AQA A-LEVEL ECONOMICS · 7136

ECONOMICS



EXAM QUESTION PACK

3.2.5.1 FISCAL POLICY

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1. In July 2012, the Office for Budget Responsibility concluded that UK Government measures to cut the budget deficit have improved the UK's long-term economic prospects.

Explain possible economic reasons why a government might prefer to cut government spending to reduce a budget deficit rather than raise taxes.

[15 marks]

2. In March 2011, the UK Office for Budget Responsibility (OBR) forecast that the budget deficit would fall from 7.9% of GDP in the financial year 2011-2012 to 1.5% in 2015-2016.

Explain the term 'living standards' **and** analyse how cuts in government spending to lower the budget deficit might affect living standards in the UK.

[15 marks]

3. THE GLOBAL CONTEXT

Extract B: Worrying times across the world for unemployment

In August 2011, it was reported that unemployment in the US economy had fallen in July from 9.2% to 9.1% of the labour force. This was seen by some as a turning point, a time when stronger real GDP growth would signal an economic recovery despite the effects of economic shocks persisting. Oil price increases, banking crises and interest rate rises are examples of such shocks. At a time when global unemployment was around 6%, many saw the US unemployment statistic as just a tiny bright spot in an otherwise depressing picture, both in America and globally.

Data from the *International Labour Organisation* (ILO) show a picture of increasing unemployment in developed economies for the period 2007 to 2009, with some levelling out in 2010 and 2011. UK unemployment in mid-2011 was around 8%. Some had anticipated that this figure would be far higher given a significant tightening of fiscal policy in the UK, severe debt problems in parts of the eurozone and a US economy stubbornly refusing to recover. Both the eurozone and the US economies are important trading areas for the UK. Further increases in UK unemployment were seen as inevitable despite job creation taking place. The number of people in work in the UK rose by 184 000 between April and June 2011, taking the total in work to over 29 million.

The UK Government has argued that its policy of fiscal restraint is the correct one in order to reduce the budget deficit, although the Managing Director of the *International Monetary Fund* (IMF) has argued that recovery in aggregate demand is 'the single best cure for unemployment'.

However, the Managing Director of the IMF has also argued that targeted programmes in the labour market are vital, even to the extent of wage subsidies paid to employers for vulnerable groups such as the young unemployed. The more people in work, he argued, the greater the spending power available to help recovery by raising demand for goods and services. The teaching of new skills and the encouragement of occupational and geographical mobility are a vital part of such programmes. For example, in the UK, the Government's Work Based Learning Programme includes apprenticeship programmes aimed at unemployed young people. Another targeted UK scheme is the Work Programme. This is designed to help the long-term unemployed of whatever age to find a job.

Such supply-side measures are regarded by some as an irrelevance in the short term when stimuli to aggregate demand are seen to be so urgently needed. However, all economies need to look at their long-term performance, and supply-side measures can create a stronger labour market. Economic recovery is then more likely to occur.

Source: official statistics, 2011

4.

THE EUROPEAN UNION CONTEXT

Extract E: The French economy faces problems

The International Monetary Fund (IMF) has warned the French government that, unless it makes major economic reforms to lower its labour costs and avoid tax rises, the economy is likely to experience reduced growth. This view was echoed in a recent survey of bankers, in which France was identified as the most serious threat to Europe's recovery from the debt crisis which has crippled growth and driven unemployment to record highs. The outlook for France, the Eurozone's second largest economy, is more worrying than that for Italy, Spain or Germany.

The Chief Executive officer of the Institute of International Finance said: 'There's a lack of concern about international competitiveness in France.' French President, François Hollande, is failing to revive business investment in the face of one of the world's highest tax burdens. Such investment could generate greater efficiency and higher productivity, especially important if the euro's exchange rate does not always work in France's favour.

An IMF spokesperson, Edward Gardner, also said that French unemployment, which currently stands at 11%, would continue to rise, despite President Hollande's vow to reduce it by the end of the year. 'It reflects in large part a general phenomenon in Europe that the recovery is slower in coming than we had expected.' The euro area's recovery almost came to a halt as the French economy unexpectedly shrank and German growth slowed.

