



Article: The Importance of Economic Growth

by Professor Noel T. Palmer

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Economic Growth refers to an increase in the productive capacity of an economy as a result of which the economy is capable of producing additional quantities of goods and services.

Normally our standard of living is measured by the quantity of goods and services available to us so that economic growth is synonymous with an increase in the general standard of living.

Cost of Economic Growth

Cost is entailed in the course of generating economic growth. Increased output requires an increase in the quality and/or quantities of inputs. At the global level this is manifest in the concern expressed at the depletion of natural resources and the environmental damage incurred as the global productive base is expanded in order to meet ever increasing global demand.

Similarly, though on a less dramatic scale, economic growth at the national level also imposes costs on the citizens of a country. If it is necessary to expand the productive base of the economy then additional capital goods and services will be required. There are three possible means by which this increase in the national stock of capital goods and services can be achieved.

- (a) The first possibility is using national resources that are **not** currently being employed.
- (b) The second possibility is diverting resources currently being used in the production of consumption goods and using them to manufacture capital goods.
- (c) And the third possibility is to import the capital goods required.

The point to note is that no matter which combination of these methods is utilised there is a reduction in the general standard of living in the country in the sense that there is a reduction in the quantity of consumption goods and services that is available to the average person.

In a modern economy this is achieved through national savings – that is people not buying consumer goods and the savings thus created can be used for investment purposes i.e. the production of capital goods.

As a student of accountancy you are involved in this overall scheme of thing in that you are saving by diverting hours that could be used for earning money or leisure towards studying i.e. you are making an investment in your own stock of human capital which will pay dividends in the future.

Potential Level of Output. At this stage we have been looking at the supply side of the situation i.e. the ability of an economy to produce greater quantities of goods and services or perhaps improved versions of existing offerings. This aspect of the subject is usually referred to as the potential level of output of the economy or in terms of a growth in the productive capacity of the economy.

Actual Level of Output. The potential level of output focuses on the quantity of goods and services that the economy is capable of producing; whether or not the goods are actually produced depends on the nature of demand. ***Thus it is demand that drives the level of production in the economy towards its potential; it is demand that stimulates the economy and determines the actual level of output in an economy.***

To summarise Potential Growth occurs through investment and Actual Growth occurs through increases in the level of demand.

When potential production is greater than the actual level of demand then we experience underemployment of factors of production.

Sectors of Growth. Given the significance of demand in our analysis it is appropriate that we consider the sectors of the economy in which this demand originates.

C The greatest level of demand originates as individuals purchase goods and services for consumption purposes. With the exception of the purchase of a house everything you and I buy are classified as being for consumption purposes. Consumption goods and services get their name from the fact that they are consumed (or used up) when providing the satisfaction that is inherent in them. Consumption goods are considered to be the end product of economic activity.

I Another source of demand is the purchase of goods for capital purposes. Capital goods are goods used for the creation of other goods e.g. machinery. The purchase of goods of this nature is classified as investment. The demand for capital goods arises **not** because they are perceived as providing satisfaction in their own right but rather because they are considered to be the means by which we can increase and enhance the stock of consumption goods.

G In the course of running the country the government requires the use of goods and services examples are teaching services, nursing services, the building of roads etc. In this way government contributes to the level of demand in the economy/

X The final source of demand in the domestic economy comes through people in other countries buying our goods and services.

You will read in your textbook that:

Aggregate demand (or total demand in the economy) = C + I + G + NET EXPORTS

Where **G** represents the demand for consumption goods,

I represents the demand for capital goods and services.

G represents the demand created by the government for goods and services that it requires.

And Net Exports is foreigners demand for goods and services minus our demand for theirs.

You will also notice that these symbols also constitute the injections into the Circular Flow of Income Diagram that we use when we are explaining the Determination of National Income.

It is ironic that the standard of living seems to be continually rising in rich countries while poorer countries find it difficult to break out of the poverty trap. Within our present analysis this phenomenon may be explained in the following way, **remembering that it is the level of demand that determines the actual level of output in an economy.**

C When an economy is performing at a high level of activity there will be high levels of employment and individuals will have money to spend. So that there will be a high level of demand for consumption goods.

I When the economy is performing well the demand for capital goods will also be buoyant since there will be **two** influences encouraging an upward thrust to the level of investment.

Firstly because there is a good demand for their output entrepreneurs will experience a need to produce increasing quantities of their product. This together the prospect of increasing their profits will increase the likelihood of there doing so.

Secondly since in the circumstances envisaged firms would be earning good profits they would have the resources to extend their capital base if they wish to undertake further investment.

G Similarly government finances are strengthened during periods of economic growth.

- (a) The revenue from taxation will be increasing;
- (b) The numbers qualifying for welfare payments will be reducing;
- (c) Both of these together with the increase in the taxable base that accompanies growth will combine to increase the revenue available to the government and thus enable the government to further increase demand in the economy.

Alternatively the government could decide to reduce the level of government debt which would have beneficial economic effects in future periods.

x – m The effect on foreign trade is ambivalent since we will probably increase our demand for imported goods and services while at the same time the effect on the demand from foreigners for our exports is uncertain. It is possible that a buoyant domestic economy may result in upward pressure on prices which could threaten our competitiveness in export markets.

These benign economic influences experienced during economic buoyancy become malign during an economic recession.

While all of these influences are favourable for continued growth when the economy is performing well they all apply with an opposite effect during a recession such as we are presently experiencing in this country. Hence in a recessionary period domestic demand for consumption goods will be declining; this will be reflected in less desire from entrepreneurs to invest. Similarly there will be a fall in government revenues from taxation. This is the reason why, in Ireland, there is consistent reference to exports being the principal hope for increasing economic activity during our present economic circumstances.

Gross Domestic Product is a measure of the value of the goods and services produced in the Irish economy irrespective of who owns the factors of production used to produce these goods and services. **Thus it will be realised that economic growth and growth in GDP are synonymous.**

Fiscal Ratios

When global financial institutions wish to assess our national solvency they look at our national debt in relation to our GDP. Again this can be compared with the situation at an individual level. A bank manager would look at your earning base and the amount of money you owe in deciding how solvent you are and whether you would be a good risk if the bank were to give you a loan. Now if we return to the national level and consider GDP to be our earning capacity and our National Debt to be the amount of money we owe you can understand the approach of the global financial institutions when they relate our National Debt to our GDP. Within the Eurozone there is a requirement on Member States that National Debt should be not more than 60% of GDP. It is considered that a country can service that level of debt without having to take actions that would impede the short or medium term economic progress of the country. So that Economic Growth and the concomitant increase in GDP facilitate higher levels of national borrowings.

The European Union is also concerned that Member States should be living within their means i.e. that current expenditure should be related to current revenue at the national level. If the expenditure and revenue were exactly matched then we would have a **balanced budget on our current account**, if current expenditure exceeds current revenue then there exists a **Budget Deficit**.

Under the terms of The European Stability & Growth Pact a current budget deficit not greater than 3% of GDP is tolerated. Thus you can further appreciate the importance of economic growth since economic growth increases our GDP and thus allows us to have a greater current account deficit **in absolute terms**. Once more you may compare this with the situation that applies at the individual level where the expenditure of an individual has to be matched by their income and the significance of any shortfall would be assessed by benchmarking the shortfall against their income.

Economic Growth is important because it is the means by which we can improve the quality of our standard of living .It also enables us to cater for any increases in our population without having to lower our standard of living.