OCR – A Level Economics

Component 2 – Macroeconomics

8. Implementing policy

Revision Notes

Contents

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8.1 Fiscal policy

Introduction to fiscal policy

Fiscal Policy – The Government's Role in Spending & Taxation

What is fiscal policy?
Fiscal policy is how a government uses **spending** and **taxes** to influence how much people are buying, selling, and working in the economy (also called *aggregate demand*). It involves:

Expansionary Fiscal Policy – Pressing the Gas Pedal

Used when the economy needs a boost (for example, during a slowdown or recession).

- **How?** Lower taxes or increase government spending.
- **Why?** More money in people's pockets → more spending → more jobs → more growth.

Example: Imagine the government builds new high-speed trains. Construction companies hire more workers, who then spend their wages on food, clothes, and entertainment, giving the whole economy a lift.

Contractionary Fiscal Policy – Hitting the Brakes

Used when the economy is overheating (too much spending, rising prices, or high inflation).

- **How?** Raise taxes or cut government spending.
- **Why?** Slows down spending to keep prices under control.

Example: If prices are skyrocketing, the government might increase VAT (sales tax) so people buy less, helping cool down inflation.

8.1 Fiscal policy

Introduction to fiscal policy

The Government Budget – The Big Annual Money Plan

The budget is where the government lays out its income and spending for the year.

- **Balanced budget:** Revenue = Spending (break-even).
- **Budget deficit:** Revenue < Spending (spending more than it earns).
- **Budget surplus:** Revenue > Spending (earning more than it spends).

When There's a Deficit…

If the government spends more than it earns, it has to **borrow**.

- This is called *public sector borrowing*, and it adds to the country's *public debt*.
- Think of it like using your credit card for bills, fine occasionally, but too much borrowing can mean trouble later.

Example:

- During the **COVID-19 pandemic**, the UK government **increased spending** on healthcare and furlough schemes to protect jobs.
- If the economy **overheats** (too much demand, causing inflation), the government may **increase taxes** to slow spending.

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Macroeconomic and microeconomic impacts of fiscal policy

📈 **Macroeconomic impacts – The "Big Picture" Effects**

Definition: *Macroeconomics* looks at the economy as a whole, things like inflation, unemployment, and economic growth across the entire country.

Fiscal policy helps governments hit their **big economic goals**:

- 🌱 **Support long-term growth** – Build a stable environment so businesses can plan ahead confidently.
- 🏷️ **Keep inflation low and steady** – Avoid prices spiralling up too fast or dropping suddenly.
- 🌎 **Balance imports and exports** – Manage trade so the country isn't overspending abroad.
- 👷 **Maintain low unemployment** – Keep people in jobs and earning wages.
- 📉 **Smooth out the business cycle** – Reduce the extreme "boom and bust" swings in the economy.
- ⚖️ **Distribute income fairly** – Use taxes and benefits to reduce big gaps between rich and poor.

Example: If the economy is slowing, the government might cut taxes and boost spending on infrastructure (roads, schools, hospitals) to create jobs and get money flowing again.

Key point: A single fiscal policy decision can send ripples through the entire economy affecting prices, jobs, investment, and trade.

8.1 Fiscal policy

Macroeconomic and microeconomic impacts of fiscal policy

🛠️ **Microeconomic impacts – The "Zoomed-In" Effects**

Definition: *Microeconomics* focuses on individual households, workers, and businesses, basically, the smaller players in the economy.

Fiscal policy can tweak policies like taxes and subsidies to directly affect these smaller units:

- 💸 **Subsidies for industries** → Lower costs for producers (e.g., farmers get subsidies for equipment), making it cheaper to produce goods and encouraging higher output.
- 🚀 **Business tax cuts** → Companies may expand, hire more staff, or take bigger risks on new projects.
- 💼 **Lower income taxes** → Workers keep more of their pay, which can motivate them to work more hours or be more productive.

Example: If the government gives renewable energy companies a subsidy, it can make solar panels cheaper 🌞, increase production, and help more people switch to clean energy.

📌 **In short:**

- **Macroeconomic impact** = steering the whole economy 🚗.
- **Microeconomic impact** = adjusting the controls for individual drivers and passengers.

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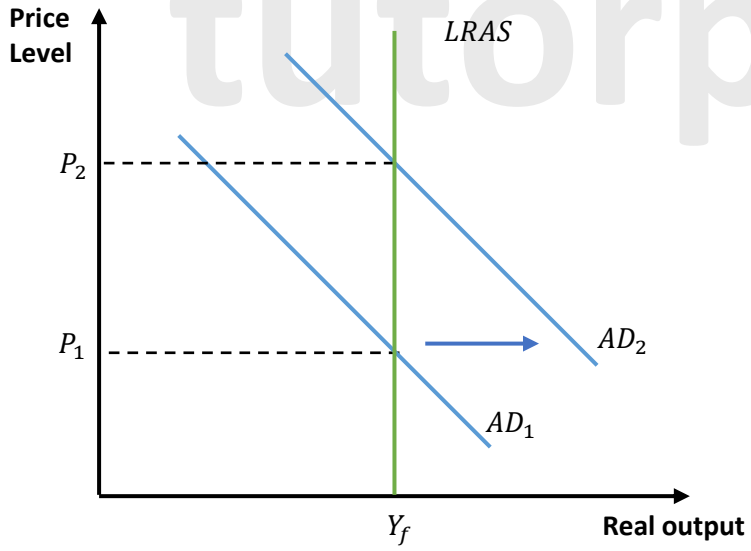
8.1 Fiscal policy

Fiscal policies influence on aggregate demand

Demand-side policies (which focus on **shifting aggregate demand (AD)** through **fiscal and monetary policies**) can help boost economic growth and reduce unemployment. However, they come with challenges, and economists **don't always agree** on their effectiveness.

Classical view

Classical economists argue that **demand-side policies only work in the short run**. They believe that **boosting AD won't increase output** in the long term but will simply cause **inflation (rising prices)**. According to them, economies naturally **correct themselves**, so it's better to focus on **supply-side policies** (like improving education, infrastructure, and business conditions).

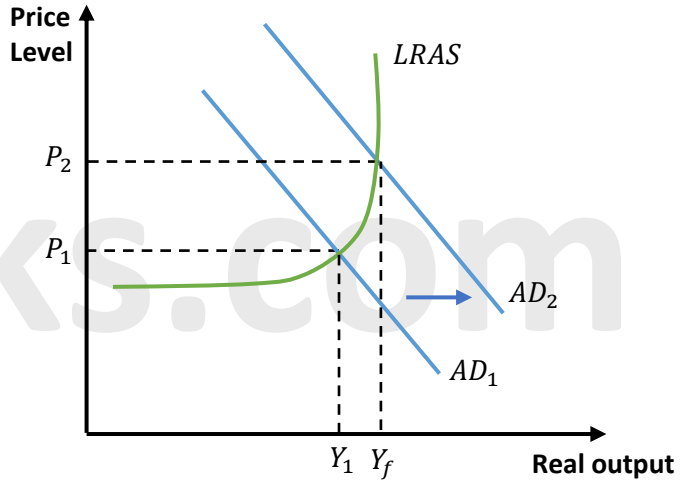


8.1 Fiscal policy

Fiscal policies influence on aggregate demand

Keynesian view

Keynesian economists argue that the **effect of demand-side policies depends on the state of the economy**:
✅ If **unemployment is high**, increasing AD **boosts output and jobs**.
❌ But if the economy is already at **full employment**, increasing AD **only raises inflation** (prices go up, but no extra goods are produced).



Expansionary and Contractionary Demand-Side Policies

Expansionary policies **increase aggregate demand (AD)** to stimulate economic growth. These are used during **recessions** or periods of **slow growth** to **reduce unemployment and encourage spending**. Done through lower interest rates, tax cuts, increased government spending and QE.

Contractionary policies **reduce aggregate demand (AD)** to **control inflation** and prevent the economy from overheating. These are used when **growth is too fast, leading to high inflation and unsustainable demand**.

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8.1 Fiscal policy

Fiscal policies influence on aggregate supply

Definition: *Aggregate supply* is the total amount of goods and services an economy can produce at a given time.
When we talk about the **supply-side** of fiscal policy, we mean policies designed to *increase* this productive potential in the long run.

How fiscal policy can help:
Some government spending might seem short-term, but it plants seeds 🌱 for long-term economic growth.

Example:

- 🎓 **Education subsidies** – If the government helps students pay for university or vocational training, it costs money *now* (short-term spending).
- But in the future, those educated workers have higher skills (known as **human capital**), meaning they can work more efficiently, invent new products, and boost overall output 🚀.

Other examples:

- 🛣️ **Infrastructure projects** – Building better roads, railways, and internet networks makes it easier for businesses to operate.
- ⚡ **Energy investments** – Funding renewable energy projects can lower future production costs for industries.
- 💊 **Healthcare improvements** – A healthier workforce means fewer sick days and higher productivity.

⏳ **Timeframe:**

- Fiscal policy actions (like setting budgets) are short-term usually planned yearly.
- But their impact on aggregate supply can last *years or decades*.

8.1 Fiscal policy

Government spending and taxation affects on economic activity

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.

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8.1 Fiscal policy

Government spending and taxation affects on economic activity

✔ **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

8.1 Fiscal policy

Types of and reasons for public 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

Types of and reasons for public 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**.

8.1 Fiscal policy

Direct and indirect taxation

Taxation is **the main way governments collect money** to fund public services like healthcare, education, and infrastructure. Taxes come in **two main types**:

1) Direct Taxes – Charged on Income & Profits

Direct taxes are taken directly from individuals or businesses **based on their income, earnings, or profits**. These taxes **cannot be passed on** to someone else – if you owe them, you **have to pay them!**

✅ **Examples:**
🔷 **Income Tax** – If you earn a salary, a portion is deducted as tax.
🔷 **Corporation Tax** – Businesses pay tax on their profits.
🔷 **Capital Gains Tax** – If you sell a house or shares for a profit, you pay tax on the gain.
🔷 **Inheritance Tax** – A tax on large estates passed down after someone dies.

