



Please write clearly in block capitals.

Centre number

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Candidate number

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Surname

StemUp Model Solution

Forename(s)

Candidate signature

AS ECONOMICS

Paper 2 The national economy in a global context

Thursday 17 May 2018

Morning

Time allowed: 1 hour 30 minutes

Materials

For this paper you must have:

- the insert
- a calculator.

Instructions

- Use black ink or black ball-point pen. Pencil should only be used for drawing.
- Fill in the boxes at the top of this page.
- Answer **all** questions in **Section A**.
- Answer **either** Context 1 **or** Context 2 in **Section B**.
- You will need to refer to the insert provided to answer **Section B**.
- You must answer the questions in the spaces provided. Do not write outside the box around each page or on blank pages.
- Do all rough work in this book. Cross through any work you do not want to be marked.

Information

- There are 70 marks available on this paper.
- The marks for questions are shown in brackets.
- No deductions will be made for wrong answers.

For Examiner's Use	
Section	Mark
A	
B	
TOTAL	



J U N 1 8 7 1 3 5 2 0 1

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7135/2

Section AAnswer **all** questions in this section.Only **one** answer per question is allowed.

For each question completely fill in the circle alongside the appropriate answer.

CORRECT METHOD



WRONG METHODS



If you want to change your answer you must cross out your original answer as shown.



If you wish to return to an answer previously crossed out, ring the answer you now wish to select as shown.

**0 1**

Which one of the following indicates a contractionary monetary policy?

A A fall in the budget deficit**B** A rise in the money supply**C** An increase in the national debt**D** Appreciation of the exchange rate**[1 mark]**

0 2

The following table shows the planned changes to injections into and withdrawals from the circular flow of income for one year.

	£bn
Exports	19
Government expenditure	29
Imports	20
Investment	35
Savings	26
Taxation	32

Other things remaining the same, these changes would cause

A consumer expenditure to decrease.

☐

B national income to increase.

☒

C the balance of trade deficit to decrease.

☐

D the budget deficit to rise.

☐

[1 mark]

0 3

A government wants to increase the economy's rate of long-run economic growth by implementing a supply-side policy. Which one of the following is a government policy aimed at stimulating the supply side of the economy?

A A new scheme to help young people buy their own homes

☐

B Greater provision of care homes for the elderly

☐

C Measures to promote competition between businesses

☒

D More generous welfare benefits for unemployed workers

☐

[1 mark]

Turn over for the next question

Turn over ►



0 4

A government reduces its budget deficit. Other things remaining the same, the most likely short-run impact of this policy is

A a reduction in the current account deficit.

☒

B a reduction in unemployment.

☐

C an increase in the rate of economic growth.

☐

D an increase in the rate of inflation.

☐

[1 mark]

0 5

Europe and North America enter a period of recovery from a recession. Other things remaining the same, the impact on the UK economy is most likely to be

A an increase in structural unemployment.

☐

B an increase in the current account deficit.

☐

C a reduction in cyclical unemployment.

☒

D a reduction in UK economic growth.

☐

[1 mark]

0 6

Which one of the following best describes the action of the accelerator theory of investment?

A Firms decide to invest more following a cut in bank rate

☐

B Firms invest in capital equipment due to higher economic growth

☒

C Improved business confidence causes firms to increase their investment

☐

D Large profits encourage firms to invest in new capital equipment

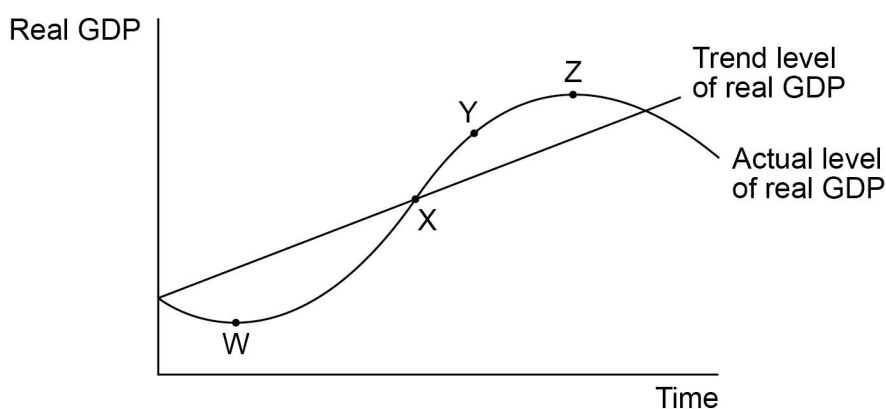
☐

[1 mark]



0 7

The diagram below shows an economic cycle and the trend level of real GDP. Which point represents the economy producing at its normal capacity level of output?



A Point W

☐

B Point X

☒

C Point Y

☐

D Point Z

☐

[1 mark]

0 8

Which one of the following is the best definition of a household's total saving?

A An injection into the circular flow of income

☐

B Contributions to a pension fund for retirement

☐

C Money placed in bank and building society accounts

☐

D That part of disposable income not spent on consumption

☒

[1 mark]

Turn over for the next question

Turn over ►



0 9

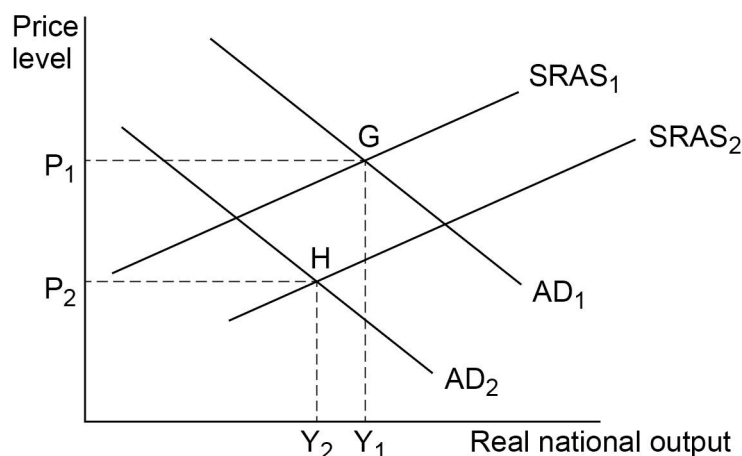
Inflationary pressures are normally low when an economy has a negative output gap. The most likely explanation for this is that

- A** consumers' spending on imports and the exchange rate rise. ☐
- B** the Bank of England may cut bank rate and increase the money supply. ☐
- C** the government's tax revenue falls and spending on benefits increases. ☐
- D** unemployment is high and firms have excess capacity. ☒

[1 mark]

1 0

In the diagram below, an economy is initially in equilibrium at point G. Aggregate demand then shifts from AD_1 to AD_2 and the short-run aggregate supply curve shifts from $SRAS_1$ to $SRAS_2$.



