CAPACITARTE

Es ser líder de tu vida

Curso de inglés económico, de finanzas y tributos

Module 2. Economic Topics II

The role of the government

We can define a government as the system by which a state or community is controlled. This can also refer to the collective group of people that exercises executive authority in a state. This usage is analogous to what is called an "administration" in American English. Furthermore, especially in American English, the concepts of the "state" and the "government" may be used synonymously to refer to the person or group of people exercising authority over a politically organized territory.

What are governments for? Governments can undertake and/or regulate many tasks and activities, such as education, health, housing, police, justice system, defense, public transport, among others.

Governments provide certain public goods that generally are not provided by the market, such as street lighting, highways, law enforcement, and the court system. Government also provides aid for people in need.

- **Government Revenue and Spending**

Where does the money come from to pay for such goods and services?

The most important source is taxes. A **tax** is a mandatory payment to a local, state, or national government.

Revenue is government income from taxes and nontax sources. Nontax sources include borrowing and lotteries.

As you have seen, the federal government takes in a huge amount of money in taxes. The programs and services the federal government funds with this revenue are divided into two categories. These are **mandatory spending**, or spending that is required by current law, and **discretionary spending**, or spending that the government must authorize each year.

For example, the law requires that the government spend money to fund the Social Security and Medicare programs. However, the federal government can decide to fund or not fund highway construction or maintenance of national parks. The federal government, then, has certain expenses that must be paid under current law, while other expenses are covered with what is left after those required expenses have been met.

A) Mandatory spending can be in the form of **entitlements**, which are social welfare programs with specific requirements. Social Security and Medicare are entitlement programs that provide payments to anyone who is eligible based on age or disability. Many of these programs are not "means tested." In other words, anyone who meets the eligibility requirements receives the benefits, regardless of income level. For some other programs, however, income level is part of the requirement.

- **Social Security** The Social Security program takes the largest amount of federal spending. It provides benefits to older retired workers, disabled workers with limited incomes, and survivors of workers who have died. Social Security is financed through a payroll tax. Therefore, workers must have worked for a certain period of time before they are eligible to receive full benefits under the program.

- **Medicare Program.** It was introduced in 1966 as an additional old-age benefit under Social Security. Originally, Medicare provided hospital insurance, funded by a payroll tax, for people over 65, as well as optional medical coverage for items such as doctor bills. This part of Medicare is funded by premiums paid by those choosing the coverage and by general tax revenues.

- **Medicaid.** It was established at the same time as Medicare. **Medicaid** is a joint federal-state medical insurance program for low-income people. The federal government funds about 63 percent of the costs of the program, and the states pay about 37 percent.

Other Mandatory Spending Programs. There are a variety of other mandatory spending programs that define eligibility requirements and are then funded based on an estimate of how many people meet those requirements. In the U.S., we can find The Food Stamp program provides funds for about 26 million low-income people to purchase food. Veterans' benefits include health care coverage and disability payments for service-related illness or injury. People who have served in the military are also eligible for education assistance. Payments for the federal portion of unemployment insurance are also part of mandatory spending. In addition, the federal government pays its workers some retirement benefits.

B) Discretionary Spending. The programs covered by discretionary spending fall into several different categories. These categories include:

- Interstate highway system and transportation programs;
- Natural resources and the environment, including conservation programs, pollution clean-up, and national parks;
- Education
- Science, space, technology, and other research programs;

- Justice administration, including enforcement agencies (such as the Federal Bureau of Investigation (FBI) in the U.S.).

- **Methods of Spending**

Government funds can be spent in several ways.

One way is direct spending, by which the government buys goods and services that it needs to operate, such as military equipment and office supplies. Paying the salaries of government employees is another type of direct spending.

A second way the government spends the money is through **transfer payments**. They consist in money distributed to individuals who do not provide goods or services in return. These payments are generally part of the mandatory spending For example, Social Security retirement or disability benefits and health care benefits from Medicare or veterans' programs are transfer payments from the government to individuals. The individuals do not provide specific goods or services in exchange for these government funds.

A **grant-in-aid** (in the U.S.) is a transfer payment from the federal government to state or local governments. These grants are transfer payments between levels of government. The federal government makes grants to states, local governments, and regions. The grants are designated for specific categories of activities such as highway construction, certain school services, or Medicaid funding.

