes will lead to high demand and cause demand-pull inflation
- The firms may find it difficult to expand as it is hard to recruit extra workers . A supply constraint and a rising demand may result in more imports, thereby worsening the current account position .
- The resulting high incomes may increase demand for imports which may cause a current account/balance of payments deficit
- A full use of resources may result in environmental damage , leading to depletion of natural resources

Stable prices/Low inflation

Price stability -Meaning

- Price stability implies avoiding both prolonged inflation and deflation.

Here is why a government would aim for low inflation or stable inflation:

- To promote investment: A low and stable inflation creates certainty/makes it easier to plan
- To promote international competitiveness: If inflation rate is below that of rival countries, it can increase exports/reduce imports
- To avoid lenders, workers with low bargaining power and other groups experiencing a fall in purchasing power. If incomes rise by less than inflation, the amount that can be purchased will fall
- To protect savers: Savers will lose if inflation rate is higher than interest rate
- To prevent people losing confidence in using the currency as money. It ay result in people resorting to barter/especially if there is hyperinflation
- To prevent inflation causing unemployment. Inflation can result in a loss in international competitiveness/reduce spending on domestic products.

Balance of payment stability:

Meaning of balance of payment stability:

- Balance of payments stability refers to a sustainable or limited current account deficit/surplus. (i.e. avoid very high deficit/surplus).

Here is why a government would aim balance of payment stability?

- To avoid a country getting into debts
- To allow a country to enjoy as many products as possible

Redistribution of income:

Meaning of redistribution of income

- Taking income from one group e.g. from the rich and giving it to another e.g. to the poor
- It means creating greater equality/reducing inequality/reducing gap between rich and poor

A redistribution of income may be achieved by using progressive taxation/state benefits

Here is why a government would aim a redistribution of income?

- To avoid a country getting into debts
- To allow a country to enjoy as many products as possible

Board Exam Questions

- **Discuss whether rapid economic growth always increases living standards.[8]**

Up to 5 marks for why it might:

- Higher income (1) will enable people to enjoy more goods and services (1)
- may reduce absolute poverty (1) with people having access to basic necessities (1)
- Likely to increase tax revenue (1) enable the government to spend more on healthcare (1) raise life expectancy (1)
- spend more on education (1) raise job prospects (1)
- may spend more on the environment (1) reduce pollution (1)

Up to 5 marks for why it might not:

- There are other influences on living standards (1) example (1)
- Growth may be unevenly distributed (1) not everyone may benefit (1)
- Average living standards may rise but some people may suffer a fall in living standards (1) if income is unevenly distributed (1) it may not benefit those living in poverty (1)
- The extra products provided e.g. defence (1) may not provide satisfaction to consumers (1)
- Producing more may involve longer working hours (1) reducing leisure hours (1) working longer hours/working more intensely may increase stress (1) endangering people's health (1)
- Increases in output may damage the environment (1) e.g. forests being cut down/pollution created (1)

- **Identify two macroeconomic aims of the Philippine government O/N/20-P23-Q1a[Extract based]**
- Ans: Economic growth and full employment

- **Explain two reasons why governments aim for economic growth. [M/J/17-P23-Q7b]**

Mark scheme:

1 mark each for each of two reasons identified:

- Higher living standards/higher incomes (1)
- higher employment (1)
- less government spending on benefits (1)
- more tax revenue (1) allowing more spending on e.g. health (1)
- more exports (1)
- reduced poverty (1)
- To attract investment from abroad/MNCs (1)

1 mark each for each of two explanations given:

- higher living standards as people can enjoy more goods and services (1)
- more workers will be needed to produce the higher output (1)
- government may be able to spend more on e.g. education and healthcare (1)
- fewer unemployed workers will reduce the burden on government expenditure (1)
- current account position will improve if there is the demand for exports (1)
- incomes will rise which may allow more people to enjoy basic necessities (1)
- growth means foreign firms have the potential to earn high revenues/make high profits (1)

- **Describe what is meant by full employment [3] [O/N/10-P22-Q5a]**

Mark Scheme:

- **Full employment exists when all those willing and able to work at a given wage are working. In other words, all unemployment is voluntary. It is thus the level of employment at which all those who wish to work have found jobs, with the exception of those who are frictionally employed. Full employment is one of the main government macro-economic objectives (1).**

- **What is meant by redistribution of income [2][M/J/17-P22-Q4a]**

Mark scheme:

- **Taking income from one group e.g. from the rich (1) and giving it to another e.g. to the poor (1).**
- **Creating greater equality/reducing inequality/reducing gap between rich and poor (1). May be achieved by using progressive taxation/state benefits (1).**

4.2.1 POSSIBLE CONFLICTS BETWEEN THE MACROECONOMIC AIMS OF GOVERNMENT

The following are possible conflicts between the macroeconomic aims of the government:

- **Lower unemployment vs. price stability:**
  A lower unemployment means higher incomes and an increasing total demand , creating demand-pull inflation
  A lower unemployment means less spare capacity and hence wage demands increase and wage-price spiral
- **Economic growth vs. price stability:**
  Production increases faster than the increase in resources leading to an increase in total demand, further leading to higher prices rather than increased output and employment
- **Economic growth vs. environmental protection:**
  As the output increases ,the consumption increases causing a rise in external costs. Example e.g. pollution, destruction of habitats

BOARD EXAM QUESTIONS:

- **Analyse two possible conflicts between government aims. [M/J/19-22-Q3C]**

Lower unemployment vs. price stability (1) lower unemployment means higher incomes (1) increasing total demand (1) creating demand-pull inflation (1) lower unemployment means less spare capacity (1) wage demands increase (1) wage-price spiral (1).
Economic growth vs. price stability (1) production increases (1) faster than the increase in resources (1) increase in total demand leads to higher prices rather than increased output and employment (1).
Economic growth vs. environmental protection (1) output increases (1) consumption increases (1) causing a rise in external costs (1) example e.g. pollution, destruction of habitats (1).