Which one of the following combinations of events will cause these shifts in AD and SRAS and move the economy to a new equilibrium at point H?

- A** A cut in income tax and an increase in VAT ☐
- B** A fall in money wages and a fall in house prices ☒
- C** An increase in productivity and a rise in consumer confidence ☐
- D** Higher energy prices and lower government expenditure ☐

[1 mark]



1 1

A country has a deficit on the current account of its balance of payments. This means that

- A** the country must have a deficit on the balance of trade in goods and services. ☐
- B** the net value of trade in goods and services plus the net value of primary and secondary income must be negative. ☒
- C** the value of all outflows from the country must be less than the value of all inflows. ☐
- D** the value of exports of goods must be less than the value of imports of goods. ☐

[1 mark]**1 2**

The table below shows the index of real GDP for the UK before and after the 2008–09 financial crisis.

	2007	2008	2009	2010	2011
UK index of real GDP 2009 = 100	105.2	104.1	100.0	101.8	102.7

From the data it can be inferred that in the UK

- A** real GDP fell by 2.5% between 2007 and 2011. ☐
- B** the annual rate of inflation was minus 1.1% in 2008. ☐
- C** the rate of economic growth was lower in 2011 than in 2010. ☒
- D** total output of the economy fell by 5.2% between 2007 and 2009. ☐

[1 mark]

Turn over for the next question

Turn over ►



1 3

A government is planning to reduce its budget deficit by increasing taxes on tobacco and reducing spending on defence.

These policies are most likely to

A change the pattern of economic activity in the long run.

☒

B increase inflation in the long run.

☐

C increase the level of economic activity in the short run.

☐

D reduce exports in the short run.

☐

[1 mark]

1 4

The table below shows four possible sets of circumstances for the UK economy. Which set of circumstances is most likely to cause the Monetary Policy Committee of the Bank of England to raise bank rate?

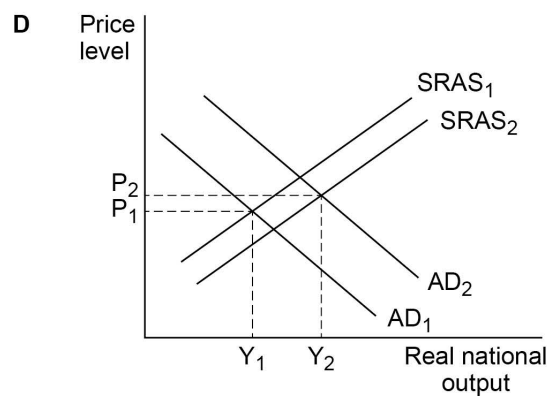
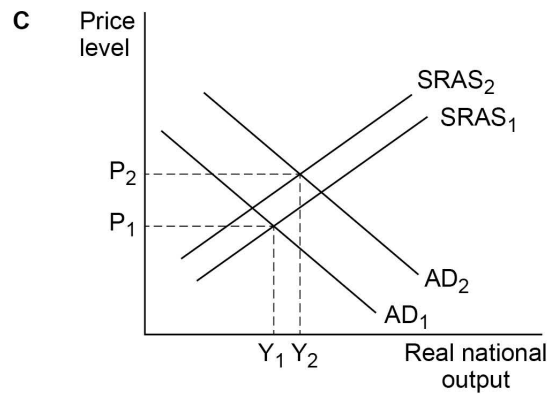
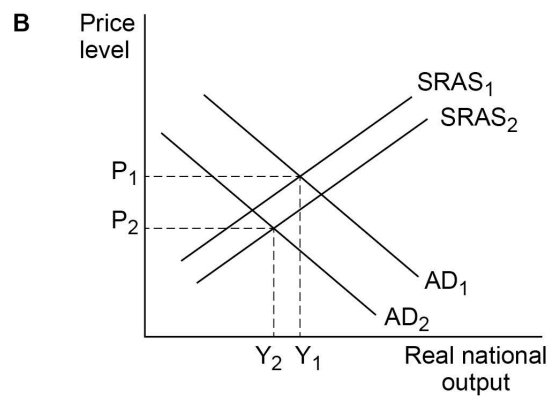
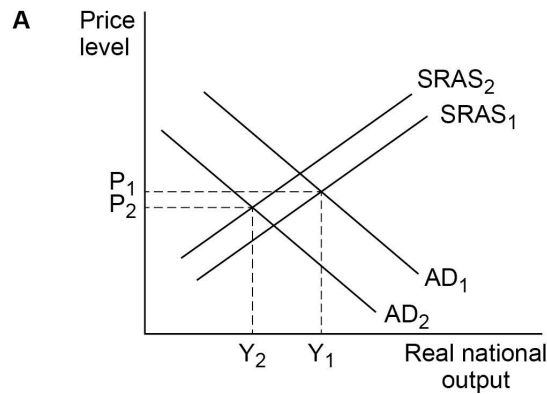
	Output gap	Exchange rate	
A	negative	falling	☐
B	negative	rising	☐
C	positive	falling	☒
D	positive	rising	☐

[1 mark]



1 5

An economy that imports most of its energy experiences a large appreciation in its exchange rate. Which one of the following AD/AS diagrams best illustrates the resulting changes to the economy's price level and real national output?