- **Fiscal Policies**

You learned that the government puts the tax money it collects to a variety of uses. The term **fiscal** refers to anything related to government revenue, spending, and debt.

Governments have two basic fiscal tools to influence the economy: taxation and government spending. **Fiscal policy** is the federal government's use of taxes and government spending to affect the economy. Fiscal policy has one of two goals: to increase aggregate demand or to fight inflation. To stabilize or strengthen the economy, the government may use one of two basic policies.

When the economy slows, the government may use **expansionary fiscal policy**, a plan to increase aggregate demand and stimulate a weak economy. Increased aggregate demand causes prices to rise, providing incentives for businesses to expand and causing GDP to increase. Expansionary fiscal policy also reduces the rate of unemployment, as there are more jobs available when businesses are expanding. Expansionary fiscal policy may involve increased government spending, decreased taxes, or both.

For example, suppose the economy is in recession and, in response, the government decides to increase spending for highways. The government spends the money by contracting with private firms in many cities to build new roads. This spending creates additional jobs as the contractors hire more and more construction workers to complete the projects. If employment increases, more people will have income to spend, and aggregate demand increases for all goods and services in the economy.

The government may also choose to cut taxes to stimulate the economy. By lowering individual and corporate income tax rates, the government allows individuals and businesses to have more income left after taxes. Individuals may spend their increased income and thereby increase demand for numerous goods and services. Increased income may allow them to increase their savings, which makes more money available to businesses to invest. Lower taxes also leave businesses with more money to invest in new equipment or plants, or in additional workers to produce more goods and services to meet increased demand.

Conversely, when the economy is in an inflationary period, the government may use a **contractionary fiscal policy**, a plan to reduce aggregate demand and slow the economy in a period of too-rapid expansion. This fiscal policy can be used to decrease the level of aggregate demand so that inflation is reduced. When the economy is growing too rapidly, aggregate demand may increase faster than aggregate supply, leading to demand-pull inflation. This type of inflation (see point … below) is characterized by a steadily rising price level and a decrease in the purchasing power of people's incomes. When the government faces such an economy, it may employ contractionary fiscal policy and use spending and taxes in ways opposite to expansionary fiscal policy. In other words, it may choose to decrease government spending or increase taxes in order to control inflation.

- **Inflation**

Inflation is a sustained rise in the general price level or a fall in the purchasing power of money.

Economists have several instruments for measuring inflation: **Consumer Price Index, which** is a measure of changes in the prices of goods and services commonly purchased by consumers. The government then creates a "market basket" of about 400 different goods and services purchased by a typical household. The basket is adjusted to account for how much of a household's budget goes to purchase each type of item. Each month, government workers research the current prices of the items in the market basket. **Producer Price Index** shows the level of inflation experienced by consumers, but producers also experience inflation. The tool that gauges that kind of inflation is the **producer price index (PPI)**, a measure of changes in wholesale prices. The PPI is constructed in roughly the same way as the CPI, but it reflects the prices producers receive for their goods rather than the prices consumers pay. The difference between consumer prices and producer prices lies in all the additional fees consumers pay, such

as sales taxes or shipping charges. The indices are grouped either by stage of production (finished goods, intermediate goods, and raw materials, for example) or by industry. Index changes from period to period are calculated in the same general way as the CPI. Because producers tend to encounter inflation before consumers, PPI tends to lead CPI as an indicator of inflation. Economists use CPI and PPI to calculate the **inflation rate**, the rate of change in prices over a set period of time.

The different **types of inflation** are defined according to the degree or level of the inflation rate. Rates below 1 percent are negligible, and those between 1 and 3 percent are moderate.

If a moderate rate continues over a period of time, the result is *creeping inflation*. A rapid increase in price level is known as *galloping inflation*. If galloping inflation gets out of hand, the result is *hyperinflation*—a rapid, uncontrolled rate of inflation in excess of 50 percent per month. *Deflation*, a decrease in the general price level, happens more rarely.

Economists generally distinguish between two **kinds of inflation**, each with a different cause.

When the inflationary forces are on the demand side of the economy, the result is **demand-pull inflation**, a situation where total demand is rising faster than the production of goods and services. Also, if the government creates too much money during the lag period before an increase in production makes more goods available, there will be too much money chasing too few goods, and prices will rise. The creation of excess money is the main reason for demand-pull inflation.

