Edexcel A - A Level Economics

Theme 4 – A global perspective

4.5 Role of the state in the macroeconomy

Revision Notes

Contents

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4.5.1 Public expenditure

Types of expenditure

The government doesn't just collect taxes and sit on a pile of money 🏢, it spends that money for lots of important reasons.

Government spending (aka **public expenditure**) makes up a big chunk of **aggregate demand (AD)** which is the total demand for goods and services in the economy.

🧠 **Why Does the Government Spend?**

Government spending helps manage the economy and reach key goals like:

- 🏗️ **Economic growth**
- 🔁 **Balanced trade (current account)**
- 💷 **Low and stable inflation**
- 📉 **Low unemployment**

It also supports **fairness** by providing services (like healthcare and education) to people who might not otherwise afford them. On top of that, the government can use spending to fix **market failures**, like building public goods (e.g. streetlights) or reducing pollution.

But not all government spending is the same. It's usually split into three types:

1. 🏗️ Capital Expenditure – Long-Term Investment

This is **spending on big projects and equipment** that last a long time. It's like the government investing in the future.

✅ **Examples:**

- Building a new school or hospital
- Upgrading the rail network or road systems
- Buying military jets or NHS ambulances
- Renewable energy projects like offshore wind farms

4.5.1 Public expenditure

Types of expenditure

2. 📄 Current Expenditure – Everyday Running Costs

This is the **money the government spends regularly** to keep things ticking over; kind of like paying the bills.

✅ **Examples:**

- Salaries of public sector workers (like teachers, NHS staff, or police)
- Fuel for ambulances or fire engines
- Stationery for government offices or medicine and supplies for hospitals

3. 💷 Transfer Payments – Helping People Out

These are payments the government makes **without getting any goods or services back**. They're simply transfers of money from one group to another.

✅ **Examples:**

- Universal Credit or unemployment benefits
- State pensions
- Disability benefits or housing support
- Student grants

👉 No goods or services are exchanged, it's **support, not spending on output**, which is why transfer payments **don't directly contribute to GDP**.

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4.5.1 Public expenditure

Reasons for the changing size and composition of public expenditure

Ever wonder why some governments spend more than others? Or why countries like the UK spend loads on public services while others don't? Let's see why:

💼 **1. Changing Incomes**

- In **low-income countries**, people earn less, which means the government collects less in **taxes**. Less tax = less money to spend.
- As **incomes rise**, tax revenue increases, and people start expecting **better public services** like faster broadband, cleaner beaches, or fancier libraries. These services are called **income elastic** (demand for them rises more than proportionately with income).

🧠 **Example:** A growing middle class might demand more recycling centres or upgraded local bus routes.

🚪 **2. Changing Expectations**

- Society changes, and people expect **more from their government**. This includes **how** services are delivered, like going digital (or more apps).
- When patients wanted to view their **medical records online**, the NHS had to spend loads creating the tech to make that happen.

🧠 **Example:** Today, people expect government websites to be as fast and easy as shopping online and that costs money to build and maintain.

4.5.1 Public expenditure

Reasons for the changing size and composition of public expenditure

👵 **3. Changing Age Distributions**

Countries like **Japan** and many in **Europe** face another big issue: ageing populations.

- Fewer babies are being born
- People are living longer

This means governments will have to spend **more on pensions and healthcare**, putting pressure on future public budgets.

🧠 **Example:** An 80-year-old may need more doctor visits, medicine, and home care all paid for by public funds.

💥 **4. The Global Financial Crisis of 2008**

When the financial system crashed in 2008:

- So the UK (and many other countries) spent a LOT to stop the economy from collapsing, especially on **welfare payments** to support people who lost jobs, and they **borrowed heavily** to boost spending and avoid a deep depression.
- But borrowed money must be **paid back with interest**, so after the crisis, the government had to **cut spending** and **raise taxes**. This is called **austerity**.
- From 2010 onwards, the UK followed a policy of **austerity** which means **cutting government spending** and trying to reduce national debt.
  This meant fewer new projects, budget cuts, and attempts to be "leaner" with public money.

🧠 **Example:** Some libraries were closed, and public sector wages were frozen to reduce spending.

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4.5.1 Public expenditure

The significance of differing levels of public expenditure as a proportion of GDP

Public expenditure (aka government spending) is a big deal and the amount a country spends compared to its **GDP** (Gross Domestic Product [the total value of everything made in the country]) can tell us a lot about how that economy works.

For example:

- France spent over 60% of its GDP
- UK spent around 40%
- Singapore spent less than 20%

So, why does this matter?

1. ⚙️ Productivity & Growth

Productivity is all about how efficiently we can produce goods and services, and government spending can affect this big time.

- **Gov spending** can feel wasteful, but it creates **economies of scale** (bulk = cheaper).
- It funds **infrastructure** (roads, internet) to help the economy run smoothly.
- **Education & healthcare** build **human capital.** Skilled, healthy workers = more productivity.
- Public **R&D funding** supports innovation when private firms won't.
- Spending can cause a **multiplier effect** – money spent → more jobs → more income → more growth.

🧠 Example: A new train line creates jobs, boosts tourism, and sparks local business.

4.5.1 Public expenditure

The significance of differing levels of public expenditure as a proportion of GDP

2. 🏠 Living Standards

Living standards = how well people live (health, comfort, happiness, access to goods and services). Public spending plays a big role here too.

- Gov spending can **reduce poverty**, **improve public services**, and **raise well-being**.
- It helps **fix market failures** (e.g. clean air, public transport).
- Critics argue it can **reduce efficiency** and **discourage work** if overused.
- There's the **principal-agent problem** – gov spends on behalf of people who might want different priorities.
- But in democracies, the **political system** lets the public influence spending through elections.

3. 🚫 Crowding Out

Crowding out happens when **government borrowing** leads to **higher interest rates**, which makes it harder for **businesses and individuals** to borrow money. This reduces **private sector investment** and **consumer spending**.

- In other words, there's only so much money available in the economy. So, when the government borrows more, it **competes with businesses and people**, which pushes up **interest rates**. That makes loans more expensive and can **discourage private investment**.