**[1 mark]****Turn over ►**

1 6

A government raises income tax rates for very high wage earners and spends all of the extra revenue raised on higher welfare benefits. The result is a reduction in income inequality and a fall in the rate of economic growth. This is also most likely to

A lead to a reduction in government borrowing and national debt.

☐

B result in an improvement in incentives to work.

☐

C show a potential conflict between macroeconomic policy objectives.

☒

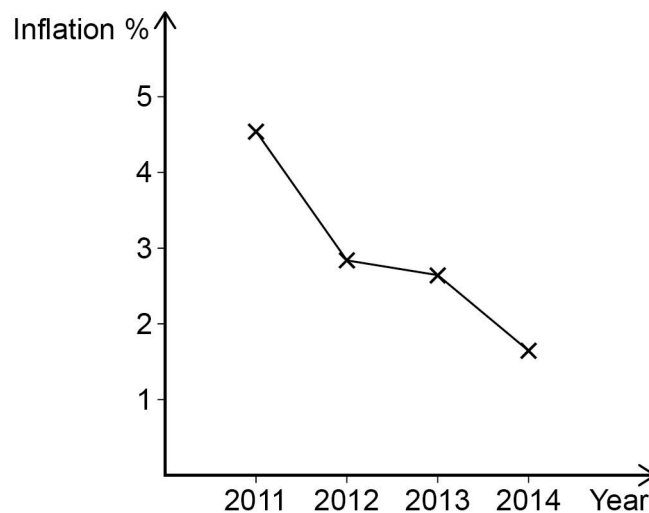
D show the use of a contractionary fiscal policy.

☐

[1 mark]

1 7

The diagram below shows the annual rate of inflation in the UK between 2011 and 2014.



From the graph it can be concluded that between 2011 and 2014

A real wages increased.

☐

B the price level was rising.

☒

C the real value of money increased.

☐

D the UK experienced deflation.

☐

[1 mark]



1 8

An expansionary monetary policy has been implemented. Which one of the following combinations of macroeconomic changes is most likely to happen?

- A** A fall in the price of imports and more demand for bank loans ☐
- B** A rise in consumption and an increase in house prices ☒
- C** An increase in employment and a rise in government borrowing ☐
- D** An increase in retail sales and a rise in the savings ratio ☐

[1 mark]**1 9**

The world market price of oil falls by 40 per cent. Other things remaining the same, the impact on the UK economy is most likely to be

- A** an increase in aggregate demand and inflation. ☐
- B** deflation and lower output. ☐
- C** disinflation and higher output. ☒
- D** higher unemployment and inflation. ☐

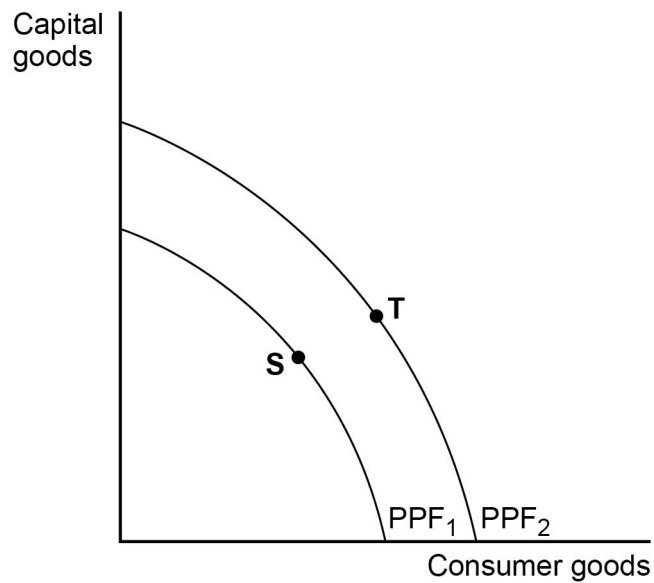
[1 mark]

Turn over for the next question

Turn over ►

2 0

The diagram below shows two production possibility frontiers (PPF) for an economy.



The economy improves its macroeconomic performance by moving from point S to point T. This is most likely to represent

- A** greater income equality.
- B** higher real national income.
- C** lower inflation.
- D** lower unemployment.

☐
☒
☐
☐

[1 mark]

20

**QUESTION 20 IS THE
LAST QUESTION IN SECTION A**



Section B

Look at the insert and choose to answer **EITHER** Context 1 **OR** Context 2.

Answer **EITHER** Questions 21 to 26 in the spaces below

OR

Questions 27 to 32 on pages 23 to 32 of this answer booklet.

There is a total of 50 marks for either context.

Shade the circle below to indicate which context you have answered.

Context **0 1** ☐

Context **0 2** ☐

WRONG METHODS



CORRECT METHOD

**EITHER****Context 1**

Total for this context: 50 marks

ECONOMIC SHOCKS AND THE UK ECONOMY

Use the insert provided to study **Questions 21 to 26** and **Extracts A, B and C**, and then answer the questions in the spaces which follow.

2 1

Define 'budget surplus' **Extract B** (line 12).

[3 marks]

A budget surplus occurs when the government's total revenue, mainly from taxation, is greater than its total expenditure over a given time period, usually one financial year. This means there is a positive budget balance, so the government has no need to borrow in that year and can repay part of the national debt.

Extra space

Turn over ►



2 2

Assume that the increase in national income as a result of the proposed Heathrow airport expansion is £29 billion.

Use **Extract C** to calculate, to one decimal place, the value of the multiplier.

[4 marks]

Multiplier = change in national income ÷ change in investment (initial injection)

The cost of the Heathrow expansion (initial investment) in Extract C = £17.6 billion

Multiplier = £29bn ÷ £17.6bn = 1.6477...

Multiplier = 1.6 (to one decimal place)

2 3

Use **Extract A** to identify **two** significant features of the changes in the sterling exchange rate over the period shown.