The failure of the French economy to improve is in contrast to the overall success of the German economy and the stronger signs of recovery in the UK. President Hollande now faces difficult choices in reducing government spending to reach European budget deficit commitments. Furthermore, a recent announcement that VAT will rise, despite previous claims that there would be no significant tax rises, may cause further problems for the economy.

Source: News reports, 2013

5.

The Global Context Extract B (lines 21–22) suggests that 'targeted programmes in the labour market are vital' in order to reduce unemployment.

Using the data and your economic knowledge, to what extent would you agree that such programmes are likely to be the most effective way of reducing unemployment in developed economies such as the UK? Justify your answer.

[25 marks]

6.

'Economic shocks can bring with them significant consequences for macroeconomic performance, as the UK knows only too well.'

Using at least **one example of each**, explain how demand-side and supply-side shocks might harm a country's economic growth.

[15 marks]

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7. In July 2012, the Office for Budget Responsibility concluded that UK Government measures to cut the budget deficit have improved the UK's long-term economic prospects.

To what extent do you agree, if at all, that the implementation of a budget deficit reduction programme will improve the UK's long-term economic prospects? Justify your answer.

[25 marks]

8. Savings often provide the funds for investment. In 1997, the UK saving ratio stood at 13%, at the beginning of the financial crisis in 2007 it was only 5% and by 2014 it had risen slightly to 7%.

Evaluate the likely impact of a fall in the saving ratio on the performance of the UK economy.

[25 marks]

9. Globalisation and outsourcing of manufacturing provides several potential benefits to economies. However, some countries, such as the UK, continue to suffer persistent trade deficits but are unable to resort to import controls.

Explain how the UK Government could reduce a balance of payments deficit on the current account, other than through the use of import controls.

[15 marks]

10. Savings often provide the funds for investment. In 1997, the UK saving ratio stood at 13%, at the beginning of the financial crisis in 2007 it was only 5% and by 2014 it had risen slightly to 7%.

Explain why the saving ratio may fall.

[15 marks]

11. **The Global Context Extract B** (lines 3–5) states: 'When taxation is progressive, it is highly debatable whether or not increasing top rate taxes on income raises extra revenue, or whether it may result in less money being collected'.

Explain the term progressive tax **and** analyse why a rise in income tax rates may lead to lower tax revenue.

[9 marks]

12. **The Global Context Extract C** (lines 9–11) states: 'However, the tax summaries have been heavily criticised in that they may make individuals more inclined to support political parties which favour lower taxes, without considering the wider picture of what state spending provides.'

Using the data and your knowledge of economics, to what extent do you agree that cuts to direct taxation would benefit growth **and** living standards in the UK?
Justify your answer.

[25 marks]

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13. THE GLOBAL CONTEXT

Extract C: Where does tax go in the UK?

In the UK, from November 2014, HM Revenue & Customs will begin sending 24 million working people the first Annual Tax Summary, showing how their money is being spent by the state, in order to make taxation more transparent. For example, someone on a salary of £30 000 will see that £1663 of their money is spent on welfare, with £1280 going to health, £892 going to education, £822 going to the state pension and £475 going on national debt interest. Ministers believed that showing exactly where taxpayers' money goes could make voters more receptive to controversial Government changes to the benefits system.

However, the tax summaries have been heavily criticised in that they may make individuals more inclined to support political parties which favour lower taxes, without considering the wider picture of what state spending provides. The breakdown does not make clear that most of the welfare budget goes to pensioners, the sick and disabled people. The Treasury originally planned to show just 3% went towards unemployment benefits while much larger amounts went to children and families, elderly people and those unable to work, but this has been left off the tax summaries.

A Labour Party spokesperson said: 'This government's record on tax is giving millionaires a huge tax cut while everyone else pays more.' She added: 'Families and pensioners are paying more in higher VAT, but that tax isn't included in these tax summaries and independent figures from the Institute of Fiscal Studies show that, by next year, families will be £974 a year worse off because of tax and benefit changes since 2010.'