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4.5.1 Public expenditure

The significance of differing levels of public expenditure as a proportion of GDP

3. 🚫 Crowding Out continued…

🧠 Why Does It Happen?

- The government borrows money to fund its spending (like building roads or schools).
- This increases **demand for money**, but the **supply of money stays the same**.
- Result: **interest rates go up**.
- Businesses then face higher borrowing costs so they may **delay or cancel investments**.

💡 Example:

- Imagine the UK government borrows billions to fund a new high-speed rail project. At the same time, a tech company wants to borrow money to open a new office. But interest rates have gone up because of all the government borrowing, now the company can't afford the loan and cancels its expansion. That's **crowding out.**

💼 When Does Crowding Out Matter Most?

It matters most during **full employment** when nearly everyone is already working, and there's no extra capacity. But...

✅ If there's **high unemployment**, government spending can actually help by creating jobs and **crowding in** investment (via the **multiplier effect,** one person's spending becomes someone else's income).

💡 **Bonus Tip: Transfer payments** (like unemployment benefits or student grants) don't use up resources; they just move money around, so they **don't cause crowding out**.

4.5.1 Public expenditure

The significance of differing levels of public expenditure as a proportion of GDP

4. 💰 Level of Taxation

If a government spends a lot, it usually needs to **tax more** to pay for it. But, **high taxes** can reduce incentives to work or invest; this is called a **disincentive effect**.

However, **oil-rich countries** can afford high spending with **low taxes** because oil sales cover the cost.

🛢️ **Example:** In the UAE, oil revenues allow low-income taxes while still funding free healthcare and education.

5. ⚖️ Equality

One key goal of public spending is to **reduce inequality** and help everyone reach a **minimum standard of living**.

- The government can do this through **redistribution,** for example, using taxes to fund services that help the poorest.
- Spending on **basic goods** like education, housing, and healthcare ensures **everyone gets a fair shot**, no matter where they start in life.

🎓 **Example:** Publicly funded schools in South Korea have helped reduce the gap between rich and poor families, improving equality and economic growth.

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4.5.2 Taxation

Tax is basically how the government earns its money. It uses this to:

- **Pay for public services** like schools, hospitals, roads, and police.
- **Fix market failure** (e.g. putting extra tax on cigarettes to reduce smoking).
- **Manage the economy** (by changing tax during booms or recessions).
- **Redistribute income:** take more from the rich to help the poor.

Progressive, proportional and regressive taxes

1. 🔼 Progressive Tax

This is when people who earn more **pay a higher percentage** of their income in tax. So, the richer you are, the more tax you pay.

Example: Imagine Amy earns £30,000 and pays 20% in tax, but Ben earns £100,000 and pays 40%. This is what **income tax** in many countries (like the UK) looks like, it's **progressive**.

✅ It's seen as fairer and helps **reduce inequality**.

UK Example (2022):

Income Band	Income Range	Tax Rate
Personal Allowance	Up to £12,500	0%
Basic Rate	£12,501 – £50,000	20%
Higher Rate	£50,001 – £150,000	40%
Additional Rate	Over £150,000	45%

4.5.2 Taxation

Progressive, proportional and regressive taxes

🔍 **Worked Example**:
On a £80,000 salary:

- **First £12,500 = 0% tax**
  → You pay **£0**
- **Next £37,500 (from £12,501 to £50,000) = 20% tax**
  → £37,500 × 20% = **£7,500**
- **Final £30,000 (from £50,001 to £80,000) = 40% tax**
  → £30,000 × 40% = **£12,000**
  🧮 Total Tax = £19,500

🎓 **Other countries** like Germany and South Africa also use progressive income taxes to help reduce inequality.

2. 🔽 Regressive Tax

Here, **everyone pays the same rate**, but **poorer people feel the impact more**, because the tax takes up a bigger chunk of their income.

Most **indirect taxes** (like VAT, fuel tax, or alcohol duties) are **regressive**.

Example: VAT (Value Added Tax). Both Sarah (on £20k) and Lucas (on £80k) pay 20% VAT when they buy a phone. But for Sarah, that VAT is a much bigger slice of her income than it is for Lucas.

⚠️ This type of tax can **widen inequality**.

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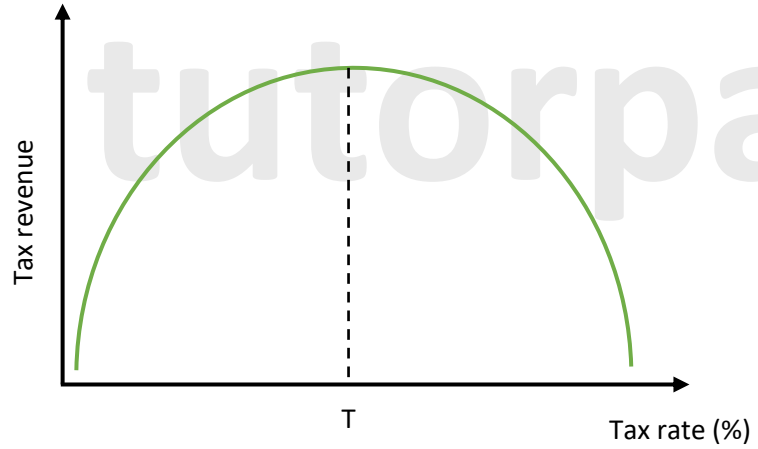
Progressive, proportional and regressive taxes

3. ➖ Proportional Tax (Flat Tax)

This is a system where **everyone pays the same percentage** of their income, no matter how much they earn.

Example: In some countries like Estonia, everyone pays 20% of their income whether they earn £5,000 or £150,000.

📌 It's simple and transparent, but critics say it **doesn't do much to reduce inequality**.



4.5.2 Taxation

The economic effects of changes in tax rates

Tax rate changes (especially **direct taxes** like income tax and **indirect taxes** like VAT) can cause ripple effects across the economy. The **bigger** the tax change, the **bigger** the impact.

1. 🎯 Incentives to work

Definition: An **incentive** is something that motivates people to behave a certain way, like working more hours or applying for a job.

What Happens?

