GCSE ECONOMICS (OCR)

Revision Guide: Unit 2

How the Economy Works

Name:

Form:

What are the Economic Objectives of Government?

There are 4 main macro-economic objectives of Governments. These are:

(1) Economic Growth

- Ideally Economic growth will increase at a steady rate.   The idea rate is an annual rate of around 2.5%
- Economic Growth needs to be sustainable. This means that it is achieved using renewable resources and in a way that is environmentally friendly

(2) Low inflation/Price Stability

- There is an acceptance that in a modern, dynamic economy prices are likely to rise over time
- However high inflation is bad for the economy
- The Government and the Monetary Policy Committee of the Bank of England set an inflation target of about 2-2.5%. They intervene (using tools such as interest rates) if inflation looks like it is going above this target level

(3) High employment/Low unemployment

- Again, it is reasonable that there will always be a small amount of frictional unemployment as workers move between jobs
- However, a key aim of government is to keep employment as high as possible

(4) Balancing imports and exports: avoiding a large current account deficit

- The government must ensure that there is not more money leaking out of the economy (to pay from imports) than is coming into the country from the sale of exports

Clashes between economic objectives

It is often very difficult for a government to achieve all four economic objectives at once.

For example, in a recession, the government may try to stimulate demand. This will stimulate economic growth and reduce unemployment. However, it may also cause demand-pull inflation and "suck in" imports, thus making the current account deficit worse

Government policies

The government will use a range of economic policies to achieve these objectives. These will include:

(a) Fiscal Policy
(b) Monetary Policy
(c) Supply-Side policies
(d) Specific policies
(e) A combination of the above

These policies will be dealt with later in this revision guide

Economic Issue 1

Economic Growth

Definition

Economic Growth can be defined as a rise in the productive capacity of the economy such that more output is being produced.

How is Economic Growth Measured?

Economic Growth is measured by looking at Gross Domestic Product (GDP)

GDP measures the VALUE of all goods and services produced in an economy over a period of time (usually a year). For example if the Wood economy only made cakes and made 10 cakes at £5 each, the GDP would be £50

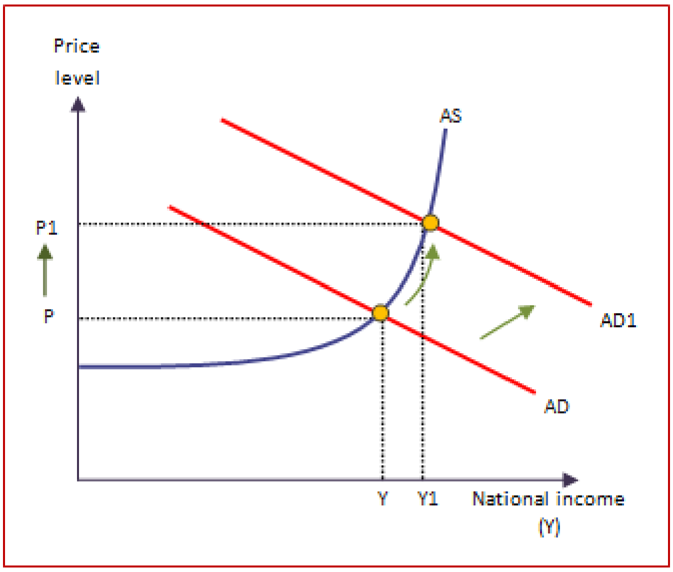
In order to accurately compare countries, it is necessary to take into account differences in population. To do this GDP is divided between the population to give **GDP PER CAPITA** (per person). In reality this is only an average as it is highly unlikely that the GDP is equally distributed between the population

Sometimes GDP rises and gives the appearance of economic growth. However this is just because prices have increased (imagine if the prices of cakes rose to £10, GDP would look like it has doubled to £100 when in reality we have made no more cakes than previously). To take into account inflation we often measure economic growth by looking at **REAL GDP PER CAPITA**

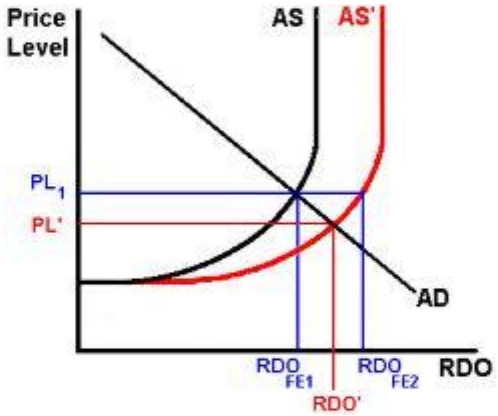
What causes Economic Growth?