- **Discuss whether economic growth conflicts with the achievement of other government economic aims [8]**

Mark Scheme:
Possible conflict:

- **price stability, if increase in demand is greater than increase in supply**
- **redistribution of income, if most of the gains from economic growth go to the richer people in the society**
- **balance of payments stability, if increase in incomes resulting from economic growth leads to a large increase in the demand for imports relative to that for exports.**

Why no possible conflict:
full employment, as economic growth is likely to lead to an increase in the demand for labour.

4.3.1 DEFINITION OF GOVERNMENT BUDGET

Government budget meaning:

- **A government budget is a document that presents a governing body's anticipated revenues and proposed spending for a fiscal year.**
- **Government budgets often require legislative approval and are subject to political pressure from interest groups that compete for resources.**

BOARD EXAM QUESTIONS:

- **What is meant by a government's budget? [O/N/09-P2-Q5C]**

Mark Scheme:

Explanation of a budget – income, expenditure for year – for government activities, enterprises, public sector subsidies.

[The above is the actual board exam markscheme]

4.3.2 REASONS FOR GOVERNMENT SPENDING

- **The main areas of government spending**
- **The reasons for government spending**
- **The effects of spending in these areas**

The following are the main areas of government spending:

- **Healthcare**
- **Education:**
- **Infrastructure development**
- **Unemployment benefits**
- **Investment spending**

Reasons for government spending:

1. To bring about economic growth:

- **A higher demand will encourage the firms to expand their output**
- **A higher government spending may raise labour productivity and so increase productive potential.**
- **A higher government spending on investment will increase productive potential.**
- **Government subsidies to firms reduces the cost of production and encourages the firms to produce more**

2. To increase productivity:

Healthcare and Education spending:

A better educated workforce is likely to be more productive. This could lead to a greater output. Also a healthier work-force is likely to miss fewer days of work, leading to an increase in productivity.

3. To reduce market failure:

- **Governments spend on public goods (example: law enforcement, national defense, and the rule of law), merit goods (example: education, health care, welfare services, housing, fire protection, refuse collection and public parks.)**
- **It spends money on regulating markets, when a difference arises in the social and private costs and benefits and any abuse of market power**

4. To pay interest on national debt:

- **Many a times , government needs to borrow money in order to finance the gap between its tax revenue and spending. It then needs to spend to pay interest on loans.**

5 To spend on unemployment benefits:

- **Government needs to spend on unemployment benefits, because the unemployed are bound to suffer from worse health and the government will then also have to spend on their healthcare.** [But a high unemployment benefit will discourage the incentive to work]**. Government tries to make benefits and products available to the vulnerable groups and the unemployed. Pension to the retired, subsidised housing schemes for poor and free education to children**

Effects of government spending on :

- **Healthcare and Education:**
  A better educated workforce is likely to be more productive. This could lead to a greater output.Also a healthier work-force is likely to miss fewer days of work, leading to an increase in productivity.
  Unemployment benefits: This incurs an opportunity cost. Spending on unemployment benefits will reduce governments ability to spend on other items, for instance healthcare, education etc

Note:

- **Infrastructure investments are a form of "real assets," which contain physical assets we see in everyday life like bridges, roads, highways, sewage systems, or energy. Such a type of asset is quite crucial in a country's development.**
- **Investment spending may include purchases such as machinery, land, production inputs, or infrastructure.**

BOARD EXAM QUESTIONS:

- **Discuss what might influence government spending. [O/N/08/P-2-Q2b]-5m**

Mark Scheme:

Discussion of the need to promote economic growth, control inflation, correct adverse changes in the balance of payments, alter the distribution of income, prevent excess inflation. Candidates could briefly debate which of the aims might be more significant. Accept any other valid influences.

4.3.2 REASONS FOR TAXATION

Following are the reasons for taxation:

- **to finance expenditure on public goods, e.g. defence, law and order**
- **to finance expenditure on merit goods, e.g. education, health care**
- **to discourage consumption of demerit goods, e.g. tobacco, alcohol**
- **to discourage consumption of imports**
- **to support different sectors of the economy**
- **to reduce consumption/growth/inflation**
- **For redistribution of income**

4.3.4 CLASSIFICATION OF TAXES

The following is the classification of taxes:

- **Direct or Indirect taxes:**
  Direct tax: A direct tax is a tax that a person or organization pays directly to the entity that imposed it. Examples include income tax, real property tax, personal property tax, and taxes on assets, all of which are paid by an individual taxpayer directly to the government.
  Indirect tax: An indirect tax is a tax on spending paid indirectly by consumers to the government via producers/the burden can be shifted. An indirect tax may have the same rate for most goods and services.
- **Progressive tax**: A tax that takes a higher proportion as income rises is called as a progressive tax. This tax falls more heavily on the rich.
- **Regressive tax:**
  An indirect tax is a tax on spending paid indirectly by consumers to the government via producers/the burden can be shifted. An indirect tax may have the same rate for most goods and services. In a regressive tax, all people pay the same rate irrespective of their income/ability to pay. The poorer people, therefore, will pay a higher percentage of income in tax than the richer people. A regressive tax is, therefore, a tax applied uniformly, taking a larger percentage of income from low-income earners than from high-income earners.
- **Proportional tax:** It is a type of tax in which the taxing authority charges the same rate of tax from each taxpayer, irrespective of income.

Board Exam Questions:

1. Explain the difference between direct and indirect taxes [4]

- Direct taxes are taxes on income (1) the burden of the tax cannot be passed on/they are paid
- directly to the government by those on whom the taxes are levied/example of a direct tax (1).
- Indirect taxes are taxes on spending (1) the burden or some of the burden can be passed on
- to others/example of an indirect tax (1).

