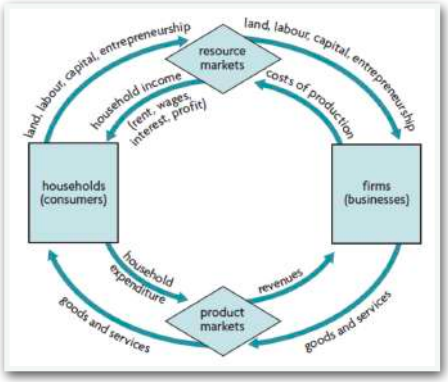
MACROECONOMICS

(Chapter 8 —> 13)

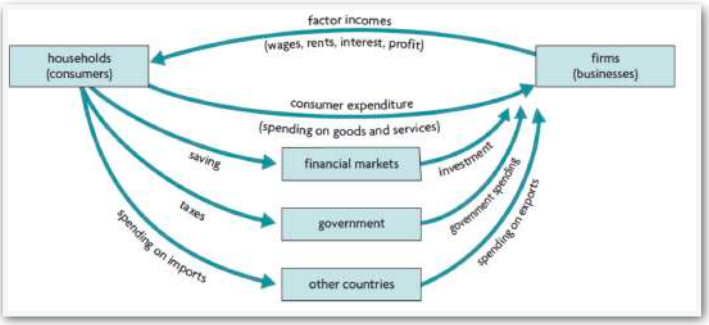
Chapter 8: The level of overall economic activity

8.1 Economic activity

The circular flow of income model:



Adding leakages and injections:



- If leakages are greater than injections, the size of the circular flow becomes smaller —> this results in fewer services purchased, firms cutting back on their output and unemployment
- If injections are larger than leakages, the opposite happens

8.2 / 8.3 Measures of economic activity and calculations

- national income accounting —> an economy's national income or the value of output
- National output —> the output of an economy (aggregate output)
- Knowing this two values allows to —> assess an economy's performance over time
  —> compare income and output performance with others
  —> have a basis for making policies to meet econ. objectives
- GDP —> the market value of all final goods and services produced in a country over a period

Measuring the value of national output

Expenditure approach:

- Measures the total amount of spending to buy final goods and services in a country
- Includes only purchases of final goods + serv. and allows to see contribution of each component
- C + I + G + (X - M) = GDP (Gross domestic product)
- C —> consumption spending —> all purchases by households on final goods and serv. in a year
- I —> investment spending —> spending by firms on capital goods + spending on constructions
- G —> Government spending —> spending by governments within a country
- X - M —> the value of all exports minus the value of all imports of a country

Income approach:
- Adds up all income earned by the factors of production within a country over a time period
- National income —> when all factor incomes are added up
- This approach allows economists to see the relative income shares of the different factors of p. and how these might change over time and across countries

Output approach:
- Measures the value of each good and service produced in the economy over a particular time period and then sums them up to obtain the total value of output produced
- It includes only the value of all final goods and serv. to avoid double counting
- It calculates the value of output by economic sector (agriculture, …) and then adds all up
- This approach provides economists the opportunity to study the performance of each sector

GDP and GNI:
- GNI —> the total income received by the residents of a country, equal to the value of all final goods and services produced by the factors of p. supplied by the country's residents regardless where the factors are located
- GNI —> Gross National Income —> GDP + net income from abroad

Nominal and real:
- Nominal if the measure is in terms of current prices, so not accounting the changes in prices
- Real if the measure of economic activity has eliminated the influence of changes in prices
- It is important to use real values when comparing a variable over time
- Nominal GDP measures the value of current output valued at current prices
- Real GDP measures the value of current output valued at constant (base year) prices

Total and per capita values:
- Per capita —> per person —> useful as a measure of standard of living in a country
- Needed because of —> differing population sizes across countries
  —> population growth

Purchasing Power Parity (PPP):
- Buying power equivalence
- The amount of a country's currency that is needed to buy the same quantity of local goods and services that can be bought with US $1 in the United States
- It makes comparisons across countries far more accurate

GDP deflator:
- Price index —> a measure of average prices in a period relative to average prices in a base year
- Real GDP = (Nominal GDP / price deflator) * 100

8.4 The business cycle

The business cycle:

- Short-term fluctuations in the growth of real output, which are alternating periods of expansion and of contraction
- Expansion —> when there is a positive growth in real GDP
- Peak —> the cycle's maximum real GDP
- Contraction —> when the economy begins to experience falling real GDP
- Trough —> the cycle's minimum level of GDP
- Potential output / GDP —> the output represented by the long-term growth trend
- Natural rate of unemployment —> only when in a point on the long-term growth trend line

Macroeconomic objectives:

- Reducing the intensity of expansions and contractions to make output gaps as small as possible
- Increasing the steepness of the line representing potential output to achieve a more rapid economic growth over long periods of time

8.5 National income statistics and alternative measures

Accuracy of national income statistics: (GDP and GNI)

- Do not include non-marketed output (which is likely to be far greater in developing countries compared to developed ones)
- Do not include output sold in underground (parallel) markets
- Do not take into account quality improvements in goods and services. Technological advances often permit improved products to be sold at a lower price giving benefits to consumers
- Do not account for the value of negative externalities such as pollution and toxic wastes
- Do not take into account the depletion of natural resources used to produce the output
- May not take into account differing domestic price levels (PPP)

Measure of economic well-being measuring issue: (GDP and GNI)

- Make no distinctions about the composition of output (not taking into account the degree to which they contribute to standards of living (military, …))
- Cannot reflect achievements in levels of education, health and life expectancy
- Provide no information on the distribution of income and output only of the average
- Do not take into account increased leisure —> average number of hours worked per week
- Do not account for quality of life factors —> non-economic factors (crime rate, stress levels, well-functioning institutions, …)

Alternative measures of well-being

OECD Better Life Index:

- It is based on a number of factors that the member countries themselves selected as factors that make better life
- Purpose —> provide a more accurate representation of well-being and form the basis of policies intended to improve the quality of life and well-being more generally

Happiness Index:

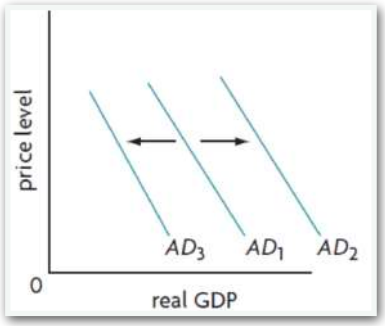
- Tries to address the interdependent economic, social and env. challenges faced by the world
- Based on —> Real GDP per capita, social support, healthy life expectancy, freedom to make life choices, generosity and perceptions of corruption
- Happiness is difficult to quantify and measure making this ranking less reliable for comparisons

Happy Planet Index:

- A measure of sustainable well-being
- HPI = (Life expectancy * well-being * inequality of outcomes) / ecological footprint

Chapter 9: Aggregate demand and supply

9.1 AD and the AD curve



- Aggregate demand —> the total quantity of aggregate output, or real GDP, that all buyers in an economy want to buy at different possible price levels, ceteris paribus
- It consists of all components of GDP

Causes of changes in consumption spending:

- Changes in consumer confidence —> the more optimistic consumers are about their future the more they will spend
- Changes in interest rates —> because some consumer spending is financed by borrowing, and the lower the interest rate, the more consumers will spend
- Changes in wealth —> wealth is the value of assets that people own. The more people feel wealthier, the more consumer spending
- Changes in income taxes —> the lower the income taxes, the higher the disposable income
- Changes in the level of household indebtedness —> the lower the level of dept, the higher the spending by consumers
- Expectations of future price levels —> if lower prices expected in future, spending is postponed

Causes of changes in investment spending:

- Changes in business confidence —> the more optimistic firms are about their future sales and economic activity, the higher the investment
- Changes in interest rates —> decreasing in interest rates lowers costs of borrowing, making firms able to invest more money
- Changes (improvements) in technology —> they stimulate investment spending
- Changes in business taxes —> firms profits after taxes fall, therefore decreasing investment
- Level of corporate indebtedness —> high levels of dept will make the firm less willing to invest
- Legal / institutional changes —> increasing access to credit and securing property rights would result in increases in investment spending

Causes of changes in government spending:

- Changes in political priorities
- Changes in economic priorities —> gov. can use its own spending to influence AD

Causes of changes in X / M spending:

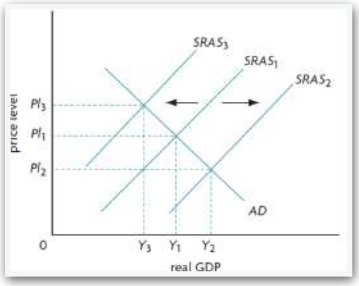
- Changes in national income abroad
- Changes in exchange rates
- Changes in trade policies, or the level of trade protection

9.2 Short-run AS and equilibrium in AD-AS

- Aggregate supply —> the total quantity of goods and services produced in an economy over a particular time period at different price levels
- Short-run AS (SRAS) —> shows the relationship between the price level and the quantity of real output produced by firms when resource prices (especially wages) do not change

Causes of shift of SRAS curve:

- Changes in wages
- Changes in non-labour resource prices
- Changes in indirect taxes
- Changes in subsidies offered to businesses
- Supply shocks such as wars and violent conflicts



- In the AD-AS model, the equilibrium level of output occurs where AD intersects with AS