Economic growth can be demand-led or supply-led.

Demand led growth occurs when Aggregate Demand (total demand in the economy) rises. This may occur because: incomes rise; taxes are cut; interest rates are cut; there are high levels of consumer and business confidence; expectations are good.



Supply-led growth occurs when there is a rise in Aggregate Supply (total supply in the economy. This occurs because there has been an increase in the QUANTITY and QUALITY of resources. For example: more investment increases the capital stock; better education and training improves the quality and productivity of labour; the discovery of North Sea Oil boosts land stocks; the support of banks and government schemes boost enterprise:



What are the economic consequences (costs and benefits) of economic growth?

Economic Growth is usually regarded as a positive with benefits outweighing costs. However, some people argue that there can be negative aspects of economic growth

The benefits of Growth	The costs of Growth	In reality it depends on
Higher GDP implies the country is richer and living standards are higher If the economy is producing more, it is likely that more people are employed. This reduces the costs of unemployment and reduces absolute poverty If GDP is rising, the government will automatically be earning more tax revenue from existing tax rates. This may finance expenditure on more public and merit goods Supply led growth increases productive capacity so may help bring down inflation	It depends on how the EG is achieved. If it is through longer working hours, living standards may be higher. If economic growth is achieved by using non-renewable resources this will be unsustainable and will cause future economic problems Demand led growth is unsustainable and may cause demand-led growth In reality GDP may be unevenly spread between the population with the rich getting richer and no benefit to the poor	HOW the GDP rise is achieved i.e.: • Demand led or supply led? • From renewable resources or non-renewable resources • How workers are treated/workers' rights HOW the rise in GDP is distributed amongst the population

What economic policies can be used to address this?

Type of Policy	What would you do?
Fiscal Policy (Changes in Government Expenditure and Taxation)	To achieve demand-led growth: • Reduce direct and indirect taxes to stimulate AD • Increase government spending on benefits and investment to stimulate demand To achieve supply-led growth: • Reduce direct taxes to improve economic incentives to work and to invest

	• Increase government expenditure on education and training
Monetary Policy	To achieve demand –led growth: • Reduce interest rates: reduces saving; encourages borrowing; makes mortgages cheaper so increases peoples disposable income; reduces exchange rates so makes demand for exports rise • Money Supply is increased (through quantitative easing) making it easier for banks to lend to consumers and businesses to stimulate consumer demand and investment To achieve supply-led growth: • Reduce interest rates to stimulate investment by firms (i.e. borrowing to buy new, more productive capital) • Increase money supply; encourage the banking sector to lend more money to new and existing businesses to stimulate enterprise
Supply-Side Policies	Classical Approach (not government intervention) • Privatisation and deregulation of markets • Get rid of minimum wage • Get rid of benefits • Reduce bureaucratic rules and costs that businesses face Keynesian approach: Government can help to stimulate AS • More spending on merit goods like: education, training, health • More spending on infrastructure (road, rail etc.) to make it easier for firms to set up and reduce transport costs
Other	In reality, there is likely to be a mix of the policies mentioned above EU grants may also be used to stimulate development and growth in certain regions

Economic Issue 2

Achieving high employment/reduced unemployment

Definition

Unemployment is defined as the number of people who are willing and able to work, and actively seeking work, but unable to find jobs

How is Unemployment Measured?

(a) The Claimant Count: Traditionally unemployment has been measured by the number of people receiving benefits. Some people think this underestimates unemployment because some people are too proud to claim benefits or may be ineligible for some reason. Other people think it over estimates unemployment because some people work but still claim benefits (benefit fraud)

(b) The International Labour Organisation (ILO) measure: This is the same measure as used across Europe and other areas of the world so it makes international comparisons easier. The ILO measure looks at who is claiming benefits but also looks at records of whether individuals are actively seeking work (i.e. job applications)

What causes Unemployment?