Source: news reports, 2014

14.

THE GLOBAL CONTEXT

Extract B: New Zealand's low tax economy

In New Zealand, The National Party recently won the general election on policies of cutting taxes and balancing the budget, beating a Labour Party opposition that promised to put up taxes. When taxation is progressive, it is highly debatable whether or not increasing top rate taxes on income raises extra revenue, or whether it may result in less money being collected. significantly reducing the top rate of income tax appears to have revived the economy, and been rewarded with electoral success as well.

After the financial crash of 2008, New Zealand started shifting taxes from earnings to consumption. While VAT was increased from 12.5% to 15%, income taxes were cut, including the top rate from 38% to 33%, and corporation tax was also cut by 2%. The government believed that lower taxes would create faster growth, a risky assumption at the time. Some cuts in government spending were also made to accompany the package.

The lower taxes seem to have worked. New Zealand has witnessed one of the most robust recoveries in the developed world, despite suffering a major shock (the Christchurch earthquake in 2011). The economy is forecast to expand by 3.9% in 2014, a faster rate than the UK or US. Higher tax revenues, and tight control of public spending, meant it was one of only three OECD countries able to balance its budget in 2014.

However, there are plenty of differences between the UK and New Zealand. For a start, it is a tiny country, with only 4.5 million people. It has been helped by strong dairy prices, although agriculture only accounts for 4% of GDP. New Zealand currently ranks 7th in the Human Development Index whereas the UK is 14th. Perhaps most importantly, its major trading partners are the fast-growing Asian-Pacific economies, while the UK is linked with the Eurozone. One big difference is in the structure of the economy. New Zealand has a far smaller public sector, with the state responsible for 32% of GDP, compared with almost 43% in the UK, but a smaller state also needs less tax revenue to fund it. Maybe the UK also should consider tax cuts to secure growth.

Source: news reports, 2014

15.

The economies of Mexico, Indonesia, Nigeria and Turkey (MINT) have all been identified as the next main emerging market economies with high rates of growth. However, there are warnings that what goes up will eventually come down.

Explain why economies may go from periods of economic growth to recession.

[15 marks]

16.

The European Union Context Extract E (lines 8−9) states: 'There's a lack of concern about international competitiveness in France.'

Explain what is meant by 'international competitiveness' **and** analyse how the international competitiveness of France might be improved.

[9 marks]

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17. Which one of the following statements about fiscal policy is **not** true?

A It can be used to change the behaviour of economic agents. ⬭

B It is a tool of economic management. ⬭

C It does not have any effect on interest rates. ⬭

D It is used to redistribute income and wealth. ⬭

[1 mark]

18. Government intervention will result in a more efficient allocation of resources if

A it leads to a reduction in the consumption of demerit goods. ⬭

B it leads to a reduction in the subsidies received by firms. ⬭

C it reduces the number of competing firms in an industry. ⬭

D consumers are charged for the provision of public goods. ⬭

[1 mark]

19. **The Global Context Extract C** (lines 7−9) states: 'These policies, however, have created greater divides in terms of the 'haves' and 'have nots' which may have consequences for the UK's macroeconomic performance.'

Using the data and your knowledge of economics, assess the importance for UK macroeconomic performance of increasing income inequality, **both** domestically **and** in other economies.

[25 marks]

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20. **THE GLOBAL CONTEXT**

Extract C: Incentives and economic performance

Could inequality be adversely affecting economic performance? According to some economists, capitalism is not working effectively. Reducing trade union power and creating more flexible labour markets have created greater income inequality. Successive governments have also reduced taxation on companies and high earners (such as the cut in income tax for those earning over £150 000 from 50% to 45%) in order to promote incentives and wealth generation, as well as focusing much of the UK's hopes on the financial services industry. These policies, however, have created greater divides in terms of the 'haves' and 'have nots' which may have consequences for the UK's macroeconomic performance.