- If **tax rates go up**, workers keep **less of what they earn**.
- This means there's **less motivation** to:
  - Work overtime
  - Apply for jobs (especially for those who are unemployed)
  - Take on extra shifts or responsibilities

🔍 **Example:** Imagine you're offered an extra shift that pays £100. If the tax rate is 50%, you only get to keep £50, not that exciting. But if tax was 20%, you'd keep £80, a lot more motivating.

What Might Happen Next?

- High earners might choose to **move abroad** to countries with **lower taxes** (aka "tax migration").
- People on low incomes might feel stuck in a **poverty trap,** where working more doesn't feel worth it because they lose benefits or pay lots of tax.

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The economic effects of changes in tax rates

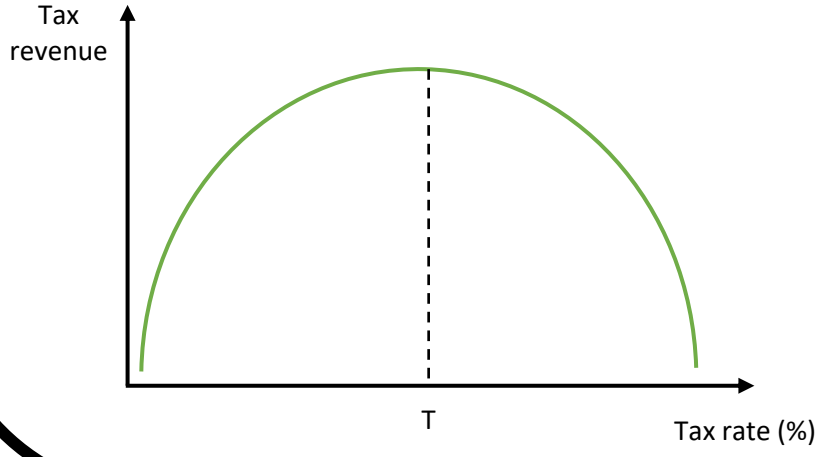
2. Tax Revenues: the Laffer Curve

What's the Laffer Curve?

- The **Laffer Curve** is a cool little economic theory that shows how changes in **tax rates** can affect **government revenue** (that's the money the government collects from things like income tax).

The Big Idea:

- When tax rates go up, the government **earns more**, right?
- Well... only **up to a point.**
- At **0 % tax** the government collects **£0** (obvious).
- At **100 % tax** nobody would bother to earn (or they'd hide the money), so revenue is **£0** again.
- Somewhere in the middle there's a **sweet spot T** where revenue is *maximised*.



4.5.2 Taxation

The economic effects of changes in tax rates

Why does revenue fall after point T?

- **Lower incentive to work** – people skip overtime, turn down promotions, or leave the workforce.
- **Tax avoidance / evasion** – clever accountants or illegal hiding reduce the declared tax base.
- **Offshore shift** – high earners or mobile firms may move profits (or themselves) to lower-tax countries.

Fresh real-world example

- **Ireland** cut its corporation-tax rate to 12.5 %. Instead of shrinking the pot, it *attracted* multinationals (Google, Apple, Pfizer) and **total corporation-tax revenue jumped**. Ireland had moved closer to its own peak T.
- Conversely, **Argentina** briefly raised export taxes on soybeans to nearly 40 %. Farmers held back crops or under-reported sales; government receipts **fell**, proving they'd slid past the peak.

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4.5.2 Taxation

The economic effects of changes in tax rates

3. 💰 Income Distribution

- A **progressive tax system** is where richer people pay a **higher percentage** of their income in tax compared to those on lower incomes. This helps reduce **income inequality** by redistributing money from the rich to the poor.
- 🧁 Example: Imagine someone earning £150,000 pays 45% in tax, while someone earning £15,000 pays nothing. That tax money can be used to support services like free school meals or public transport.
- On the flip side, a **regressive tax** does the opposite. Everyone pays the same amount (like a sales tax), but it hits poorer people harder because it takes up a bigger chunk of their income.
- 🛒 Example: VAT on food, e.g., 20% of a small grocery bill matters a lot more to someone earning £20,000 than to someone earning £200,000.
- **Corporate taxes** (tax on company profits) also shift money from wealthier shareholders to fund public services.
- **Inheritance tax** is one of the most progressive taxes as it takes a cut from wealthy estates when someone passes away and redistributes that money through government spending.
- However, tax alone doesn't directly give money to the poor, so **benefits** (like Universal Credit or housing support) are needed alongside tax to really tackle poverty.

4.5.2 Taxation

The economic effects of changes in tax rates

4. 🏭 Real Output and Employment

- Some taxes affect **aggregate demand (AD),** which is the total demand in the economy, while others affect **aggregate supply (AS),** which is the total amount of goods and services available.
- When **direct taxes** (like income tax) rise, people have **less disposable income** (what's left after taxes), so they spend less. This leads to a **fall in AD**, and possibly a fall in business investment too.
- 🎯 Example: If people cut back on holidays due to higher taxes, travel companies might lose money and stop hiring.
- **Indirect taxes** (like VAT or National Insurance) increase costs for firms. This can shift **short-run aggregate supply (SRAS)** to the left, meaning higher prices and lower output.
- Some argue that high **income taxes** make working less rewarding, especially for skilled workers. This can cause a **disincentive to work** or even push talented people to move abroad, which could shrink the **long-run aggregate supply (LRAS)** of the economy.
- ✈️ Example: A top doctor in the UK might move to Australia if they feel they keep too little of their salary after tax.

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The economic effects of changes in tax rates

5. 📈 The Price Level

The **price level** refers to the average of all prices in an economy, basically, how expensive things are overall.

- When **indirect taxes** (like VAT) go up, people have **less disposable income (**the money left after tax). Workers might then ask for **higher wages** to keep up with rising costs.

🔄 If businesses agree to the raise, this could cause a **wage–price spiral** where higher wages push prices up, and rising prices push wages up again… and round it goes.

- Businesses also face **higher production costs** due to increased taxes on things like fuel or materials. This can cause **cost–push inflation**, where prices rise because making goods gets more expensive.

🛠️ Example: If VAT rises on building materials, construction firms may charge more for home renovations.