4.3.5 PRINCIPLES OF TAXATION

The following are the principles of taxation:

- **Equity: The tax should be a fair one , based on the person's ability to pay.**
- **Certainty: Households and firms should be able to calculate on their own, how much tax is payable by them.**
- **Convenience: A tax should be easy to pay**
- **Economy: The cost of collecting a tax should be considerably less than the revenue it generates.**
- **Flexibility: The tax should be flexible in nature. Based on the change in the economic activity or government aims , the tax should be changeable.**
- **Efficiency: A tax should improve the performance of markets or at least not reduce their efficiency.**

4.3.6 IMPACT OF TAXATION

The following are the impacts of direct taxation:

- **A very high direct tax might demotivate people from taking up jobs. People already employed would not want to work extra and gain overtime allowance due to the high nature of this tax.**
- **High rates of corporation tax would not encourage entrepreneurs to expand their firms, not to try out newer markets**
- **A high direct tax would create a work pressure on people who have to pay off huge loan amounts, to cover up for any extra amount they are paying as a part of tax increase. So such people will be forced to work for longer hours for overtime.**
- **If high taxes are imposed on income earned from savings, then this would make people save less, but at the same time, this may encourage target savers to save more.**

  Note: Target saver: In this, a household saves in the present in order to finance a target level of consumption outlays in the future.

The following are the impacts of indirect taxation:

- **It can cause inflation**
- **Indirect taxes can be used to selectively achieve certain aims. For instance, alcohol consumption can be reduced by increasing these taxes.**
- **Since people decide what kind of products to buy, hence they may decide not to buy a highly priced product.**

Impact of taxation on consumers:

- **Reduces their purchasing power: Taxation reduces the purchasing power of the people and it reduces their consumption. The decline in consumption leads to decrease in effective demand for the goods and services, which in turn affects the production of these commodities.**
- **Higher direct taxes may act as a disincentive to work , reducing employment**

Impact of taxation on producers/entrepreneurs

- **Higher direct taxes may act as a disincentive to enterprise, thus reducing the output**
- **Higher income tax rates may cause workers to press for wage rises this may increase labour costs or may provoke industrial action which can disrupt production**

Impact of taxation on economy:

- **Higher taxes may encourage tax evasion, and this may cause tax revenue to fall, hence less available for spending**
- **Higher corporation/indirect tax rates increase firms' costs of production (1) causing cost-push inflation**
- **Higher tax rates may reduce total demand causing unemployment**

Board Exam Question:

1. Explain how people's spending could be affected by changes in both direct and indirect taxes. [6]

Up to 4 marks for direct tax:

- increase in income tax would reduce disposable income (1) and so make spending less likely (opposite effect with a reduction in income tax) (1)
- change in tax bands would affect spending (1), e.g. if lower rate starts at a lower level of income; same applies if top rate starts at a lower level of income (1)

Up to 4 marks for indirect tax:

- increase in a sales tax (e.g. VAT or GST) would make products more expensive (1) and discourage spending (opposite effect with a reduction in indirect tax) (1)
- if a sales tax was taken off a product (e.g. zero-rated) (1) it would make products less expensive and encourage spending (1)

2. Discuss whether a government should increase tax rates. [8]

Up to 5 marks for why it should:

Higher tax rates may increase tax revenue (1) this would enable the government to spend more on, e.g. education and health care (1). Higher tax rates may reduce demand (1) this could lower demand-pull inflation (1). Higher tariffs could reduce imports (1) improve the current account position (1) demand for imports may also fall when income tax rates are raised (1). Higher tax rates on, e.g. cigarettes and alcohol (1) could improve people's health (1). Higher taxes on products that create external costs/demerit goods (1) may result in a better allocation of resources (1). Higher taxes on monopolies (1) may encourage competition. (1).

Up to 5 marks for why it should not:

Higher direct taxes may act as a disincentive to work (1) reducing employment (1). Higher direct taxes may act as a disincentive to enterprise (1) reducing output (1). Higher taxes may encourage tax evasion (1) and this may cause tax revenue to fall (1). Higher corporation/indirect tax rates increase firms' costs of production (1) causing cost-push inflation (1). Higher tax rates may reduce total demand (1) causing unemployment (1). Higher income tax rates may cause workers to press for wage rises (1) this may increase labour costs (1) or may provoke industrial action (1) which can disrupt production (1).

3. Discuss whether a government should increase tax rates during a recession.

Up to 5 marks for why it should:

To prevent tax revenue falling (1) lower output may reduce profits (1) lower revenue from corporation tax (1) a recession will lower incomes (1) reduce income tax revenue (1) reduce revenue from indirect taxes (1). Higher tax revenue could be used to implement policies to stop the recession (1) government may be able to spend on supply-side policy measures (1) example (1). A higher tax on imports / import tariff (1) may encourage some consumers to switch to buying domestic products (1) reverse fall in output/employment (1). May want to redistribute income (1) progressive taxes could be increased (1) and tax revenue used to help the poor (1) who may be particularly harmed by a recession (1).

Up to 5 marks for why it should not:

Higher tax rates may reduce disposable income (1) reduce consumer expenditure (1) may reduce investment (1) lower consumer expenditure and investment would lower total demand (1) this may reduce output further (1). Higher tax rates may discourage MNCs from setting up in the country (1) this may mean it will take longer to get out of a recession (1). Higher tariffs may provoke retaliation (1) reduce both imports and exports (1).

4. **Discuss whether a government should increase taxes on food.**

Up to 5 marks for why it should:

Would raise total revenue (1) demand for food is price inelastic (1) so a good source of tax revenue (1) enabling the government to spend more on e.g. education and healthcare (1). May reduce the problem of obesity (1) improve health of population (1) reduce the burden on healthcare facilities (1). Reduce food wastage (1) lowering costs of waste disposal (1).