[4 marks]

Feature 1 *Overall the value of the pound fell against the US dollar over the period, from US\$1.46 in May 2016 to US\$1.29 in April 2017, a fall of 17 cents.*

Feature 2 *The most significant change was in June 2016, when the pound fell sharply from its highest value of US\$1.48 to US\$1.32 in a matter of days. It reached its lowest value of US\$1.21 in January 2017.*

Extra space

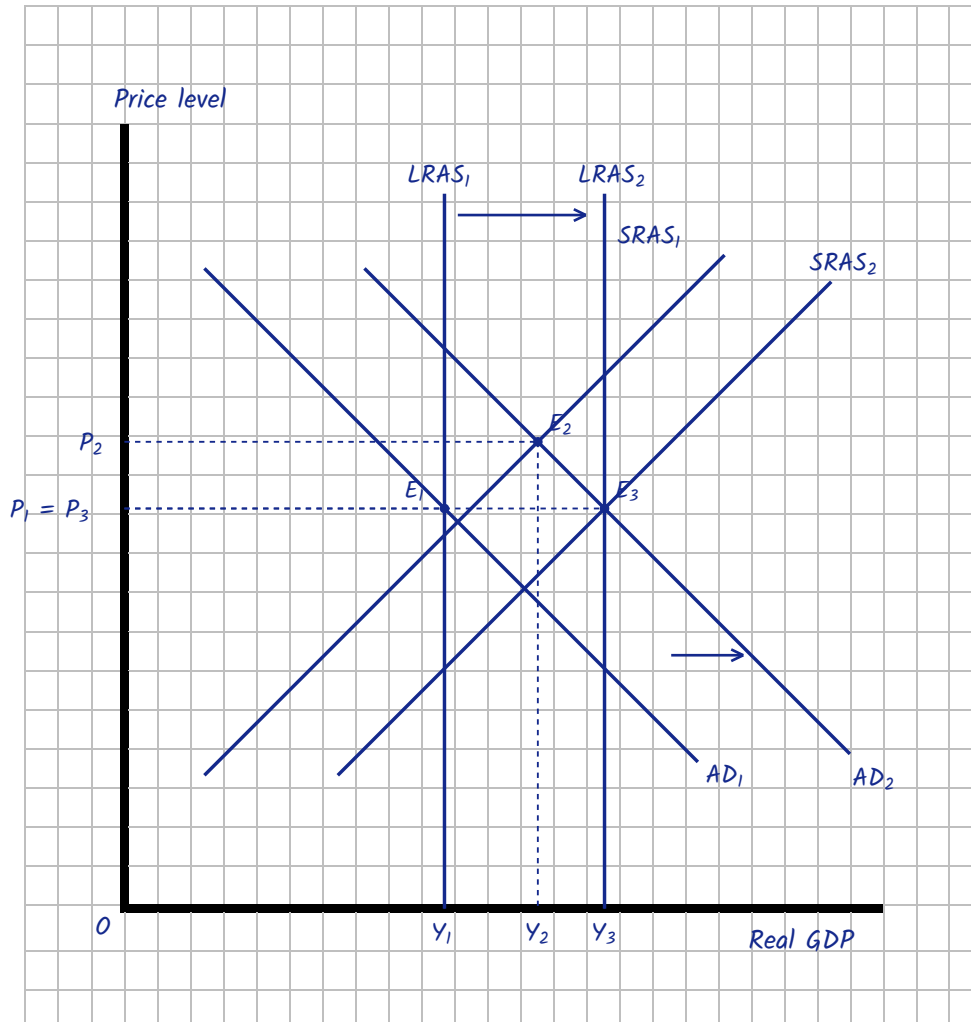


2 4

Extract C (lines 7–9) states ‘During late 2016 the Government gave the go-ahead to the construction of the third runway at Heathrow airport in London.’

Draw an AD/AS diagram to show **both** the short-run **and** long-run effects ‘on macroeconomic equilibrium’ of investment in a large infrastructure project such as this.

[4 marks]



Short run: AD_1 to AD_2 , E_1 to E_2 (higher output Y_2 and price level P_2).

Long run: capacity rises, $LRAS_1$ to $LRAS_2$ and $SRAS_1$ to $SRAS_2$, so the new equilibrium is E_3 , with real output Y_3 and the price level back at P_3 .

Turn over for the next question

Turn over ►



2 5

Extract B (lines 9–11) states ‘The Bank of England’s Monetary Policy Committee loosened its monetary policy in an attempt to prevent a downturn in the economic cycle.’

Explain how monetary policy might help to prevent a downturn in the economic cycle.

[10 marks]

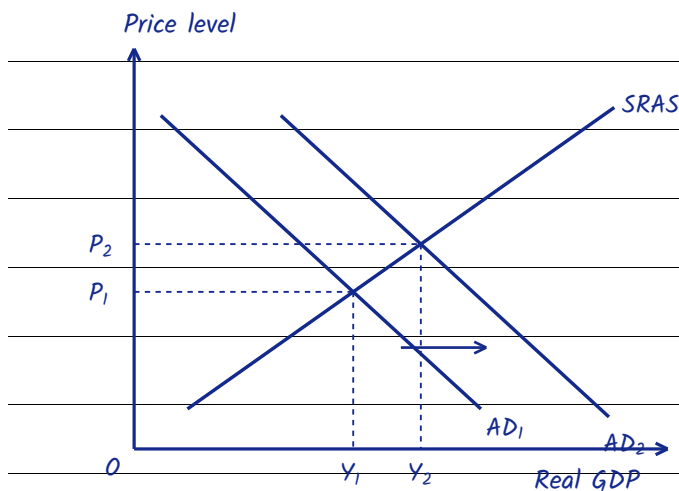
Monetary policy is the use of interest rates (Bank Rate), the money supply and quantitative easing by the central bank, here the Bank of England's Monetary Policy Committee, to influence aggregate demand in order to meet the 2% CPI inflation target and support growth and employment. A downturn in the economic cycle is a period when the rate of economic growth slows or real GDP falls, so economic activity weakens and cyclical unemployment rises.