4.5.2 Taxation

The economic effects of changes in tax rates

6. 🌎 Trade Balance (Exports – Imports)

- If people are paying more in taxes, they have **less disposable income**, so they'll likely spend less on imported goods.

📦 Example: Instead of buying a new iPhone from the US, someone might stick with their current phone.

- Because of lower spending on imports, the **trade balance** (difference between what a country exports and imports) might **improve**.

7. 🌐 Foreign Direct Investment (FDI) flows

Foreign Direct Investment (FDI) is when a company from one country sets up or invests in a business in another country, think of Toyota opening a car factory in the UK.

- If the UK raises its **corporation tax** (tax on company profits) more than other countries, businesses might decide it's too expensive to invest there.

- ✈️ Example: A US tech firm might choose to expand in Ireland instead of the UK because Ireland has lower corporate taxes, meaning higher profits for the business.

- But countries might start a **"race to the bottom"** which means cutting taxes more and more just to attract investors. This can lead to **less tax revenue** overall, which hurts public services like schools and hospitals.

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Automatic stabilisers and discretionary fiscal policy

🔁 **What are Automatic Stabilisers?**

Automatic stabilisers are **built-in government tools** that automatically help smooth out the ups and downs of the economy as it goes through the business cycle (recession, boom, etc) without needing anyone to take action.

✔ **Examples include**:

- **Taxes**: When people earn more in a boom, they pay more in income tax. This takes some money out of the economy and **slows down demand**, stopping the economy from overheating.
- **Welfare benefits**: In a recession, more people lose jobs and automatically qualify for **unemployment benefits**. This puts money in their pockets, **softening the fall in demand**.

💡 These changes happen **without any new laws or decisions;** they just work in the background. This helps keep **Aggregate Demand (AD)** from swinging wildly.

🛠 **Discretionary Fiscal Policy**

This is the government taking the wheel. It's when they **deliberately change taxes or spending** to boost or slow down the economy.

✅ **In short:**

This policy is **planned and chosen** by the government to increase or decrease **Aggregate Demand (AD),** basically how much people, businesses, and the government are spending.

4.5.3 Public sector finances

Automatic stabilisers and discretionary fiscal policy

✔ **Two types**:

- **Expansionary** (used in recessions): The government **spends more or cuts taxes** to boost economic activity.
- **Deflationary** (used in booms): The government **spends less or raises taxes** to cool things down.

🧠 Example: During the COVID-19 pandemic, governments around the world used discretionary policy by increasing health spending and providing furlough payments to workers.

🧩 **Key Difference?**

- Automatic = works by itself
- Discretionary = needs action by the government

4.5.3 Public sector finances

Fiscal deficit and the national debt

Think of the government's budget like your bank account:

📉 **Fiscal Deficit = This Year's Overspend**

A **fiscal deficit** happens when the government spends **more money than it earns in tax** in a single year.

Example:
If the UK government spends £900 billion but only collects £800 billion in taxes in 2025, that year's **fiscal deficit** is £100 billion.

🏢 **National Debt = The Running Total**

The **national debt** is the **total amount** the government owes over time, in other words, all those past annual deficits added together (plus interest).

Example:
If the government runs a £100 billion deficit every year for 5 years, the national debt builds up to **£500 billion**, assuming nothing is paid off.

🧠 **Simple Analogy:**

- 📜 Fiscal Deficit = "This year, I spent more than I earned"
- 💳 National Debt = "All the extra I've spent over many years, piled up"

4.5.3 Public sector finances

Structural and cyclical deficits

🔄 **Cyclical Deficits – Temporary Budget Gaps**

These happen when the economy hits a rough patch like a recession.

- **Why?** When people earn less and businesses make smaller profits, the government collects **less tax**.
- At the same time, **government spending goes up** (e.g. more people claim unemployment benefits).
- This gap between spending and income is a **cyclical deficit** and the good news is, it usually **fixes itself** as the economy recovers.

🛍️ **Example**: During COVID-19 lockdowns, the UK government collected less VAT and income tax but had to increase spending on furlough and support; a classic cyclical deficit.

🧱 **Structural Deficits – Built-In Budget Problems**

These are long-term deficits that **don't go away**, even when the economy is doing well and everyone's working.

- They exist because the **government's spending permanently exceeds its revenue**.
- These deficits are **harder to fix** often caused by things like poor tax systems, inefficient public services, or a culture of **tax avoidance** (where people and firms legally dodge paying their fair share).

🏗️ **Example**: A country spends a huge amount on defence, healthcare, or pensions every year but doesn't collect enough tax, this creates a structural deficit.

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Structural and cyclical deficits

📊 **Actual Deficit = Structural Deficit + Cyclical Deficit**

Think of the actual deficit as the full picture:

- The **structural deficit** is permanent unless policy changes.
- The **cyclical deficit** comes and goes with the economy.

4.5.3 Public sector finances

Factors influencing the size of fiscal deficits

🏢 **1. The Trade Cycle**

When the economy is booming (i.e. people are earning and spending), **tax revenues** go up; more income tax, more VAT, and so on. At the same time, **government spending** may fall because fewer people need help (like unemployment benefits). This helps reduce the deficit.

But during a **recession**, it's the opposite:

- Fewer jobs = lower income tax
- Less shopping = lower VAT
- More people need support = higher government spending

💡 **Result?** Fiscal deficits tend to grow in bad times and shrink in good ones.

🎯 **2. Government Goals**

Government **priorities** really matter. Some aim to cut the deficit (e.g. through **austerity** — cutting public spending to reduce the deficit), while others want to grow the economy by investing more (which may temporarily increase the deficit).

💡 **Example:** After the 2008 financial crisis, the UK government borrowed heavily to stabilise the economy. Later, it introduced **austerity**.

🌪️ **3. Unforeseen Events**

Unexpected shocks, like pandemics, natural disasters, or wars, often force governments to spend more urgently. These events are unpredictable and can suddenly push up deficits.

💡 Example: The COVID-19 pandemic led to huge spending on the NHS, furlough schemes, and emergency aid pushing deficits up fast.