When the forces that lead to inflation originate on the supply side of the economy, the result is **cost-push inflation**, a situation where increases in production costs push up prices.

Wages are a large part of the production costs for many goods, so rising wages can lead to cost-push inflation. A **wage-price spiral** is a cycle in which increased wages lead to higher production costs, which in turn result in higher prices, which then lead to demands for higher wages.

Since the 1960s, the impact of inflation on the economy has been significant. Inflation has raised interest rates, limited the growth of the stock market, forced agricultural bankruptcies, and slowed production. Inflation is a major challenge to economic stability. For the economy as a whole and for individual consumers, inflation has an especially strong impact on the purchasing power of the dollar and on interest rates.

- **Effects of Inflation**
  - **Decreasing Value of the Currency**

With inflation, today's currency buys less than last year's. Suppose, for example, that your cousin started college with a savings of $10,000 to see him through. He planned to spend $2,500 a year on carefully budgeted expenses. However, because of inflation, each of those notes bought less each year. To pay for exactly the same things he bought in his freshman year for $2,500, by the time he was a senior he needed $2,750. Inflation had pushed prices up by 10 percent over the four-year period. Senior citizens living on a fixed retirement income—as well as anyone else with a fixed income—are especially vulnerable to the decreasing value of the currency through inflation. Conversely, inflation can help borrowers. With inflation, those who borrow at a fixed rate of interest can repay their debts with currency that is worth less, making their repayments smaller than they would have been without inflation. Suppose someone borrows $100 at 5 percent interest, promising to pay the lender $105 after a year. If inflation rises at 5 percent, the $105 the borrower pays the lender will have the same purchasing power as

the $100 of the original loan. The borrower essentially paid no real interest on the money he borrowed.

- **Increasing Interest Rates**

As prices increase, interest rates also tend to increase. Lenders raise their interest rates to ensure they earn money on their loans despite inflation. Higher interest rates mean that borrowing money becomes more expensive. For example, a $10,000 loan at 10 percent interest to be repaid over the course of five years would have a monthly payment of $212.47. At 5 percent interest, the monthly payment would be only $188.71. At the end of five years, you would have paid over $1,425 more for the loan at the higher rate. When interest rates are high, businesses are less likely to borrow to expand or to make capital improvements. Consumers are less likely to make purchases of high-priced items that they would need to finance. People carrying debt on credit cards have to make higher monthly payments as their rates rise.

- **Decreasing Real Returns on Savings**

Inflation also has a significant effect on savings. People who save at a fixed interest rate get a lower rate of return on their savings. While the interest paid on savings tends to increase during inflationary times, the difference between the rate of return and the rate of inflation still leaves them at a disadvantage. For example, if someone puts $100 in a savings account that pays 5 percent interest per year, they will have $105 at the end of a year. But if the rate of inflation for the year was 10 percent, that $105 will buy only about what $95 bought when they deposited their money. Although they have more notes, that money will buy less. Inflation, then, can discourage savings, leading more people to make purchases today rather than saving for tomorrow.

- **Unemployment**

Economists use unemployment figures to judge the performance of the economy. The measure they use most is the **unemployment rate**, the percentage of the labor force that is jobless and actively looking for work. The civilian labor force is made up of people over the age of 16 who are employed or actively looking and available for work. It does not include people in the military or those in schools, prisons, or other institutions.

To determine the unemployment rate, the Bureau of Labor Statistics (BLS) (INDEC in Argentina) surveys the labor force in 60,000 households each month. Workers over the age of 16 who are not working but are able to work and who have looked for work sometime during the previous four weeks are considered unemployed.

The BLS then divides the number of unemployed persons by the total number of workers in the civilian labor force to arrive at the unemployment rate.

While very useful, the unemployment rate does not account for discouraged workers who have stopped looking for work. Nor does it count the **underemployed**, those who work part-time when they want full-time employment or those who work at a job below their skill level. These include recently laid-off workers who may be in a temporary, lower-paying job.

Economists pay attention not only to the unemployment statistics, but also to the reasons for unemployment. Economists recognize four **types of unemployment**, as you can read on the slide.