Loosening monetary policy means cutting Bank Rate. Commercial banks then reduce the interest rates they charge on loans, mortgages and credit cards, and the return on savings falls. Borrowing becomes cheaper and saving less attractive, so households increase consumption, especially of durable goods such as cars bought on credit. Those with variable rate mortgages have lower repayments, raising their disposable income. Lower interest rates also raise house and share prices, creating a positive wealth effect and increasing consumer confidence, so consumption rises further.

Lower interest rates also reduce the cost of borrowing for firms, so more investment projects become profitable at the lower rate of interest and investment rises. In addition, lower rates make the UK less attractive to holders of 'hot money', so the exchange rate falls.

Extra space UK exports become cheaper abroad and imports more expensive, so net exports increase.





The central bank can also use quantitative easing, creating new money to buy government bonds and corporate bonds. This raises bond prices and lowers long-term interest rates, and it increases the liquidity of banks so that they can lend more to households and firms, again boosting spending.

Since consumption, investment and net exports are components of aggregate demand ($AD = C + I + G + X - M$), AD shifts to the right, from AD_1 to AD_2 in the diagram. Real GDP rises from Y_1 to Y_2 instead of falling, and this initial increase in spending is magnified by the multiplier, as higher spending creates income for others who spend part of it. Firms need more workers to produce the extra output, so employment rises and the rise in cyclical unemployment is prevented.

Therefore, by cutting Bank Rate and using quantitative easing, as the MPC did, monetary policy can boost aggregate demand and help to prevent a downturn, although its effect depends on confidence and works with time lags.

Turn over ►



2 6

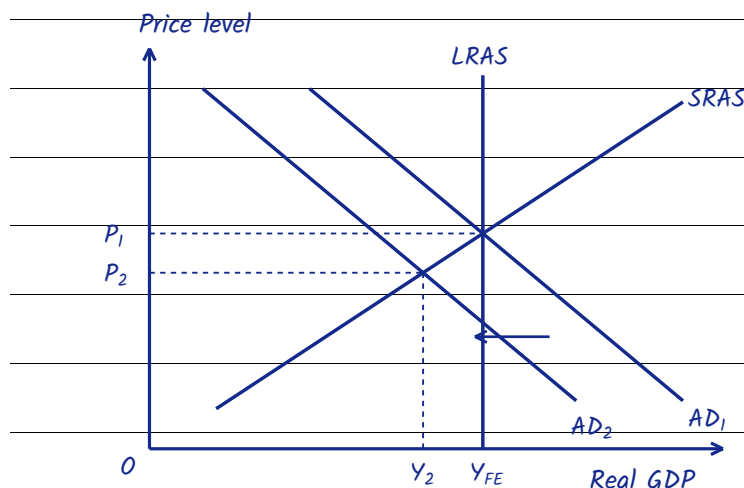
Extract C (lines 5–6) states ‘Some economists believe that a reduction in the level of economic activity and an increase in unemployment are inevitable.’

Use the extracts and your knowledge of economics to assess the view that when an economy experiences a negative economic shock there will always be a sustained increase in unemployment.

[25 marks]

A negative economic shock is an unexpected event, outside the control of policymakers, that reduces aggregate demand or aggregate supply, for example a financial crisis, a sharp rise in oil prices, a recession in major trading partners or, in the UK's case, the uncertainty following the June 2016 referendum vote to leave the EU. Unemployment is when people of working age are willing and able to work but cannot find a job, and a sustained increase means that unemployment remains higher for a long period rather than rising only briefly.

There are strong arguments supporting the view that a negative shock leads to higher unemployment. A demand-side shock reduces consumption, investment or exports. Uncertainty reduces consumer and business confidence, so households save more and firms delay investment projects. As shown in the diagram, AD shifts left from AD_1 to AD_2 , so real GDP falls from Y_{FE} to Y_2 and a negative output gap opens up.



Because the demand for labour is a derived demand, firms need fewer workers to produce less output, so cyclical (demand-deficient) unemployment rises. The fall in spending is magnified by the negative multiplier effect, since workers who lose their jobs spend less, reducing other firms' incomes, and by the accelerator, since lower growth reduces investment further.

Unemployment can also become sustained. If the shock is long-lasting, for example a serious financial crisis in which banks cut their lending, firms may close and the economy's productive capacity is damaged.

Workers who are unemployed for a long time lose skills and motivation (hysteresis), so cyclical unemployment can turn into structural unemployment. A shock that causes structural change, such as the decline of an industry, leads to occupational and geographical immobility of labour, because the skills of the unemployed do not match the new jobs available, or the jobs are in other regions. A supply-side shock, such as higher energy prices or the higher import prices caused by the sharp fall in the pound shown in Extract A, from US\$1.48 to US\$1.21 at its lowest, shifts SRAS to the left and causes cost-push inflation. If the central bank responds by raising interest rates to control inflation, AD falls further and unemployment rises. Higher inflation also reduces real wages and so real incomes and consumption.

However, there are good reasons to dispute the view that

Extra space unemployment will 'always' rise in a sustained way. Firstly, the authorities can use stabilisation policy. Extract B shows that the MPC loosened monetary policy in an attempt to prevent a downturn:

Turn over ►



in August 2016 Bank Rate was cut to a record low of 0.25% and quantitative easing was extended. Lower interest rates boost consumption and investment and shift AD back to the right. The government can also use expansionary fiscal policy, for example by abandoning its target of a budget surplus and increasing infrastructure spending. Extract C shows that the Government gave the go-ahead to the third runway at Heathrow, worth £17.6 billion, which with a multiplier of about 1.6 could add around £29 billion to national income and create many jobs.

Secondly, the fall in the exchange rate acts as an automatic stabiliser. The 17 cent fall in the pound against the dollar, from US\$1.46 to US\$1.29, makes UK exports more price competitive and imports more expensive, which increases net exports and AD, provided the demand for exports is price elastic and the Marshall-Lerner condition holds. Tourism to the UK also benefits.