There has been a shift, over the last generation, in the share of GDP from the workforce to shareholders of between 5% −7%, with many low earners finding it difficult to get onto the property ladder. Neo-classical economists cite the trickle-down effect as a way of improving the living standards of all by cutting taxes for upper income groups and business, stating that economic progress depends on saving and innovation which, in turn, depends on the ability to make high profits. However, research by the Tax Justice Network claims that, when there are high levels of inequality, to avoid tax, financial capital often leaves the country, rather than staying in the domestic economy.

It has been argued that other policies such as public sector pay rise limits of 1%, benefits rising at 1% rather than inflation-linked increases, and the removal of some housing benefit, as well as the culture of bankers' bonuses, have all contributed to growing inequality. This is likely to have consequences for consumer spending power, but may also help to contribute to reduced inflationary expectations. There has also been criticism of the UK banking system, in that it has been too focused on making quick financial returns rather than long-run investment. Ultimately, these factors may damage the UK's ability to achieve its macroeconomic targets.

Source: News reports, 2013

21. Many people were surprised when UK unemployment fell during 2013. The government's policy of deficit reduction was expected to prevent significant falls in unemployment and some called for the government to reverse its policy of planned cuts in expenditure.

Evaluate the view that a policy of budget deficit reduction will make it harder to reduce unemployment further.

[25 marks]

22. In May 2014, the European Central Bank (ECB) President, Mario Draghi, warned that there was a risk of deflation across economies in Europe.

Evaluate the view that the UK government should give higher priority to preventing deflation rather than controlling inflation.

[25 marks]

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23. In 2013, two key aims of the UK Government were: to move the budget deficit towards a surplus over the course of the Parliament and to ensure that the main burden of deficit reduction would be through reduced government spending, rather than increased taxation.

Explain the possible demand-side consequences of an increase in taxation in the UK.

[15 marks]

24. In 2013, two key aims of the UK Government were: to move the budget deficit towards a surplus over the course of the Parliament and to ensure that the main burden of deficit reduction would be through reduced government spending, rather than increased taxation.

Evaluate the view that the UK Government's policy of deficit reduction through lower government spending is unnecessary and undesirable.

[25 marks]

25. In recent years, growth rates in the UK have been low and unemployment has risen. For example, in 2012 output was still below its peak of 2008 and unemployment had risen from 6.4% from 7.8%.

Evaluate the view that a reduction in UK unemployment is best achieved through the use of supply-side policies.

[25 marks]

1. Commercial banks provide financial services for both individuals and businesses. In 2007–08, the financial crisis led many to argue for tighter regulation of the banks to prevent problems in financial markets affecting the real economy. However, financial markets are not the only source of cyclical instability. Governments can use a variety of policies to try to create a more stable economy.

Assess policies which can be used to reduce cyclical instability in the UK.

[25 marks]

2. 'George Osborne talks about boosting exports and rebalancing the economy, but the Chancellor is not nearly as worried about the trade deficit as he is about the budget deficit.'

To what extent do you agree that a persistent trade deficit is more damaging to the UK's macroeconomic performance than a persistent budget deficit? Justify your answer.

[25 marks]

3. 'George Osborne talks about boosting exports and rebalancing the economy, but the Chancellor is not nearly as worried about the trade deficit as he is about the budget deficit.'

Explain the factors which are likely to cause a large budget deficit.

[15 marks]

4. The Office for Budget Responsibility (OBR) forecast that government spending would account for 36% of GDP by 2020 compared to 45% of GDP in 2010.

To what extent do you regard a contraction of the public sector to be beneficial for the UK economy? Justify your answer.

[25 marks]

5. **Extract F** (lines 4 – 6) states: 'some are now arguing that further improvements in the unemployment statistics can only be gained through improvements in the supply-side of the economy, rather than relying on demand.'

To what extent do you agree that a further reduction in the UK's unemployment rate is most likely to be achieved by improvements in the supply-side rather than the demand-side of the economy? Use the data and your own knowledge of economics, to justify your answer.

[25 marks]

6. It is now nearly a decade since the financial crisis caused a recession in the UK. In March 2009, the Monetary Policy Committee (MPC) set the UK Bank Rate at 0.5%, which was a record low, in order to stimulate economic growth.