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4.5.3 Public sector finances

Factors influencing the size of fiscal deficits

🏠 4. The Housing Market

When homes are bought and sold, the government collects **stamp duty** (a type of **indirect tax** on property transactions).

If the housing market is strong, lots of homes being sold, the government earns more from this tax, which helps **reduce the deficit**.

💡 **Example:** In 2021, the UK housing market boomed due to the stamp duty holiday. That meant more revenue for the government despite the tax cut.

👨‍👩‍👧 5. Population Demographics

If a country has many **dependents** (like children or the elderly), the government must spend more on things like pensions, healthcare, and education, while collecting less tax from them directly.

💡 A country with a growing elderly population may see higher spending and a bigger deficit unless more people are working and paying taxes.

4.5.3 Public sector finances

Factors influencing the size of national debts

1️⃣ Constant Borrowing (a.k.a. Fiscal Deficits)

If a government spends more money than it earns (a **fiscal deficit**) year after year, it has to borrow to make up the difference. That borrowed money adds up, creating a **national debt**.

📉 Economists generally agree that:

- If a country runs fiscal deficits over **3% of its GDP** (Gross Domestic Product), its **national debt** will grow and grow.

🧠 Think of GDP as the country's total yearly income. So, if the government is spending way more than it's earning, debt builds up, just like a credit card.

✅ The only way to shrink national debt? Run a **budget surplus,** that's when the government earns more than it spends and can use the extra to pay off debt.

2️⃣ Government Policies

🏛️ What the government decides to do with taxes and spending can have a huge impact on the debt.

💼 For example, if the government cuts corporation tax (a tax on business profits) during a time when the economy is booming, it might reduce how much money it brings in.

📈 That could increase the deficit and therefore the national debt, even though the economy is doing well.

🚀 Usually, during a boom, the debt would naturally shrink thanks to automatic stabilisers like higher income taxes and lower benefit payments. But government policy can change that.

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Factors influencing the size of national debts

3 Ageing Populations 👵👴

As more people retire, governments need to spend a lot more on pensions, healthcare, and social care.

💸 This can lead to a **structural deficit**, which is long-term and sticks around even when the economy is doing well.

📈 More older people = more spending and less tax income (because retirees don't work full-time) = bigger national debt.

🧠 Real-life example: Countries like Japan have one of the oldest populations in the world and one of the highest national debts.

4.5.3 Public sector finances

Significance of the size of fiscal deficits and national debts

The size of a country's **fiscal deficit** (when spending is more than income in a year) and **national debt** (the total of all past deficits) can seriously affect how the economy performs, especially in the long term.

Why it matters?

💳 **1. Interest Rates**

When a government borrows a lot of money, it can push up **interest rates** which is the cost of borrowing. Think of it like this: the more people want to borrow money, the more expensive it becomes to do so. If the government is also borrowing a lot, this might lead to **higher interest rates** for everyone else too. This can discourage investment by businesses and slow down the economy.

However, sometimes governments borrow from overseas or during periods when businesses aren't investing much anyway, in those cases, interest rates might stay low.

🔁 **2. Servicing the National Debt**

Paying back debt isn't free, the government has to pay **interest** on what it owes. "Servicing the debt" just means paying back the **interest** on what the country owes. For example, the UK spends around **£100 billion a year** just on these interest payments, that's a lot, but it's still small compared to the total size of the economy (**GDP**). This money could have been spent elsewhere, like on healthcare or education, so it's called an **opportunity cost**.

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Significance of the size of fiscal deficits and national debts

📈 3. Inflation Worries

A high level of debt can be tempting to "inflate away". **Inflation** means prices rise and money loses value. This can make it easier for governments to repay debt with “cheaper” money, but it also reduces your **purchasing power** (what you can buy with your money).

💡 *So while it might help the government,* it makes life more expensive for everyone else.

💳 4. Credit Ratings

Governments get **credit ratings** (like AAA, AA… to D.) based on how likely they are to pay back debt. A high level of debt might make lenders nervous and lead to a **lower rating**, which means the government will be charged **higher interest rates** when borrowing more money. But it’s not just about the size of the debt, history and political stability matter too.

🌍💵 5. Foreign Direct Investment (FDI) and Foreign Currency

If a country owes **external debt** (money borrowed from abroad), it must repay it in foreign currency (e.g., US dollars). If it doesn’t have enough, it may try to attract **FDI** (money coming in from international businesses investing in the country).

💡 *This can lead to:* Selling assets or offering incentives to foreign companies just to get enough dollars to repay debt, which may or may not be a good long-term strategy.

4.5.3 Public sector finances

Significance of the size of fiscal deficits and national debts

📜 6. Primary Deficit vs. Budget Deficit

- The **budget deficit** is how much more the government spends than it earns in a year.
- The **primary deficit** is the same but **excludes** interest payments on previous debt.

Running a budget deficit now means future generations may have to pay more tax. But if today’s deficit is used for things like building roads, schools or hospitals (called **capital expenditure**), then future generations might benefit making it more justifiable.

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4.5.4 Macroeconomic policies in a global context

Use of government policies

In today's world, countries don't exist in little economic bubbles. Thanks to **globalisation**, what happens in one economy often affects others. So, when governments try to fix problems like high debt or low growth, their success often depends on what's going on elsewhere too.

However, governments have a whole toolkit of policies they can use to solve economic problems and shape the economy. These include:

- **Fiscal policy**: Changing how much the government spends or taxes
- **Monetary policy**: Adjusting interest rates and controlling money supply
- **Supply-side policy**: Making the economy more efficient (e.g., better education or business incentives)
- **Exchange rate policy**: Managing the value of the national currency
- **Direct controls**: Setting price caps, import limits, or rules like maximum interest rates

📊 **How Effective Are Government Policies?**

The impact of **macroeconomic policies** (like changing tax or interest rates) and **direct controls** (rules and regulations) depends on the bigger global picture.

For example:

- If the global economy is booming, even struggling countries might benefit.
- But if everyone's in a downturn, national policies might not work as well — especially in smaller or developing countries.

4.5.4 Macroeconomic policies in a global context

Use of government policies

🧠 **Different Governments, Different Game Plans**

Governments don't always agree on how to handle economic crises.