Thirdly, the shock may not reduce confidence by as much as expected. In fact, after the 2016 referendum consumer spending remained fairly strong and UK unemployment continued to fall, to around 4.5% in 2017, its lowest rate for over 40 years. This shows that a reduction in economic activity and an increase in unemployment were not inevitable. Firms may also adjust to weaker demand by reducing hours, freezing pay or employing workers on flexible or zero-hours contracts rather than making them redundant, so the effect falls on wages rather than jobs. A flexible labour market, together with supply-side policies such as training and improved labour mobility, helps workers move quickly into new jobs.

The impact also depends on the size, nature and duration of the



shock. A small, temporary shock may cause only a short-term rise in cyclical unemployment that disappears as the economy recovers. A deep financial crisis, such as that of 2008 to 2009, has a larger and more lasting effect, because it damages the banking system and the willingness to lend, and UK unemployment then rose to over 8% and took several years to fall. The state of the economy before the shock also matters: an economy with a positive output gap may experience a slowdown in growth rather than a rise in unemployment. In addition, the size of the multiplier, the time lags before policy takes effect, and external influences such as growth in the world economy and in the UK's major trading partners all affect the outcome.

Finally, the authorities' ability to respond may be limited. With Bank Rate already close to zero, there is little room to cut it further, and a large national debt may limit the scope for fiscal stimulus. There may also be conflicts between objectives: a lower exchange rate raises inflation, which may lead the MPC to raise interest rates sooner than it otherwise would.

In conclusion, I disagree with the view that a negative economic shock will always lead to a sustained increase in unemployment. A negative shock is very likely to reduce economic activity in the short run, and a large and long-lasting shock, such as a financial crisis that causes structural change, can lead to sustained unemployment through hysteresis and labour immobility. However, it is not inevitable: the UK evidence after 2016 shows that unemployment can continue to fall when the central bank loosens monetary policy quickly, the exchange rate falls and the labour market is flexible. Whether unemployment

Turn over ►



risers in a sustained way therefore depends mainly on the size and nature of the shock and on how quickly and effectively monetary, fiscal and supply-side policies respond, since in the long run the level of unemployment depends on the supply side of the economy rather than on the shock itself.



Do **not** answer Context 2 if you have answered Context 1.

OR

Context 2

Total for this context: 50 marks

A NEW APPROACH TO GOVERNMENT POLICY

Use the insert provided to study **Questions 27 to 32** and **Extracts D, E and F**, and then answer the questions in the spaces which follow.

2 7

Define 'progressive taxation' **Extract E** (line 17).

[3 marks]

Progressive taxation is a tax system in which the proportion (percentage) of income paid in tax rises as income rises, so higher income earners pay a larger share of their income in tax than lower income earners. This means the marginal rate of tax is higher than the average rate, for example UK income tax with rates of 20%, 40% and 45%.

Extra space

Turn over for the next question

Turn over ►



2 8

Use **Extract D** to calculate the median amount of funding allocated to the local enterprise partnerships in the Northern Powerhouse.

[4 marks]

The median is the middle value when the funding allocations are arranged in order of size.

There are 11 local enterprise partnerships, so ranking their allocations from the lowest, Cumbria (£12.7m), to the highest, Greater Manchester (£130.1m), the median is the $(11 + 1) \div 2 = 6$ th value.

The 6th value is the funding allocated to Cheshire and Warrington.

Median = £43.3m (£43.3 million)

2 9

Use **Extract D** to identify **two** significant features of the funding allocated to the Northern Powerhouse.

[4 marks]

Feature 1 *Greater Manchester received the most funding, £130.1 million, while Cumbria received the least, £12.7 million, giving a range of £117.4 million.*

Feature 2 *The total funding for the Northern Powerhouse was £556.3 million, a mean of £50.6 million per LEP, yet Greater Manchester alone received more than the five lowest-funded LEPs combined (£130.1m compared with £123.9m).*