Discuss the importance of low interest rates in bringing about sustained economic growth in an economy such as the UK.

[25 marks]

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7. The national debt is the

A annual budget deficit plus the external trade deficit. ○

B amount by which the budget deficit increases each year. ○

C annual difference between government spending and tax receipts. ○

D the cumulative stock of outstanding central government borrowing. ○

[1 mark]

8. The Office for Budget Responsibility (OBR) forecast that government spending would account for 36% of GDP by 2020 compared to 45% of GDP in 2010.

Explain the economic reasons for government spending.

[15 marks]

9. The table below shows the marginal income tax rates in an economy for 2016.

Table: Marginal income tax rates for every $1 of income

Taxable Income	Income tax rates 2016
From $0 to $10 000	0%
From $10 001 to $30 000	10%
From $30 001 to $50 000	30%
$50 001 and above	45%

How much income tax would be payable by someone earning $40 000 in 2016?

A $5 000 ○

B $5 500 ○

C $10 000 ○

D $12 000 ○

[1 mark]

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10. The Government has ruled out the possibility of a rise in VAT before 2020 but other indirect taxes may increase. It has also stated that the personal income tax allowance will be increased from £10 800 in 2015/16 to £12 500 by 2020, and plans to cut the main rate of corporation tax from 20% to 17%.

Evaluate the economic consequences for the UK economy of a significant shift in the burden of taxation from direct taxes to indirect taxes.

[25 marks]

11. The Government has ruled out the possibility of a rise in VAT before 2020 but other indirect taxes may increase. It has also stated that the personal income tax allowance will be increased from £10 800 in 2015/16 to £12 500 by 2020, and plans to cut the main rate of corporation tax from 20% to 17%.

Explain how changes in both government spending **and** taxation might affect the level of economic activity.

[15 marks]

12. **Extract F** (lines 19–20) states 'What is not clear is what should be done if low inflation turns to bad deflation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that monetary policy is the most effective way of tackling deflation in developed economies such as the UK and Japan.

[25 marks]

13. The UK has seen significant changes in its pattern of trade with the rest of the world in terms of what we trade and with whom. The UK's current account deficit widened from £29.1bn in 2011 to £100.2bn in 2015. The deficit in 2015 was 5.4% of GDP, the largest annual deficit as a percentage of GDP since records began in 1948.

Evaluate the measures that might be taken to reduce a deficit on the current account of the UK's balance of payments.

[25 marks]

14. Between 2011 and 2016, UK unemployment fell from a high of 8.5% to 4.8%. Some argue that government attempts to reduce unemployment inevitably lead to trade-offs with other macroeconomic policy objectives.

Discuss the view that falling unemployment will inevitably lead to trade-offs with other macroeconomic policy objectives.

[25 marks]

15. **Extract C** (lines 2–3) states 'More recently, India has begun to use more market-based strategies to help its development, including liberalising trade and privatisation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that greater use of market-based strategies is the best way to improve the economic development of India.

[25 marks]

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16. **Extract B** (lines 17–19) states ‘India still protects its economy with anti-dumping measures and export subsidies that are designed to promote economic growth.’

With the help of a diagram, explain how export subsidies may help promote economic growth in India.

[9 marks]

17. At the start of the financial year, an economy’s national debt stands at £1000 billion. Over the course of the year, the government plans to spend an extra £100 billion and borrow an extra £40 billion.

If the government achieves its spending and borrowing targets, by the end of the financial year the national debt will have increased by

A 4% ⬭

B 10% ⬭

C 14% ⬭

D 40% ⬭

[1 mark]

18. Which one of the following is most likely to cause an increase in the structural budget deficit?

A A fall in income tax receipts in the downturn of the economic cycle ⬭

B A rise in government spending on unemployment-related benefits during a recession ⬭

C A rise in healthcare expenditure and state pension provision due to an ageing population ⬭

D A rise in spending on imports during an economic recovery ⬭

[1 mark]

19. In the 2016 Autumn statement, the UK Chancellor of the Exchequer, Philip Hammond, officially abandoned the government’s policy of trying to achieve a budget surplus by 2020. While some criticise the government for failing to achieve its fiscal target, others argue that the government should be doing more to help the supply side of the economy.

