Fiscal Policy Questions (MCs & Essays)

GCE A-LEVEL ECONOMICS

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A interest rates.

B direct and indirect taxes.

C the money supply.

D exchange rates.

[1 mark]

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(c) If a government takes decisions to target a budget surplus, this is an example of:

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- ☐ **A** contractionary monetary policy
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(Total for Question 4 = 5 marks)

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Which one of the following macroeconomic policies is a Keynesian economist most likely to recommend as a means of stimulating recovery for an economy that has been in recession for several years?

A Increasing taxes to finance increased government expenditure. ⬭

B Increasing the money supply to maintain very low interest rates. ⬭

C Increasing government expenditure financed by increased government borrowing. ⬭

D Cutting government expenditure to balance its budget. ⬭

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A A decrease in income tax

B A decrease in the budget deficit

C An increase in government spending

D An increase in the rate of interest

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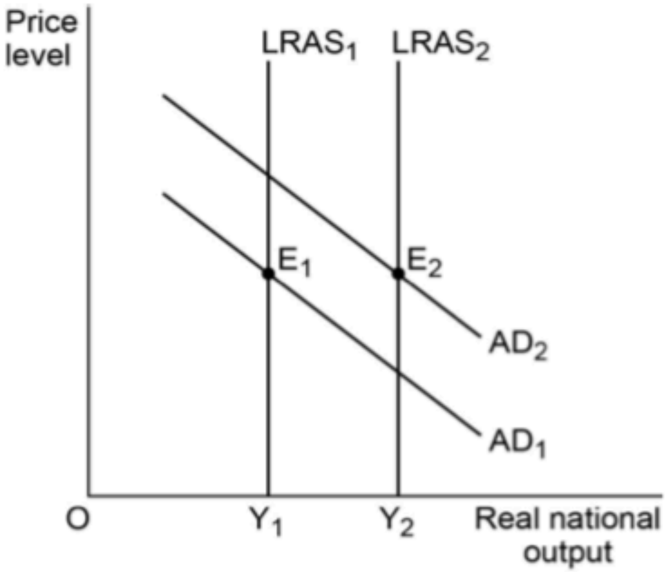
The diagram below shows two aggregate demand curves (AD) and two long-run aggregate supply curves (LRAS) for an economy. The economy's initial equilibrium point is at E_1.



All other things being equal, which one of the following combinations of macroeconomic policies, **A**, **B**, **C** or **D**, is most likely to have moved the economy to its new equilibrium point at E_2?

	Monetary policy	Fiscal policy
A	Increase in interest rates	Increase in Value Added Tax (VAT)
B	Reduction in interest rates	Reduction in direct taxes
C	Increase in interest rates	Reduction in Value Added Tax (VAT)
D	Reduction in interest rates	Increase in direct taxes

[1 mark]

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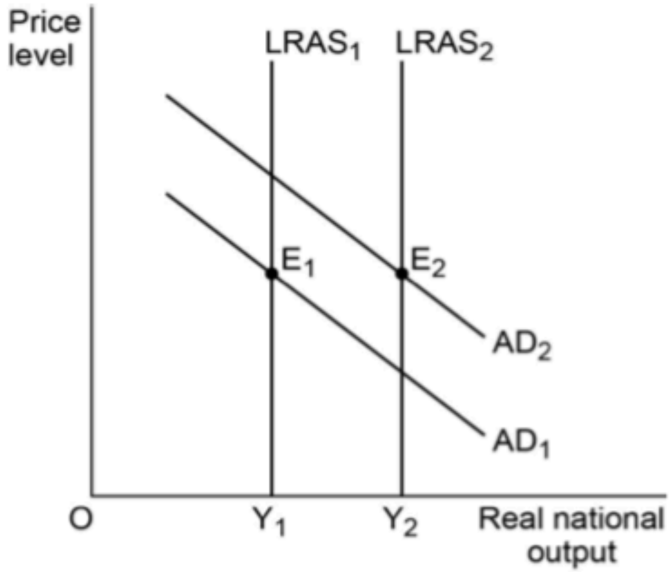

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[1 mark]

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*(c) To what extent is the policy of reducing the 'fiscal (budget) deficit' (Extract 2, line 7) helping the government to achieve its macroeconomic objectives?