2) Indirect Taxes – Charged on Spending

Indirect taxes are **charged on goods and services** rather than income. These are collected by **businesses**, which then **pass them on** to the government. **Consumers indirectly pay** these taxes when they buy things.

✅ **Examples:**
🔷 **Value Added Tax (VAT)** – A percentage added to most goods and services (e.g., in the UK, VAT is **20%**).
🔷 **Excise Duties** – Extra taxes on **alcohol, cigarettes, and fuel** (because the government wants to discourage their use).
🔷 **Sugar Tax** – Some countries charge extra on sugary drinks to reduce obesity.
🔷 **Tariffs** – Taxes on imported goods (e.g., if the UK imports American cars, a tariff may be added).

Key Differences:
💰 **Direct tax** = Paid **directly** by individuals & businesses (e.g., income tax).
🛒 **Indirect tax** = Paid **when you buy things** (e.g., VAT on shopping).

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8.1 Fiscal policy

Again 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%

8.1 Fiscal policy

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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8.1 Fiscal policy

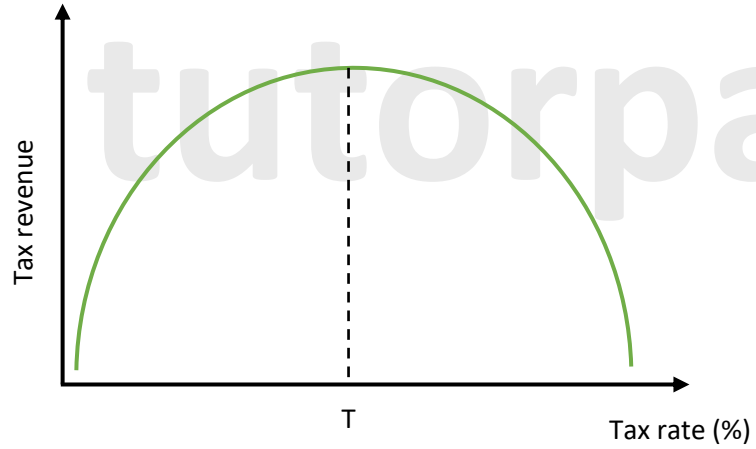
Progressive, proportional and regressive taxes

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**.



8.1 Fiscal policy

The merits of different UK taxes

Each tax has its *good points* ✅ and *not-so-good points* ❌.

1 Income Tax

Definition: A tax on the money you earn from work or investments.

✅ **Advantages:**

- **Seen as fair** – You pay based on what you earn; higher earners often pay a bigger share (*progressive tax*).
- **Can reduce inequality** – By taking more from the rich and funding support for the less well-off.
- **Easy for most workers** – Employers take it automatically from wages (PAYE system).

❌ **Disadvantages:**

- **Work disincentive** – Higher taxes might make some people less motivated to work extra hours.
- **Complex rules** – Progressive systems can be tricky to understand.

Example: If you earn £30,000, you might pay less tax per pound earned than someone earning £100,000.

2 VAT (Value Added Tax)

Definition: A tax added to most goods and services you buy.

✅ **Advantages:**

- **No impact on work effort** – It's based on spending, not earnings.
- **Hard to avoid** – Charged at the point of sale.

❌ **Disadvantages:**

- **Regressive** – Takes a bigger percentage of income from low earners, since they spend more of what they earn.
- **Can fuel inflation** – Raising VAT can make prices jump.

Example: Buy a £20 shirt? With VAT, it might cost £24.

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The merits of different UK taxes

3 Excise Duties

Definition: Special taxes on certain goods like alcohol, cigarettes, or fuel.

✅ **Advantages:**

- **Changes behaviour** – Can reduce harmful habits (e.g., smoking less).
- **Generates targeted revenue** – People who use these products pay more.

❌ **Disadvantages:**

- **Job losses risk** – If demand falls, related industries may shrink.
- **Encourages black markets** – People might seek untaxed, illegal alternatives.

Example: A high petrol tax might push people to drive less or switch to electric cars.

4 Council Tax

Definition: A local tax based on your home's value, used to fund local services like waste collection and libraries.

✅ **Advantages:**

- **Seen as fair locally** – Based on property value, so wealthier homeowners pay more.
- **Funds local needs** – Money stays in the community.

❌ **Disadvantages:**

- **Outdated valuations** – Property value "bands" often don't reflect today's market.
- **Cash-poor homeowners** – People with valuable homes but low incomes may struggle to pay.

Example: Two pensioners in a big old house may pay more than a young professional in a modern flat.

8.1 Fiscal policy

The merits of different UK taxes

5 Corporation Tax

Definition: A tax on company profits.

✅ **Advantages:**

- **Targets success** – More profitable companies pay more tax.
- **Doesn't hit smaller, struggling firms as hard**.

❌ **Disadvantages:**

- **May deter investment** – High taxes could scare off foreign investors.
- **Encourages avoidance** – Companies may move profits overseas to pay less tax.

Example: If a UK company earns £10 million, a portion of that goes to the government before paying shareholders.

8.1 Fiscal policy

Why governments levy taxes

Governments tax for several reasons:

1 **To raise money for public spending**

- The UK government spends around **£800 billion** a year on things like healthcare, schools, roads and defence.
- Most of this comes from taxes, though the government often still needs to borrow more.

Example: Your income tax helps pay for the NHS, just like council tax helps fund your bin collections.

2 **To change economic behaviour**

- Taxes can encourage or discourage certain activities.
- Lower taxes on renewable energy could get more people to switch from fossil fuels.
- Higher taxes on petrol might push people to use public transport instead.

3 **To discourage harmful products** (*demerit goods*)

- The government often taxes things that are bad for health or society (like tobacco or alcohol) to make them less attractive.
- These are called **excise duties**. Even if people don't stop buying them, the government still earns money from the tax.

8.1 Fiscal policy

Why governments levy taxes

4 **To redistribute income**

- Progressive taxes (where richer people pay a higher percentage) help close the gap between the rich and poor.
- This can reduce **relative poverty** and make society fairer.

Example: Someone earning £150k a year pays a higher rate of tax than someone earning £25k, meaning more money goes into public services.

🏷 **Hypothecated Taxes**

Definition: A *hypothecated tax* is money collected for a **specific** purpose, not just added to the general government budget.

- For example, in 1997–2001 the UK Labour government put a special **windfall tax** on certain privatised companies, using the money for job training and employment schemes.
- Governments could also tax industries that cause pollution and use that money to clean up the environment.

Pros: It's clear where the money goes, and it directly tackles the problem caused.
Cons: It can tie the government's hands; if tax revenue falls, the funding for that project also drops.

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8.1 Fiscal policy

Principles of taxation

Let's be honest, nobody likes paying more tax, so, what makes a tax "good" and fair?

The famous economist **Adam Smith** came up with a set of rules, called the *canons of taxation*, to guide this. Over time, extra principles have been added to keep them relevant today.

The 6 Principles of a Good Tax

1) Economical
The cost of collecting the tax should be low compared to the money it brings in.
Example: Income tax is deducted directly from salaries (PAYE), so it's cheaper to collect than chasing millions of small payments.

2) Equitable
Taxes should be **fair** and based on the ability to pay.

- **Horizontal equity:** People in similar situations should pay the same (e.g., two teachers on £30k should pay equal tax).
- **Vertical equity:** People who earn more should pay more.
  Example: A millionaire pays a higher tax rate than a shop assistant, making it progressive.

3) Efficient
The tax should not cause too many side effects or unintended problems.
Example: A tax that makes companies move abroad would be inefficient because it hurts jobs and growth.

4) Convenient
Paying the tax should be straightforward and not a huge hassle.
Example: Online filing for self-assessment makes it easier than sending paper forms in the post.

8.1 Fiscal policy

Principles of taxation

5) Certain
People should know roughly how much tax they'll owe and when it's due, no nasty surprises.
Example: VAT is clearly stated on receipts, so you know it's already included in the price.

6) Flexible
The tax system should be able to adapt when the economy changes.
Example: Governments can adjust fuel duty in response to oil price changes to help consumers.

In short:
A "good" tax is **fair, clear, cheap to collect, easy to pay, doesn't cause chaos, and can adapt when needed**.

8.1 Fiscal policy

The budget balance and the national debt

Definition: The **government budget** is a yearly plan showing how much money the government expects to bring in (revenue) and how much it plans to spend (expenditure).
It can be in one of three states:

📏 **Balanced Budget**

Government revenue = Government spending
Like earning £2,000 a month and spending exactly £2,000, no savings, no debt.

📉 **Budget Deficit**

Government revenue < Government spending
The government spends more than it earns, so it has to borrow the difference.
Example: You earn £2,000 a month but spend £2,200, so you put £200 on your credit card.

📈 **Budget Surplus**

Government revenue > Government spending
The government earns more than it spends, so it can save or pay off debt.
Example: You earn £2,000 but only spend £1,800, so you have £200 left over.

🏢 **What Happens When There's a Deficit?**

When the government has a **budget deficit**, it has to borrow money, this is called **public sector borrowing**.
That borrowing gets added to the **national debt;** the total amount the government owes from past borrowing (plus interest).

8.1 Fiscal policy

The budget balance and the national debt

📚 **Keynesian View**

Economist John Maynard Keynes argued that during tough economic times, governments *should* run a deficit to boost spending and help the economy grow.
Example: Building new hospitals or roads during a recession can create jobs and encourage businesses to invest.