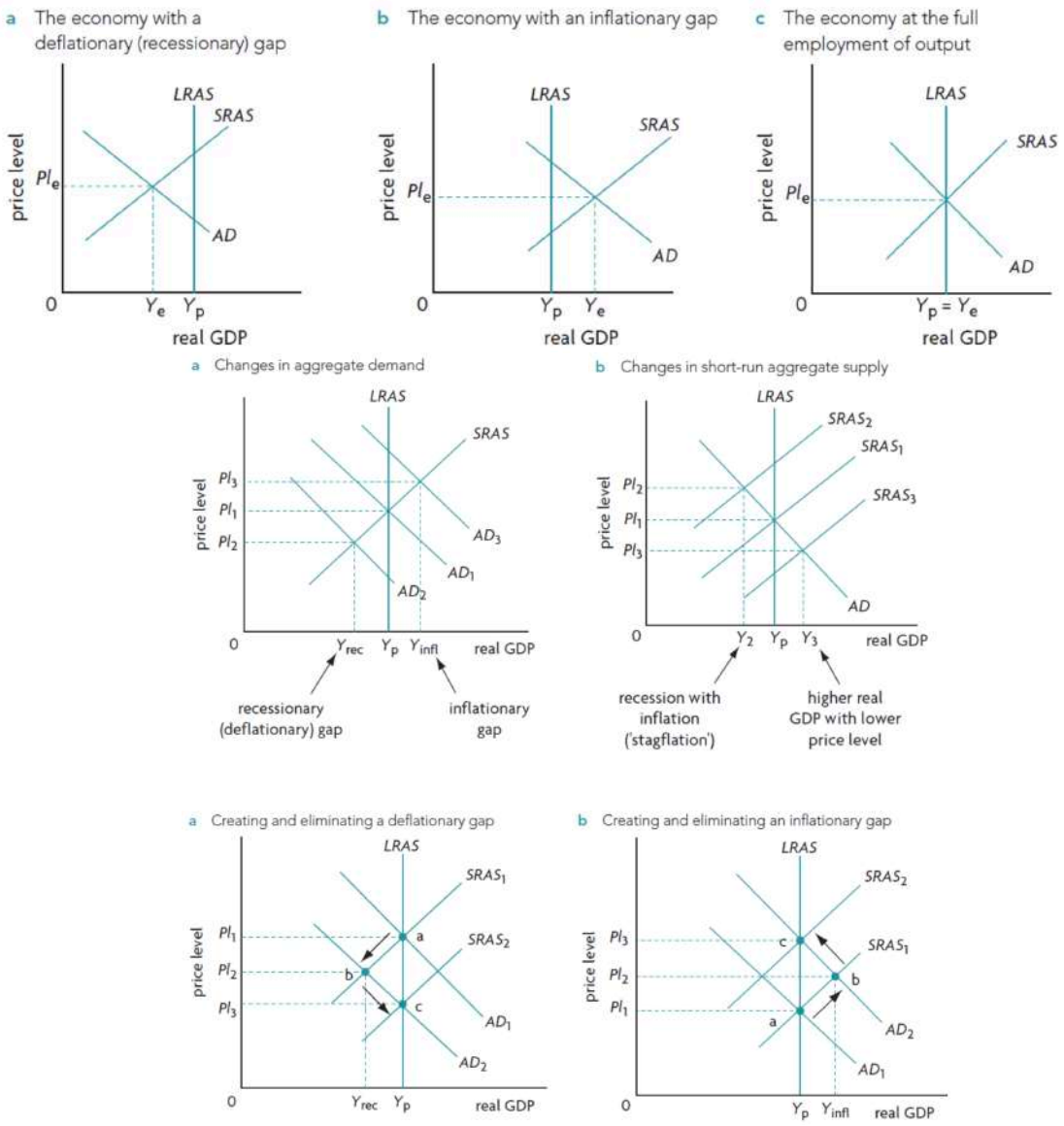
9.3 Long-run AS and equilibrium

The monetarist / new classical model:

- Importance of the price mechanism in co-ordinating economic activities
- Concept of competitive market equilibrium
- The economy as a harmonious system that automatically tends towards full employment
- The LRAS curve is vertical at the full employment level of output
- Long-run equilibrium occurs when the SRAS and AD curves intersect on the LRAS curve
- LRAS curve is vertical because with constant real costs, firms' profits are also constant, and firms no longer have any incentive to increase or decrease their output levels
- Governments should try to make markets work as freely as possible, to let it adjust alone

Short-run equilibrium:

- Deflationary gap —> unemployment is greater than the natural rate of unemployment
  —> not enough total demand in the economy to make it worthwhile for firms to produce potential GDP, so requiring less labour
- Inflationary gap —> real GDP is > than potential GDP and unemp. is less than the natural rate
  —> to much total demand in the economy and firm produce a greater quantity
- Full employment of output —> real GDP = potential GDP
  —> unemp. is = to the natural rate and no deflation or inflation gap
- The economy has a built-in tendency towards full employment equilibrium

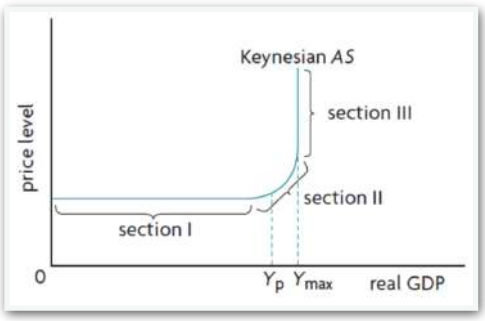


9.4 AS and equilibrium in the Keynesian model

- Inflexible wages and prices in the downward direction mean that the economy cannot move into the long run when experiencing a deflationary gap (can be seen in the Keynesian AS curve)
- If wages and prices do not fall easily, this means the economy may get stuck in the short run
- The gov. must intervene in the economy with policies to help it come out of deflationary gap

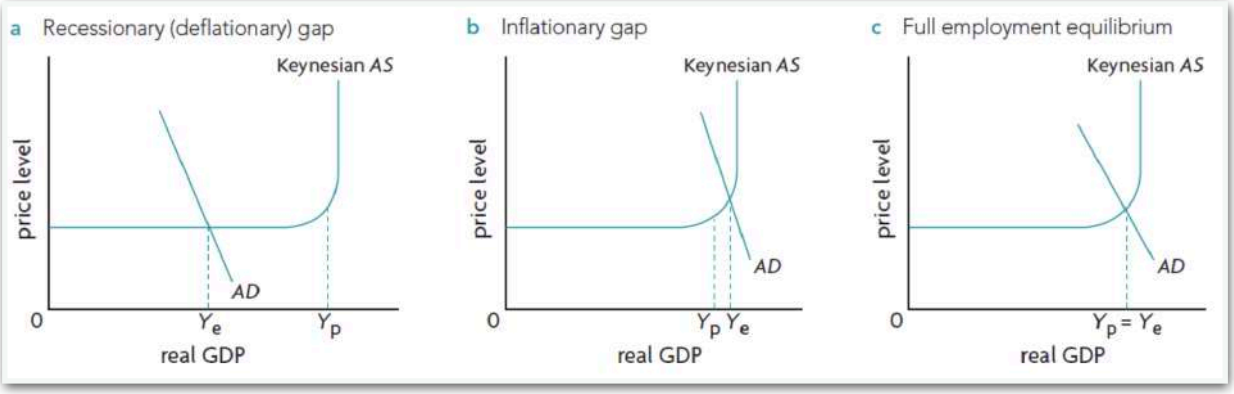
Keynesian AS curve:

- Section I —> real GDP is low —> a lot of unemployment of resources and scarce capacities
- Section II —> real GDP increases with the price levels and output increases, so increasing also employment of resources
- Section III —> real GDP reaches a level beyond which it cannot increase anymore —> firms are using the max. amount of labour and all other resources in the economy



The three equilibrium states:

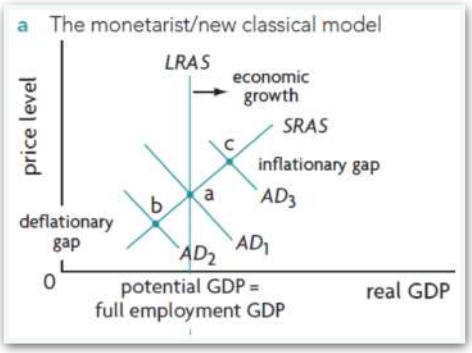
- The economy in the Keynesian model can remain indefinitely stuck in a deflationary gap
- Increases in AD does not necessarily result in increases in the price level