Up to 5 marks for why it should not:

Taxes on food are regressive (1) take a higher proportion of the income of the poor (1) food is a necessity (1) may mean poor cannot afford sufficient food (1) may cut back on other necessities (1) may increase poverty (1) thereby increasing inequality (1). A tax on food (1) may stimulate wage demands (1) increase costs of production (1) cause inflation (1) may increase government expenditure on healthcare (1) may lead to lower labour productivity (1) there may be tax evasion (1). Fall in demand results in less production of food (1) leading to reduced employment in agriculture and food processing industries (1).

4.3.7 FISCAL POLICY DEFINITION

Definition of fiscal policy. Expansionary fiscal policy and contractionary fiscal policy.

- **Fiscal policy:** **It refers to the government spending and taxation design to influence aggregate demand**

4.3.8 FISCAL POLICY MEASURES

The following are the fiscal policy measures:

- **Taxation**
- **Public spending**

Definition of expansionary fiscal policy and contractionary fiscal policy.

- **Expansionary fiscal policy:** **It refers to the rise in government expenditure and / or cuts in taxation designed to increase aggregate demand.**
- **Contractionary fiscal policy:** **It refers to the cuts in government expenditure and / or rises in taxation designed to reduce aggregate demand.**

4.3.9 EFFECTS OF FISCAL POLICY MEASURES ON THE MICRO-ECONOMIC AIMS OF GOVERNMENT

Fiscal policy measures	
Government spending	• Rise in government spending on education make it easier for people to gain jobs / better paid jobs . • Rise in government spending on healthcare provides a basic necessity / increase productivity of workers . • Subsidised / free provision of food provides a basic necessity / reduce absolute poverty • Subsidised / free provision of housing helps those unable to afford housing . • Increase in state benefits e.g. paying more in unemployment benefit will raise the income of some of the poor • Use of progressive taxes / reduction of regressive taxes reduce relative poverty
Taxation	• A rise in taxes causes a fall in disposable income/rise in costs • A fall in government spending will reduce total (aggregate) demand and reduce demand-pull inflation • Government spending on education/training/subsidies lower taxes could reduce costs of production and will increase total (aggregate) supply , lower cost-push inflation . • Lower taxes on imports would reduce cost-push inflation

Board questions:

1. **Explain two fiscal policy measures that can be used to reduce poverty. [4]**

Mark scheme:

Logical explanation which might include:

- Rise in government spending on education (1) make it easier for people to gain jobs / better paid jobs (1).
- Rise in government spending on healthcare (1) providing a basic necessity / increase productivity of workers (1).
- Subsidise / free provision of food (1) providing a basic necessity / reduce absolute poverty (1).
- Subsidise / free provision of housing (1) helping those unable to afford housing (1).
- Increase in state benefits (1) e.g. paying more in unemployment benefit will raise the income of some of the poor (1).
- Use of progressive taxes / reduction of regressive taxes (1) reduce relative poverty (1).

2. **Explain how fiscal policy can be used to encourage economic growth. [6]**
    - **The government spending could be increased, e.g. on infrastructure projects and education**
    - **The direct taxation could be lowered, e.g. corporation tax on firms and income tax on workers**
    - **The indirect taxation could be lowered, e.g. VAT, to stimulate demand**
    - **The tariffs could be placed on imported goods to protect domestic producers**

    [Note: Answers which deal only with the expenditure side, or the revenue side can gain no more than 4 marks
    Note: maximum of 6 marks. [6]]
3. **Analyse how fiscal policy could reduce the inflation rate. [6]**
    - **The Contractionary/deflationary fiscal policy could be used.**
    - **A reduction in government spending may reduce total demand, reducing**
    - **demand-pull inflation.**
    - **An increase in income tax would reduce disposable income and this may lower**
    - **consumer spending, reducing total demand and lowering demand-pull inflation**
    - **Increased in spending on education/healthcare may raise productivity and lower costs and reduce cost-push inflation.**
4. **It was predicted that global unemployment would rise by over two million in 2017. Unemployment rates, however, vary between countries. Some governments use fiscal policy measures and others use supply-side policy measures to reduce unemployment. The unemployment rate can also be influenced by trade protection.**
    (a) Identify two fiscal policy measures. [2]
    - **Government spending**
    - **Taxation**

5. **Analyse how fiscal policy can encourage firms to produce more. [6]**
Coherent analysis which might include:

- **Reduce corporation tax (1) could lead to more profits after tax (1) enabling firms to invest more and expand (1).**
- **Reduce income tax (1) could increase spending (1) raise total demand (1) encouraging firms to produce more (1).**
- **Increase government spending (1) such as increasing subsidies (1) could lead to firms being able to expand production (1) decreasing cost of**
- **production (1) decreasing prices (1) increasing demand for the firms' products (1).**

4.4 MONETARY POLICY

4.4.1 DEFINITIONS:

- ✓ **MONEY SUPPLY:**
  Money supply consists of all the money in an economy at any one time
- ✓ **MONETARY POLICY:**
  It refers to the decisions on the money supply, the rate of interest and the exchange rate taken to influence aggregate demand.

4.4.2 MONETARY POLICY MEASURES:

Change in the money supply

Increase in money supply:

- ✓ **By printing more money, by buying back government bonds or encouraging commercial banks to lend more.**
  Increasing money supply is likely to lead to an increase in consumer spending and investment. Such a rise in aggregate demand is likely to increase output

Changes in the interest rates

When a central bank alters the rate of interest it charges to commercial banks, those banks are then likely to alter the rate of interest that they charge to their customers.