Type of Unemployment	Explanation
Cyclical Unemployment	Unemployment caused by a general lack of demand across the whole economy (i.e. recession) Labour is an example of derived demand, so if there is no demand for goods there is no demand for labour to make the goods
Structural Unemployment	Unemployment caused by a lack of demand for particular industries goods. For example a lack of demand for UK coal will lead to unemployment amongst UK miners
Regional Unemployment	Unemployment that is particularly high in a given region. This has been linked to structural unemployment because when a particular industry is concentrated in one region, the demise of the industry will hit that region particularly hard
Frictional Unemployment	When people are in between jobs. There may physically be enough jobs for everyone BUT the jobs are either in the wrong area or in the wrong occupation. It takes time for people to re-train or re-locate
Classical Unemployment	Unemployment caused by Trade Unions and Minimum Wages. TU's and minimum wages have the effect of creating wages that are above the market clearing free market wage, thus causing excess supply of labour
Voluntary Unemployment	Unemployment caused when workers are unwilling to work at existing rates of pay. This is often made worse by the tax and benefit system which may make it more financially worthwhile not to work
Technological Unemployment	Unemployment caused when new capital takes over jobs that were previously done by workers, examples include: Banking; Newspaper Printing

What are the economic consequences (costs)

Costs to	What are they?
Unemployed worker	• Reduced disposable income • Low self-esteem/morale • Possibility of absolute and relative poverty • Over time lose skills and become increasingly unemployable
Business	• May be less consumer demand for their products when unemployment is high (especially if they make income elastic normal goods) • Although it may be easier and cheaper to recruit labour. Skills may be lower if labour has been out of work for a long time- may need to spend money on re-training
Government	• Tax revenue falls from both direct taxes (income tax) and indirect taxes (VAT) • Government expenditure on benefits (social protection) will rise • If the government is spending more and earning less it will contribute to a budget deficit and may require further borrowing by the government • The government may have to pay for some of the social costs of unemployment (crime)
Society	• Increased crime rates • Increased social breakdown (divorce) • Increased alcohol/drug issues • Low engagement with education if perceive it is pointless
The Economy	• Unemployment represents an unproductive use of a scarce resource (labour) • The economy will be producing less GDP than it is capable of • The longer labour is unemployed the more it deteriorates in quality

What economic policies can be used to address unemployment?

Economic Policy	How would it work?
Fiscal Policy	Government Spending would increase: • To stimulate demand via the MULIPLIER effect • On specific projects- re training; attracting firms to areas of high unemployment through subsidies Taxation would decrease • Lower levels of direct tax would increase the incentive to work and give people higher disposable incomes, thus increasing spending • Lower levels of indirect tax would stimulate demand by making prices cheaper • Lower levels of business tax allow firms to invest more money in new capital

Monetary Policy	Interest rates would decrease: • Would reduce saving and encourage people to spend, demand for goods increases demand for workers • Would encourage people to borrow to finance spending • Would make mortgage repayments cheaper, giving people more money to spend • Would make it cheaper for firms to borrow to finance investment and expansion • Would lead to a fall in exchange rates which might make UK goods more competitive and stimulate demand for exports Money Supply would increase • More money is available from the banking sector to finance consumption and investment demand
Supply-side policies	• Remove the minimum wage • Cut benefits • Lower direct taxes on workers to encourage incentives to work • Lower direct taxes on businesses • Remove unnecessary legislation and bureaucracy
Specific policies	Policies that match to specific types of unemployment are likely to be more effective. Fiscal and monetary policy will help with cyclical unemployment but will not help other types Regional: Regional Policy to attract new industries to an area Structural: As above and re-training of workers Frictional: Re-training to improve occupational mobility of labour; schemes to help workers physically re-locate- e.g. support with housing and removal expenses Classical: Reduce TU power; get rid of the minimum wage Voluntary unemployment: Reduce direct taxes (income tax); reduce benefits