Let's take the **Global Financial Crisis of 2008**:

- In the **UK**, the government first used a **Keynesian approach** — this means they boosted government spending to get the economy moving again (like bailing out banks).
- Later, they switched to **austerity** — a more cautious strategy that cuts public spending to reduce debt.
- Meanwhile, in the **USA**, the Democratic-led government also used **Keynesian policies**, like bailouts and stimulus packages, and then continued with more **expansionary policies** to keep demand high.

4.5.4 Macroeconomic policies in a global context

Use of government policies

🎯 Reduce Fiscal Deficits and National Debt

Fiscal deficit = when a government spends more than it earns in a year
National debt = the total of all the money the government owes over time

🏦 Debt Isn't Always a Bad Thing…

- Governments can borrow to **invest in the future,** like building roads or hospitals, which can boost long-term growth.
- But **unsustainable debt** is a real risk. If debt gets too big (e.g., more than 90% of GDP), it becomes harder to manage and repay. Think of it like maxing out your credit card.

Let's look at some of the ways governments can reduce their debt and deficits:

1. ✂️ Austerity: Spend Less, Tax More

Since 2010, the **UK government** has followed a policy of **austerity,** basically, spending less and trying to **increase taxes**. The idea is simple: bring in more money and spend less to shrink the deficit.

But here's the catch:

- It's **not popular** because it can hurt public services and reduce living standards.
- It might **slow down economic growth** and increase inequality.
- Free-market thinkers argue we can just **cut waste**, but it's unlikely those savings alone would make a huge impact.

4.5.4 Macroeconomic policies in a global context

Use of government policies

2. 💸 High Spending to Boost Growth

On the flip side, some argue for **demand stimulus** which means the government spends big to grow the economy. If the economy grows:

- People and businesses earn more
- That means more **tax revenue** for the government
- Eventually, this could lead to **budget surpluses** and help shrink national debt naturally

Think of it as "spend now, grow later."

3. 💰 Quantitative easing: Can't We Just Print More Money?

- Some argue: Why not just use **quantitative easing** when central banks create money to help the economy?
- While this can help in the short term, printing too much money can lead to inflation, and borrowing still might be needed for bigger investments.

4. ⚙️ Let Built-In Systems Do the Work (Automatic Stabilisers)

Automatic stabilisers are clever tools that work behind the scenes:

- When the economy slows, the government automatically pays out more in benefits (like unemployment support)
- When the economy picks up, people pay more taxes

📍 **Example**: In **Canada**, these stabilisers helped ease the impact of the 2008 crash without huge new laws or changes – unemployment benefits kicked in and taxes naturally adjusted.

This keeps the economy stable without the government having to constantly interfere.

Use of government policies

Reduce poverty and inequality

Economies don't magically make everything fair. Left on its own, the market often leaves a big gap between the rich and the poor. That's where governments step in.

1. Redistribute from Rich to Poor

Most people agree we need to shift some money from those who have a lot to those who don't but how much? That's where the debate starts.

Progressive tax systems: These are tax systems where people with higher incomes pay a bigger percentage. Think of it like this: if Alice earns £1 million, she pays more tax (percentage-wise) than Bob who earns £20,000.

- In **Japan**, inheritance tax helps stop wealth from passing down and piling up in rich families.
- **Germany** uses progressive taxes to fund its generous welfare programs.

The catch? Rich people often hire clever accountants to avoid paying more tax. So, it's tricky to enforce.

2. Government Spending – Benefits & Transfers

Governments can give direct help to people through **benefits**.

- **Universal benefits**: Everyone gets them, like child allowance or free school meals.
- **Means-tested benefits**: Only available if your income is low. Like housing assistance or food vouchers.

For example:

- **Canada** offers the Canada Child Benefit which is tax-free money to help parents raise kids.

4.5.4 Macroeconomic policies in a global context

Use of government policies

3. Providing Services Everyone Needs

Free education, healthcare, and housing help create a level playing field.

- In **Norway**, healthcare and university education are free, giving everyone a shot at success no matter their background.
- In contrast, in **the US**, many low-income families struggle with medical costs due to limited public healthcare.

4. Reducing Wage Gaps

Governments can pass laws that affect wages and workplace fairness:

- **Minimum wage laws**: Like Australia's high minimum wage helps low-income earners survive in an expensive country.
- **Worker benefits**: Employers might be required to offer pensions, sick leave, or health insurance.
- **Support for trade unions**: In countries like **Sweden**, unions negotiate better wages, especially for lower-paid workers.

5. Education and Training

Helping kids from poorer backgrounds reach their full potential is key.

- In **South Korea**, the government heavily invests in education, boosting social mobility.

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Use of government policies

Changes in interest rates and the supply of money

Central banks (like the **Reserve Bank of India**, **Bank of Japan**, or **South African Reserve Bank**) have two main powers:

- **Change interest rates** – that's the cost of borrowing money.
- **Control the supply of money** – how much cash is flowing through the economy.

They do this to help things like:

- Controlling inflation (keeping prices stable)
- Boosting jobs and economic growth
- Stabilising their currency (how strong it is against other currencies)

They usually make these changes based on what their own country needs. For example, if inflation is high, they may raise interest rates to cool down spending.

But… the world is connected!

Sometimes, central banks can't just do what's best for their own country. Why?

- Let's say the European Central Bank raises its interest rates. This could make the euro stronger compared to other currencies.
- Now the UK might worry that its currency (the pound) will become too weak making imports more expensive.
- To **stabilise the currency**, the UK might feel pressured to also raise interest rates even if it's not ideal for its economy at the time.

4.5.4 Macroeconomic policies in a global context

Use of government policies

So… who's right about money supply and inflation?

There's a big debate among economists. Here are the two main views:

The Monetarist View (Milton Friedman)

Monetarists believe:

- "Too much money chasing too few goods = inflation."

Example:
In **Venezuela**, the government printed loads of money without increasing production. Result? **Hyperinflation.** Prices doubled every few days. Buying bread became a daily struggle.

They say printing money carelessly is dangerous.