Case 1: Increase in the interest rate:

When there is a rise in the rate of interest by the commercial bank the aggregate demand is likely to be lowered by lowering consumer expenditure and investment. The central bank will do this in three main ways :

- **The households of firms who have borrowed in the past will have to pay more interest on their loans. This will reduce the amount they have to spend.**
- **The central bank will make it more expensive for households and firms to borrow to finance their spending. Borrowers will now have to pay more for any new loans they go for.**
- **If the rate of interest becomes higher, then it will increase the incentive to save. Households and forms will on more than before from saving. This means that for households, the opportunity cost of investment will have increased. Firms we also have less incentive to invest as they will expect consumption to be lower.**

[Note:

- **Some households and firms that are savers, will now earn more interest and so then will spend more. Those people who save are, however, less likely to spend any extra money then borrowers are, and so the net effect will probably be a reduction in consumer expenditure.**
- **A higher interest rate may also reduce aggregate demand by encouraging a rise in the price of exports and a fall in the price of imports.]**

Case 2:

Central bank may decide to keep the price constant for long periods. It may do this to promote certainty , which can make planning easier. This in turn may encourage investment.

Case 3:

Central bank may decide to reduce the rate of interest rate in-order to reduce unemployment and to increase economic growth.

4.4.3 EFFECTS OF MONETARY POLICY ON GOVERNMENT MACROECONOMIC AIMS

Macroeconomic aim	Policy measure and effect of the policy
Reduce unemployment	Expansionary monetary policy: Rate of interest may be reduced or the money supply may be increased
Reduce increasing price levels	Contractionary monetary policy: If price level is rising too quickly, the central bank may increase the rate of interest or reduce the growth in the money supply.
Rate of economic growth	• lowering of interest rates will make borrowing cheaper and will reduce the reward from saving and therefore be likely to increase spending and so increase demand and output • increase in the money supply to make funds more available. With more money people are likely to spend more , again contributing to an increase in demand and output.

4.5 SUPPLY-SIDE POLICY

4.5.1 DEFINITIONS:

- ✓ **SUPPLY-SIDE SUPPLY:**

  It is a policy that is designed to increase aggregate supply

4.5.2 SUPPLY-SIDE POLICY MEASURES:

Following are the supply-side policy measures:

- education and training
- labour market reforms
- lower direct taxes
- deregulation
- improving incentives to work and invest
- privatisation

4.5.3 EFFECTS OF SUPPLY-SIDE POLICY MEASURES ON GOVERNMENT MACROECONOMIC AIMS

Macroeconomic aim	Policy measure and effect of the policy
Reduce unemployment	[Through taxes] • decrease corporation / profit tax, more profits, more investments, more demand for labour, reduction in cyclical unemployment • decrease interest rates, more borrowing, more investment, more demand for labour, reduction in cyclical unemployment • decrease income tax, increase disposable income, more spending / demand for goods and services, more production, increase demand for labour • government subsidies can encourage firms to expand and take on more workers, reduce cyclical unemployment • increase spending on education and training, increase skills / productivity of labour, increase demand for labour, decrease structural unemployment. • provide more information on jobs / job centres, easier for workers to find jobs, decrease frictional unemployment • reduce unemployment benefit to reduce the time workers are between jobs, decrease frictional unemployment.

Reduce the rate of unemployment	[Through education and training] • It will raise workers' skills and make them more productive and make them more occupationally mobile • increase demand for their labour/make them more employable and reduce structural unemployment increase incomes (e.g. teachers) and so increase demand • It creates jobs in education (e.g. teachers) • It increases total (aggregate) demand which increases employment • new skills acquired allow them to start their own business and this may require more employees • workers might become highly skilled which could help them obtain jobs abroad.
Rate of economic growth	[Through large number of measures] • supply-side policy measures are designed to increase the output potential of the country • education and training may increase productivity, subsidies/lower corporation tax may increase investment • privatisation may increase efficiency • deregulation can reduce firms' costs of production • some fiscal policy measures can increase both total demand but also total supply • supply-side policy measures can allow growth to occur over time and can allow growth to take place without inflation • It can increase the economy's international competitiveness • It can help in improving the current account position • supply-side policies that remove trade restrictions attract foreign investors which leads to increased capacity, higher output/income and leads to economic growth

4.6 ECONOMIC GROWTH

4.6.1 Definition of economic growth:

- **Inflation:** Inflation is a rise in the prices of goods and services. Inflation is a persistent or sustained rise in the general level of prices/fall in the value of money in an economy over a period of time.
- **Deflation:** Deflation is a fall in the price of goods and services. Deflation is a persistent or sustained fall in the general level of prices/rise in the value of money in an economy over a period of time. It conveys the idea of disinflation or negative inflation.

4.6.2 Measurement of economic growth:

- Rate of growth measured can be measured through change in output/real output
- Change in GDP/real GDP/GDP per head (1)
- Over a period of time (usually one year) (1)
- Shift outwards of the production possibility curve (1)
- Increase in productive potential (1)

4.6.3. Causes and consequences of recession:

Recession:

Recession is a fall in a country's output/GDP over a period of six months/two successive quarters.

Causes of recession:

- Recession is caused by an decrease in aggregate demand or a decrease in aggregate supply.
- Aggregate demand may fall [Negative demand-side shocks] as consumer expenditure and investment could decline due to a fall in business and consumer confidence arising from a global finance crisis or falling house prices in the domestic economy. The government may cut back its spending too much and net exports could fall as a result of a rise in the exchange rate
- A decrease in aggregate supply, a negative supply-side shock. could result from a rise in fuel pr raw material costs/ Such effects would increase firm's costs of production which may cause them to produce less.