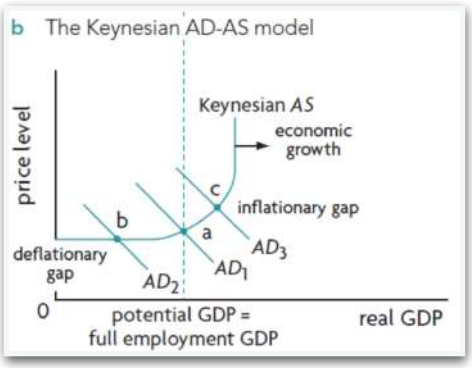


9.5 Shifting AS curve over the long term

Influences on AS over the long term:

- Increases in quantities of the factors of production
- Improvements in the quality of factors of production
- Improvements in technology
- Increases in efficiency
- Institutional changes —> how efficiently resources are used
- Reductions in the natural rate of unemployment





Chapter 10: Macroeconomic objectives I

10.1 Low unemployment

Unemployment:

- Unemployment —> people of working age actively looking for a job but who are unemployed
- Labour force —> the number of people employed + the number of people of working age who are unemployed
- Measured in two ways —> numerical —> total number of unemployed people in the economy
  —> unemp. rate —> (number of unemployed / labour force) x 100

Difficulties in measuring unemployment:

- Official statistics underestimate true employment because of hidden unemployment
  —> discouraged workers who gave up looking for a job are not excluded
  —> do not make a distinction between full-time and part-time employment
  —> do not make a distinction on the type of work done
  —> do not consider people on retraining programmes and early retired people
- Official statistics may overestimate true unemployment because of:
  —> do not include people working in the underground economy
- A disadvantage of this calculation is that it is an average over the entire population —> for this reason the calculation is done on different population groups in a society (region, gender, age …)

Costs of unemployment:

Economic costs:

- A loss of real output (real GDP)
- A loss of income for unemployed workers
- A loss of tax revenue for the government —> larger budget deficit or smaller budget surplus
- Costs to the government of unemployment benefits
- Costs to the government od dealing with social problems resulting from unemployment
- More unequal distribution of income
- Unemployed people may have difficulties finding work in the future (lose the skills)

Personal and social costs:

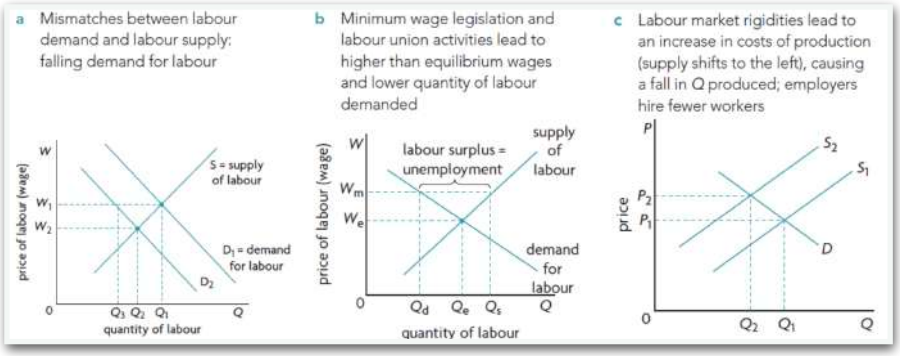
- Personal problems —> indebtedness and loss of self-esteem
- Greater social problems —> increased crime and violence, drug use and homelessness
- Arising levels of poverty

Types and causes of unemployment:

- Natural rate of unemployment —> the sum of Structural, Frictional and seasonal unemployment

Structural unemployment:

- Caused by changes in demand for particular labour skills
- Caused by changes in the geographical location of jobs —> firms may move …
- Caused by labour market rigidities —> factors preventing the forces of supply and demand from operating in the labour market
  —> minimum wage legislation
  —> labour union activities and wage bargaining
  —> employment protection laws
  —> generous unemployment benefits



Frictional unemployment:

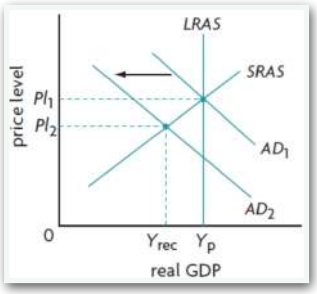
- Occurs when workers are between jobs —> have been fired, are in search of a better job or
- Tends to be short term —> does not involve a lack of skills that are in demand

Seasonal unemployment:

- Occurs when the demand for labour in certain industries changes on a seasonal basis because of variations in needs

Cyclical unemployment:

- Occurs during the downturns of the business cycle in a deflationary gap
- The downturn arises from low aggregate demand (demand-deficit unemployment)

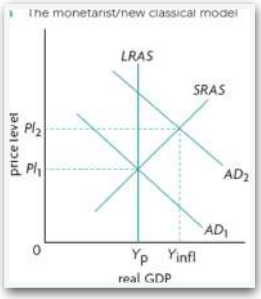


10.2 Low and stable rate of inflation

- Inflation —> a sustained increase in the general price level
- Inflation indicates that prices of goods and services are increasing on average
- Deflation —> a sustained decrease in the general price level
- Disinflation —> a decrease in the rate of inflation
- Consumer price index —> a measure of cost of living for the typical household —> compares the value of a basket of goods and services in one year with the value of a base year
  —> ((Final value of A- initial value of A) / initial value of A) x 100
- Real income —> (nominal income / CPI) x 100

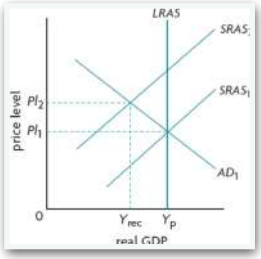
Problems with CPI:

- Different rates of inflation for different income earners
- Different rates of inflation depending on regional and cultural factors
- Changes in consumption patterns due to consumer substitutions when relative prices change
- Changes in consumption patterns due to increasing use of discount stores and sales —> prices are lower than those indicated in the CPI calculations
- International comparisons —> types of goods included, weights used and methods of calculation
- Changes in consumption patters due to introduction of new products
- Changes in product quality
- Comparability over time —> revising CPI baskets and changing the base year



Causes of inflation:

- Demand-pull inflation —> increases in aggregate demand shift right of AD)
- Cost-pull inflation —> increases in costs of production or shocks (AS to left)



Impact of inflation:

Negative impacted by inflation:

- People who receive fixed income or wages
- People who receive income that increase less rapidly than the rate of inflation
- Holders of cash
- Savers —> interest rates must be greater than inflation
- Lenders —> (lend money to people) —> money will lose a bit of its value over time

Positive impacted by inflation:

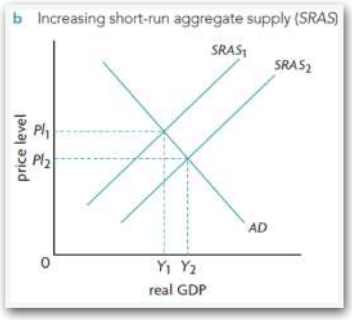
- Borrowers
- Payers of fixed incomes or wages
- Payers of incomes or wages that increase less rapidly than the rate of inflation

- Uncertainty —> cannot predict future changes in purchasing power —> fewer investments
- Savers —> lowered incentive to save money
- Export —> become more expensive to foreign buyers and imports become cheaper —> ability to compete with foreign centuries is reduced
- Economic growth —> lowered economic growth for the country
- Resource allocation —> prices rise rapidly so the signalling and incentive functions not effective
- Social and personal costs are unequally distributed —> poor people more affected by inflation

Hyperinflation:

- When there are very high rates of inflation
- Results from very significant increases in the supply of money
- Inflationary spiral —> inflation sets in motion a series of events that worsen inflation
- A low and stable rate of inflation between 2-3% if preferred overall

Causes of deflation:



- Deflation occurs very rarely because:
  —> wages of workers do not ordinarily fall
  —> large oligopolistic firms may fear price wars
- It is caused by decreases in AD and increases in AS

Costs of deflation:

- Falling price levels —> individuals on fixed incomes, holders of cash, savers and lenders gain
  —> borrowers and payers of individuals with fixed incomes lose
- Increases in real value of debt
- Uncertainty —> firms unable to forecast their costs and revenues due to declining price levels
- Deferred consumption —> consumers postpone spending —> deflationary spiral
- Risk of bankruptcies and a financial crisis
- Inefficient resource allocation —> signalling and incentive functions are not effective
- Policy ineffectiveness —> people won't be willing to spend

- Exports may increase as prices will be lower —> not enough to sustain all other negative effects

10.3 The relationship between unemployment and inflation

- An increase of one percentage point in unemployment lowers well-being nearly six times more than a one percentage point increase in inflation
- Misery index —> the sum of the unemployment rate and the inflation rate of a country
  —> the higher the index, the greater the misery of a population
  —> does not distinguish between the separate effects of unemployment and inflation on the well-being of the population

---

Chapter 11: Macroeconomic objectives II

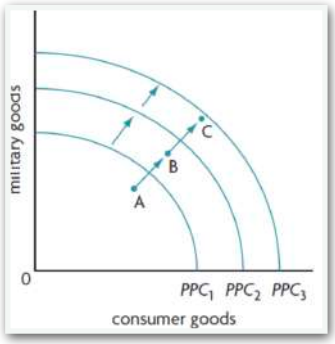
11.1 Economic growth

Economic growth:

- Refers to an increase in real GDP, or the real quantity of goods and services produced over a period of time
- Percentage change in real GDP or in real GDP *per capita*
- % change in real GDP = ((final value of real GDP - initial value of real GDP)/initial value) x 100
- % change in real GDP per capita = % change in real GDP - % change in population

Short term growth vs long term growth:

- Economic growth occurs as a result of:
  - —> increases in aggregate demand (short-term growth)
  - —> increases in short-run aggregate supply (short-term growth)
  - —> increases in long-run aggregate supply (long-term growth)
- In the Keynesian model, short-term growth does not involve an increase in potential output
- Short-term growth is affected far more by increases in aggregate demand rather than in short-run aggregate supply
- Short-term growth is shown in the expansion phase of the business cycle
- Usually long term growth needs an extended period of time to take effect



	***AD-AS* model**	***PPC* model**
Short-term growth	• increases in *AD* • increases in *SRAS* (less important)	• reduction in unemployment • improvement in efficiency
Long-term growth	• increased resource quantity • improved resource quality • technological change	
	• improvements in efficiency • institutional changes	–

Why economic growth occurs:

- Increase in the quantity and improvements in the quality of physical capita, due to investments
- Increased quantities of labour are unlikely to be a source of economic growth over long periods, but improvements in the quality of labour effects greatly economic growth
- Marketable commodities (minerals, metals, ecological resources, …) can contribute to growth but are not essential
- Common pool resources are crucially important to long-term growth —> as ability of countries to maintain them

Impact of economic growth on living standards:

- Greater potential for people to increase their consumption of goods and services, and improve their standards of living —> require policies to make effective use of the resources available
- Distribution of income —> greater income going to poorer household means greater living stand.
- Household spending —> greater income spent on food, education, health is greater living stand.
- Share of income controlled by women —> the greater, the stronger the impact
- Government spending on merit goods —> budget allocated to areas such as education or health
- Contributions by non-gov. organisations —> poverty oriented that reach more poor people

Impact of economic growth on the environment:

1) Some environmental damage is irreversible
2) Growth justifies government inaction on the environment
3) Growth is not bad for the environment but how it is pursued
4) Growth based on unsustainable resources use may threaten future growth

To pursue growth ecofriendily:

—> governments implement market-based policies that internalise the externality
—> Governments pursue more env. regulations that encourage pollution-free tech. change
—> Increased emphasis on human capital in production (which is pollution-free)
—> increased emphasis on green investments
—> changes in the structure of the economy towards more pollution-free services

Inappropriate gov. policies:

—> introduction of capital-using technologies (labour-saving)
—> low levels of government investment in human capital
—> services and infrastructure to urban areas ignoring rural sector with most people
—> concentrating investments in rich people and ignoring the urban slums

11.3 Potential conflict between macroeconomic objectives

Demand-pull inflation and economic growth:

- In the Keynesian model —> as long as AD increases along horizontal part of AS curve —> economic growth with no inflation —> no conflict between low inflation and growth
- New classical model —> when in a deflationary gap, increases in AD result in both growth and increase in price level —> possible conflict

Cost-push inflation and economic growth:

- Caused by decreases in SRAS due to factors such as high prices of factors of production
- Stagflation —> negative economic growth (not possible to have positive growth in cost-push)

Chapter 12: Economics of inequality and poverty

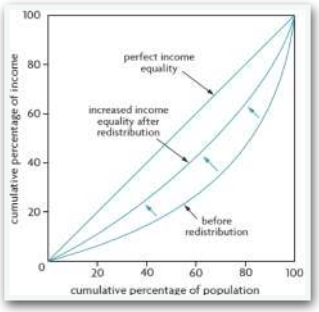
12.1 Inequality

Economic inequality:

- Refers to the degree that people in a pop. differ in their ability to satisfy their economic needs
- It results mainly from differences in income and wealth
- Income inequality —> differences in how evenly income is distributed in a population
  —> income includes interest from saving, bonds and share in stock markets
- Wealth inequality —> arises from differences in the amount of wealth people own

Measurements of economic inequality:

- Income is distributed in a quintiles of the population (20% of the whole)



Lorenz curve:

- Is used to show the degree of income inequality in an economy
- The closer a Lorenz curve is to the diagonal representing perfect income equality, the greater is the equality in income distribution

Gini coefficient:

- Is a summary measure of the information contained in the Lorenz curve of an economy
- (Area between diagonal and Lorenz curve / Entire area under diagonal)
- Has a value between 0 and 1
- The closer the value to 1 the greater the income inequality

Wealth inequality:

- The Lorenz curve and the Gini coefficient can be used in the same way to show wealth inequality
- Reasons behind greater wealth inequality:
  —> Limited growth in wages makes it difficult for low-income people to accumulate wealth
  —> High-income people consume a smaller fraction of their income —> can save more
  —> Income and wealth inequalities feed on each other

12.2 Poverty

- Refers to an inability to satisfy minimum consumption needs
- Absolute poverty —> a situation where a person does not have enough income to meet basic human needs

- Poverty line —> minimum income level before absolute poverty
- World bank poverty lines —> living on less than 1.90 $ a day is extreme poverty
  —> living on less than 3.20 $ a day for lower-middle income countries
  —> living on less than 5.50 $ a day for upper-middle income countries

- Relative poverty —> compares the income of individuals in a society with median incomes
- Poverty rates differ widely among social groups in a society
- Measures for absolute and relative poverty are useful to governments as guides to policies providing income support as well as measures intended to combat poverty

Minimum income standards (MIS):

- Method to measure poverty
- Consists of ongoing research on what people in a population believe are the essentials for a minimum acceptable standard of living that allows people to participate in society
- It calculates the minimum income that is required for different family types to be able to buy the essentials in the basket
- This measure reveals info on —> number of people living under minimum income
  —> the relative contribution of each item in the basket
  —> how these factors change over time

Composite indicators:

- Measures of complex phenomena that cannot easily be described by a single indicator
- Multidimensional poverty index (MPI) —> measures poverty in three dimensions —> health, education and living standards —> each dimension is intended to reflect deprivations
- MPI of the world bank —> as noted by the bank, the standard monetary measure of poverty does not capture important aspects of well-being, such as access to health care or a secure community

Difficulties in measuring poverty:

- Poverty has different meaning and different approaches to measurement
- Measurement problems —> do not take wealth or savings into consideration
  —> in some cases poverty is measured based on household surveys
  —> is subjective
  —> do not include homeless people
  —> freelance work or income from investments not included
- Overestimation or underestimation of the national poverty line

12.3 Causes of economic inequality and poverty

Causes of inequality:

- Circumstances that affect life opportunities and are beyond one's control include:
  —> parents' level of education, occupation and income
  —> place of birth
  —> gender
  —> race and ethnicity

- Different levels of human capital —> differences in skills, education and good health possessed
- Different levels of resource owned —> some people inherit, or accumulate through savings from high incomes, financial capital or other forms of property which gives both income and wealth
- Discrimination —> some social groups often face discrimination in the job market, with the result that they may receive lower wages or may find greater difficulty finding work
- Unequal status and power —> people in positions of power may sometimes use this to influence government policies favouring their own interests, rather than policies favouring redistribution
- Government tax and benefits policies —> people on low income must often rely heavily on transfer payments and social services and merit goods provided by the government
  —> tax policies that favour the rich and do not favour redistribution of income
- Technological change —> it has eliminated some jobs by replacing human labour with machines
- Globalisation —> economic integration on a global scale —> foreign direct investment involves greater demand for skilled rather than unskilled workers + economies may offshore certain jobs
- Market-based supply-side policies —> such as discouraging trade unions and reducing bargaining power of labour, or reducing the minimum wage
- Increases in pay of certain occupations —> certain occupations increased much more than others
- Unemployment —> if long-term then an individual is more likely to become poor
- Geography —> people may live in remote regions with limited possibilities for employment
- Age —> older people may receive pensions that are barely enough to cover minimum needs
- Poverty —> low incomes leads to low human capital, and so further low income

