**Economics Notes – Chapter 5 – Role of Government in an Economy**

**Part One – Macroeconomic Policies**

**1) Demand-side Policies – Affect Aggregate Demand (AD)**

1. Monetary Policy
2. Fiscal Policy
3. Exchange Rate Policy

**2) Supply-side Policies – Affect Aggregate Supply (AS)**

1. Infrastructural Development
2. Manpower Development
3. Technological Development (R&D)
4. Trade Development Policies
5. Wage Regulation

**1) Demand-side Policies**

* Expansionary demand-side policies will increase aggregate demand
* Contractionary demand-side policies will decrease aggregate demand

1. **Monetary Policy**

* Monetary policy involves the changes in money supply and interest rates by the central bank, so as to influence the aggregate demand and achieve certain macroeconomic aims
* **Expansionary Monetary Policy**
* Expansionary monetary policy increases the money supply through the buying of government bonds, which will decrease interest rate.
* Lower interest rate will decrease the cost of borrowing, leading to the increase in borrowing, thus increasing consumption and investment.
* Consequently, lower interest rate will increase consumption (C) and investment (I), resulting in the increase in aggregate demand (AD). Hence, this will increase real GDP and employment

Evaluation

* Effective in promoting higher economic growth rate
* Inability of central bank to control money supply due to liberalization of banking sector

×However, lower interest rate will contribute to outflow of hot money, which will lead to depreciation of the currency

×Also, increase in local investment may not be able to compensate the decrease in production due to fall in external demand

×Market pessimism will not lead to the increase in aggregate demand even if interest rate is lowered

* **Contractionary Monetary Policy**
* Contractionary monetary policy decreases the money supply through the selling of government bonds, which will increase interest rate
* Higher interest rate will increase the cost of borrowing, leading to the decrease in borrowing, thus decreasing consumption and investment
* Consequently, higher interest rate will decrease consumption (C) and investment (I), resulting in the decrease in aggregate demand (AD). Hence, this will decrease real GDP and employment

Evaluation

× Cannot tackle imported inflation, which is caused by external factors and that contractionary monetary policy can only reduce domestic demand

1. **Fiscal Policy**

* Fiscal policy involves the changes in government expenditure and taxation, so as to influence the aggregate demand and achieve certain macroeconomic aims
* **Expansionary Fiscal Policy**
* Expansionary fiscal policy increases the government expenditure, such as the provision of public services and spending on public projects, which increases the aggregate demand
* Also, expansionary fiscal policy decreases the taxes, which increases the disposable income of consumers, leading to increase in consumption, thus resulting in the increase in aggregate demand
* Consequently, the increase in consumption (C) and government expenditure (G) will increase aggregate demand (AD), thus increasing real GDP

Evaluation

* Effective in tackling economic recession

×Effectiveness of policy will be affected by time lag

×High cost of financing

* **Contractionary Fiscal Policy**
* Contractionary fiscal policy decreases the government expenditure, such as the provision of public services and spending on public projects, which decreases the aggregate demand
* Also, contractionary fiscal policy increases the taxes, which decreases the disposable income of consumers, leading to decrease in consumption, thus resulting in the decrease in aggregate demand
* Consequently, the decrease in consumption (C) and government expenditure (G) will decrease aggregate demand (AD), thus leading to the fall in real GDP

Evaluation

* Contractionary Fiscal Policy is effective in tackling demand-pull inflation by lowering aggregate demand

×Difficult to reduce government expenditure for on-going public projects

×Increase in taxation is politically unfavourable

×Cannot solve cost-push inflation, such as imported inflation, as the increase in tax will lead to tax-based inflation

1. **Exchange Rate Policy**

* Exchange rate policy involves changes in the foreign reserves of the country to influence the exchange rate, which will affect the trading and investment activities, thus affecting aggregate demand to achieve certain macroeconomic aims
* **Strong Exchange Rate Policy**
* Increase exchange rate through the direct buying of the local currency and selling of foreign currencies, so as to increase demand for the local currency
* As a result, this will lead to appreciation of the foreign value of the local currency