Consequences of recession:

Reduction in a country's imports:

- A recession is a decrease in GDP (1) over 6 months or more / two consecutive quarters
- A recession is likely to reduce incomes, increase unemployment and reduce confidence levels
- consumer spending is likely to fall .
- As output is falling , firms are likely to buy less raw materials from abroad and buy fewer capital goods from abroad
- During recessions governments may impose trade restrictions which will reduce imports
- A recession may cause a depreciation of the currency making imports more expensive

Reduced consumer spending:

- Rise in unemployment causes reduced income and reduced ability to spend
- Consumers save more for fear of future / increased pessimism
- Likely to be associated with lower prices and consumers delay purchases

Increase in the budget deficit and reduction in budget surplus:

- This is due to decline in the tax revenue and increase in the government spending on benefits

Recession in one country can cause unemployment in another country:

- **Emigration to another country may push that country's workers out of a job**
- **Income / GDP per head would have fallen, the country may buy fewer imports demand for the country's products may fall**
- **firms in exporting countries may reduce output, lower output would reduce demand for workers**
- **MNCs in the country may make less profit / make a loss ,may reduce production in other countries**
- **A recession in a large economy could create worldwide uncertainty and discourage investment / output of capital goods and reduce employment in the capital goods industries of another country**

4.6.4. Causes of economic growth:

- improvements in education or other supply-side policy may raise the quality of resources/this will increase productive capacity
- advances in technology will increase total demand/productive capacity
- net investment/MNCs entering the country will increase total demand/productive capacity
- increase in net exports will increase total demand
- consumer boom will increase total demand/which will encourage firms to produce more
- expansionary fiscal or monetary policy may increase total demand/which may make use of previously unused resources
- increase in size of labour force/employment rate will increase total demand/productive capacity
- fall in unemployment will increase total demand
- discovery of minerals more raw materials will enable firms to produce more

4.6.5. Consequences of economic growth:

Increase in the living standards:

- **Higher income will enable people to enjoy more goods and services and may reduce absolute poverty with people having access to basic necessities**
- **Likely to increase tax revenue and enable the government to spend more on healthcare and raise life expectancy**
- **spend more on education will raise job prospects**
- **may spend more on the environment and reduce pollution**

4.6.6. Policies to promote economic growth:

The following are the policies that might be used to promote economic growth:

Demand side policies include:

- **Fiscal policy (cutting taxes/increasing government spending)**
- **Monetary policy (cutting interest rates)**

Supply side policies include:

- **Privatisation, deregulation, tax cuts, free trade agreements (free market supply side policies)**
- **Improved education and training, improved infrastructure. (interventionist supply side policies)**

Board question:

1.Explain two reasons why governments aim for economic growth.

1 mark each for each of two reasons identified:

- Higher living standards/higher incomes (1)
- higher employment (1)
- less government spending on benefits (1)
- more tax revenue (1) allowing more spending on e.g. health (1)
- more exports (1)
- reduced poverty (1)
- To attract investment from abroad/MNCs (1)

1 mark each for each of two explanations given:

- higher living standards as people can enjoy more goods and services (1)
- more workers will be needed to produce the higher output (1)
- government may be able to spend more on e.g. education and healthcare (1)
- fewer unemployed workers will reduce the burden on government expenditure (1)
- current account position will improve if there is the demand for exports (1)
- incomes will rise which may allow more people to enjoy basic necessities (1)
- growth means foreign firms have the potential to earn high revenues/make high profits

2. An aim of government policy is to achieve economic growth. Explain what benefits economic growth can bring to a country. [6]

- Up to 6 marks for explaining the benefits of growth, such as increased incomes, employment, and government revenue and a better use of resources. The question only asks for benefits.[6]

4.7 EMPLOYMENT AND UNEMPLOYMENT

Definition of employment, unemployment and full employment

- **Employment: Being involved in a productive activity for which a payment is received**
- **Unemployment: Unemployment is the condition where a person is able and willing to work/ actively looking for a job but unable to find a job .**
- **Full employment: the condition in which virtually all who are able and willing to work are employed.**

Changing patterns and level of employment:

The nature and causes of changes in the pattern of employment, for example increase in proportion of workers employed in the tertiary sector and formal economy as an economy develops; a greater proportion of women in the labour force due to changes in social attitudes; decline in the proportion employed in the public sector as a country moves towards a market economy.

Changes in the pattern of employment:

- **Industrial structure**
- **Proportion of women in employment**
- **Proportion of workers in private and public sectors**
- **Full-time and part-time work**
- **Employed and self -employed**
- **Informal and formal economies**
- **High and low quality employment**
- **Flexible employment**

Measurement of unemployment:

Two ways of measuring unemployment are:

- **claimant count :** This is a relatively cheap and quit method. But the disadvantage is that it tends to under state unemployment. For instance, Some people fraudulently claim unemployment benefits although they might be actually working somewhere. On the other hand there are people on government training schemes, those staying on at school and some who have been forced to retire early, may actually be searching for employment but they might not be receiving unemployment benefits
- **labour force survey** : In this method regular service of a proportion of households are conducted, in which the adults are asked about their employment status. In this method the people are counted as unemployed if they are without a job and have been actively searching for employment in the past month. The best part of this method is that this method can be used to make international comparison and to identify the unemployed population more accurately. Accuracy of the data collected depends on how well the questions are asked and interpreted and whether the sample selected is representative of the labour force as a whole. This methods takes much more time to gather the information as compared to a claimant count. In this method the information that is collected has to be examined very carefully.

Formula for the unemployment rate:

Unemployment Rate = Unemployed / Civilian Labour Force

Or

Unemployment Rate = No. of Unemployed Persons / (No. of Employed Persons + No. of Unemployed Persons)

[The civilian labour force, as mentioned in the formula, consists of both employed and unemployed people.]

Types of unemployment:

Frictional, structural and cyclical unemployment.