12.4 Impacts of income and wealth inequality

Economic growth:

- Greater inequality lowers growth by reducing the ability of lower income people to invest
- Children of low-income families are likely to also have low incomes in future
- Savings of wealthy people often leave the country (reduces resources available domestically)
- Income and wealth in a few hands results in significant political control —> influence policies
- Significant political control by the rich may result in less government provision of merit goods
- Improved income distribution increases the demand for locally produced goods and services —> encourages local production and promotes local employment and investment
- High income inequality means that the poor are unable to obtain credit so can't make investments
- High income inequality leads to social dissatisfaction, unrest and political instability

Low living standards:

- Lack of access to health care and education
- Higher infant, child and maternal mortality
- Higher levels of preventable diseases
- Social problems (crime rates, drug use, …)
- Inability to realise one's full potential —> waste of human capital

Social and political instability:

- High income and wealth inequalities create societies that are polarised and divided —> different interests created so interactions between groups are difficult
- The groups at the top begin to have a stronger political influence
- Rise in sense of dissatisfaction

12.5 Policies to reduce income and wealth inequalities and poverty

Taxation:

- It can lower inequalities by taking more taxes from the rich than from the poor
- Are the most important source of government revenues
- Divided in two types —> direct taxes and indirect taxes

Direct taxes:

- Taxes paid directly to the government tax authorities by the taxpayer
- Personal income taxes —> taxes paid by individuals on all forms of income
- Corporate income taxes —> taxes on the profits of corporations
- Wealth taxes —> taxes on ownership of assets (property taxes or inheritance taxes)

Indirect taxes:

- Taxes on spending on goods and services
- General expenditure taxes —> VAT for Europe and sales taxes for USA
- Excise taxes —> taxes paid on specific goods and services such as cigarettes and petrol
- Customs duties (tariffs) —> tax applied on imports of foreign goods into a country
  —> it keeps imports out of the country and it raises tax revenue
- Indirect taxes are inconsistent with the objective of a more equal distribution of income

Taxation types:

- Proportional —> as income increases, the tax rate remains constant
- Progressive —> as income increases, the tax rate increases
- Regressive —> as income increases, the tax rate decreases

Evaluating taxes as a policy for redistribution:

Transfer payments:

- Payments made by the government to individuals specifically for the purpose of redistributing income away from certain groups and towards other groups (vulnerable groups)
- Conditional cash transfers if they are granted with conditions to meet certain requirements
- They use a big part of the government budget and create incentives for people not to work

Targeted gov. spending:

- Governments spend to provide merit goods that are under provided by the market
- Uses tax revenue to provide the good in larger quantities and at very low or zero prices

Universal basic income:

- A method intended to provide residents in a country with a sum of money that they would receive regardless of any other income they may have

Polivies to reduce discrimination:

- Countries around the world usually have legislation that forbids discrimination in the workplace
- It is essential to ensure that discrimination does not occur

Government intervention in markets:

- Minimum wage legislation —> sets a legal minimum wage
- Price controls such as food price ceilings or price floors for farmers

- 25% of redistribution occurs through the tax system while 75% occurs through benefits

---

Chapter 13: Demand-side and supply-side policies

13.1 Macroeconomic policies

Demand-side policies:

- Also called demand management —> focus on changing AD to achieve macroeconomic goals
- Try to counteract the effects of short-term fluctuations in real GDP and bring full employment level of real GDP, or potential GDP
- Two types of stabilisation policies —> either monetary policies or fiscal policies —> try to minimise the short-run fluctuations of the business cycle

Supply-side policies:

- Focus on the production and supply side of the economy (specifically the LRAS curve)
- Aim to increase potential output and achieve long-term economic growth
- Focus on increasing the quantity and quality of factors of production (LRAS curve factors)
- Two major categories of supply-side policies:
  —> market-based (rely on the working of the market)
  —> interventionist (rely on government intervention)

13.2 Demand management and monetary policy

The role of central banks:

- Monetary policy is carried out by the central bank of each country
- Commercial banks are financial institutions whose main functions are to hold deposits for their costumers, loans, transfer funds and to buy government funds —> cannot be central banks
- Are responsible for: —> Banker to the government (as commercial banks for costumers)
  —> Banker to commercial banks —> holds deposits for them and for loans
  —> Regulator of commercial banks —> regulates and supervises them
  —> Monetary policy —> controls the supply of money and interest rates
- It has a degree of independence from government interference in the pursuit of monetary policy

The goals of monetary policy:

- Low and stable inflation
- Low unemployment (specifically cyclical unemployment)
- Reduce business cycle fluctuations
- Promote a stable economic environment for long-term growth —> needed to be able to plan and carry out economic activities
- External balance —> country's revenues from exports are balanced by spending on imports over an extended period of time

Inflation targeting:

- The public announcement of medium-term numerical targets for inflation with an institutional commitment by the monetary authority to achieve these targets
- Between 1.5% and 2.5% usually
- Advantages —> achievement of a low and stable rate of inflation
  —> improved ability of economic decision-maker to anticipate future inflation
  —> greater co-ordination between monetary and fiscal policy
- Disadvantages —> reduced ability of the central bank to pursue macroeconomic objectives
  —> conflict between a low rate of inflation and low unemployment
  —> reduced ability of CB to respond to supply-side policies —> leads to cost-push inflation and stagflation
  —> a too low inflation target may lead to higher unemployment
  —> a too high inflation target may lead to problems resulting from high inflation

Real vs Nominal interest rates:

- Real interest rate = nominal interest rate - rate of inflation

The role of monetary policy:

- The point of changing the money supply and changing interest rates is ultimately to influence AD
- Changes in interest rates affect —> Investments and consumption in the GDP
- Higher interest rates —> lower spending so AD to the left
- Lower interest rates —> higher spending so AD to the right
- Expansionary monetary policy —> An increase in the money supply by the central bank
  —> aim to expand AD and the level of economic activity
  —> easy money policy
- Contractionary monetary policy —> A decrease in the money supply by the central bank
  —> aim to contract AD and the economy
  —> tight money policy
- Ratchet effect —> the price level moves up when there is an increase in AD and then remains at the same level until there is a further increase in AD

Evaluating monetary policies:

Strengths:

- Interest rate changes can be incremental
- Interest rates changes are reversible
- Monetary policy is flexible
- Relatively short time lags (time delays)
- Central bank independence
- Limited political constraints (no changes in government budget)
- No crowding out

Constraints:

- Possible ineffectiveness in recession —> rates cannot fall when approaching zero
  —> low consumer and producer confidence
  —> banks may be fearful of lending
- Conflict between government objectives
- May be inflationary
- Problematic when dealing with stagflation or cost-push inflation as they are supply-side issues

---

13.3 Demand management and fiscal policy

The government budget:

- Type of plan of a country's revenues and expenditures over a period of time (usually one year) that the government makes to plan its activities
- Sources of gov. revenue —> taxes of all types
  —> from the sale of goods and services
  —> from the sale of government-owned assets or properties
- Types of gov. Expenditures:
  —> Current expenditures —> spending on day-to-day items that are recurring (wages, …)
  —> Capital expenditures —> include public investments or spending to produce physical capital (roads, airports, …)
  —> Transfer payments —> payments to vulnerable groups (for income redistribution)

Goals of fiscal policy:

- Refer to manipulations by the gov. of its own expenditures and taxes to influence AD
- Can affect G, C and I components of the GDP
- Equitable distribution of income
- Low and stable rate of inflation
- Low unemployment
- Reduce business cycle fluctuations
- Promote a stable economic environment for long-term growth
- External balance (Imports - Exports)

Expansionary fiscal policy:

- Increasing government spending
- Decreasing personal income taxes
- Decreasing business taxes (taxes on profits)
- Combination of the above

Contractionary fiscal policy:

- Decreasing government spending
- Increasing personal income taxes
- Increasing business taxes
- Combination of the above

Evaluating fiscal policy:

Strengths:
- Pulling an economy out of a deep recession
- Ability to target sectors of the economy
- Direct impact of government spending on AD
- Dealing with rapid and escalating inflation
- Ability to affect potential output

Constraints:
- Problems of time lags —> problem must be recognised, appropriate policy must be decided, policy takes effect in the economy
- Political constraints —> as numerous political pressures
- Sustainable dept
- In a recession, tax cuts may not be effective in increasing AD
- Inability to "fine tune" the economy —> cannot be used to reach a precise target as general
- May be inflationary —> if it lasts to long
- Unable to deal with cost push inflation or stagflation as it is a demand-side policy

---

13.6 Supply-side policies

Goals of supply-side policies:
- Promote long-term growth by increasing the productive capacity of the economy
- Improve competition and efficiency
- Reduce costs of labour and reduce unemployment through greater labour market flexibility
- Increase incentives of firms to invest in innovation by lowering costs of production
- Reduce inflation to improve international competitiveness

Market-based supply-side policies:

Encouraging competition:
- Privatisation —> increases efficiency due to improved management and operation of private
- Deregulation —> elimination or reduction of government regulation of private sector activities
- Contracting out to the private sector
- Anti-monopoly regulation —> assures fair competition
- Trade liberalisation

Labour market reforms:
- Abolishing minimum wage legislation
- Weakening the power of labour unions
- Reducing unemployment benefits
- Reducing job security (against being fired)

Incentive-related policies:
- Lowering personal income taxes
- Lowering taxes on capital gains and interest income
- Lowering business taxes

Strengths:
- Improved resource allocation
- May not burden the government budget
- Ability to create employment
- Ability to reduce inflationary pressure (LRAS to right)

Constraints:
- Time lags as effects over the long term
- Possible unfavourable impact on unemployment (competition may increase unemployment)
- Possible negative effects on equity
- Negative impact on the government budget (policies in the form of tax cuts)
- Possible interference of vested interests (strong personal interests) —> oppose and may prevent the policies from being implemented
- Possible negative effects on the environment

Interventionist supply-side policies:

- Presuppose that the free market economy alone cannot achieve the desired results in terms of increasing potential output —> so gov. intervention is required
- Investment in human capital —> training and education
  —> improved health care services and access to these
- Investment in new technology —> research and development
  —> results in new or improved capital goods
  —> gov. usually provides incentives to firms for this
- Investment in infrastructure —> can lead to more efficient transport of goods …
- Industrial policies —> gov. policies designed to support the growth of the industrial sector
  —> Support for small and medium-sized enterprises of firms (SMEs)
  —> tax exemptions, grants, low-interest loans and business guidance
  —> support for infant industries (as SMEs but also protection against exports)

Strengths:

- Direct support of sectors important for growth
- Ability to create employment
  —> enabling workers to acquire the skills…
  —> providing assistance to workers to relocate
  —> providing info that reduces unemployment when workers are between jobs/season
- Potential ability to reduce inflationary pressure —> by increasing potential output
- Possible positive effects on equity —> skilled workers are more likely to be employed and be an active and productive part of the society

Constraints:

- Time lags —> time needed is long
- Negative impact on the government budget as heavily based on gov. spending

Overlaps between demand-side and supply-side policies:

- Interventionist supply-side policies involve an increase in government spending —> more AD
- Market-based supply-side policies encourage firms to invest more in R&D —> it is an investment so leads to an increase in AD

- Demand-side policies can contribute to long-term growth of potential GDP by providing a stable macroeconomic environment
- Fiscal policies —> gov. spending for provision of physical capital improves also quality of goods
  —> gov. spending for instruction also improves the quality of the labour force
  —> lower business taxes also promote technological innovations
- Monetary policies —> a fall in interest rates encourages more spending by firms on capital goods, so increasing their quantity —> this affects potential output

---