

Macroeconomic Policies in a Global Context

Due to globalisation, economies are increasingly interconnected. This means the effectiveness of a government's macroeconomic policies partly depends on events and policies in other countries.

Governments can use:

- Fiscal policy
- Monetary policy
- Supply-side policies
- Exchange-rate policies
- Direct controls, such as minimum or maximum wages, import quotas and regulation

Different governments may use different combinations of policies to achieve the same objective.

Reducing Fiscal Deficits and National Debt

A **fiscal deficit** occurs when government spending exceeds government revenue over a particular period.

National debt is the accumulation of past government borrowing.

Government debt is not necessarily harmful if borrowing finances productive investment that increases long-run economic growth. However, persistently large fiscal deficits can cause national debt to become increasingly difficult to manage.

Austerity

Austerity involves reducing government spending and/or increasing taxation to reduce the fiscal deficit.

Lower government spending + higher taxation → smaller fiscal deficit → slower growth of national debt.

However:

Higher taxes + lower government spending → ↓ AD → ↓ economic growth → ↓ employment and household incomes.

Austerity may therefore reduce living standards and increase income inequality, particularly when government services and welfare spending are cut. Around **800 UK libraries closed following the introduction of austerity in 2010**.

UK Austerity After the 2008 Financial Crisis

Following the 2008 Financial Crisis, the UK fiscal deficit reached a recent record of **10.2% of GDP (£153bn) in 2009**. In response, the 2010 Government introduced austerity.

Government spending fell from **47.5% of GDP in 2009–10 to 39.8% by 2015–16**, helping reduce the fiscal deficit to **below 3% of GDP**. However, austerity involved significant cuts to welfare and public services, including around **£39bn in annual social-security cuts** and a **16% real-terms fall in non-health departmental budgets** over the decade.

Demand-Side Stimulus

An alternative is to use **expansionary fiscal policy**.

↑ Government spending / ↓ taxation → ↑ AD → ↑ real GDP → ↑ employment and incomes → ↑ tax revenue + ↓ welfare spending → fiscal deficit may eventually fall.

Governments may therefore attempt to **grow their way out of debt** rather than immediately cutting expenditure.

However, this depends on the size of the multiplier and the amount of spare capacity in the economy. Higher government spending could instead increase the fiscal deficit and national debt further.

Automatic Stabilisers

Governments can also allow **automatic stabilisers** to operate as the economy recovers.

Economic growth → ↑ employment and incomes → ↑ income tax revenue + ↓ unemployment benefits → ↓ fiscal deficit.

This can reduce the fiscal deficit and national debt as a percentage of GDP without requiring large discretionary spending cuts or tax increases.

Reducing Poverty and Inequality

Free-market outcomes can create significant differences in income and wealth.

Governments can therefore redistribute income and improve access to essential goods and services.

However, the extent of redistribution is influenced by normative judgements and political ideology, meaning different governments may take different approaches.

Progressive Taxation

A **progressive tax** is one where a larger percentage of income is paid in tax as income rises.

Higher-income households pay proportionately more tax → government redistributes revenue towards lower-income households → disposable income becomes more evenly distributed.

Inheritance taxes can also reduce wealth inequality by reducing the amount of wealth transferred between generations.

However:

↑ Tax rates → ↓ incentive to work and invest → ↑ tax avoidance/evasion → government may collect less additional revenue than expected.

The effectiveness of redistribution therefore depends not only on how progressive the tax system is, but also on how effectively tax revenue is redistributed through government spending.

Benefits and Transfer Payments

Governments can redistribute income through **welfare benefits and transfer payments**.

Universal benefits are available to everyone who meets particular criteria, regardless of their income. For The **UK State Pension** is a universal transfer payment costing over **£125 billion annually**

Means-tested benefits are only available to households with sufficiently low levels of income or wealth. They are more targeted towards reducing inequality because they directly support those most in need.

However:

Generous benefits → ↓ financial incentive to work → possible welfare dependency.

The extent of this depends on the size and design of benefits and the difference between income received in and out of employment.

Provision of Goods and Services

Governments can provide essential goods and services such as:

- Healthcare
- Education
- Housing

Free or subsidised provision → ↑ access for lower-income households → ↑ equality of opportunity → ↓ inequality over time.

For example:

↑ Access to education → ↑ skills and qualifications → ↑ productivity → ↑ earning potential → ↓ long-term income inequality.

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However, universal provision also benefits higher-income households who may be able to afford these services privately. It also creates a significant **opportunity cost** for the government.

Reducing Wage Differentials

Governments can directly influence differences in wages.

A **national minimum wage** can increase the incomes of low-paid workers → ↓ income inequality.

For example NMW was set at £11.44 in 2024 .

However:

↑ Minimum wage → ↑ firms' labour costs → ↓ demand for labour → possible unemployment.

Governments can also use:

- Equal pay legislation
- Trade-union-friendly legislation
- Maximum wages or pay ratios
- Requirements for employers to provide pensions, sick pay and other benefits

Maximum wages may reduce income inequality, but could reduce incentives or encourage highly skilled workers to move elsewhere.

Price Controls

Governments may introduce **maximum prices** on essential goods such as housing, transport or energy.

↓ Price of necessities → ↑ real purchasing power of low-income households → ↑ living standards → ↓ poverty.

However, maximum prices set below the market equilibrium can create **excess demand**, leading to shortages and potentially black markets.

Increasing International Competitiveness

International competitiveness refers to the ability of a country's firms to compete successfully against foreign firms.