Structural unemployment:

- this occurs when people lose their jobs as a result of a particular industry being in decline, e.g. coal, shipbuilding.

Demand-deficient (cyclical) unemployment:

- this occurs when the level of aggregate demand in the whole economy falls; it is also called cyclical unemployment because it is associated with downturn/slump/recession stages of the trade cycle.

Frictional unemployment :

- This occurs when people are in between jobs/there is a mismatch between the demand for, and the supply of, labour , it tends to be short-term .
- There are various types of frictional unemployment, such as search, casual and seasonal unemployment

Causes of unemployment:

- **Frictional unemployment: this is a temporary unemployment that arises from workers been in between jobs.**

- **Structural unemployment: this is caused by long term changes in the pattern of demand and the methods of production.**

- **Cyclical unemployment: this is caused by a lack of aggregate demand.**

- **Search employment: this arises from workers who have lost their jobs looking for a job they are willing to accept.**

- **Casual unemployment: this type of unemployment arises from the workforce regularly being between periods of employment.**

- **Seasonal unemployment: this type of unemployment is caused by a fall in the demand at particular times of the year.**

- **Regional unemployment: this kind of unemployment is caused by a decline in job opportunities in a particular area of the country.**

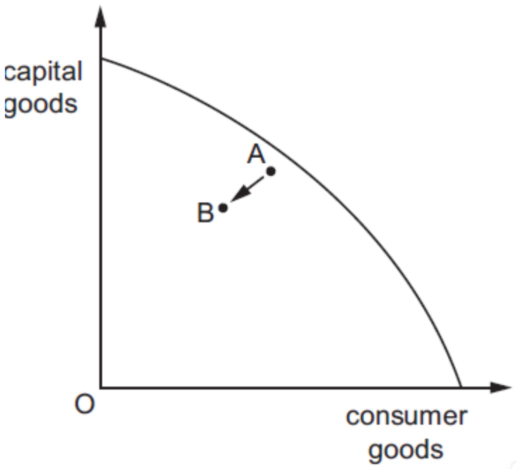
- **Technological unemployment: this is caused by workers being replaced by capital equipment.**

Consequences of unemployment:

The consequences of unemployment for the individual, firms and the economy as a whole.

- **Effects on the unemployed:** Many on employed people suffer a fall in income. Unemployed people in many countries do not receive any kind of financial assistance.
- **Effects on firms:** Firms may benefit from unemployment. This is because they are able to employ the unemployed workers in order to expand their production.
- Unemployment create a downward pressure on the wage crisis because the workers fear the loss of their job
- Firms now enjoy greater flexibility from workers in terms of the task they performed and the number of hours they are willing to work. This is because the workers fear losing their jobs in case the act rigid.
- **Effects on the economy:**

Using a production possibility curve (PPC) diagram, the effect of an increase in unemployment on an economy.



- **Unemployment means resources are not used ,there is inefficiency ,reduces output/GDP / and causes a recession .**
- **An increase in unemployment may cause some workers to leave the labour force –'unemployment causing unemployment'.**

Note:

- **There will be a reduction in the indirect tax revenue. This is because the expenditure of the people falls due to a loss of their jobs. Thus income and firms' profit fall. As a result, the revenue from income tax and corporation tax decreases**

- **Unemployment creates a pressure on the government expenditure. The government has to spend more on unemployment benefits. Amount spent on healthcare also increases if the unemployed suffer from bad health.**

- **Unemployment might increase the risk of crime and hence the government might have to spend more to ensure security of its citizens**

Policies to reduce unemployment

Supply side policies to reduce unemployment:

- **Education and training: To solve occupational immobility**
- **Geographical subsidies: To help workers and firms move**
- **Remove labour market regulations: To increase flexibility**
- **Employment subsidies: To encourage firms to take on long term unemployed.**
- **Reduce power of trade unions: To reduce real wage unemployment**

Demand side policies to reduce unemployment

- **Monetary policy: Cutting interest rates**
- **Fiscal policy: Cutting tax and higher spending**
- **Depreciation of exchange rate: in-order to boost export demand**

4.8 INFLATION AND DEFLATION

Definition of inflation and deflation:

- **Inflation:** Inflation is a rise in the prices of goods and services. Inflation is a persistent or sustained rise in the general level of prices/fall in the value of money in an economy over a period of time.
- **Deflation:** Deflation is a fall in the price of goods and services. Deflation is a persistent or sustained fall in the general level of prices/rise in the value of money in an economy over a period of time. It conveys the idea of disinflation or negative inflation.

Difference between inflation and deflation[4m]

Inflation	Deflation
Inflation is a persistent or sustained rise in the general level of prices/fall in the value of money in an economy over a period of time.	Deflation is a persistent or sustained fall in the general level of prices/rise in the value of money in an economy over a period of time. It conveys the idea of disinflation or negative inflation.

Measurement of inflation and deflation:

Measurement of inflation and deflation using the Consumer Prices Index (CPI).