(30)

Extract 2 UK growth for final quarter of 2011 revised down

Britain's struggle to shake off the effects of the recession has been set back by news that the economy shrank more than previously thought in the final quarter of 2011 and remains no bigger than in the autumn of 2010. The Office for National Statistics estimated that the Gross Domestic Product (GDP) fell 0.3% in the fourth quarter of 2011, down from its previous estimate of 0.2%. Though most think the economy is now growing again, the figures still provided fresh information for critics of the coalition government's fiscal (budget) deficit reduction policies of cuts in government spending and increases in tax. An opposition spokesman said the news showed the March 2012 Budget from Chancellor George Osborne "made the wrong choice in sticking to policies that are failing on jobs, growth and the deficit."

(Source: adapted from © Financial Times, 28 March 2012)

Extract 3 Outlook for the UK Economy 2012–3

Weak international demand, continued low household consumption and the needed reduction in the fiscal deficit has halted the recovery. Growth will start to pick up during 2012 as exports and household consumption recover, with further strengthening in 2013. Unemployment is rising and will reach 9% in 2013, while inflation is presently peaking as anticipated and is expected to fall below the 2% target in 2013 as the temporary inflationary effects from the increase in VAT and higher commodity prices diminish. Monetary policy is supporting economic recovery, with the Bank of England interest rate at 0.5% and quantitative easing being resumed. The ambitious fiscal deficit reduction programme has helped to keep market interest rates low by maintaining confidence in the money markets.

(Source: adapted from © OECD Outlook 90 database)

(c) QWC i-iii	KAA 18 **Up to 6 marks (3 x 2marks):** • Definition of macroeconomic objectives (the aims/targets of the government to improve economic welfare) • Definition of a fiscal (budget) deficit • Identification of cutting government spending • Identification of raising taxation • Use of relevant data • AS/AD diagram showing impact of falling government spending and/or rising taxation **12 marks (3 x 4 marks or 2 x 6 marks) - Identification of macroeconomic objective (2) and explanation of effect on objective (up to 4 marks)** Factors might include: • Reduce unemployment / achieve full employment (2) - AD would be reduced leading to lower demand for labour and increased unemployment (2) • Low, stable inflation (2) - AD would be reduced leading to reduced price level or deflationary demand-pull pressure (2) • Sustainable economic growth (2)- AD would be reduced leading to lower real output (2) • Equilibrium on balance of payments on current account (2) - falling real incomes leads to lower demand for imported goods and services which would reduce the deficit on the current account of the balance of payments (2) • More equal income distribution (2) - cuts in government spending likely to affect lower income earners more, but rising tax rates could have a regressive or progressive effect (2) • Achievement of environmental goals - likely to be positive as real output / production levels fall • Reduction of national debt or balancing the budget - objective achieved	(30)

Evaluation 12 marks (2 x 6 marks or 3 x 4 marks):

- Despite fiscal retrenchment unemployment is falling and employment is at an historic high, although this could be accounted for by record number of part time workers
- Despite fiscal retrenchment inflation remains above target, although this could be accounted for by cost push inflation from a weakening exchange rate or rising raw material prices
- The impact on the deficit on current account might be relatively small if imports are relatively income inelastic such as oil / food
- Rising tax on firms and falling government spending may reduce international competitiveness, worsening the current account position
- Falling real incomes should lead to lower demand for imports which will reduce the leakages from the circular flow of income and the size of AD's fall.
- Fiscal retrenchment will reduce the speed of economic recovery so delay reduction of the budget deficit and national debt (Labour argument)
- Prioritisation of objectives
- Elasticity of AS curve / level of spare capacity
- LR / SR effects
- Availability of credit
- Size of the multiplier
- Size and speed of reduction of fiscal deficit
- Size of national debt
- Time lag and implementation lags
- Other things are not equal - e.g. depends on global economic changes
- Conflict between policies

(b) In 2012, France announced its intention to increase its top rate of income tax from 46.7% to 75%.