Extra space

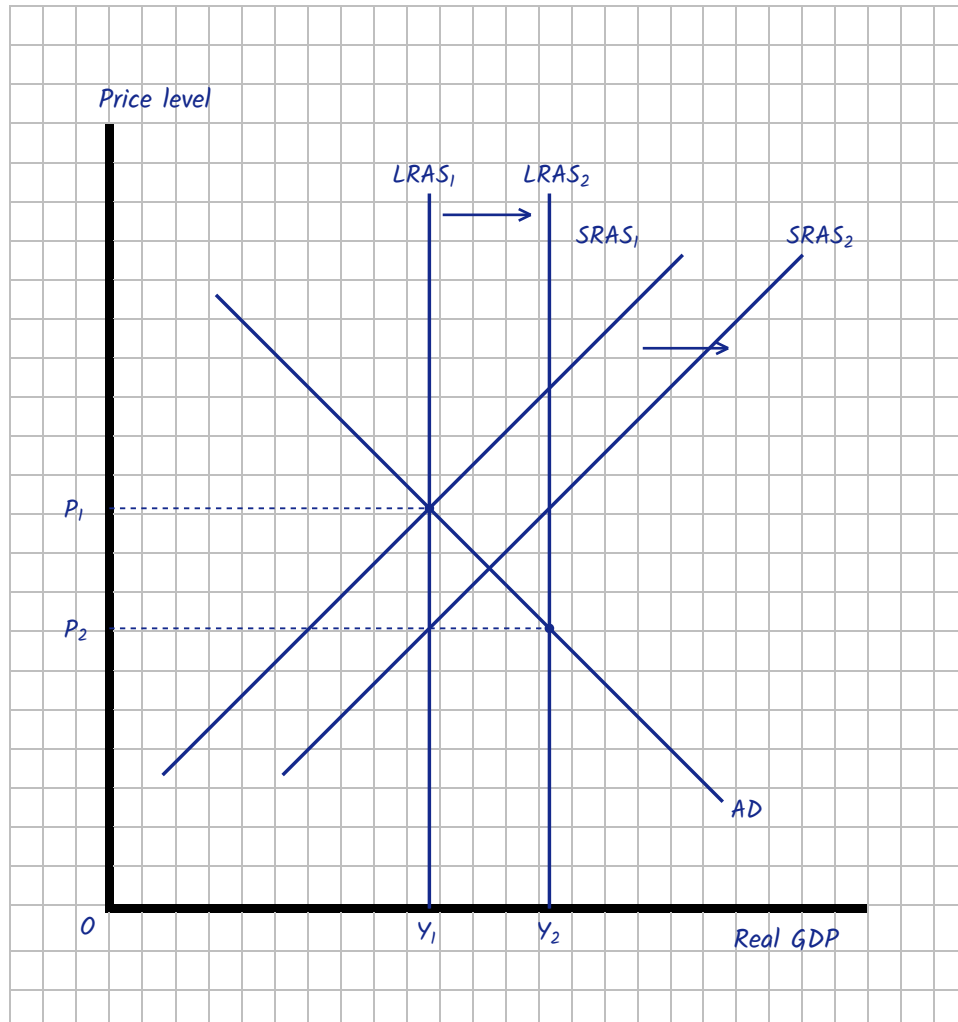


3 0

Extract F (lines 8–9) states ‘This makes it even more difficult to achieve increases in productivity.’

Draw an AD/AS diagram to show the effects of **both** short-run **and** long-run productivity gains on macroeconomic equilibrium.

[4 marks]



Short-run productivity gains lower unit costs: $SRAS_1$ shifts to $SRAS_2$.
 Long-run gains raise productive capacity: $LRAS_1$ shifts to $LRAS_2$.
 Real output rises from Y_1 to Y_2 and the price level falls from P_1 to P_2 .

Turn over for the next question

Turn over ►



3 1

Extract E (lines 18–19) states ‘the 2017 Budget Report stated the intention to reduce the rate of corporation tax further to 17% by 2020.’

Explain how a reduction in corporation tax on firms’ profits might lead to supply-side improvements in the economy.

[10 marks]

Corporation tax is a direct tax on the profits made by companies, and

Extract E shows that the government intends to cut it further, to

17% by 2020. Supply-side improvements are increases in the

productive capacity of the economy, through improvements in the

quantity and quality of the factors of production and in productivity,

which shift the long-run aggregate supply (LRAS) curve to the right.

Firstly, a lower rate of corporation tax increases firms’ post-tax

profits. Since retained profit is the main source of finance for

investment, firms have more funds available, and the expected

post-tax rate of return on new investment projects rises, so more

projects become profitable. Firms therefore increase investment in new

capital goods, such as machinery and new technology. This increases

the size of the capital stock and, because workers have more and

better capital to work with, raises labour productivity and efficiency.

Secondly, firms may use the extra profits to invest in human capital,

through training and apprenticeships, which improves the skills and

quality of the labour force and so increases labour productivity. Higher

post-tax profits also allow more spending on research and

development, leading to innovation, new products and more efficient

methods of production, which is a key source of long-run growth.

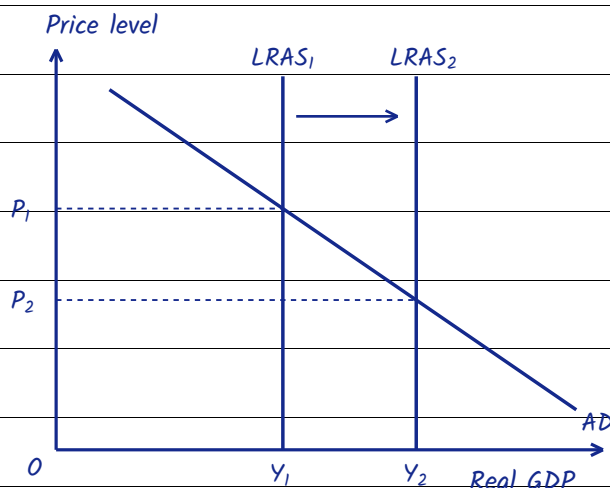
Extra space *Thirdly, a low rate of corporation tax, compared with*

other countries, makes the UK more attractive to multinational

companies, so inward foreign direct investment increases. Foreign firms



bring new capital, technology and management techniques, creating jobs and raising productivity. It also creates incentives for entrepreneurs to start new businesses, since they keep more of the reward for risk taking, which increases competition and efficiency.



As a result, the productive capacity of the economy increases and the LRAS curve shifts to the right, from $LRAS_1$ to $LRAS_2$ in the diagram.

Real output rises from Y_1 to Y_2 , while the price level falls from P_1 to P_2 , so the economy can achieve non-inflationary economic growth.

Higher productivity also lowers unit costs and improves the international competitiveness of UK firms, which can increase exports and improve the current account.

However, this depends on firms investing the extra profits rather than paying higher dividends, and the effects take time.

Turn over ►



3 2

Extract E (lines 3–4) states that there is ‘a new approach to government...a new, active role that backs business and ensures more people in all corners of the country share in the benefits of its success’.