Consumer price index (CPI): it is a measure of the weighted average of the prices of a representative basket of goods and services

Measuring inflation:

- The rate of inflation is measured through a Consumer (or Retail) Prices Index (1) which
- involves the following features:
- based on a survey of households
- a basket of goods and services
- a base year (100)
- measurement of changes of prices of products in the basket
- products are given weights
- to reflect their importance in buying patterns
- weighted price index is then constructed
- example of how measured e.g. if CPI rises from 100 to 105, the inflation rate is 5%

Measuring the rate of inflation:

Describe how the rate of inflation in a country can be measured. [6]

The rate of inflation is measured through a Consumer (or Retail) Prices Index (1) which involves the following features:

• based on a survey of households
• a basket of goods and services
• a base year (100)
• measurement of changes of prices of products in the basket
• products are given weights
• to reflect their importance in buying patterns
• weighted price index is then constructed
• example of how measured e.g. if CPI rises from 100 to 105, the inflation rate is 5%

Discuss whether deflation is a greater problem than inflation. [10]

Problems of inflation:

• the real value (purchasing power) of money falls
• certain people are badly affected, e.g. those on fixed incomes
• saving is discouraged because the real value of savings can fall
• businesses suffer when the increase in costs is greater than the increase in prices
• exports are discouraged because prices become more expensive in foreign markets

Problems of deflation:

• businesses will not be encouraged to increase production
• workers will lose jobs leading to an increase in unemployment
• this period of reduced economic activity will not only lead to a fall in output and employment but also in incomes
• this can give rise to a slump

Note: You need to make an attempt to state why one could be more of a problem than the other (And why) to get 9 or more marks. Inflation is certainly a more frequent problem in recent years than deflation; many countries have suffered from inflation but few from deflation. Inflation, however, may be accompanied by a rise in output.

Define a 'weighted price index'. [2]
It is a measure of changes in the price level/measure of inflation which takes into account the different proportions spent on items in a basket of goods and services.

Causes of inflation and deflation:

- **Causes of inflation: demand-pull and cost-push.**
- **Demand-pull inflation: it refers to the rises in the price level caused by excess demand.**
- **Cost-push inflation: it refers to the rises in the price level caused by higher cost of production.**
- **Causes of deflation: demand-side and supply-side.**

Causes of deflation:

- A fall in the price level could be caused by a fall in total (aggregate) demand .
- This may be due to a fall in consumer expenditure / rise in saving a fall in borrowing , a fall in investment due to e.g. a lack of confidence , spending may be delayed due to the expectation that prices may be lower in the future , deflationary demand-side policy measures e.g. a rise in the rate of interest , rise in direct taxation .
- Exports may fall due to e.g. fall in incomes abroad , a rise in exchange rate .
- A rise in total (aggregate) supply due to e.g. advances in technology ,increased investment , reduced costs of production , increase in productivity , supply-side policy measures resulting from e.g. improvements in education and training

Causes of inflation:
- Demand-pull/consumer boom/higher government spending/increase in net exports/ increase in aggregate demand
- Cost-push inflation/higher wages/higher raw material costs / depreciation or devaluation of domestic currency / imported inflation

Difference between demand-pull inflation and cost-push inflation.

Demand-pull inflation	Cost-push inflation
Demand-pull inflation is caused by excess demand (2). Demand-pull is caused by total demand increasing more rapidly (1) than total supply (1). Higher demand may be the result of higher consumer spending/higher government spending/higher investment/ higher net exports (1). An AD/AS diagram showing AD increasing (1).	Up to 2 marks for cost-push inflation: Cost-push inflation is caused by increases in the costs of production (1), e.g. higher wages/higher raw material costs/higher import costs/higher indirect taxes (1). Firms pass on higher costs in the form of higher prices to maintain profit levels/margins (1). An AD/AS diagram showing AS decreasing (1)

Consequences of inflation and deflation:

The consequences of inflation and deflation for consumers, workers, savers, lenders, firms and the economy as a whole.

Consequences of deflation.

- Output may fall if due to lower demand firms will cut back production
- Unemployment may rise , fewer workers will be needed to produce fewer goods and services
- Economic growth may decline, a recession may occur due to lower total (aggregate) demand
- Output may rise if due to lower costs of production / advances in technology
- Exports may increase if domestic products have become more price-competitive.

Consequences of inflation:

- Most consequences of inflation are thought to be harmful
- The consequences of influences depend on factors such as rate of inflation, stability of this rate, it's rate relative to the inflation rates of other countries and the reaction of the government

Disadvantages of a very high rate of inflation:

- Fall in international price competitiveness causes the currency to rapidly devalue, worsening current account position / reduced exports if inflation rate is higher than rival countries
- Discourages saving / savers lose if inflation rate is higher than interest rate, redistribution of income from lenders to borrowers
- Those on fixed incomes are disadvantaged e.g. pensions do not buy as many goods and services as they did before
- Inflationary expectations increase discouraging investment and uncertainty is created by inflation
- Inefficient choices due to difficulty in judging relevant prices (inflationary noise)
- The cost of changing prices (menu costs) e.g. price tags, menus
- Costs of moving money around in search of the highest interest rate
- People's income is dragged into higher tax brackets (fiscal drag) ,reducing their disposable income
- Unemployment occurs if caused by higher costs / cost-push inflation
- Lower purchasing power / fall in values of money

Policies to control inflation and deflation

- **Expansionary fiscal policy: [used by government]: This is used to avoid bad deflation or to correct it , if it is occurring.**
- **Expansionary monetary policy [used by central bank]: This is used to avoid bad deflation or to correct it , if it is occurring.**

Discuss whether a cut in the rate of interest would end deflation. [8]

Up to 5 marks for why it might:
• A reduction in the rate of interest will reduce the return from saving/discourage saving (1) instead of saving households may spend (1).
• A lower interest rate will cut the cost of borrowing (1) this may encourage households to take out loans and spend (1).
• Firms may spend more on capital goods/invest (1) as it will be cheaper to borrow (1) they may expect a rise in consumer expenditure (1).
• Higher total (aggregate) demand (1) may push up the price level (1).
Up to 5 marks for why it might not:
• Households may be pessimistic about the future/may expect prices to fall further in the future or that a recession will occur (1) and so may not spend more despite a lower interest rate (1). May choose to repay past debts (1).
• Firms may be pessimistic about the future/may expect prices to fall in the future (1) and so may not borrow/ invest more despite a lower interest rate (1).
• The interest rate may initially have been low (1) and so a cut may make little difference (1).
• Households and firms may not expect the cut to last (1) and so will not alter their spending and investment plans (1).