⚠️ **The Downside**

More debt means future generations will have to help pay it off through taxes, a bit like giving your kids your old credit card bill.

In short:

- **Balanced budget** = Even.
- **Deficit** = Spending more than you earn → Borrowing → More debt.
- **Surplus** = Earning more than you spend → Savings or debt repayment.

Cyclical and structural 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.

📊 **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.

8.1 Fiscal policy

The consequences of budget deficits and surpluses

Definition:

- A **budget deficit** is when the government spends more than it earns in revenue.
- A **budget surplus** is when the government earns more than it spends.

Both can have big effects on the economy and it's important to figure out whether the economy is *causing* the change in the budget or the budget change is *causing* changes in the economy.

🚀 **Economic Growth**

- A **budget deficit** often means the government is using *expansionary fiscal policy* (spending more or taxing less) to increase **aggregate demand,** boosting short-term economic growth.
- A **budget surplus** usually means *contractionary policy;* taking demand out of the economy, which can slow growth.
- Growth itself also affects the budget: slower growth means less tax revenue and higher welfare payments, while faster growth means the opposite.

Example: During a recession, the government might spend billions on infrastructure projects 🚄 to create jobs and boost demand, even if it pushes the budget into deficit.

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8.1 Fiscal policy

The consequences of budget deficits and surpluses

Typical Mistake:
A budget deficit isn't always bad; it could be a sign of a struggling economy **or** a deliberate move to boost growth. Always check the wider economic indicators 📈 before jumping to conclusions.

👷 **Unemployment**

- Higher government spending (and a larger deficit) can create more jobs because businesses see more demand and hire more workers.
- However, some economists believe that over the long run, unemployment will return to its "natural rate" no matter what fiscal policy does.

Example: A temporary public works programme might cut unemployment sharply, but when it ends, jobless rates may climb again.

💸 **Inflation**

- **Demand-pull inflation** happens when there's too much demand chasing too few goods and prices rise.
- Expansionary fiscal policy (bigger deficits) can cause this if the economy is already near full capacity.
- A surplus (through higher taxes or lower spending) can help slow down inflation.

Example: If wages and spending are already high, a tax cut could cause prices in shops 🛒 to rise quickly.

In short:

- Deficit → Can boost growth and cut unemployment but risks inflation and higher debt.
- Surplus → Can reduce inflation and debt but risks slowing growth and raising unemployment.

8.1 Fiscal policy

The significance of the size of the national debt

Definition:

- **Budget deficit** → When the government spends more than it earns.
- **National debt** → The total amount the government owes from all past borrowing, plus interest.

When there's a budget deficit, the government has to borrow money; this is called **public sector borrowing**.
Every time it borrows, the amount gets added to the national debt.

Example: During the Covid-19 pandemic 🦠, the UK government borrowed heavily to fund furlough schemes, healthcare spending, and business support, causing the national debt to grow significantly.

📊 **Debt-to-GDP Ratio**

Definition: The **Debt-to-GDP ratio** compares a country's total debt to the size of its economy (GDP = Gross Domestic Product, or the total value of everything produced in the country in a year).
It's like comparing your credit card debt to your yearly salary; it shows whether your debt is manageable or risky.

- **High ratio** → More vulnerable, as a bigger share of the country's income would be needed to pay off debt.
- **Low ratio** → More breathing space for borrowing if needed.

Example: If the UK's GDP is £2.5 trillion and its debt is £2.5 trillion, the Debt-to-GDP ratio is 100%, meaning the country owes as much as it produces in a year.

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8.1 Fiscal policy

The significance of the size of the national debt

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**.

8.1 Fiscal policy

The significance of the size of the national debt

📈 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.

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The significance of the size of the national debt

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.

7. Crowding out

Definition: *Crowding out* happens when government borrowing makes it harder or more expensive for businesses and households to borrow money.

How it works:

1 **Government borrows**
When the government needs money, it sells **bonds** (IOUs, also called treasury bills) to investors often to people or institutions who want a safe place to put their savings.

2 **More demand for savings = higher interest rates**
Selling bonds increases the competition for available savings. Investors want a good return, so interest rates rise.

3 **Borrowing becomes pricier for everyone else**
When interest rates go up, businesses and consumers find loans more expensive.

- Firms might delay building new factories.
- Households might skip buying a home or a car.

4 **Result: Lower spending in the economy**
With less borrowing, **aggregate demand** (total spending in the economy) can fall, slowing economic growth.

Example:
Imagine there's only one big swimming pool of savings. The government jumps in and takes a large share to fund projects. This leaves less "water" for everyone else, and those who want to swim (borrow) now have to pay a higher fee (interest) to get in.

8.1 Fiscal policy

The Office for Budget Responsibility

Definition:
The **Office for Budget Responsibility** (OBR) is an independent body created by the UK government in **2010** to give unbiased, expert analysis of the government's finances.
The idea was to make it harder for politicians to change fiscal policy (government spending & tax plans) just for political gain rather than because it's the *right* economic choice.

Main Functions of the OBR

1 **Economic forecasting**

- Predicts the future state of the UK economy, with a special focus on the government's income and spending.
- *Example:* Estimating how Brexit or rising energy prices will affect tax revenues and borrowing over the next five years.

2 **Evaluating fiscal policy**

- Checks whether the government is meeting its own targets for borrowing, debt, and spending.
- *Example:* If the government promised to cut the deficit by 2025, the OBR assesses if they're on track.

3 **Sustainability analysis**

- Looks at whether the government's current financial path is sustainable in the long term.
- *Example:* Will pension and healthcare costs for an ageing population overwhelm the budget in 20 years?

4 **Assessing fiscal risks**

- Identifies threats to the government's finances, such as recessions, pandemics, or rising interest rates.

5 **Tax and welfare cost analysis**

- Works out how much new policies will cost or raise.
- *Example:* Calculating the cost of increasing Universal Credit or cutting fuel duty.

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8.2 Monetary policy

The money supply

The **money supply** is just a fancy term for the total amount of money available in an economy. But money isn't just what jingles in your pocket, it includes several different things.

Notes and Coins

These are the physical bits of money (paper notes and metal coins) that you carry in your wallet. 💡Fun fact: They make up **only about 2%** of the total money supply in the UK. So, money is mostly... not money you can touch.

🏦 **Bank Accounts**

Most of us keep our money in **bank current accounts,** these are super convenient for things like:

- Using your debit card at a shop
- Taking cash out of an ATM
- Paying bills online or via direct debit

This money still counts as part of the money supply because it can be spent almost instantly.

🚫 **Typical Mistake**

A lot of people think there's a bar of gold sitting in the Bank of England for every pound in your bank account.
🚨 Not true. We left the gold standard behind ages ago. Today's money isn't backed by gold; it's backed by trust in the system.

8.2 Monetary policy

The money supply

🏢 **What about Savings & Building Societies?**

- **Savings accounts** may also be counted as money, but some of them make it harder to access your cash quickly.
- **Building societies** are like banks – they hold your deposits and help you pay or borrow money. Many big banks actually started off as building societies.

📈 **Other Financial Assets**

There are things that *feel* like money (such as **shares**, **bonds**, and **treasury bills)** because they can be sold for cash. But they're **not quite money**, because:

- They aren't always easy to turn into cash without losing value
- They may take time to sell

So, economists usually don't count them in the main money supply... but they do keep an eye on them.

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The money supply

📊 **Narrow vs Broad Money – What's the Difference?**

To make things easier, economists split money into two main groups:

1. Narrow Money

This includes:

- Notes and coins
- Bank and building society accounts that you can access easily (like your current account)
- 🛍️ This is the money you can spend right now!

2. Broad Money

This includes:

- Everything in narrow money
- Plus, savings accounts and other deposits held at banks and building societies

🏢 This shows a fuller picture of all the money that exists in the economy, even if it's not always ready to spend immediately.

🧠 **Why Does This Matter?**

Central banks (like the Bank of England) use this info to:

- Judge how much spending and borrowing might happen
- Decide whether to raise or cut interest rates
- Manage inflation and economic growth

8.2 Monetary policy

The money supply

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8.2 Monetary policy

Main functions of a central bank

Central Banks are the **guardians of the financial system**. They help keep the economy running smoothly, protect your savings, and even play a part in how expensive your shopping trip feels each month.

Let's look into their 4 main roles:

1. 💰 Implementation of Monetary Policy

Monetary policy means managing interest rates and the money supply to keep things like inflation, unemployment, and growth under control.

- If prices are rising too fast (**inflation**), the central bank can raise interest rates to slow things down.
- If the economy is slowing down, it can lower rates to encourage borrowing and spending.

🧠 **Example:** If the central bank like the Bank of England (BoE) increases interest rates, your loan becomes more expensive but saving money earns you more interest. That's monetary policy in action. During COVID-19, like the BoE cut interest rates to near 0% to keep money flowing.

2. 🏛 Banker to the Government

The government has its own massive "bank account" with the central bank. This bank:

- Manages all **tax income and government spending** (like paying teachers or NHS staff).
- Holds **foreign currency reserves** and even **gold**.
- May lend money to the government by buying its bonds (aka public debt).

8.2 Monetary policy

Main functions of a central bank

3. 🏢 Banker to the Banks – Lender of Last Resort

Commercial banks (like HSBC or Barclays) can get into trouble if they suddenly don't have enough cash; this is called a **liquidity problem**.

Luckily, the central bank is their **backup plan**.

- It can lend money to keep banks afloat.
- It stops one bank's failure from causing a domino effect and crashing the entire system.

Why this matters:
If a big bank fails, it could cause chaos as people might lose savings, businesses could collapse, and confidence in the system would drop like a stone.

📉 **Example:** In the 2007-08 Financial Crisis, central banks stepped in to stop banks from collapsing when their mortgage-backed assets lost value.