The *frictionally unemployed* might include a parent who has spent time at home raising children and decides to move back into the workforce; a magazine designer who leaves his job to seek work as a designer at a book publisher; or a recent college graduate who is looking for her first full-time job. *Frictional unemployment* is a reflection of workers' freedom to find the work best suited for them at the highest possible wage. Economists consider frictional unemployment normal and not a threat to economic stability.

Demand for some jobs changes dramatically from season to season, resulting in *seasonal unemployment*. Demand for construction workers, for example, typically falls in the winter months when construction activities are more difficult. Tourism peaks at certain times of the year, and different regions have different tourist seasons. Migrant farm workers, who move from one area to another following the growing schedules of the crops, are hard hit by seasonal unemployment. The winter months are especially slow, resulting in economic hardship for many migrant families.

A dynamic economy will often create *structural unemployment* as businesses become more efficient and require fewer workers to create the same amount of output. There are a number of possible triggers for structural unemployment. New technology can replace human workers or require workers to retrain. New industries requiring specialized education can leave less well-educated workers out of work. A change in consumer demand—from compact discs to computer music files, for example—can shift the type of workers needed. Offshore outsourcing, when jobs once held by Americans are staffed overseas, is another cause of structural unemployment.

Cyclical unemployment results when the economy hits a low point in the business cycle and employers decide to lay off workers. Workers who lose their jobs during a recession can have trouble finding new jobs because the economy as a whole is scaling back, and the demand for labor declines. When the economy picks up again, many workers are again able to find jobs. The duration of unemployment in these four types ranges widely, but the average duration of unemployment is relatively short.

Despite its name, **full employment** does not mean a zero unemployment rate. Instead, it means a level of unemployment in which none of the unemployment is caused by decreased economic activity. Even in a healthy economy there is always some level of unemployment. Sometimes people become unemployed when they relocate or when they leave one job to try to find another job that suits them better. Sometimes the

available jobs do not match up with the skills of the available workers. In other words, some amount of unemployment is inevitable.

Although some unemployment is unavoidable, excessive or persistent unemployment hurts the economy in several ways:

- It reduces efficiency; it hurts the least economically secure; and it damages workers' self-confidence. Unemployment is inefficient. It wastes human resources, one of the key factors of economic growth.
- Unemployment does not follow equal opportunity rules. In an economic slowdown, those with the least experience lose their jobs first—usually minorities and the young. Also, with fewer jobs available, people on the lower rungs of the employment ladder have less opportunity to advance.
- People who are unemployed—or underemployed—for long periods of time may begin to lose faith in their abilities to get a job that suits their skills. Potentially productive workers may give up their search for work. If they are underemployed, they may not be motivated to do their best work.

- **Economic Theories on Government Intervention in the Economy**

The 18th and 19th century classical economists, most notably Adam Smith in the Wealth of Nations (1776) argued in favor of laissez-faire and insisted that natural forces such as individual self- interest and competition naturally determine prices and incomes. Theoretically, under perfect competition, wages and prices would be perfectly flexible. It was argued that a perfectly competitive economy would produce a general equilibrium. This in turn would lead to allocative efficiency, the point at which all the resources of an economy are being fully and efficiently employed so that no particular output can be

increased unless another is reduced, and no-one can become better-off without making someone else worse off.

- **Keynesianism**

The great depression of the 1930s demonstrated that, at least in the short run, the market system does not automatically lead to full employment. In the General Theory of Employment, Interest and Money (1936), Jhon M. Keynes argued that market forces could produce an equilibrium with high unemployment of indefinite duration. For example, if people are worried about the possibility of losing their jobs in the near future, they will probably start saving money and consuming less, which will lead to a fall in demand, and consequently in production and employment. In such circumstances, producers will clearly not be interested in making new investments, so people's savings will remain unused, and the economy will settle into a new equilibrium at a lower level of activity – with fewer goods being produced, fewer people employed, and reduced rates of income and investment, Classical economic theory stated that in the long run excess savings would cause output to fall and investment to increase again. Keynes disagreed arguing that market economies are inherently unstable and without self-correcting mechanism, except perhaps in the long run – but as he famously put it, 'in the long run, we are all dead'.