The Keynesian View

- Keynesian economists argue that inflation happens when the **economy is running too hot** (i.e., demand is higher than supply), not just because of more money.
- According to them, it's more about how much the economy is producing.

Real-World Case: Quantitative Easing (QE) in... Turkey

In recent years, **Turkey** cut interest rates and injected money to boost the economy. However, inflation soared. Prices of everyday goods jumped, and the currency weakened. This is a modern case where more money **did** lead to inflation, just as Monetarists would predict.

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Use of government policies

Measures to increase international competitiveness

When a country wants to boost its success in global trade (basically, sell more stuff abroad) it needs to become more **competitive**. Here are some tools the government can use:

1. Supply-Side Policies

These are policies designed to boost **productivity** (how efficiently things are made) and **flexibility** (how quickly businesses can adapt).

✅ Examples of supply-side actions:

- **Cutting unnecessary rules** (aka deregulation) so it's easier to start or grow a business.
- **Reducing taxes** for companies to encourage investment.
- **Improving education** and training so workers are more skilled and adaptable.

Example:
Singapore invests heavily in education and skills training, which keeps its workforce world-class and highly competitive.

2. Use of Protectionism

Protectionism means putting up trade barriers like tariffs (taxes on imports) or quotas (limits on how much can be imported) to shield local industries from foreign competition.

Example:
India has raised tariffs on certain electronics to help local tech manufacturing grow, but this can make gadgets more expensive for consumers.

4.5.4 Macroeconomic policies in a global context

Use of government policies

3. Adjust the Exchange Rate (Tweak the value of your currency)

The **exchange rate** is the value of your currency compared to others. A **weaker currency** makes exports cheaper for foreign buyers, so it can boost demand for your goods abroad.

Example:
Vietnam has kept its currency relatively low to encourage exports of electronics and textiles, helping it become a major manufacturing hub.

⚠️ But be careful. This can upset trade partners and lead to accusations of **currency manipulation**.

4. Watch Out: It's a Team Sport

The success of these policies often depends on how other countries (**your trading partners)** react. If you impose tariffs, others might retaliate.

Example:
In the U.S.–China trade war, the U.S. imposed tariffs on Chinese steel, and China responded with its own tariffs on U.S. soybeans, bad news for American farmers.

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Macroeconomic policies to respond to external shocks

💣 **1. The Global Financial Crisis (2008)**

What happened?

Banks took too many risky bets and the housing bubble burst in the US, spreading chaos worldwide.

Response:

Use **stimulus packages**, like giving money to banks or households. Lower interest rates to encourage people to borrow and spend. Increase government spending to create jobs and keep the economy going.

📍 After 2008, the US launched the "Troubled Asset Relief Program" and bailed out big banks. It helped avoid a full-blown collapse.

🌐 **2. The Global Trade War (2016–2020)**

What happened?
The US, under President Trump, imposed tariffs (taxes) on imports—especially from China. China hit back.

Response:
Countries shifted suppliers and renegotiated trade deals. Businesses paid higher prices, and many adjusted by moving production to other countries like Vietnam or Mexico.

📍 **Other example:**
India boosted its "Make in India" initiative to reduce reliance on Chinese imports.

4.5.4 Macroeconomic policies in a global context

Macroeconomic policies to respond to external shocks

GB **3. Example 3: Brexit (2016)**

What happened?

Brexit was the UK's decision to leave the European Union — a political and economic bombshell. It led to uncertainty, currency swings, and trade disruption.

Response:

Interest rates were cut to calm nerves. Later, rates were raised to fight inflation. The UK government spent over **£35 billion** on Brexit preparations, and **£3 billion** to support the economy during the transition.

😷 **4. The Covid-19 Pandemic (2020)**

What happened?
The world went into lockdown. Travel stopped. Shops shut. Health systems were overwhelmed.

Response:
Massive **fiscal stimulus** (government spending), **furlough schemes**, **vaccination drives**, and interest rate cuts.

📍 **Other example:**
New Zealand went for full elimination early on, shutting borders and avoiding the worst of the first waves.

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4.5.4 Macroeconomic policies in a global context

Measures to control global companies'

What are TNCs?
TNCs (Transnational Companies) are businesses that operate in more than one country. Think of companies like Coca-Cola, Toyota, or Nestlé; they have factories, shops, or offices scattered across the globe.

✅ **The Upside: How TNCs Help Economies**

TNCs can bring some serious benefits to a country's economy:

- **Jobs, jobs, jobs!** They often set up factories or offices, giving local people employment.
- **More money for governments** through the taxes they pay (if they pay them... more on that later).
- **Investment and knowledge sharing**, like bringing in advanced technology or training staff.

📍 Example: Samsung has factories in Vietnam and has helped boost local employment and tech skills there.

⚠️ **The Downside: TNCs Aren't Always Angels**

TNCs can also have some pretty damaging effects:

- They might **harm local culture**, **pollute the environment**, or **suck out more money** than they put in like taking profits back to their home country.
- Some are known for **pressuring politicians** to make decisions that benefit them (like lowering taxes or reducing environmental regulations).
- They often use **tax avoidance** strategies, shifting profits to low-tax countries like Ireland or the Cayman Islands to dodge higher taxes.

📍 Example: In Nigeria, oil companies like Shell have been criticised for pollution and community tensions in the Niger Delta.

4.5.4 Macroeconomic policies in a global context

Measures to control global companies'

🌍 **How Developing Countries Stay in Control**

To make sure TNCs don't just sweep in, take the money, and leave, some countries have smart rules in place:

- They use **import contracts** that say, "If you want to sell here, some of the product must be made here too."
- They ask TNCs to **form joint ventures** with local companies. That way, profits stay local and local workers learn new skills.

📍 Example: India has required companies like Apple to do local assembly if they want to avoid import taxes.

➢ 📄 **The regulation of transfer pricing**

What *is* transfer pricing?
It's when a big international company sets up lots of smaller companies it owns (called **subsidiaries**) in different countries. Then, it "sells" things between them (sometimes at *very* low prices) to avoid paying taxes where they should.