4. 🛡 Role in Regulation of the Banking Industry

The financial system can be risky if left unmonitored. Central banks **set rules to stop dodgy behaviour**, protect consumers, and avoid another crisis.

They watch over:

- How much money banks must keep in reserve (**liquidity ratios**)
- Banning scammy or super risky products
- Stopping **market rigging**
- Ensuring fair access to loans and banking services

One big tool:
They use **reserve ratios** [rules on how much money banks must keep in reserve (and not lend out)].

- **Higher ratio = less money flowing in the economy**
- **Lower ratio = more money flowing**

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8.2 Monetary policy

The objectives of monetary policy

Definition:
Monetary policy is all about how a country's central bank controls the **cost** and **availability of money** in the economy. It's like the thermostat for the economy, turning the heat up or down depending on what's needed.

Key tools include:

- **Interest rates** – The percentage charged for borrowing money or earned on savings.
- **Money supply** – How much money is flowing around the economy.
- **Availability of credit** – How easy or hard it is to borrow money.
- **Exchange rate** – The value of your country's currency compared to others.

In the UK:
The Bank of England takes the lead on monetary policy. Since 1997, it has been mostly independent, meaning politicians don't get to directly set interest rates, although the government still gives it targets and can step in during emergencies (like the 2008 financial crisis).

Objectives of Monetary Policy – The Game Plan

The UK's **main aim** is to keep inflation (the general rise in prices) at around **2% per year** (give or take 1%).

- Inflation is measured by the **CPI** (Consumer Prices Index), which tracks how much everyday goods and services cost.

Why 2%?

- Too high = your money loses value quickly.
- Too low = risk of stagnation or deflation (falling prices).

The Bank of England's Monetary Policy Committee meets every month to decide whether to raise, lower, or keep interest rates the same to hit that inflation target.

8.2 Monetary policy

The objectives of monetary policy

Other important goals:

- Keep people in jobs (low unemployment).
- Support steady economic growth.
- Make sure the financial system is stable.

💡 **Fun Example:**
If the economy is "too hot" (prices rising too quickly), the Bank might raise interest rates, making loans for things like cars or houses more expensive, so people spend less, and prices cool down.
If the economy is "too cold" (slow growth or falling prices), it might lower interest rates, making borrowing cheaper to encourage spending and investment.

While interest rates do change how much you earn on savings, in economics the bigger deal is **how they affect borrowing costs**. Cheaper borrowing can speed up the economy; expensive borrowing can slow it down.

Limitations of Monetary Policy

1. 🏦 Banks might not "play along": Even if the **central bank cuts the base rate** (the official interest rate), commercial banks don't always pass this saving on to customers. Example: The Bank of England cuts interest rates to 1%, but your bank still charges 6% for a loan because it wants to protect its profits. The central bank's decision loses some of its power.

2. 🛍️ Confidence is key: Even with rock-bottom interest rates, people and businesses won't spend if they don't **feel confident** about the economy. Example: If you think you might lose your job soon, you're unlikely to buy a new car — even if borrowing is cheap. Same for firms: they won't invest in new factories if they think customers won't buy their products.

3. 💰 Cheap borrowing doesn't always mean easy borrowing: Sometimes, even if interest rates are very low, **banks may not want to lend**. After the **2008 financial crisis**, banks became super cautious (risk-averse). They didn't want to hand out loans to people or businesses who might not pay them back.

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8.2 Monetary policy

The Monetary Policy Committee (MPC)

Definition:
The **Monetary Policy Committee (MPC)** is a group within the Bank of England that decides the UK's **interest rates**. Their main goal is to keep inflation at a healthy, stable level.

🔍 What the MPC Thinks About Before Changing Rates

Before deciding whether to turn the interest rate dial up or down, the MPC looks at a variety of clues about the economy, such as:

- 🛒 **Consumer spending** – Are people shopping or saving?
- 👷 **Jobs market** – Are people finding work easily or struggling?
- 🏭 **Business investment** – Are companies building, hiring, and expanding?
- 🛢️ **Commodity prices** – Are oil, gas, and food prices rising or falling?
- 💼 **Government spending & taxes** – Is the government boosting or slowing the economy?
- 💱 **Exchange rate** – Is the pound strong or weak compared to other currencies?

⚖️ How They Decide

The MPC predicts what the economy might look like over the next **two years**.

- If inflation looks set to **rise too much**, they might **increase interest rates**.
  - Higher rates make borrowing more expensive and saving more rewarding → people spend less → demand cools down → prices rise more slowly.
- If inflation looks set to **fall too low**, they might **cut interest rates**.
  - Lower rates make borrowing cheaper and saving less attractive → people spend more → demand rises → prices increase.

8.2 Monetary policy

The Monetary Policy Committee (MPC)

Example – Raising the Bank Rate

Imagine the Bank of England increases interest rates:

- 💰 **People save more** – because savings accounts pay better interest.
- 🏠 **Mortgage payments rise** – especially for those on variable rates.
- 💳 **Borrowing costs go up** – buying a car or taking out a loan becomes pricier.
- 🏭 **Businesses invest less** – as loans for new projects cost more.
- 💷 **The pound gets stronger** – making UK exports pricier abroad but imports cheaper.

All of this leads to **lower demand in the economy**, which can reduce inflation, but it may also slow growth and increase unemployment.

Rising rates shift the demand curve left (AD1 → AD2) ↔ price levels drop, but output (GDP) falls too.

⏳ The Time Lag

Interest rate changes are **not instant magic**. It can take **12–24 months** for the effects to ripple through the economy.
This is called a **time lag;** the MPC has to think ahead like chess players about where inflation will be in the future.

8.2 Monetary policy

The effect of interest rates

Sometimes, using **interest rates** (the cost of borrowing money, set by the central bank) to fight inflation can cause problems elsewhere in the economy.
When interest rates go up, people and businesses tend to spend less; this is called **lower aggregate demand** (the total spending in the economy).

But with lower spending, we also get side effects:

- 🐢 **Slower short-term economic growth** – Less demand means the economy grows more slowly.
- 💸 **Lower tax revenue** – With less economic activity, the government collects less in taxes.
- 📉 **More unemployment** – Fewer purchases mean fewer sales, so businesses may cut jobs.
- 🏭 **Weaker supply-side growth** – Businesses invest less in new machinery or technology, limiting long-term productivity.
- 🌎 **Fewer exports** – Higher interest rates often push up the currency value, making UK goods more expensive abroad.

⚠️ **Limitations of Interest Rates in Controlling the Economy**

While raising interest rates is great for cooling spending, it's less effective for stopping **cost-push inflation** (price rises caused by higher costs like oil prices or imported goods).

For example: In 2012, UK inflation went above 5% because oil prices and the cost of imports shot up. The Bank of England didn't raise rates because it wouldn't have fixed the real problem.

8.2 Monetary policy

The effect of interest rates

Other limitations include:

- 🚫 **Low-rate limits** – If rates are already low, you can't cut them much more.
- 🤷 **Uncertainty** – We can't always predict exactly how people will react.
- 📏 **Small changes = small effects** – Most rate changes are tiny (like ±0.25%), so they may not be enough.
- ⏳ **Time lag** – Changes can take 12–24 months to fully affect the economy.

🌐 **Interest Rates and the Exchange Rate**

Changing interest rates also affects the **exchange rate** (how much a currency is worth compared to others).

- If UK interest rates rise, investors from around the world may want to put their money here to earn more interest. This demand for pounds pushes the value of the pound up.
- A stronger pound means imports become cheaper 🛒, which helps reduce inflation.
- But… UK exports become more expensive for other countries, which can hurt British businesses selling abroad.

Fun fact: This flow of short-term investment money chasing higher interest is sometimes called **"hot money"** 🔥.

Typical Mistake to Avoid:
People often assume the exchange rate will only change after interest rates go up. In reality, markets often *expect* changes and adjust early, so the pound's value can rise *before* the actual rate change.

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Impacts of exchange rate on AD and macroeconomic policy objectives

First, what's an **exchange rate**?
It's the price of one currency compared to another. For example, if £1 = $1.20, that's the exchange rate.

Changes in the exchange rate (whether caused by interest rate changes or other factors) can affect the economy in lots of ways:

- 📈 **When the exchange rate rises** (the pound gets stronger), UK exports become more expensive abroad, making them less competitive. For example, British cheese might cost more in France, so fewer people there buy it.
- 📉 **When the exchange rate falls** (the pound gets weaker), UK exports become cheaper abroad, which can boost demand and create more jobs in industries like manufacturing and tourism.
- 💸 A weaker pound also makes **imports** (goods bought from abroad) more expensive. If we import electronics, clothes, or oil, prices could rise, which can cause **inflation** (general rise in prices).
- ⚖️ **Unstable exchange rates** (big ups and downs) make it hard for UK exporters to plan production. For instance, a car manufacturer selling overseas might not know how much money they'll actually make after converting sales back into pounds. This uncertainty can also put off foreign buyers unless UK companies absorb the cost by cutting into their profits.

8.2 Monetary policy

Impacts of exchange rate on AD and macroeconomic policy objectives

💡 **Typical Mistake to Avoid:**
A weaker pound makes imports more expensive, but that doesn't mean UK shoppers will instantly stop buying them. In the short run, people often still buy their favourite imported goods, even at higher prices. For example, someone who loves Italian coffee might still buy it, even if it costs 20p more per cup.