Evaluate the likely economic effects of such an increase in the marginal rate of income tax.

(30)

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Question No.	Answer	Mark
1 (b)	KAA: 21; *Ev: 9* Effects include: • Impact on incentives to work: could act as disincentive to take higher paid jobs *But: workers might work harder to maintain standard of living* • Tax revenues/public finances: these might be expected to increase: reference to Laffer curve analysis *But: depends at what rate of tax that tax revenues are maximised; reference to Laffer curve analysis; also depends on overall impact on AD & economic growth* • Could cause an increase in tax evasion (illegal) and tax avoidance (legal) *But: depends on powers of tax authorities to collect taxes* • Might cause an increase in number of tax exiles *But income tax is not the only factor which influences a person's decision on where to live* • Increased income equality: the tax system is more progressive so if the taxes collected are used to redistribute incomes to the poor then inequality will be reduced *But: depends on how tax revenues are used and whether other fiscal changes offset the impact of the higher marginal tax rate.* • Impact on AD and growth, unemployment and inflation *But: if savings are reduced to pay for the higher rate of tax, then the effects will be minimal* • Impact on FDI flows *Further evaluative points:* • *Impact depends on where the higher rate threshold is set.* • *Number of higher rate tax payers* • *MPC of higher rate tax payers*	**(30)**

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(e) Discuss 'looser fiscal policy' and 'supply-side reforms' (Extract A, lines 20 and 21) that may be used by governments of Eurozone countries to increase economic growth.

(15)

Extract A

European Central Bank disappoints markets with weaker than expected stimulus

Mario Draghi, president of the European Central Bank (ECB), surprised financial markets in November 2015 with a less ambitious package of monetary stimulus than many had anticipated.

The ECB cut its base interest rate by 0.1% to minus 0.3% in order to encourage private banks to lend funds to companies and households rather than deposit them at the central bank. The central bank agreed to extend its €60 billion (£45 billion) monthly bond-buying quantitative easing (QE) programme for a further six months. The ECB's €1.1 trillion QE scheme had originally been due to end in September 2016.

"We are doing more because it works," Mr Draghi said. Yet the ECB did not increase the size of its monthly asset purchases and also disappointed those expecting that it would cut interest rates more aggressively.

The euro rose almost 3% against the dollar to $1.08 after the announcement. Italian and Spanish bond yields both jumped by 0.27% to 1.62% and 1.72% respectively.

The ECB's economists reduced their inflation forecasts for the next two years. They now predict consumer prices in the Eurozone rising by just 1% in 2016 and 1.6% in 2017 – still below the central bank's ceiling of 2%. In November 2015, the inflation rate was just 0.1% and core inflation, excluding volatile items such as fuel and food, dropped to 0.9%.

Mr Draghi stressed again that monetary policy alone could not restore the Eurozone to economic health. He called for looser fiscal policy among member states to support aggregate demand and more rapid implementation of supply-side reforms. "In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively," he said.

(Source: http://www.independent.co.uk/news/business/news/ecb-disappoints-traders-with-weaker-than-expected-stimulus-a6759786.html, 4th December 2015)

Question Number	Indicative content	Mark
6(e)	**Knowledge 3, Application 3, Analysis 3** **Potential policies may include:** • Fiscal policies, e.g. reduced corporation tax to increase investment and therefore increase AD • Supply-side policies, e.g. increased investment in education to create a more highly-skilled and therefore more productive workforce N.B. Candidates may discuss more than one of each type of policy N.B. Candidates must discuss both fiscal and supply-side policies for level 3	**(9)**

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Question Number	Indicative content	Mark
6(e) continued	**Evaluation 6** Evaluation of the policies, e.g. • Governments in many Eurozone countries are having to focus on reducing national debt and can't afford policies such as tax cuts • Supply-side policies take a long time to have an impact on the economy	**(6)**