Explain how fiscal policy can be used to try to improve the supply side of an economy.

[15 marks]

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20. The table below shows different combinations of changes in the rate of interest and the government's budget position. The economy has a negative output gap. All other things being equal, which one of the combinations of policies, **A**, **B**, **C** or **D**, is most likely to reduce the economy's negative output gap?

	Rate of interest	Government's budget position	
A	Increase	Decrease in surplus	⬭
B	Decrease	Increase in surplus	⬭
C	Increase	Decrease in deficit	⬭
D	Decrease	Increase in deficit	⬭

[1 mark]

21. **INVESTIGATION**

Scenario

You are an economist working for the Ministry of Housing, Communities and Local Government (MHCLG).
You have been asked to investigate the state of the UK housing market.
As part of this investigation, you are to provide answers to three questions.

Referring to the **Extracts A**, **B**, **C** and **D**, use them and your knowledge of economics to help you answer this question.

After considering **Extract E**, and the original evidence in Extracts **A**, **B**, **C** and **D**, would you recommend that the Government should increase its spending on housing? Justify your recommendation.

[25 marks]

22. Which one of the following is correct for a proportional tax on income?

A The amount of tax paid increases as income increases ⬭

B The marginal rate of tax is lower than the average rate ⬭

C The average rate of tax falls as income increases ⬭

D The average rate of tax is lower than the marginal rate ⬭

[1 mark]

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23. **INVESTIGATION**

Scenario

You are an economist working for an organisation which investigates ways to improve the standard of living of UK citizens.

You have been asked to review changes in living standards and inequality since the 2007–2008 financial crisis.

As part of this investigation, you are to provide answers to the following question.

Study **Extracts A**, **B**, and **C**, and then use these and your knowledge of economics to help you answer this question. There is also a news report, **Extract D**, which is to be used with the other extracts to help you answer this question.

After considering **Extract D**, and the original evidence in **Extracts A**, **B** and **C**, would you recommend that the government implement a further substantial increase in the National Living Wage? Justify your recommendation.

[25 marks]

24. All other things being equal, which one of the following is most likely to increase the national debt?

A Foreign companies increasing their direct investment into the economy ⬭

B The central bank using its reserves of foreign currency to fund a trade deficit ⬭

C The government reducing its budget surplus by increasing its expenditure on infrastructure ⬭

D The government running a budget deficit, financed by selling bonds to foreign investors ⬭

[1 mark]

25. In 2017, the UK's annual budget deficit was 2.3% of GDP, the lowest level since 2001. In 2017, the UK's deficit on the current account of the balance of payments fell to 3.3% of GDP, the lowest level since 2011.

To what extent do you agree that reducing the budget deficit is more important to the UK's macroeconomic performance than reducing the current account deficit on its balance of payments? Justify your answer.

[25 marks]

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1. **The European Union Context Extract D** (lines 1−2) refers to EU governments 'spending their way out of recession'.

Explain the term 'spending their way out of recession' **and** analyse **two** reasons for government spending **other** than to influence the economic cycle.

[9 marks]

2. 'It is better to do everything you can to prevent deflation before it begins, even if there is only a small chance of it occurring.'

Assess the impact on UK macroeconomic performance of a prolonged period of deflation.

[25 marks]

3. The Budget Report of April 2009 estimated that UK government borrowing for 2009-10 would be £175 billion, or about 12% of GDP.

To what extent should government borrowing be a cause for concern?

[25 marks]

4. In March 2011, the UK Office for Budget Responsibility (OBR) forecast that the budget deficit would fall from 7.9% of GDP in the financial year 2011-2012 to 1.5% in 2015-2016.

Explain the term 'living standards' **and** analyse how cuts in government spending to lower the budget deficit might affect living standards in the UK.

[15 marks]

5. The Budget Report of April 2009 estimated that UK government borrowing for 2009-10 would be £175 billion, or about 12% of GDP.