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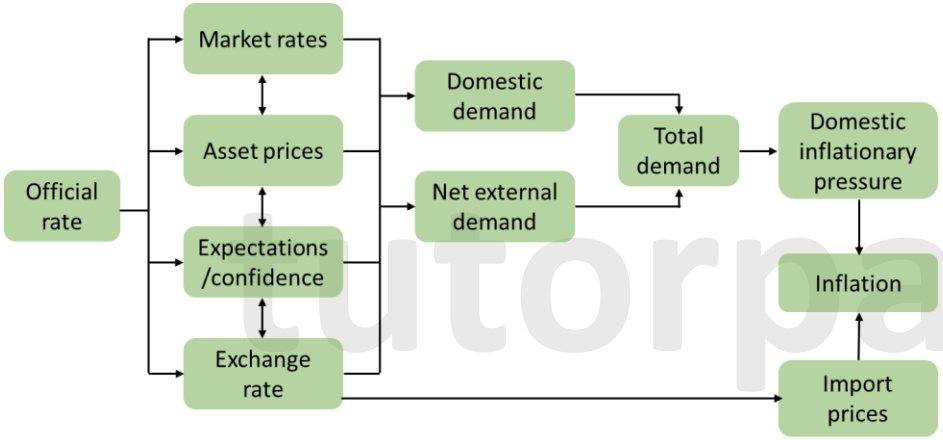
8.2 Monetary policy

The monetary policy transmission mechanism

Monetary policy = how the central bank (in the UK, the Bank of England) uses tools like **interest rates** to influence spending, borrowing, and inflation in the economy.
Think of it as a chain reaction: change one thing (like the official interest rate) → lots of other things shift in response → the economy speeds up or slows down.



📊 **How it works (step-by-step):**

When the **Bank of England's Monetary Policy Committee (MPC)** changes the **official interest rate**:

- **Banks change their rates** 💳
  Within hours or days, banks adjust the rates they charge borrowers (loans, mortgages, credit cards) and the rates they pay savers.
  - Higher rates → borrowing is more expensive (less demand for loans) and saving is more rewarding.
  - Lower rates → borrowing is cheaper (more spending) and saving looks less attractive.

8.2 Monetary policy

The monetary policy transmission mechanism

- **Asset prices react** 📈
  Things like shares, bonds, and house prices can shift.
  - If rates go up, bond prices usually fall.
  - Falling asset values can make people feel "poorer", so they might spend less (called the **wealth effect**).
- **Confidence changes** 😕
  Expectations matter. If people think higher rates mean tougher times ahead, they might spend less. If rates are cut, they might feel more optimistic and splash out.
- **Exchange rate moves** 💸
  Higher rates can attract foreign investors chasing better returns (**hot money**), making the pound stronger. A stronger pound makes UK exports more expensive abroad and imports cheaper.
- **Domestic demand shifts** 🏠
  For example, households with variable-rate mortgages will see payments change; higher rates mean bigger monthly bills, leaving less money for other spending.
- **Business investment changes** 🏭
  If it costs more to borrow, fewer businesses will invest in new projects. Lower rates can encourage expansion.
- **Export & import prices change** 🚢
  Exchange rate movements affect trade; stronger pound = more expensive exports (less competitive) but cheaper imports.

The term **stance** describes the overall "mood" of monetary policy:

- **Expansionary stance** → encouraging growth (lower rates, cheaper borrowing).
- **Contractionary stance** → slowing growth (higher rates, discourage borrowing).

⏳ **Time lag warning:**
It can take up to 2 years for the full effects of a rate change to ripple through the economy. So, the MPC must think ahead, like steering a cruise ship, not a speedboat.

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8.2 Monetary policy

The Bank of England and the money supply

The **money supply** = all the money circulating in the economy (notes, coins, and bank deposits).
If the money supply grows too fast, it can cause **inflation** (prices rising quickly). If it shrinks too much, it can signal an economic slowdown or even a recession.

The **Bank of England** can't directly control every pound in circulation, but it *can* influence it through tools like interest rates. Lower interest rates usually make borrowing more attractive (people and businesses take out loans, spend more), while higher rates slow borrowing and spending.

Aside from changing rates, the Bank also has other tricks up its sleeve to keep the economy stable and encourage growth. Let's discuss them 👇

💷 Quantitative Easing (QE) – AKA "Boosting the Economy When Rates are Stuck"

Definition: Quantitative easing is when the Bank of England creates new money to buy government bonds or other assets from investors.

Why do it?

- It gives investors extra cash, which they might spend on other investments, like buying company shares or lending to businesses.
- It makes borrowing cheaper and encourages spending.

Example:
The Bank buys £50 billion worth of bonds from insurance companies. Those companies use the cash to help fund a massive renewable energy project, hiring thousands of workers and boosting spending in the economy.

Fun fact: QE was introduced in the UK in 2009 after the financial crisis, when interest rates were already super low and couldn't be cut much further.

8.2 Monetary policy

The Bank of England and the money supply

💡 Funding for Lending Scheme (FLS) – "Helping Banks Help You"

Definition: A scheme launched in 2012 to make it easier for banks to lend money to people and businesses.

How it works:

- Banks swap assets (like loans they've made) with the Bank of England for **Treasury bills** (safe, short-term government IOUs).
- Treasury bills can be used to borrow more money cheaply from other markets.

Why it matters:

- Cheaper funding for banks = more incentive to lend at low rates.
- Helps boost business activity and consumer spending.

Example: If a bank can borrow at 0.5% instead of 3%, it might offer small business loans at 2% instead of 5%, encouraging more businesses to invest and grow.

📣 Forward Guidance – "Telling the Future… Sort Of"

Definition: When the Bank of England tells everyone what it *plans* to do with interest rates in the future, to help guide borrowing and investment decisions.

Why it matters:

- If people know rates will stay low, they might be more confident about taking a mortgage or investing in their business.
- It reduces uncertainty, which encourages spending.

Example: The Bank says, "We won't raise interest rates for at least 18 months." A tech company hears this and decides it's the perfect time to take out a loan to build a new office, knowing repayments will stay manageable for a while.

Liquidity and capital ratios

Back in 2007, the world had a big financial mess (a.k.a. the global financial crisis). One major lesson we learned? Banks can't just take wild risks without having a safety net.
Now, banks must meet *capital* and *liquidity* requirements, basically, prove they have enough resources to survive sudden money problems (think of it like carrying an umbrella just in case a storm hits ⚡).

💧 **Liquidity Ratio – Your "Rainy Day" Readiness**

Definition: The liquidity ratio measures how easily a bank can get its hands on cash to cover short-term needs.
It compares what the bank *could quickly turn into cash* (like cash in the vault or money in very safe investments) to what it *owes soon* (like customer withdrawals).

💡 **Example:** Imagine you run a café. You have £1,000 in your cash register and £2,000 worth of milk, coffee, and sugar in stock (easy to sell if needed). If you owe your suppliers £2,500 next week, your liquidity ratio tells you whether you can pay them without borrowing money.

✅ A higher liquidity ratio = the bank is more ready for sudden "cash now" situations.

💎 **Capital Ratio – The Bank's Safety Cushion**

Definition: The capital ratio measures how much of a bank's own money (profits, reserves, or money raised from selling shares) it has compared to how much it has lent out or invested.

💡 **Example:** If your friend borrows your bike, you'd feel safer if you have a spare bike at home. That spare is your *capital cushion*. In banking, it means if loans go bad, the bank has its own funds to absorb the losses without collapsing.

✅ A higher capital ratio = the bank can handle more bad-loan "oopsies" without needing a bailout.

8.2 Monetary policy

Liquidity and capital ratios

Continue to the next page…

8.3 Supply side policy

Supply-side policies and supply-side improvements

Supply-side policies are all about making an economy better at producing things in the long run. Imagine giving the economy a "productivity upgrade" like installing faster machinery, smarter workers, and smoother processes so more goods and services can be made.

Economists call this pushing out the **long-run aggregate supply (LRAS),** basically, the economy's maximum output if everything is running efficiently. Supply-side policies try to push this limit further out.

There are **two main flavours**:

- **Free market policies** – where the government steps back, letting businesses and competition do the heavy lifting.
- **Interventionist policies** – where the government jumps in to help directly.

Supply-side Policy vs. Supply-side Improvements

- **Supply-side Policy** → The *rules and support systems* set by the government to make production easier (like building a new highway (capital) or funding coding bootcamps (labour)).
- **Supply-side Improvements** → The *upgrades and innovations* businesses make themselves (like a bakery buying a bigger oven or a delivery company switching to electric vans).

8.3 Supply side policy

Supply-side policies and supply-side improvements

Objective

- **Policy:** Create an environment where the *whole economy* can grow steadily and compete internationally .
- **Improvements:** Make individual firms or industries more efficient, higher quality, and more competitive .

Examples

- **Policy:**
  - Cutting business taxes so firms invest more.
  - Building faster internet across the country .
  - Funding renewable energy projects .
  - Paying for more nurses and doctors to improve healthcare .
- **Improvements:**
  - A car company switching to AI-powered assembly lines .
  - A farm using drones to monitor crops .
  - A cafe launching a slick online ordering app .

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8.3 Supply side policy

Supply-side policies to improvement the economy

Supply-side policies = policies designed to make the economy more productive ⚙️.
These policies shift the **long-run aggregate supply (LRAS)** curve outward 📈 → meaning the economy can produce *more stuff* with the same resources. Let's see how this plays out…

🎞️ Effect on GDP

GDP (Gross Domestic Product) = the total value of goods and services produced in a country.

When supply-side policies are successful, the economy can produce *more output*, meaning higher GDP.

- Example: If the UK builds faster internet nationwide 🌐, businesses can operate more efficiently → boosting production and GDP.
- But remember: GDP growth also needs **aggregate demand (AD)** (the demand for goods/services) to rise, or else that new capacity goes unused.

📉 Effect on Inflation

Inflation = the rate at which prices rise.

Supply-side policies can help lower inflation by making production cheaper and more efficient:

- 🏭 **More capacity** → the economy can handle more demand without prices spiking.
- 🏎️ **More competition** → harder for firms to keep prices high, as customers can switch to cheaper alternatives.
- 💼 **Union reforms** → less upward pressure on wages, meaning lower cost-push inflation.
- Example: Cheaper renewable energy 🌞 reduces production costs, lowering prices in the long run..