Keynes therefore recommended governmental intervention in the economy to counter the business cycle. During an inflationary period, governments could decrease their spending or increase taxation. During a recession, on the contrary, they could increase their expenditure, or decrease taxation, or increase the demand and reduce interest rates, so as to estimulate the economy and increase output, investment and consumption and employment. Keynes also argued that even a small amount of additional government spending or an increase in private investment causes money supply to expand by an amount greater than itself, because of the multiplier effect: the

new money is repeatedly represented, except for the proportion that people choose to save.

- **Monetarism**

In the 1950s and 1960s, monetarists, most notably Milton Friedman, began to argue that Keynesian fiscal policy had negative long-run effects. Unlike Keynessians, monetarists insisted that money is neutral, meaning that in the long run, changes in the money supply will only change the equilibrium level and have no effect on output and employment.

They argued that governments should abandon any attempt to manage the level of money supply in the economy through fiscal policy. On the contrary, they should try to make sure that there is constant and non-inflationary growth in the money supply.

Monetarists argue that recessions are not caused by long-run market failures but by short-run errors by firms and workers who do not reduce their prices and wages quickly enough when demand falls. When economic agents recognize that prices and wages have to fall, the economy will come back to normal.

Since the government will not be able to recognize a coming recession any more quickly than the companies that make up the economy, it will only be able to act at the same time as everyone else in recognizing the need to cut prices and wages. Consequently, its fiscal policies measures will take effect when the economy is already recovering, and so will merely make the next swing in the business cycle even greater.

- **Neo-classicism**

If the post-war period was the era of keynesianism, events after the 1973 oil crisis demontrated that Keynes did not have all the answers, and the late 1970s and the 1980s saw the rise of various forms of neo-classicism, all of which agree that medium or long-

term economic growth is damaged by short-term Keynesian or "stop-go" government policies to stabilize the economy.

The ultimate aim of Keynesian governmental intervention or demand management is full employment – when no involuntary unemployment exists. However, this is now widely considered to be impossible, and even undesirable, as it causes inflation to rise. Many economists now talk about "the natural rate of unemployment" which corresponds to optimal output, when upward and downward forces on prices and wages are in balance, so that inflation is stable. In the 1960s, it was believed that there was a "trade-off" or exchange between low unemployment and high but stable inflation. Yet the development, in the 1970s and 1980s, of "stagflation" – high unemployment or stagnation and persistent and rising inflation, seems to disprove this. It also became clear that in the long run, low unemployment, achieved by fiscal policies, results in rising inflation, because inertial inflation always rises after inevitable shocks.

Since it is argued that attempts to force unemployment below its natural rate lead to accelerating inflation, the natural rate is also known as the non-accelerating-inflation rate of unemployment (or NAIRU).

- **Rational Expectation theory**

In his General Theory of Employment, Interest and Money (1936), Keynes argued that people's economic expectations about the future were generally erratic and random, and could consequently be systematically wrong. In the 1970s, the Rational Expectations school, led by Robert Lucas and Thomas Sargent, began to argue that, on the contrary, people (or "economic agents") generally make rational choices according to the information available to them. For example, if people anticipate that the government will cut taxes or allow the money supply to grow or interest rate to fall, so as to boost employment and stimulate demand, they will plan and behave accordingly. Even before the government announces such measures, companies will plan prices rises, and trade

unions will demand higher pay. This means that predictable and systematic policies to stabilize the business cycle (e.g., monetary expansion and tax cuts) will instantly be compensated for and thus become ineffective. In other words, fiscal and monetary policy will only affect output and unemployment if it is unpreictable and comes as a surprise, in much the same way as only random news shocks stock market prices.

- **Neo Keynesianism**

Whereas classical (and neo-classical) economic theory assumes pices and wages to be flexible enough to eliminate excess supply or demand, Keynesians (today often called neo-Keynesians) argue that wages are inflexible and sticky because of labour union contracts, government regulation, and so on. Furthermore, business cannot change their prices too frequently, because they do not have perfect information, and because there are many costs involved. These are sometimes known as 'menu costs', drawing on the example of restaurateurs who cannot afford to print menus with the new prices every day according to small fluctuations in demand.

"Supply-side" theorists agree with Keynesians that there is a role for economic policy, but they argue that it should focus on aggregate supply or potential output rather than on aggregate demand. They recommend boosting supply in a stagnant economy by lowering taxes on capital and business profits, which will lead to an increase in the supply of inputs, namely capital and labour.