Explain possible economic reasons for changes in the level **and** distribution of government expenditure.

[15 marks]

6. 'The UK economy has recently been in the grip of its worst recession for 60 years.'

Assess the contribution which supply-side reforms might make in helping avoid major recessions.

[25 marks]

7. An economy which is enjoying rapid economic growth experiences a significant rise in the external value of its currency within a floating exchange rate system.

Evaluate the possible macroeconomic consequences for an economy of a rise in the exchange rate of its currency.

[25 marks]

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8. The deficit on the UK balance of trade in goods and services rose from £26 billion in 2003 to £44 billion in 2008.

Evaluate government policies which might bring about a reduction in the UK deficit on the balance of trade in goods and services.

[25 marks]

9. 'The UK economy has recently been in the grip of its worst recession for 60 years.'

Explain possible reasons for an economy moving from a period of prosperity to one of recession.

[15 marks]

10. **The Europena Union Context Extract Extract D** (lines 27−28) states that 'the impact of the increased government borrowing arising from budget deficits across the EU is of concern amongst some economists'.

Using the data and your economic knowledge, assess the impact on the UK economy of increased government borrowing by EU governments.

[25 marks]

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11. THE EUROPEAN UNION CONTEXT

Extract D: Is EU unity threatened?

Europe, and indeed much of the world, was shaken by the depth of the economic downturn from 2008. Many countries, including the UK, saw the solution to be a return to Keynesian economics and, therefore, tolerance of large budget deficits. This was coupled with significant monetary expansion, so that, in the UK for example, the Bank of England Bank Rate was cut to 0.5% in 2009, accompanied by a policy of 'quantitative easing' (increases in the money supply).

The UK pressed other EU governments to embark on fiscal expansion. Not all shared the UK's enthusiasm and, at best, wanted only a much more modest fiscal stimulus than was the case in the UK. However, events sometimes overtook such wishes. Ironically, given the scale of the UK fiscal stimulus, until the latter part of 2009 the UK was the only major economy to remain in recession. This may reflect the greater significance of the housing and financial sectors in the UK compared to other EU countries.

The fiscal position of many EU countries has given rise to concern. Italy, for example, now has a national debt (the total outstanding debt of central government) of around 120% of GDP, even though its annual budget deficit is not exceptionally large. Some countries have shown a greater determination than Italy to cut their deficits. In December 2009, for example, Ireland announced sharp cuts in public sector wages. But it is certainly not just Italy which has shown complacency. The EU's Stability and Growth Pact limits annual borrowing to 3% of GDP. EU governments are under increasing pressure to return to this target by 2014.

The short- to medium-term benefits of fiscal expansion during downturns cannot be denied. Government spending can initiate a powerful stimulus to an economy through the multiplier process. Aggregate demand therefore rises. The UK Pre-Budget Report put government spending at £676 billion. Tax cuts will give households more spending power. Coupled with cheap credit and retail price discounts, recovery can therefore be helped through increased consumption.

However, the impact of increased government borrowing arising from budget deficits across the EU is of concern amongst some economists. It may eventually force the authorities to increase interest rates, lead to 'crowding-out' of private sector activity and make public spending cuts and tax increases an inevitability. In the UK, for example, a VAT rate of 17.5% was restored in January 2010 following a temporary cut to 15%. Equally, the 2009 Pre-Budget Report announced an increase in National Insurance contributions.

The problem in trying to assess the impact of fiscal expansion is, of course, not knowing what might have happened without it. Certainly, some economists are quick to attribute the end of recession in France and Germany in 2009 to such fiscal loosening. Indeed, it is difficult to argue that, for any country in the EU, economic growth and employment cannot be beneficial to some extent at a time when business and consumer confidence are both at a low level.

Whether such a policy eventually causes inflation to make an unwelcome return remains to be seen. At that point, EU members may experience a greater urgency to balance budgets and reduce monetary expansion.

Source: various sources, 2010

12. ‘UK government policy might not always be able to achieve fully all the macroeconomic objectives which are regarded as important.’