8.3 Supply side policy

Supply-side policies to improvement the economy

🌎 Effect on Balance of Payments (Current Account)

Balance of payments = a record of trade (exports vs imports).

Supply-side policies can make exports more competitive:

- 📉 **Lower costs** → UK goods/services become cheaper abroad → more exports.
- 👷 **Skilled workforce** → better quality products = more global demand.
- 🏫 **Investment in education/training** → creates innovation → e.g. world-class UK tech exports 💻.
- Example: If UK firms produce high-quality green tech 🌱⚡, demand abroad increases, improving the trade balance.

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8.3 Supply side policy

Supply-side policies to improvement the economy

Effect on Unemployment

The **natural rate of unemployment** is the level of unemployment that exists even when the economy is doing well. It happens because of things like:

- **Frictional unemployment**: when people are between jobs (e.g., a teacher quits and takes a few months to find another school).
- **Structural unemployment**: when workers don't have the right skills for new industries (e.g., a coal miner struggling to find work in a renewable energy economy).

✅ **Supply-side policies** can help reduce this "natural" level of unemployment by making the job market work more smoothly:

- **Lower taxes on income** → gives people more incentive to actually work rather than stay out of the workforce.
- **Better education & training** → helps workers gain skills to switch careers or adapt to new industries.
- **Research & development subsidies** → can create brand-new industries (think AI, green tech) that provide fresh jobs.
- **Less generous unemployment benefits** → encourages people to take jobs sooner instead of waiting for the perfect one.
- **Improved infrastructure (like transport & broadband)** → makes it easier for people to move to where jobs are.

If unemployment falls, the country's **national income** rises, meaning more money in the economy, stronger growth, and less risk of inflation getting out of control.

In the UK, the natural rate of unemployment is around **5%** (a few people will *always* be between jobs). In some EU countries, it's higher.

Supply-side policies don't magically "fix" unemployment. Instead, they create the right *conditions* (like better training and lower barriers) so that other policies can help reduce it.

8.3 Supply side policy

Free market supply-side policies

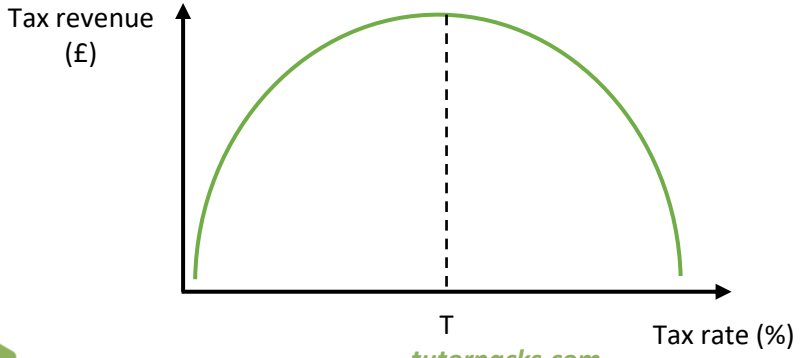
Free market supply-side policies are all about *removing barriers* that stop the economy from working smoothly and efficiently. Think of it as "decluttering" the economy so businesses, workers, and consumers can perform at their best. These policies usually focus on:

- Cutting **taxes**
- Reforming the **labour market**
- Reducing **government control** (privatisation & deregulation)

1. Income Tax Cuts & Work Incentives

- **Income tax** = the percentage of your wages the government takes to fund public services.
- Lower taxes mean workers keep more of what they earn → making work more attractive.
- This can encourage people to work longer hours or even enter the workforce if they weren't working before.

Example: 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).



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8.3 Supply side policy

Free market supply-side policies

🧠 **The Laffer curve explained:**

- 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*.

But caution: if taxes are already low, cutting them further may not change behaviour much. For example, dropping from 20% to 19% probably won't make someone suddenly work double hours.

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.

Real-World Context

- Over the past 30 years, the UK has gradually shifted taxes from **direct taxes** (like income tax) towards **indirect taxes** (like VAT on goods and services).
- There's also been an increase in **tax-free allowances** (the amount you can earn before paying tax), which helps low-paid workers.

8.3 Supply side policy

Free market supply-side policies

2. 🛠 Reduction in Trade Union Power

- **Trade unions** are groups of workers banding together to negotiate better pay and working conditions.
- If unions have too much power, they may push wages above what businesses can afford, leading to fewer jobs.
- Reducing their influence could lower costs for businesses, encouraging them to hire more staff.

3. 🏢 Cutting Unemployment Benefits

- If benefits (money given to people out of work) are very generous, people may not feel pressure to find jobs quickly.
- Reducing benefits creates stronger incentives to seek work.
- Downside: it could also increase poverty and inequality if people struggle to cope.

4. 👷 Less Labour Protection

- **Labour protection** = rules like paid holidays, sick pay, maternity leave, and limits on working hours.
- These protect workers, but they also raise costs for businesses.
- Reducing protections could lower hiring costs, encouraging firms to take on more workers. But this might make jobs more insecure or stressful for workers.

5. ⏳ Zero-Hour Contracts

- A **zero-hour contract** means workers aren't guaranteed any hours; they only work when the employer needs them.
- This gives businesses flexibility and can help reduce unemployment.
- However, it makes income less predictable for workers.

8.3 Supply side policy

Privatisation

When the government owns a company (like a railway or a broadcaster), it might scare off private competitors because the government firm has deep pockets and advantages.
Privatisation means selling these companies to private owners, making the market more open and competitive.

Example:
In the 1980s, the UK government **privatised British Telecom (BT),** before that, telecoms were a government monopoly. After privatisation, lots of new companies entered the market (like Vodafone), giving customers more choice and better prices.

⭐ **Advantages of privatisation:**

- **More competition**: Firms now have to fight for customers! This cuts **X-inefficiency** (when businesses get lazy and wasteful) and usually means **lower prices** and **better quality** for everyone.
- **Boosts government cash**: Selling companies brings in money straight away, helping reduce the **Public Sector Net Cash Requirement (PSNCR).** Basically, the government's need to borrow money.
- **Less political interference**: Firms don't have to stress about changing their plans every time a new government gets elected. They can **invest with more confidence** in the long term.

⚡ **Disadvantages of privatisation:**

- **Natural monopolies become risky**: In industries like water and electricity, where it's impractical to have loads of competitors, a private monopoly could exploit customers. Some say the government should stay in charge here.
- **Some industries are too important**: Services like **hospitals, electricity, and public transport** are vital to society. Leaving them purely to private profit-seeking companies could be risky.
- **Externalities and inequality**: Private companies might not think about the broader impacts (like pollution), and poorer people might end up worse off.

8.3 Supply side policy

Deregulation

Deregulation means reducing or removing government rules, giving firms more freedom. It's like **cutting the red tape** that slows businesses down.

Why Deregulate?

- It encourages **competition** – more firms can enter the market, keeping prices down and quality up.
- It can improve **economic efficiency** – businesses can produce more, innovate faster, and react to consumer needs.

Advantages	Disadvantages
💸 **Lower Prices** – Deregulation can increase competition, which often leads to lower prices for consumers. For example, in the airline market, budget airlines have popped up.	💼 **Hard for Small Firms to Compete** – Big private firms might dominate the market, making it hard for smaller ones to survive.
⚡ **Better Efficiency** – Firms are motivated to cut waste, improve services, and reduce costs.	💰 **Higher Prices Possible** – If one big firm takes over, it might charge more without regulation keeping it in check.
🏢 **Less Red Tape** – Fewer government rules can mean lower administrative costs for businesses.	📉 **Worsened Service Quality** – Companies might cut corners to save money. For instance, deregulated bus routes sometimes led to congestion and duplicated services.
🧑💼 **More Choice** – With fewer barriers, new firms can enter the market, giving consumers more options.	⚠️ **Safety Risks** – In essential industries (like construction), cutting rules might put safety at risk.

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8.3 Supply side policy

Reforms of the tax and benefits system

- **Marginal tax rate** = the extra tax you pay on an additional £1 you earn.
- By reducing **income tax** (what workers pay on wages) and **corporation tax** (what firms pay on profits), the government can:
    - Encourage people to work more (since they keep more of their income).
    - Boost business investment (since firms keep more of their profits).

👉 Example: If income tax drops, a part-time worker might decide it's worth taking on extra shifts. If corporation tax falls, Apple might invest more in UK offices or factories.

- Reforming **benefits** could also encourage more people to work. If benefits are less generous, some people may prefer employment over relying on welfare.

Improving labour market flexibility

Flexibility means how easily workers and firms can adapt to changes in the economy. The more flexible the labour market, the easier it is for people to move into jobs and for businesses to adjust.

How governments can help:

- **Minimum Wage Reform**: Some argue that reducing (or even removing) the **National Minimum Wage** allows wages to be set by market forces. Critics say this could lower wages for vulnerable workers, but supporters argue it might increase employment.
- **Geographical Mobility**: Workers often find it hard to move for jobs (because of high house prices, relocation costs, or lack of information). Subsidies for relocation or better job vacancy platforms could help.

8.3 Supply side policy

- **Flexible Contracts**: Encouraging part-time work, gig economy jobs, or zero-hour contracts makes it easier for businesses to hire when needed. (Controversial, though, since job security can suffer).
- **Reducing Trade Union Power**: Weaker unions make it easier for firms to hire and fire workers, improving efficiency but at the cost of worker protections.

Example: In the gig economy (like Uber or Deliveroo), firms can quickly adjust the number of workers to meet demand, showing high flexibility.