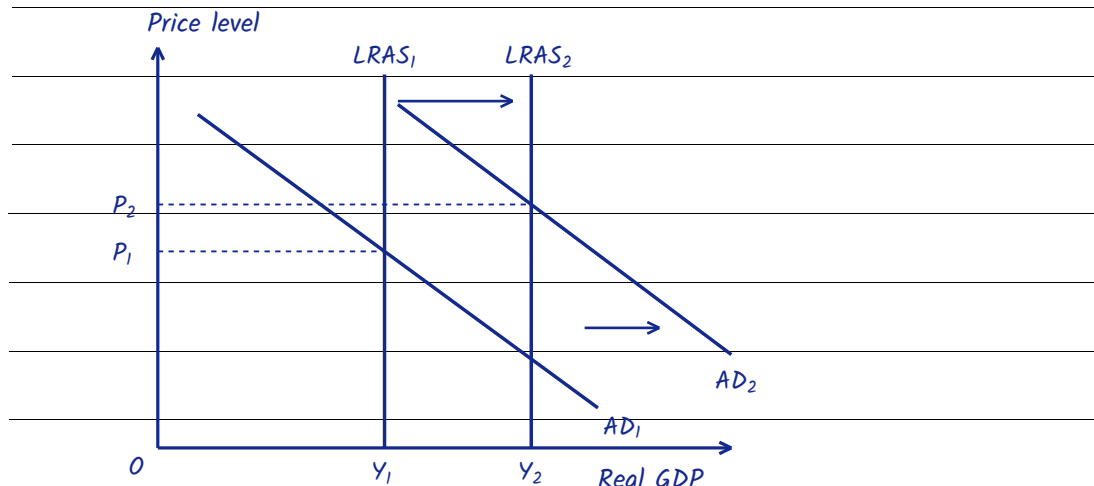
Use the extracts and your knowledge of economics to assess the view that a more active government industrial policy will make a significant improvement in macroeconomic performance.

[25 marks]

Macroeconomic performance is judged by how well an economy achieves the government's main objectives: strong and sustainable economic growth, low unemployment, low and stable inflation (2% CPI) and a satisfactory current account position. Industrial policy is a type of supply-side policy in which the government intervenes to support particular industries and regions, for example through spending on infrastructure, research and development, technical education and regional funding. A 'more active' industrial policy, as described in Extract E, means the government backs business directly rather than leaving outcomes to the free market.

There are strong arguments that a more active industrial policy will improve macroeconomic performance. Firstly, the UK suffers from a productivity gap, with output per worker below that of countries such as Germany and the USA, and Extract F suggests that it is becoming even more difficult to achieve increases in productivity. Government spending on technical education and apprenticeships improves the skills and quality of the labour force (human capital), while subsidies and tax credits for research and development encourage innovation and new technology. Better infrastructure, such as transport links, reduces firms' costs. These policies increase productivity and the productive capacity of the economy, so the LRAS curve shifts to the right, as shown in the diagram.





Secondly, the government spending itself is an injection into the circular flow, so in the short run AD shifts to the right from AD_1 to AD_2 , and with the multiplier effect this increases real GDP and employment. In the long run, because LRAS also shifts right from $LRAS_1$ to $LRAS_2$, output can rise from Y_1 to Y_2 without causing inflation, so the economy achieves non-inflationary growth with lower unemployment.

Thirdly, regional policy can reduce unemployment in areas of high unemployment. Extract D shows that £556.3 million has been allocated to the 11 local enterprise partnerships in the Northern Powerhouse, with Greater Manchester receiving £130.1 million.

Investment in these regions creates jobs, reduces structural unemployment, and helps to reduce the regional imbalance between the North and London and the South East, so that 'more people in all corners of the country share in the benefits'. It also uses unemployed resources, moving the economy closer to its production possibility frontier.

Fourthly, lower costs and higher productivity improve the international

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competitiveness of UK firms. Lower corporation tax, cut to 17% by

Extra space *2020 according to Extract E, together with a more skilled workforce and better infrastructure, attracts foreign direct investment and makes UK goods more price and quality competitive, so exports increase and the current account deficit may fall. Active government support also increases business confidence, which, through the accelerator, encourages further private sector investment.*

However, there are significant arguments against the view. Firstly, affordability and opportunity cost. The government has a large budget deficit and national debt, and the money spent on industrial policy could have been used for health care or education, or to reduce borrowing. If financed by higher taxes or borrowing, it may crowd out private sector investment. The amounts involved may also be too small to make a significant difference: £556.3 million is very small compared with UK GDP of around £2 trillion, and the five lowest-funded LEPs together received only £123.9 million.

Secondly, there is a risk of government failure. Governments have imperfect information and may 'pick losers' by supporting industries or firms that are not competitive, leading to an inefficient allocation of resources. Funding may also be influenced by political pressure. Free market economists argue that market-based supply-side policies, such as lower taxes, deregulation and labour market flexibility, are more effective than intervention, because firms and consumers know better than the government where resources should be used.

Thirdly, the policy may not deal with the underlying causes of weak performance. Extract F suggests that low wages and job insecurity make it more difficult to achieve increases in productivity: firms can



hire cheap labour instead of investing in capital, and insecure workers spend less, reducing consumption and confidence. In addition, cutting corporation tax while leaving regressive taxes such as VAT unchanged reduces the progressiveness of the tax system, which could increase inequality. The benefits may also be concentrated in the large cities such as Manchester, widening imbalances within regions.

Fourthly, there are long time lags. Training workers, building infrastructure and carrying out research and development take many years before they increase productive capacity, so the policy will have little effect on macroeconomic performance in the short run. In the short run the increase in AD could even cause inflationary pressure if the economy is close to full capacity, which may lead the Bank of England to raise interest rates. External influences, such as the UK's decision to leave the EU or a slowdown in the world economy, could easily outweigh the effects of the policy.

Finally, it is not clear how different the 'new approach' really is. Many of the measures, such as regional funding, apprenticeships and corporation tax cuts, have been used by previous governments, and the UK's productivity gap has persisted. The success of the policy also depends on how it is combined with other policies: much of the burden of managing the economy has been placed on monetary policy, and industrial policy works best when it complements, rather than replaces, sound monetary and fiscal policy.

In conclusion, a more active industrial policy is likely to improve macroeconomic performance, especially productivity, long-run growth and regional unemployment, but whether the improvement is

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'significant' is doubtful, at least in the short run. The amounts of funding shown in Extract D are small relative to the size of the economy, there is a risk of government failure, and the benefits will take many years to appear. The extent of the improvement depends on the scale of the funding, whether it is well targeted at the causes of the productivity gap such as skills and infrastructure, and on whether the private sector responds with higher investment. Over the long run, if it is sustained and well designed, industrial policy could make a significant improvement, but on its own it is unlikely to transform the UK's macroeconomic performance.

END OF QUESTIONS