Evaluation

* Can reduce imported inflation

× However, appreciation may not be enough to cope with a sharp increase in price of imported resources (example, sudden shortage of sand due to ban)

×Appreciation of the local currency will mean that exports are more expensive, thus leading to the fall in export demand, which may result in the increase in unemployment in export-oriented industries

× Increase in opportunity cost, seen in terms of the government funds that could have been used for other areas of economic development, such as public healthcare services and facilities

* **Weak Exchange Rate Policy**
* Decrease exchange rate through the direct selling of the local currency and buying of foreign currencies, so as to decrease demand for the local currency
* As a result, this will lead to depreciation of the foreign value of the local currency

Evaluation

* Depreciation will mean that exported goods are relatively cheaper than imported goods, thus increasing net exports, which will increase aggregate demand and real GDP

× Imported goods and resources for production will be more expensive, leading to higher cost of production and cost of living

× Depreciation will not increase export demand in the world economy is in recession due to the fall in national income in foreign economies

**2) Supply-side Policies**

* Supply-side policies involve changes in the infrastructure and labour, so as affect aggregate supply and achieve certain macroeconomic aims

1. **Infrastructural Development**

* Infrastructural development involves the setting up of facilities to attract foreign investment and increase productivity of the economy
* This will lead to the outward shift of the PPC, thus achieving potential economic growth
* For example, the building of transport and communication networks, so as to decrease the transportation time. Also, the setting up of factories for MNCs to set up their companies easily

Evaluation

* Increase in foreign investment due to inflow of MNCs which will increase labour demand, thus raising domestic employment
* Improve living standards due to the setting up of public infrastructure

× However, budget strain due to the problem of funding

× Long duration for completion of public projects

1. **Manpower Development**

* Manpower development will raise labour productivity through skills training, which will overcome skills incompatibility

Evaluation

* Can tackle structural unemployment

× High cost of training

× Difficult to convince firms to send workers for training due the problem of job-hopping

1. **Technological Development**

* Increase productivity and efficiency through research and development (R&D), so as to raise the competitiveness and achieve higher economic growth rate

Evaluation

× Requires highly-skilled labour to undergo research

× Problems of funding

× No assurance in achieving results

1. **Trade Development Policies**

* Free Trade Agreements will remove trade barriers, so as to promote freer flow of resources, labour and capital
* Expand export market

**Conflicts between Government Aims**

Unemployment and Inflation

The policies implemented to reduce unemployment may increase inflation.

For example, an increase in government expenditure, such as the increase in subsidies to firms to send their workers for manpower training to raise employability, will raise aggregate demand.

As such, an excess demand condition will lead to demand-pull inflation, which will raise price level.

Balance of Payment and Economic Growth

The policies implemented to contribute to balance of payment equilibrium may reduce economic growth rate.

For example, the increase in income tax will lower disposable income, which will reduce domestic demand for both foreign imports and locally-produced goods.

As such, the fall in consumption and will lower aggregate demand, which will reduce national output, thus reducing real GDP, which means there is a fall in economic growth rate.

Government Aims and Policies

Expansionary fiscal and monetary policies will reduce unemployment and promote economic growth.

In contrast, contractionary fiscal and monetary policies will reduce inflation and lower import expenditure, which will lead to balance of payment equilibrium.

Conclusion

If there are conflicting aims, the government will prioritize based on the severity of the problems affecting the economy, such as high unemployment.