Immigration

Immigration brings in workers from abroad, which can:

- Fill skill gaps (e.g., NHS doctors and nurses from overseas).
- Reduce unemployment (more workers = more production).
- Boost productivity, since firms can access a bigger pool of skilled labour.

Example: The tech industry in London relies heavily on skilled migrants (programmers, engineers). Without them, growth would be slower.

In short: Lower taxes can motivate people and businesses to do more. Labour market flexibility makes hiring and working easier (though sometimes controversial). Immigration helps fill crucial gaps and increases productivity. Together, these supply-side policies aim to create a stronger, more efficient economy.

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8.3 Supply side policy

Free market supply-side policies

Again, free market supply-side policies are designed to let the economy "run free" by reducing government interference, think tax cuts, deregulation, and privatisation. These policies aim to make businesses more efficient and competitive.

But like everything in economics, there are both **upsides** and **downsides.**

Advantages

- **No big strain on government spending**
  - Because the government isn't funding lots of projects directly, taxpayers' money doesn't have to cover huge costs.
  - Instead, the private sector invests.
  - Example: If a railway is privatised, the company (not the government) pays for upgrades and maintenance.
- **Better use of resources (resource allocation)**
  - *Definition:* Resource allocation = how an economy decides to use its workers, money, and materials.
  - Free markets encourage businesses to be efficient because they have to compete.
  - Example: If one company wastes too much on admin, a rival offering cheaper prices will win more customers.

8.3 Supply side policy

Free market supply-side policies

Disadvantages

- **Time lags**
  - It takes *years* for these policies to show real benefits.
  - Example: Cutting taxes today doesn't mean workers instantly produce more; the effect builds slowly.
- **Equity problems (fairness issues)**
  - *Definition:* Equity = fairness in how income and opportunities are shared.
  - Reforms may mean lower wages or less protection for some workers.
  - Example: Deregulation might allow firms to cut staff benefits, making income inequality worse.
- **Environmental costs**
  - Big projects can harm nature.
  - Example: Building a hydroelectric dam boosts energy supply but can flood habitats and damage ecosystems.
- **Vested interests (powerful groups influencing outcomes)**
  - Sometimes policies don't work as planned because big players get special treatment.
  - Example: In privatisations, politically connected firms may scoop up government assets "on the cheap," instead of genuine competition creating efficiency.

8.3 Supply side policy

Interventionist supply-side policies

Unlike free-market policies (which let businesses "do their thing"), **interventionist supply-side policies** are where the **government steps in directly** to help boost the economy. They aim to increase both **aggregate supply** (the economy's productive capacity) and sometimes **aggregate demand** (overall spending in the economy).

The catch? They often take longer to show results than quick fixes like tax cuts. But the long-term benefits can be huge. Policies include:

🎓 **Education**

Education reform + investment = a smarter, more adaptable workforce.

- **Reducing occupational immobility** (👉 *definition:* when workers struggle to switch between different types of jobs).
    - Example: If a coal miner retrains as a software coder, they can move into new industries instead of being stuck unemployed.
- **Boosting productivity** — better-educated workers are usually more efficient, so the whole economy produces more.
    - Example: Investing in STEM education in schools can fuel growth in tech industries.

🛠️ **Training**

Training is like education's best friend; it helps workers stay sharp and adaptable.

Ways governments can support training:

- **Directly:** e.g. welfare recipients might get benefits only if they complete job training.
- **Indirectly:** e.g. offering tax breaks to companies that invest in employee training.

Example: A government might subsidise apprenticeships in renewable energy to prepare workers for the green economy 🌱.

8.3 Supply side policy

Interventionist supply-side policies

🔬 **Research and Development (R&D) Subsidies**

R&D = research + innovation 💡

When businesses (or universities) do research, they can invent better tech or new ways of working, which boosts productivity.

- The government can give **grants** (free money for research) or **tax breaks** (companies pay less tax if they invest in R&D).
- Example: UK grants for green technology have supported innovations like offshore wind turbines.

🏭 **Industrial Policy**

This is when governments give the business world a little "nudge" through **rules, laws, and incentives**.

- Could involve changing labour laws (like trade union reforms).
- Could mean laws to encourage business start-ups or help small businesses compete.
- Example: South Korea's government heavily supported car and tech industries in the 20th century → now they've got Hyundai and Samsung.

💡 **Exam Tip:** Supply-side policies are often sneaky, they cross over with lots of other topics (like education, unemployment, growth). Always make those links in your answers for extra marks ✨.

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8.3 Supply side policy

Interventionist supply-side policies

Interventionist supply-side policies are when the **government directly invests in or supports industries and infrastructure** to boost the economy's productive capacity. Think of it as the government stepping in as the "coach" rather than just letting the "players" (businesses) figure it out themselves.

Here are the **pros and cons** ↕️

✅ **Advantages**

- **Direct support for key industries** 🏭
  - Giving subsidies (government financial help) to important industries can boost growth, reduce unemployment, and even help exports.
  - Example: If the government funds green energy projects (like solar or wind farms), it creates jobs, reduces reliance on imported fuel, and can make the country a leader in renewable exports. 🌍⚡
- **Better living standards** 🏘️
  - Big investments in infrastructure (roads, schools, hospitals, broadband internet) make everyday life easier, healthier, and more productive.
  - Example: Expanding public transport means people spend less time stuck in traffic 🚇 → more time for work, family, or leisure.

8.3 Supply side policy

Interventionist supply-side policies

❌ **Disadvantages**

- **Time lags ⏳ + political changes** ⚖️
  - These policies often take **years (or decades)** to show results.
  - Plus, if a new government comes into power, they may cancel or cut funding for projects, making them less effective.
  - Example: The UK's **High Speed Rail project (HS2)** has been scaled back and delayed multiple times due to political and budget shifts.
- **High costs** 💸
  - These projects are **expensive** and usually paid for by higher taxes or government borrowing (which adds to national debt).
  - Example: Building new airports, highways, or high-speed rail can cost billions; money that might otherwise be used for healthcare or education.

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8.3 Supply side policy

Other strengths and weaknesses of supply-side policies

✅ **Strengths of Supply-Side Policies** 🚀

- ✓ **Lower Prices for Consumers** 🛒 – More efficient production reduces **costs**, leading to **lower average price levels** (helping fight inflation).
- ✓ **Faster Economic Growth** 📈 – By making businesses **more efficient** and workers **more skilled**, supply-side policies **increase the economy's long-term growth rate**.
- ✓ **Lower Unemployment** 👷 – Policies like **education investment** and **labour market reforms** help **get more people into work**.
- ✓ **Better Infrastructure** 🏗️ – Government investment in **transport, energy, and digital infrastructure** improves **quality of life** and **supports economic growth**.
- ✓ **Boosting International Trade** 🌍 – When a country becomes **more productive**, its goods and services become **cheaper and more competitive abroad**, increasing **net exports**.

🔷 **Example:** In **Singapore**, government investment in **education and digital infrastructure** has helped create a **highly skilled workforce**, attracting **foreign investment** and boosting long-term growth.

8.3 Supply side policy

Other strengths and weaknesses of supply-side policies

❌ **Weaknesses of Supply-Side Policies** ⚠️

- ❌ **Income Inequality Increases** 💰⚖️ – Labour market reforms, such as **weakening trade unions or reducing minimum wages**, can **lower worker pay**, benefiting businesses but **worsening income inequality**.
- ❌ **High Costs** 💸 – Policies like **building infrastructure** and **improving education** require **huge government spending**, leading to **budget deficits**.
- ❌ **Slow to Show Results** ⏳ – Supply-side policies take **years** to fully impact the economy. Governments **spend money now** but may **not see benefits for decades**.
- ❌ **Changes in Government** 🏛️ – Different political parties have **different priorities**. If one government **starts a major infrastructure project**, the next might **cancel or change it**, making policies **less effective**.

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8.3 Supply side policy

Competition policy is all about making sure businesses compete fairly so that consumers get better prices, more choices, and good quality. It's kind of like being a referee in a football match, making sure no team (or business) plays dirty.

In the **UK**, competition policy includes a bunch of tools to keep the market fair and open:

- **Legislation**: Laws are made to stop unfair practices like price fixing (where companies secretly agree to keep prices high).
- **Privatisation**: When the government sells public companies (like Royal Mail) to private owners to increase competition.
- **Deregulation**: Removing unnecessary rules so more companies can enter the market. For example, letting more bus companies operate in one city.
- **Stopping harmful mergers**: Big mergers (when two companies combine) might reduce competition. So, the government checks if a merger would hurt customers by giving one firm too much power.
- **Controlling monopoly power**: A **monopoly** is when one firm dominates the market. Policies help stop them from charging super high prices or reducing quality just because they can.

👮 In the UK, all of this is overseen by the **Competition and Markets Authority (CMA).** They're like the watchdogs making sure the rules are followed.

8.3 Supply side policy

Principles of UK competition policy

⚖️ **Key Ideas Behind the Policy:**

- **Efficiency is better with competition**: If we ignore the benefits of large-scale production (**economies of scale**), then **perfect competition** (many small firms) is seen as more efficient. This is because it pushes firms to use resources wisely (**productive efficiency**) and to produce what society actually wants (**allocative efficiency**).
- **Monopolies can be bad for consumers**: A monopoly might limit how much they produce so they can charge higher prices and earn **supernormal profits** (profits above the normal expected level). This means consumers lose out as they pay more and get less, which reduces **consumer surplus** (the extra value consumers get over what they pay) and leads to lower **welfare** in society.

😏 **But Wait — Monopolies Aren't Always Bad...**

- **Sometimes big firms are cheaper**: If a monopoly can produce at a lower cost per unit than smaller firms (thanks to **economies of scale**, like bulk buying or big machines), then it might actually be good for prices.
- **Innovation can thrive in big firms**: Some monopolies, like big tech companies, can reinvest their profits into new technologies, making them more **dynamically efficient** (better over time).
- **Each case is different**: The CMA looks at every situation on its own. Not all monopolies are punished; it depends on whether they harm consumers or not.