Economic Issue 3

Reducing Inflation (ensuring price stability)

Definition

Inflation can be defined as a sustained rise in the general level of prices

The rate of inflation is the rate at which the general price level rises over time

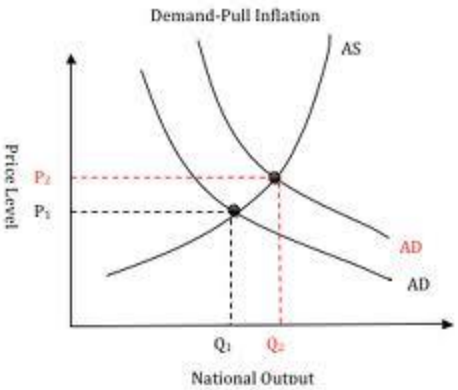
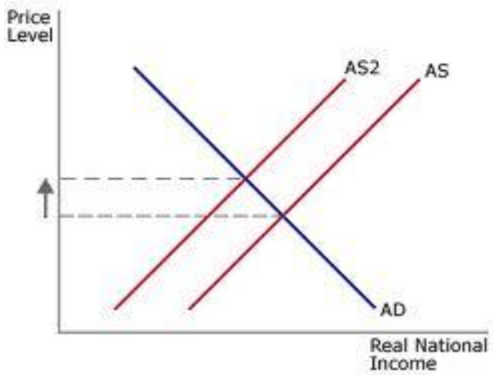
Price Stability means that the general level of prices is kept constant or grows at an acceptably low rate over time.

How is Inflation Measured?

Inflation is now measured using the Consumer Price Index (CPI) which is the same as the rest of Europe

- The government selects a "basket of goods" that represents the spending patterns of UK households.
- It then weights the goods/services according to how important they are to spending patterns
- Prices are measured at a range of outlets across the country
- Inflation is then calculated

What causes Inflation?

Demand Pull Inflation	Cost- Push Inflation
Inflation is caused when aggregate demand increases in the economy so that there is excess demand. AD may rise for a number of reasons: • Economic Boom • Tax cuts • Low interest rates • Income rises • Consumer Confidence • Business Confidence  	Inflation is caused when firm's costs of production rise. Firms put their prices up to compensate for the rising costs of production. Costs may rise because: • Oil/Petrol prices rise • Primary commodity prices rise • Wage levels increase (perhaps the minimum wage increases) • Government taxes increase • Government legislation imposes extra costs to firms 

What are the economic consequences (costs) of Inflation

Cost	Explanation
Menu Costs	Firms and the government have to spend time/money changing menus/vending machines/parking meters/published prices

Shoe-leather costs	Consumers and businesses have to spend time finding out where the cheapest prices are after a period of inflation
Income re-distribution problems	Some people gain from inflation and some people lose Gainers: People with loans; workers in strong trade unions Losers: People on fixed incomes (pensioners, people in low paid, un-unionised jobs); savers
May cause a wage-price spiral	When there is inflation, workers are worse off in real terms. This will cause them to demand a wage increase. However, a wage increase will cause a firms costs to rise again, fuelling further inflation. This cycle may continue
It makes our goods uncompetitive abroad and will damage our current account	If UK inflation is higher than other countries, our goods will be priced more highly than other goods. This will cause a reduction in the demand for our exports and an increase in the demand for imports which are cheaper
Unemployment	As a result of the above, there is less demand for UK goods. Because labour is an example of derived demand, it means that there is also less demand for labour

What economic policies can be used to address this?

Policy	**How it would work?**
Fiscal Policy	To reduce demand pull inflation • Government expenditure would be cut to reduce demand in the economy via the multiplier effect • Direct taxes would rise. This would reduce disposable incomes and deter people from spending • Indirect taxes would rise. This would increase prices and deter spending/demand To reduce cost-push inflation • Lower direct taxes on business • Lower indirect taxes that have a big impact on businesses-e.g. fuel tax
Monetary Policy	To reduce demand pull inflation • Increase interest rates: encourages saving; deters borrowing; reduces business demand for investment; raises exchange rate so may reduce the demand for exports • Reduce money supply: Makes it harder for banks to lend money to consumers and businesses To reduce cost push inflation • Lower interest rates as most firms have loans
Supply-side policies	• Remove minimum wage • Lower business taxes
Other policies	In the past prices and incomes policies have been tried. This act like a maximum price on incomes and prices. They did not really work!