**Part Two – Taxation and Subsidies**

Explain the reasons for governments to introduce taxation

1. **Collect tax revenue**

* Tax revenue collected can be used to finance government expenditure to be spent on the provision of public goods, such as street lights, overhead bridges and public parks

1. **Correct market failure**

* Taxation will increase the cost of production of demerit goods, such as alcohol and cigarettes, thus lowering the production of demerit goods

1. **Trade protection policy**

* Taxation on imported goods will encourage local consumers to switch to the consumption of domestic goods
* The reduction of import demand will correct balance of payment deficits

1. **Redistribution of income**

* Taxation contributes to a more even distribution of income
* For example, progressive taxes reduce the income disparities between the high and low income groups
* As such, redistribution of income can help to maintain social and political stability in the country

1. **Reduce inflation**

* Taxation can reduce demand-pull inflation
* Over-consumption of goods and services leads to excess demand condition and thus demand-pull inflation
* Taxation will lower the relative purchasing power of consumers, thus discouraging the consumption of goods and services

1. **Environmental sustainability**

* Taxation on producers will increase the cost of production, which lowers the profit levels, thus causing the fall in production of goods and services
* For example, tax on petrol will reduce car usage and thus reduce air pollution
* As such, the environment can be preserved, which is important in maintaining the non-material aspect of standard of living

Explain the different types of taxation governments can introduce

Taxation is the most common method to generate tax revenue, which is used to finance government expenditure

1. **Direct Taxes**

* A tax that is imposed on the income or profits of the person who pays it, rather than on goods and services
* For example, personal income tax, corporate tax, property tax, inheritance tax and stamp duties

1. **Indirect Taxes**

* A tax that is imposed on goods and services, rather than the income or profits of the person who pays it
* For example, Goods and Services Tax (GST), Value-added Tax (VAT), excise duties and customs duties
* **GST** is a form of regressive indirect tax as it takes a larger proportion of the low income consumer
* **VAT** is a form of consumption tax, in which the consumer sees it as a form of tax on purchase price, whereas the producer sees it as a tax on the value added to the goods and services
* **Excise duties** are taxes placed on certain local goods
* **Custom duties** are taxes placed on certain imported goods

Distinguish between the three types of tax systems

1. **Progressive Tax**

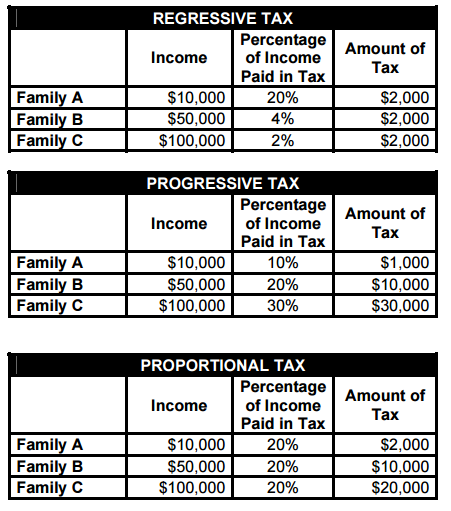
* Tax that takes a larger proportion of income from the high-income earners than from the low-income earners
* As an individual’s income increases, the proportion of income being taxed increases

1. **Proportional Tax**

* Tax that takes the same percentage of income from all income groups
* As an individual’s income increases, the proportion of income being taxed remains the same

1. **Regressive Tax**

* Tax that takes a larger proportion of income from the low-income earners than from the high-income earners
* As an individual’s income increases, the proportion of income being taxes decreases



Explain the impacts of Taxation

1. **Reduce the ability to work, save and invest**

* Tax on producers will increase the cost of production, resulting in higher prices and lower production level
* Unemployment level will increase
* Taxation creates disincentive to work, which contributes to the fall in productivity level
* Higher taxes will reduce the ability of households and firms to save, thus reducing the sources of investment

1. **Reduce the desire to work, save and invest**

* Higher taxes may motivate a person to work harder to earn more, so as to maintain the same level of standard of living
* Higher taxes may create disincentive to work and incentive for leisure
* Hence, taxes will determine the production level

1. **Re-distribution of income**

* Progressive taxes will reduce the degree of income inequality
* Regressive taxes will widen the income gap

1. **Changes in consumption and production level**

* Personal income tax and other direct taxes will reduce disposable income for consumption, thus reducing consumption spending and thus the fall in production of goods and services

1. **Changes in cost of production and cost of living**

* Increase taxes will increase cost of production, which contributes to lower profit levels and thus the fall in production
* As such, taxes may give rise to cost-push inflation