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8.3 Supply side policy

Principles of UK competition policy

🔍 **What Does UK Competition Policy Focus On?**

- **Monopolies** – preventing abuse of power and high prices
- **Mergers** – making sure big companies joining forces won't reduce competition
- **Restrictive practices** – stopping sneaky behaviour like price-fixing or blocking rivals
- **Promoting competition** – encouraging new businesses to enter the market and shake things up

8.3 Supply side policy

Monitoring Monopolies

In the real world, we don't see many true monopolies (where one firm completely controls a market). Most markets are **concentrated**, meaning just a few big firms dominate. These are often called **oligopolies**.

The UK's **Competition and Markets Authority (CMA)** looks at how firms behave (structure, conduct, and performance) to decide if they're being fair and what action to take if not.

🛠️ **How Can We Keep Monopolies in Check?**

1. Break Them Up
Some economists believe breaking up big monopolies is the way to go. The idea is that smaller companies = more competition = better prices and services for consumers.
📌 Example: Think of breaking up a huge tech company into separate businesses like messaging, shopping, and video each competing on its own.

2. Tax Their Huge Profits (Windfall Taxes)
When a monopoly makes **supernormal profit** (extra big profits above what's considered normal), the government might step in with a special tax to share the wealth.
📌 Example: An energy company making record profits during a fuel crisis could face a windfall tax.

3. Price Controls
The government might set a **maximum price** that the company can charge, to stop it from taking advantage of its power.
📌 Example: A cap on electricity prices to protect households.

4. Nationalise It (Public Ownership)
This means the government takes over the company, so it's run for the benefit of the public, not for profit.
📌 Example: Some people argue the train network or healthcare should be publicly owned and focused on service, not profits.

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Monitoring Monopolies

5. Sell It to Private Firms (Privatisation)
On the flip side, some think private companies do a better job because they're more focused on being efficient and satisfying customers.
📌 Example: A government-run service being sold to a private business that then competes to improve performance.

6. Remove Rules (Deregulation)
Sometimes, the government takes away rules that stop new businesses from entering the market. This makes the market more **contestable**, meaning even if there's one big player, the threat of new competitors keeps them in check.
📌 Example: Letting smaller delivery companies enter the parcel market to compete with the big names.

8.3 Supply side policy

Controlling Mergers

Mergers (when two or more companies join together) can sometimes create super-powerful firms that dominate a market. This can lead to problems like:

- Higher prices for consumers
- Less choice
- Poorer quality products

That's where the **Competition & Markets Authority (CMA)** steps in. 🛑

The CMA works alongside other regulatory bodies too, like:

- **CAA (Civil Aviation Authority)** – keeps the skies fair
- **OFGEM** – keeps an eye on energy companies
  In the **EU**, the **European Commission** also helps crack down on businesses that try to reduce competition unfairly. So, if a UK company trades in the EU, it must follow **both UK and EU rules**.

🔍 **How Does the CMA Keep Mergers in Check?**

One of their superpowers is the ability to **monitor mergers**.

A **merger** is when two businesses combine into one. While sometimes that's good, it can be a problem if the new firm becomes too big especially if it ends up with more than **25% of the market share** (that's considered a lot of power in one firm).

Here's what the CMA can do:

- 🚫 Stop the merger if they think it would harm competition
- ✔ Let it go ahead, but with conditions (e.g. force the company to sell off parts of the business to keep things fair)

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8.3 Supply side policy

The cost and benefits of competition policies

Competition policies are rules and actions put in place to keep markets fair. The goal? Stop firms from becoming too powerful and ensure consumers get good value.

But let's be real, to make these policies work, regulators (like the CMA in the UK) need to constantly check up on businesses. And that takes a lot of time and money.

🏆 Benefits of competition policies

✅ What's Great About It	💬 Why It Matters
📉 **Lower Prices**	When firms compete, they often drop prices to attract customers. More competition = cheaper prices for us.,
⭐ **Better Quality & Service**	No business wants to lose customers. So, they work harder to give us better products and friendlier service.
⚙️ **Efficiency Boosts**	We get: • **Productive efficiency** – making stuff using fewer resources • **Allocative efficiency** – producing what people actually want.
💡 **More Innovation**	Companies invest more in R&D (research and development) to stay ahead. That means new tech, smarter processes, and better products.

8.3 Supply side policy

The cost and benefits of competition policies

⚠️ Costs of competition policies

❌ Potential Downsides	💬 Why It's a Problem
🏛️ **Risk of Government Failure**	If the government messes up (like regulating too much or in the wrong way) it could make markets worse, not better. That's called **government failure**.
🏗️ **Hurts Natural Monopolies**	Think of water or rail networks, these are **natural monopolies** (where it's more efficient for one company to operate). Interfering might stop them from growing efficiently.
🚫 **Less "Creative Destruction"**	Some monopolies (big dominant firms) pump tons of money into R&D. If you limit their power, you might limit future innovation too.

Example:

- **Innovation win**: In a competitive tech market like smartphones, we get new features every year. That's thanks to companies trying to outdo each other.
- **Government failure risk**: If regulators set price limits on energy that are too low, companies might stop investing and then everyone suffers from blackouts or poor service.

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8.4 Policy conflicts

Potential policy conflicts and trade-offs

Governments use **fiscal, monetary, and supply-side policies** to manage the economy, but these policies often **conflict with each other**, creating trade-offs. While one policy might **boost growth**, it could also **increase inflation, worsen income inequality, or harm exports**. Let's break down these conflicts.

1. Expansionary vs. Deflationary Policies 📈📉

✓ **Expansionary policies** (e.g., tax cuts, increased government spending, lower interest rates) **boost Aggregate Demand (AD)**, leading to **higher output, more jobs, and economic growth**.

❌ However, they can also cause **inflation** and **worsen the trade deficit** by **increasing imports**.

✓ **Deflationary policies** (e.g., tax hikes, spending cuts, higher interest rates) **reduce inflation** but also **lower AD**, which can **increase unemployment and slow growth**.

🔷 **Example:** In the 1980s, the **UK government raised interest rates to control inflation**, but this led to **higher unemployment and a recession**.

2. Interest Rate Changes & Their Effects 💰

✓ **Higher interest rates** help **reduce inflation** by **discouraging borrowing and spending**.

❌ But they **discourage business investment**, slowing **long-term economic growth**.

❌ They also **strengthen the currency** (making **exports more expensive** and **imports cheaper**), worsening the **balance of payments**.

8.4 Policy conflicts

Potential policy conflicts and trade-offs

✓ **Lower interest rates** encourage **investment and growth** but may lead to **higher inflation**.

❌ They also **increase income inequality**, as wealthier people **benefit more** from rising **asset prices (stocks & property)**, while middle and working-class individuals **rely more on savings**, which earn **less interest**.

3. Supply-Side Policies & Their Side Effects 🚀⚠️

✓ **Supply-side policies** focus on **increasing productivity and efficiency** by **reducing business taxes, investing in education, or improving infrastructure**.

❌ However, some measures **worsen inequality (**such as **weakening trade unions, cutting benefits, or lowering taxes on businesses)** which may hurt **low-income households**.

🔷 **Example:** Reducing **welfare benefits** to encourage people to work might help increase **employment**, but it could also **increase poverty**.

4. Fiscal Deficits: Balancing Growth & Debt 💷

✓ **Reducing government debt** (fiscal deficit) through **spending cuts & tax increases** can **improve long-term financial stability**.

❌ However, this **reduces AD**, leading to **higher unemployment and lower growth** in the short term.

❌ It can also **disproportionately hurt low-income groups** who **rely on public services**.

🔷 **Example:** In the early 2010s, **Greece and the UK adopted austerity measures** (spending cuts to reduce debt), but this **led to slower economic growth and public backlash**.

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8.4 Policy conflicts

Conflicts and trade-offs between the macroeconomic objectives

1. Economic Growth vs. Protection of the environment

- Growth often leads to **more production, more pollution, and depletion of non-renewable resources**.
- **Faster growth = Higher carbon emissions and environmental damage**.

Example: China's industrial boom led to **higher GDP** but also **severe air pollution and resource depletion**.

2. Economic Growth vs. Inflation

- As the economy **expands**, businesses demand more **workers and resources**, pushing wages and prices **higher**.
- **If demand grows too fast**, it **exceeds supply**, leading to **demand-pull inflation** (rising prices due to excessive demand).

Example: The **UK's rapid recovery post-COVID-19** saw **economic growth** but also **rising inflation**, prompting the Bank of England to increase **interest rates**.

3. Economic Growth vs. Budget Deficit

- Governments use **expansionary fiscal policy** (higher spending and tax cuts) to **stimulate growth**, but this **increases the budget deficit** (when government spending exceeds revenue).

Example: The **US government stimulus packages** during **COVID-19** boosted growth but **increased national debt significantly**.

8.4 Policy conflicts

Conflicts and trade-offs between the macroeconomic objectives

4. Economic Growth vs. Balancing the Current Account

- Growth **raises household incomes**, leading to **more imports** (buying goods from abroad).
- If **imports grow faster than exports**, the **current account deficit worsens**.

Example: The **UK consistently runs a current account deficit** because **high consumer spending leads to more imports than exports**.

5. Unemployment vs. Inflation

- As the economy nears **full employment**, **businesses struggle to find workers**, so they **offer higher wages**.
- **Higher wages = Increased production costs = Higher prices (inflation)**.

Example: In **post-Brexit Britain**, **labour shortages** led to **higher wages for lorry drivers**, but this also caused **rising prices for goods**.

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Please see the ‘8. Implementing policy Worked Examples’ pack for exam style questions.

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