Economic Issue 4

Avoiding a large current account deficit

Definition

The current account measures the amount of money the country earns from selling exports – the amount of money that is spent on imports

A current account deficit means that more money is leaving the country to pay for imports than is entering the country to pay for exports

How is Measured?

The current account is a section within the Balance of Payments. The current account looks at both goods (visible) and services (invisibles)

What causes a current account deficit

A current account deficit is caused by a lack of competitiveness of UK goods. This will be caused by a range of factors:

- High UK wage costs compared to elsewhere means UK prices are higher
- High levels of business tax in the UK increase costs and hence prices
- Historically there have been low levels of investment , innovation and productivity in the UK- this means that our goods are less good and more expensive
- A strong pound (high exchange rate) has made our exports more expensive and imports cheaper)

In addition, as you UK has got more developed and richer, this has "sucked in" imports

There has also been a rise in imports of manufactured goods as, following the process of de-industrialisation, we no longer have the capacity to produce these ourselves.

What are the economic consequences (costs)

A current account deficit is both the symptom of a problem and a cause of future problems:

SYMPTOM: A current account deficit suggests that the economy is not as productive, efficient and competitive as foreign rivals (see above)

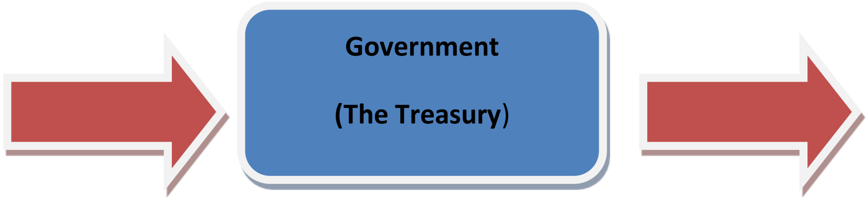
CAUSE:

- If more money is "leaking out" of the economy to pay for imports GDP will fall
- If we are buying imports and not selling exports, there will be a fall in demand for UK workers. This will cause higher UK unemployment and may contribute to absolute and relative poverty in the UK

What economic policies can be used to address this?

Policy	**How will it work?**
Fiscal Policy	**N/A**
Monetary Policy	**Interest rates will be cut. This will lead to a fall in the exchange rate, making UK goods more competitive and imports more expensive/less competitive**
Supply side policies	**Policies to reduce UK business cost: lower min wage; lower business taxes; less legislation that firms have to meet- e.g. health and safety legislation** **Policies to promote efficiency, productivity and investment**
Other specific policies	**Could use protectionism- but retaliation is highly likely!**

Explain how the Government Earns and Spends its Money



GOVERNMENT REVENUE GOVERNMENT EXPENDITURE

Government Expenditure

- Sometimes called "Public Expenditure" or "Public Spending", this is spending by the government
- The main areas of public spending are:
    - Social Protection (Benefits and Pensions etc.)
    - Health
    - Education

The main economic reasons for Government Spending

Reason	Explanation
(1) To correct market failure/provide public and merit goods	Market failure is the idea that a free market economy may fail to produce some goods and services in sufficient quantities Public goods are goods such as defence and the police. These would not be provided at all in a free market because it is impossible to stop people from having them if they don't pay ("Non excludability") For this reason, it is impossible to make profit from them Merit goods are "Good" goods such as health and education. They carry external benefits and are important for economic growth. In a free market, there would be some private sector health and education but not everyone would have access to it. A large proportion of government spending occurs because the government has to provide (and fund) the goods and services that the private sector will not produce in sufficient quantities
(2) To redistribute income	In a free-market economy there will be huge inequality of income. Those born into rich families will have access to private sector health and education and are likely to get richer and richer. On the other hand, people born into poor families will not be able to afford education and health and so are unlikely to get high paid jobs. Without benefits they are likely to face both absolute and relative poverty The government uses its finances to try to redistribute income. It does this by taxing those who can afford to pay (see later) and using this money to help the poorest. This will include:

	• Provision of benefits such as unemployment benefit and housing benefit • Provision of council houses • Government provision of health and education so that everyone has a chance to better themselves
(3) To help stabilise the economy and alter the levels of demand in the economy	The economy will go through a trade cycle. The government will use Government Spending as part of its fiscal policy to try to minimise booms and slumps/recessions. In particular the government may: • Increase government spending to stimulate demand if we are in a recession and unemployment is high • Reduce government spending to dampen demand if we were in a boom and there was too much demand pull inflation

<u>Government Revenue</u>

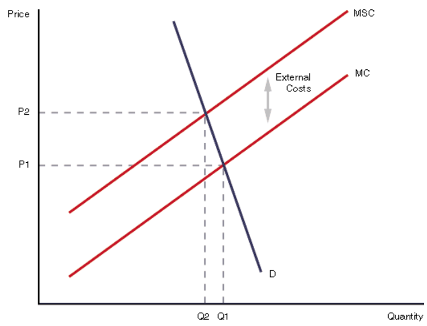
Most government revenue comes from Taxation. There are different types of taxes:

Type of Tax	What is it?	Examples
Direct Tax	A tax that is levied on a particular individual or business	Income tax National Insurance Contributions Corporation tax (tax on company profits)
Indirect Tax	A tax that is levied on a good or service	VAT Excise Duties- taxes on alcohol, petrol, cigarettes etc.

<u>Reasons for Taxation</u>

There are a number of economic reasons for taxation

Reason for Taxation	Explanation
(1) To raise revenue	Taxes provide the money necessary to fund public and merit goods
(2) To help reduce market failure. In particular, to deter the consumption and production of goods which have external costs	Some goods have external costs, these are costs imposed on a third party- e.g. passive smoking In a free-market economy, there will be over consumption and/or production of goods with external costs as individuals and firms only care about their private costs and benefits when making decisions. The government can impose a tax on a good or service in order to deter its consumption. Examples include: taxes on alcohol; cigarettes; road use In reality, taxes are often not that effective in reducing consumption because the demand for these products is price inelastic. However critics argue that the tax at least creates revenue that can be used to address the issue

	
(3) To redistribute income	As described above, incomes will be very unequally distributed in a free market economy. The government can use its tax and benefit policy to redistribute income To do this the government needs to tax those people who can most afford to pay it (progressive taxation)
(4) To stabilise the economy/alter levels of demand in the economy	Taxes are part of a government's use of fiscal policy. When demand is too high in the economy, the government will increase taxes to address this When demand is too low in the economy, the government will reduce taxes to try and stimulate the economy

<u>Different tax structures</u>

Taxes can be set up to work in different ways. A key issue is the structure of the tax.

Tax Structure	Explanation	Pros and Cons/Examples
Progressive Taxation	As your income rises, you pay a bigger proportion of your income in taxation	Pros: Fairer; can be used to re-distribute income Cons: Progressive taxes can have a disincentive effect Egs: Direct taxes like income tax can be organised so that they are progressive
Proportional Taxation	As your income rises, you pay the same proportion of your income in taxation	Pros: Fair-ish; less of a disincentive effect than a progressive tax Cons: Some would argue that the rich can afford to pay a bigger proportion of their income
Regressive Taxation	As your income rises, you pay a smaller proportion of your income in taxation	Pros: Less disincentive effects Cons: UNFAIR!!! Example: VAT (and all indirect taxes)- everyone pays the same actual amount of tax but this will vary as a proportion of their income

What sorts of tax are best for the economy?

Over the last 20 years, there has been a switch away from direct taxes and towards indirect taxes. Some people argue that this is good, and others that it is bad

	Advantages	Disadvantages
Direct Taxes	• Are often more progressive • This means that they are regarded as fairer and can be used to re-distribute income	• Direct taxes are very visible- people notice them more • High rates of direct tax can have a disincentive effect. For example someone who works hard to earn over £60K may be deterred if it means they enter a much higher tax band • High direct taxes on businesses can add to costs and contribute to UK firms being uncompetitive
Indirect Taxes	• Less noticeable to us • Have less disincentive effects therefore are less likely to affect the supply side of the economy and GDP	• Are likely to be unfair as indirect taxes are regressive

How does the government balance its budget?