🛠️ **How Does This Work?**

- Imagine a U.S.-based tech giant operates in South Africa and extracts **rare earth minerals** (used in smartphones and electric vehicles).
- Instead of selling these minerals at market price to real buyers, it sells them *cheaply* to its own branch in Ireland, where corporate tax rates are much lower.
- The result? **South Africa loses out** on tax income, and the company makes bigger profits in a low-tax country.

📉 The local country (in this case, South Africa) gets **less tax revenue**, even though the resources came from its land.

4.5.4 Macroeconomic policies in a global context

Measures to control global companies'

💬 **A Simple Analogy**

- Let's say you're running a lemonade stand in Ghana. You sell a glass for $1 to your cousin (who lives in Luxembourg) and then your cousin re-sells it for $5 in London. You pay tax on that $1 sale in Ghana… but *most of the real profit* is hiding in Luxembourg. That's transfer pricing in action.

🌍 **A Different Example: Starbucks in the EU**

Starbucks has faced criticism in Europe for using **transfer pricing** to pay royalties (for using its own brand) to another Starbucks company in a low-tax country like the Netherlands or Switzerland.

So even though Starbucks cafés in France or Germany made good money, most of the profit "magically" disappeared meaning **little tax was paid locally**.

😬 **Why It's a Problem**

- It **hurts developing countries** that rely on natural resources for income.
- It allows companies to shift profits unfairly and **pay minimal tax** where they operate.
- It's **hard to regulate**, especially for governments that don't have strong legal systems or technical know-how.

4.5.4 Macroeconomic policies in a global context

Measures to control global companies'

🦸 **What's Being Done About It?**

- Organizations like the **OECD** and **United Nations** are helping countries create clearer rules to **stop abusive transfer pricing**.
- Countries like **India** and **Brazil** are setting up tougher tax laws, demanding multinational companies **prove** their internal prices are fair.
- And the **World Bank** is working with smaller nations to help them **negotiate better contracts** and increase transparency.

4.5.4 Macroeconomic policies in a global context

Measures to control global companies'

➢ 🌎 **Limits to government ability to control global companies**

Controlling huge multinational businesses (also known as **Transnational Corporations** or TNCs) isn't easy. These companies often have more money, lawyers, and global reach than some entire countries. But governments can try to regulate them, depending on a few key factors:

🚫 **1. The Size Mismatch**

- Imagine a small country trying to control a business that makes more money than the country's entire government! That's often the case.
- TNCs hire brilliant experts to work out the best (and cheapest) legal ways to save money, usually through **tax avoidance**, which means paying less tax without breaking the law.

🏛️ **2. Power of the Government vs. Power of TNCs**

- Some governments are strong enough to stand up to TNCs and make them follow rules.
- Others, especially in lower-income countries, struggle when TNCs threaten to pull out jobs or investment if they don't get their way.
- **Example:** In **Australia**, the government forced mining giant BHP to pay higher environmental fines. But in **Zambia**, copper mining companies have often been accused of polluting with little punishment.

4.5.4 Macroeconomic policies in a global context

Measures to control global companies'

🕵️ **3. Levels of Corruption**

- In less corrupt countries, it's easier to make TNCs follow the rules.
- **Corruption** means companies might bribe officials or cut deals under the table to avoid taxes or environmental laws.
- **Example: New Zealand** has one of the lowest corruption levels in the world, helping it hold corporations accountable. But in **Guatemala**, some TNCs have allegedly used bribes to get access to protected land.

🏗️ **4. Strength of Institutions**

- Good **institutions** like strong courts, media, and independent regulators help governments fight back when companies break the rules.
- If those institutions are weak, companies can take advantage.
- **Example: South Korea**'s fair-trade watchdog fined Samsung for abusing its market position. In contrast, some African countries with weaker legal systems struggle to sue TNCs for environmental damage.

💼 **So, What Can Be Done?**

- Solutions exist but they need global teamwork, political courage, and time.
- International groups like the **OECD** are trying to create fair rules, but big corporations often **lobby** hard to block changes they don't like.
- Meanwhile, small and developing countries continue to lose billions in potential tax revenue.

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4.5.4 Macroeconomic policies in a global context

Problems facing policymakers

1. Inaccurate Information – the data doesn't always tell the full story

Imagine trying to solve a jigsaw puzzle with pieces missing, that's what it's like making economic decisions with outdated or incomplete data. Economic info like GDP (how much a country produces), inflation, or unemployment figures often reflects what was happening *last month* or even earlier. But the economy moves fast, and past data doesn't always show where things are heading.

For example, a country might raise interest rates because inflation seems to be rising. But by the time the data comes out and action is taken, inflation may have already started falling on its own. Decisions made on outdated or unclear info can lead to poor outcomes based on wrong assumptions.

2. Risks and Uncertainties – expect the unexpected

Even if you had the perfect data, there's always the unknown. Governments can't see the future, so they never know exactly how people will respond to new policies.

Take the US–China trade tensions. When the US introduced tariffs on Chinese imports, it was clear some products would get more expensive. But what many didn't expect was the knock-on effect it had on American farmers who couldn't export their crops to China anymore. That's the kind of *unforeseen consequence* that makes policymaking tricky.

Plus, not all risks are even identifiable when a policy is made. For instance, when India announced its sudden currency demonetisation in 2016 to tackle corruption, no one anticipated just how much it would disrupt small businesses and rural economies.

4.5.4 Macroeconomic policies in a global context

Problems facing policymakers

3. External Shocks – global problems don't care about borders

External shocks are surprise events from outside the country, like a global oil crisis, a war, or a pandemic. These are out of the government's control, but they still have to deal with the consequences.

Take the 2021 global shipping crisis. A ship got stuck in the Suez Canal, and suddenly the price of everything from PlayStations to car parts went up. That wasn't part of anyone's economic plan, but it hit households and businesses hard.

Governments can't prevent these shocks, but they can try to cushion the blow. Still, the solutions aren't one-size-fits-all, and sometimes policies clash. For example, the U.S. stimulus spending during COVID helped the economy recover, but also contributed to a spike in inflation, which then required new measures to fix.

Please see the ‘4.5 Role of the state in the macroeconomy Worked Examples’ pack for exam style questions.

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