Explain how budget deficits in an economy might help to influence the rate of inflation in that economy.

[15 marks]

13. ‘While it is necessary to have macroeconomic policy objectives, such as price stability and full employment, they can sometimes prove difficult to reconcile.’

Discuss ways in which government economic policies can be used to try to reconcile conflicts between macroeconomic objectives.

[25 marks]

14. ‘Oil, as a form of energy, reigns supreme but it has brought significant problems to economies in terms of inflation in particular, and the potential for economic instability in general.’

Explain the main causes of inflation.

[15 marks]

15. UK exports of goods which, in 2002, were valued at £187 billion, had risen to £228 billion in 2009.
The deficit on the UK balance of trade in goods rose from £48 billion in 2002 to £82 billion in 2009.

Explain **three** possible reasons for growth in the value of an economy’s exports of goods.

[15 marks]

16. The global economic slowdown in recent years saw UK unemployment, as measured by the claimant count, rise from 870 000 in 2004 to 1.5 million in 2009.

To what extent would a significant fall in the exchange rate of the pound sterling achieve a sustained reduction in unemployment in the UK?

[25 marks]

17. **The European Union Context Extract D** (lines 16−18) suggests that France and Germany would like the EU to have ‘the power to impose an EU-wide fiscal policy on all member states and not just the eurozone’.

Using the data and your economic knowledge, assess the possible economic consequences for the UK economy of an EU-wide fiscal policy requiring all member states to balance their budgets.

[25 marks]

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18. In March 2011, the UK Office for Budget Responsibility (OBR) forecast that the budget deficit would fall from 7.9% of GDP in the financial year 2011-2012 to 1.5% in 2015-2016.

Discuss whether the UK Government should **either** raise taxes **or** cut government spending to achieve its 2015-2016 fiscal objective.

[25 marks]

19. **THE EUROPEAN UNION CONTEXT**

Extract D: The fiscal remedy for recession

The recession of 2009 brought renewed interest amongst EU governments in a so-called Keynesian approach to spending their way out of recession. They were desperate to avoid a prolonged period of negative growth and the accompanying mass unemployment.

In the UK, as well as within the eurozone, fiscal rules were abandoned as the fight for economic recovery began. The Stability and Growth Pact of the eurozone, to which the UK had also adhered in an informal way before the recession, limited budget deficits to 3% of GDP and a nation's debt to 60% of GDP. Such constraints were often far exceeded and increasing concerns were being expressed. In May 2010, the new UK Government became a prominent voice within Europe for a reversal of fiscal policy, with public spending cuts and tax increases.

The UK Government's policy was given some support by the economic crisis unfolding in Greece, a member of the eurozone. The Greek Government needed to be 'bailed out' by fellow member states if it was not to default on its debts. It had a budget deficit of 14% of GDP and a national debt of 115% of GDP in 2009, a year when its GDP also fell by 2%.

There was concern in the EU that such a situation had been allowed to develop, with increasing calls for EU-wide controls. France and Germany were pressing for an EU institution such as the European Commission to provide such a role, with the power to impose an EU-wide fiscal policy on all member states and not just the eurozone.

The UK Government opposed any such powers over member countries. However, it had gone as far as to establish an Office for Budget Responsibility (OBR), intended to keep the Government's tax and spending plans under control by providing a reality check on the state of the nation's finances. The OBR, however, does not have the powers that some were envisaging for the EU.

In a climate of greater stability in 2010, some still believed that an EU-wide fiscal policy needed to be a key part of the evolution towards a federal state. It cannot be denied that the best way forward must be that which delivers macroeconomic stability across the EU. Whether this comes about through member governments each developing a policy of fiscal responsibility or through a fiscal policy imposed by the EU on all member states remains open to debate.

Source: various sources, 2010

20. Weaknesses in the UK balance of trade in goods persist, with a deficit of £27.6 bn in the third quarter of 2011, compared, for example, to £23.3 bn in the same quarter in 2010.

Discuss the possible contribution of supply-side reforms to achieving an improvement in the UK balance of trade in goods.

[25 marks]

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