It is important that the government tries to balance money coming in (Government Revenue) with money going out (Government Spending)

Balanced Budget	Government Spending = Government Revenue
Budget Deficit	Government Spending is greater than Government Revenue
Budget Surplus	Government Revenue is greater than Government Spending

If the government has a budget deficit, it will have to borrow money to finance this. It borrows money from private individuals and financial institutions within the UK and outside of the UK.

The amount of money the government borrows each year is the Public Sector Net Cash Requirement (PSNCR) The sum total of all previous borrowing that the government still has to pay back is known as the NATIONAL DEBT

Economists are divided about whether government borrowing/debt is a problem

YES!	NO!	IT DEPENDS
(1) It imposes a burden on future generations of tax payers who have to pay it back (2) If the money is borrowed from abroad, repayments involve money leaving the country	(1) Spending on merit goods will lead to a rise in GDP. If the country becomes richer, it will easily be able to repay the debt (2) A lot of money is borrowed from within the UK so when it is paid back money is not actually leaving the country	(1) On WHAT the borrowing financed (2) WHO the money was borrowed from

(3) It does not model financial prudence (living within you r means) (4) A lot of borrowing finances "dead weight" spending that brings no benefits to future generations	(3) Future generations will benefit from investment in infrastructure, education, health etc.	

The Redistribution of Income

Income is redistributed by using progressive taxation and then using this money to fund "means tested" benefits. This means benefits that you have to apply for and depend on you having very low wages/income

Some people agree with the redistribution of income and some disagree with it

Arguments for the redistribution of income	Arguments against the redistribution of income	In reality it depends on:
It relieves absolute and relative poverty If poor people are given money they spend a high proportion of it- this goes back into the economy and creates demand for goods and jobs Living standards will be increased because the poor will value the money more than the rich did	Progressive taxes have disincentive effects. They may deter people from getting jobs or working harder. This will cause GDP in the economy to be lower than it otherwise would be. This will also mean that tax revenues are lower. The poor may be better off if the economy is allowed to grow as this will provide more jobs and greater tax revenue to re-invest	HOW the income is redistributed- i.e. (a) How progressive is the tax system (b) How rigorous is the approach for giving benefits?

Correcting Market Failure

As has been seen, a key reason for both taxation and government spending is to correct market failure, particularly in relation to goods which have external costs and external benefits.

In the exam, you will need to be able to suggest and evaluate strategies for dealing with externalities

	Examples	Strategies	Factors to consider when evaluating
Goods with external costs	Car use Cigarettes Alcohol Drugs	Taxes Legislation (e.g. bans) Subsidising alternatives Advertising campaigns about the external costs	Will they work (diagrams) Cost of the policy Opportunity cost of the policy Likely price inelastic demand and implications Possible disincentive effects
Goods with external benefits	Education Health Training	Subsidies Public sector provision (e.g. in the case of health and education Advertising campaigns about the external benefits	Will it work? Efficiency Cost to the government OC to the government

What Economic Policies does the Government Use?

The main government policies are:

- **Fiscal Policy**
- **Monetary Policy**
- **Supply-Side Policies**
- **In addition the government may use specific policies**

POLICY 1
Fiscal Policy
Main Policy Tools
Government Expenditure (G) **Taxation (T)** Fiscal policy is the deliberate manipulation of G and T by the government in order to achieve its macro-economic objectives
More Information
Traditionally fiscal policy has been used to try and influence levels of demand in the economy ("demand management") Increasingly, G and T are also being used to try and influence the supply side of the economy Please see the section on how the Government raises and spends money
How does the policy work?
Please see the section on the macro-objectives/issues that the government faces
Evaluating the Policy
There are a number of problems/issues with fiscal policy: (1) There may be a time lag (2) There are trade-offs. For example using fiscal policy to stimulate demand will increase GDP and reduce unemployment BUT it may also cause demand-pull inflation and suck in imports, thus making the current account worse (3) The effect on the government budget. Expansionary fiscal policy (aimed at stimulating demand) will require increasing government spending and reducing taxes. This will contribute to a budget deficit and will require borrowing (4) High levels of tax at times of boom, may affect the supply side of the economy and will cause disincentive effects