Governments can improve international competitiveness through:

- Supply-side policies
- Currency depreciation
- Protectionism
- Trade agreements

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Supply-Side Policies

Supply-side policies can increase productivity and reduce firms' production costs.

For example:

↑ Education and training → ↑ human capital → ↑ labour productivity → ↓ unit labour costs → ↓ prices / ↑ quality → ↑ international competitiveness.

Exchange-Rate Policies

A depreciation of the currency makes exports cheaper for foreign consumers.

Currency depreciation → ↓ foreign price of exports → ↑ demand for exports → potentially ↑ international competitiveness and net trade.

However:

Currency depreciation → ↑ price of imported raw materials → ↑ firms' costs of production → possible cost-push inflation.

Protectionism

Governments may protect domestic industries using **tariffs, quotas or other trade barriers**.

Protectionism → ↓ competition from imports → domestic firms gain market share → potentially protects domestic employment.

However, protectionism can create conflicts within the domestic economy.

Responding to External Shocks

An **external shock** is an unexpected event originating outside the domestic economy which significantly affects economic activity.

Globalisation increases the transmission of external shocks because economies are increasingly connected through trade, financial markets and global supply chains.

Examples include:

- Global Financial Crisis (2008)
- Supply-chain disruptions
- Global trade conflicts
- COVID-19 pandemic
- Russia–Ukraine war

Government Responses

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The appropriate policy response depends on the type of external shock.

A **negative demand shock** causes:

↓ AD → ↓ real GDP → ↑ unemployment.

The government may respond with expansionary fiscal or monetary policy → ↑ AD → limits the fall in output and employment.

For example when in 2020 **UK** GDP plummeted by a record **20.4% in Q2 2020** which the UK govt responded to 0.1% IR , £895bn worth of QE and fiscal interventions such as UK Furlough Scheme (£70bn+ covering 80% of wages) and temporary VAT cuts (hospitality reduced from 20% to 5%).

A **negative supply shock** causes:

↑ production costs → ↓ SRAS → ↑ inflation + ↓ real GDP.

This creates a policy conflict. Expansionary policy may support economic growth but worsen inflation, while contractionary policy may control inflation but worsen the fall in output.

For example the Russia/Ukraine war.

Governments therefore face a **trade-off between their macroeconomic objectives** when responding to some external shocks.

Transnational Corporations

Transnational corporations (TNCs) are firms that operate across several countries.

TNCs can benefit host economies through:

- Job creation
- Investment
- Tax revenue

However, TNCs may also create economic and social costs.

They may repatriate profits, damage the environment, weaken local firms or use their bargaining power to secure favourable treatment from governments.

The ability of governments to control TNCs depends on the relative power of the government and the corporation, as well as the strength of the country's legal, political and financial institutions.

Developing economies may find regulation particularly difficult because large TNCs can possess significantly greater financial and legal resources than governments.

Joint Ventures and Local Requirements

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Governments can require TNCs to establish **joint ventures with domestic firms**.

TNC + domestic firm → profits partly retained domestically + technology and knowledge transferred → greater potential long-run benefits to the host economy.

Governments can also require part of a contract to be produced domestically, increasing local employment and economic activity.

Transfer Pricing

Transfer pricing occurs when different parts of the same TNC set prices for goods and services transferred between their subsidiaries.

Transfer pricing can be used to shift reported profits from a **high-tax country to a low-tax country**.

For example:

Subsidiary in high-tax country sells to subsidiary in low-tax country at an artificially low price → ↓ reported profit in high-tax country + ↑ reported profit in low-tax country → ↓ overall corporation tax paid.

This reduces the tax revenue received by governments.

For example, some firms extracting cobalt in the **Democratic Republic of Congo** have arrangements to pay the government **40% of the revenue received from cobalt sales**. Selling cobalt to their own subsidiary at a low price can reduce the reported revenue and therefore the amount received by the government.

Regulation of Transfer Pricing

Governments can require transactions between subsidiaries to follow the **arm's-length principle**.

This means the transfer price should be similar to the price that would have been charged if the two firms were independent of each other.

However:

TNCs operate internationally → individual governments have limited control → firms can shift activity between countries → effective regulation often requires international cooperation.

This makes controlling international tax avoidance particularly difficult.

Problems Facing Policymakers

Governments do not have perfect information and cannot know exactly how households, firms or other economies will respond to their policies.

This creates uncertainty and makes it difficult for policymakers to determine the most appropriate policy.

Inaccurate Information

Economic data often arrives with a **time lag** and may later be revised.

Policymakers use data such as:

- GDP growth
- Inflation
- Unemployment
- Government borrowing

However, the data may identify a trend without clearly explaining why that trend is occurring.

Incorrect diagnosis → inappropriate policy introduced → economic problem may worsen.

For example, the Bank of England may make an interest-rate decision using historical data even though current economic conditions have already changed.

Risks and Uncertainties

Governments cannot perfectly predict how consumers and firms will respond to a policy.

For example:

↑ Government spending → expected ↑ AD → households instead increase saving → multiplier smaller than expected → policy less effective.

Some risks can be identified before a policy is introduced, but other consequences may be impossible to predict.

Therefore, the eventual impact of government intervention can differ significantly from its intended impact.

Inability to Control External Shocks

Governments have limited control over events originating elsewhere in the global economy.

Globalisation means:

External shock in one economy → transmitted through trade, financial markets and supply chains → affects other economies.

Governments may therefore be able to **reduce the impact** of an external shock, but they cannot necessarily prevent it.

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