POLICY 2

Monetary Policy

Main Policy Tools

The Money Supply

The rate of interest (the price of borrowing money)

Monetary policy is policy that deliberately manipulates the money supply and the rate of interest in order to achieve macro-economic objectives

More Information

- Interest rate policy is the main feature of monetary policy in the UK
- The main objective is to use interest rates to keep inflation to about 2%. Since 1997 it has been the responsibility of the Monetary Policy Committee of the bank of England to do this
- The MPC change the BASE RATE. This is the interest rate at which the Bank of England lends to other commercial banks. If the base rate goes up, other banks tend to put their rates up too

Interest Rates- more detail

- Interest rates are the reward to saving and the cost of borrowing- they can be seen as the price of money
- There are many different interest rates in the economy because:

❖ There are different rates between savings accounts and loan accounts. Banks make their money by charging higher interest rates on loans than they give on savings
❖ Different amounts of risk. Most banks will deter risky borrowers with high rates of interest. On the other hand safe borrowers who are perhaps longstanding customers will be rewarded by lower interest rates
❖ Competition- there are now lots of different ways to get credit from banks, building societies, supermarkets, shops- interest rates will vary according to how much competition there is for that type of loan- e.g. car loans
❖ Interest rates given on savings account will be higher if you have a bigger deposit and are less likely to take out your money (eg you don't have a debit account). This is because the bank can make a lot of money from loaning out your money! On the other hand, if you want ready access to your money you will not get such a high interest rate

How does the policy work?

Different interest rates affect aggregate demand because they affect:

- Borrowing
- Saving
- Mortgage repayments
- The cost of borrowing for firms (for investment)
- Exchange rates- a rise in interest rates will lead to a rise in exchange rates which causes a lack of demand for UK goods as they are less competitive

Evaluating the Policy

- Time lags
- Commercial banks don't always pass on base rate cuts
- Trade-offs (as with fiscal policy above)
- Link between interest rate and exchange rate means that the MPC always has to consider the effect on international competitiveness and trade

POLICY 3

Supply-Side Policies

Main Policy Tools

Supply side policies are policies that are aimed at increasing the amount of aggregate supply in the economy.

The best way to do this is to find approaches that cause an increase in the QUANTITY and QUALITY of the factors of production:
LAND
LABOUR
CAPITAL
ENTERPRISE

More Information

Classical (free market) economists believe that an important part of supply-side economics is to keep the government out of business and to create as many incentives as possible and as much competition as possible

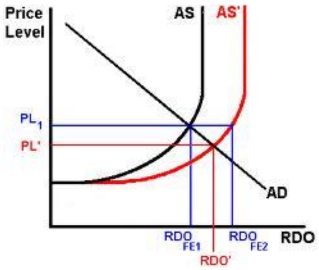
Keynesian economists believe that there is market failure. They believe that the government has a responsibility to intervene to stimulate aggregate supply in the economy

How does the policy work?

	How to increase the QUANTITY	How to increase the QUALITY
Land	Discovery of new resources	Investment in new technologies, e.g. farming methods
Labour	Reduce direct taxes and benefits so that there is more incentive to go to work	Improved education, health and training
Capital	Offer subsidies to encourage investment Lower business taxes so firms have more money to invest Create more competition (e.g. through privatisation) as this will spur on efficiency drives	Encourage more innovation and R&D- either through subsidies or by reducing the other costs businesses face (taxes and legislation such as health and safety)
Enterprise	More business loans and grants/enterprise schemes; tax allowances and relief for new businesses	Improved enterprise education in schools

Evaluating the Policy

Theoretically, supply side policies avoid the trade-offs that come with demand management policies. It is theoretically possible to achieve improvements in all 4 macro-economic variables:



However: supply side policies take a long time to implement; they are often seen as putting efficiency ahead of fairness (e.g. cutting benefits, reducing direct taxes); they may make the vulnerable more vulnerable!