



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

I declare this is my own work.

AS ECONOMICS

Paper 2 The National Economy in a Global Context

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.
- If you need extra space for your answer(s), use the lined pages at the end of this book. Write the question number against your answer(s).
- Do all rough work in this book. Cross through any work you do not want to be marked.

Information

- The maximum mark for this paper is 70.
- 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 2 2 7 1 3 5 2 0 1

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**

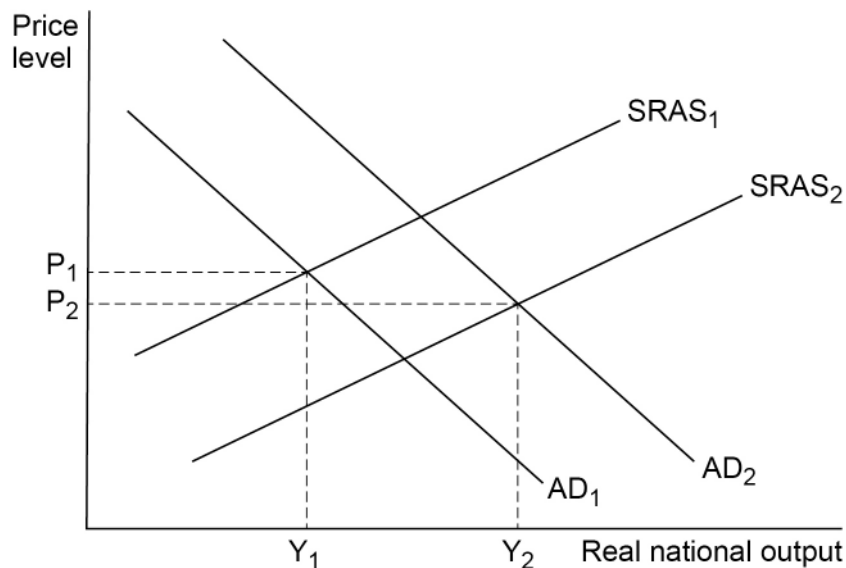
Which one of the following is most likely to be an objective of government economic policy?

A A low level of employment**B** A lower price level**C** An equal distribution of income**D** An increase in productive potential**[1 mark]**

0 2

Figure 1 shows the aggregate demand (AD) and short-run aggregate supply (SRAS) curves for an economy.

Figure 1



Which one of the following combinations of events is most likely to cause the curves to shift from AD_1 to AD_2 and from $SRAS_1$ to $SRAS_2$?

- A** A higher rate of savings and faster labour productivity growth
- B** Faster economic growth abroad and lower world commodity prices
- C** Higher money wages and more household consumption
- D** Lower interest rates and a higher rate of indirect taxes

☐
☒
☐
☐

[1 mark]

0 3

The main reason that economic statistics are often expressed as index numbers is to

- A** allow easier comparison of data.
- B** calculate cost of living data.
- C** convert nominal data to real data.
- D** even out fluctuations in raw data.

☒
☐
☐
☐

[1 mark]

Turn over ►



0 4

Unemployment rose in an economy despite overall economic growth. This is most likely to be explained by an increase in

A cyclical unemployment.

☐

B job vacancies.

☐

C structural unemployment.

☒

D the school leaving age.

☐

[1 mark]

0 5

An economy experiences an increasing negative output gap. Which one of the following combinations of outcomes most accurately describes the likely effects of this?

	Imports	Inflationary pressure	Unemployment
A	Falling	Falling	Rising
B	Falling	Rising	Falling
C	Rising	Falling	Rising
D	Rising	Rising	Falling

☒
☐
☐
☐

[1 mark]

0 6

A deflationary policy is designed to

A avoid deflation.

☐

B increase aggregate demand.

☐

C lead to deflation.

☐

D reduce aggregate demand.

☒

[1 mark]



0 7Index numbers for real GDP per head for Country X and Country Y, are shown in **Table 1**.**Table 1**

Year	Country X	Country Y
2016	100	100
2017	102	104
2018	101	103
2019	105	107

From **Table 1** it can be concluded that real GDP per head**A** grew at the same rate between 2018 and 2019 in both countries.☐**B** grew every year throughout the period in both countries.☐**C** rose faster in Country X between 2017 and 2019.☒**D** was higher in Country Y than in Country X from 2017 to 2019.☐**[1 mark]****0 8**

Nominal GDP for an economy fell from £318 billion to £310 billion. Average prices also fell over the same period. It can be concluded that

A deflation resulted in a recession.☐**B** output fell, but by less than £8billion.☐**C** real GDP was lower at the end of the period.☐**D** real incomes may have risen or fallen.☒**[1 mark]****Turn over for the next question****Turn over ►**

0 9

An economy has a positive output gap and the government decides to increase interest rates. Which one of the following outcomes is most likely to result from the higher interest rates?

	Investment	Output gap	Savings
A	Decrease	Decrease	Increase
B	Decrease	Increase	Decrease
C	Increase	Decrease	Decrease
D	Increase	Increase	Increase

☒☐☐☐**[1 mark]****1 0**

Faster growth in national income caused investment in an economy to increase. This means that the increase in investment resulted from

A an increase in spare capacity.

☐

B lower interest rates.

☐

C the action of the accelerator.

☒

D the action of the multiplier.

☐**[1 mark]****1 1**

An indirect tax is a tax levied on

A firms' profits.

☐

B income.

☐

C savings.

☐

D spending.

☒**[1 mark]**

1 2

The Bank of England decides to raise interest rates to bring inflation back to its target rate. This policy is less likely to be effective if at the same time

A firms' profits and investment fall.

☐

B income tax rates are reduced.

☒

C labour productivity grows more quickly.

☐

D other countries reduce their demand for UK exports.

☐

[1 mark]

Turn over for the next question

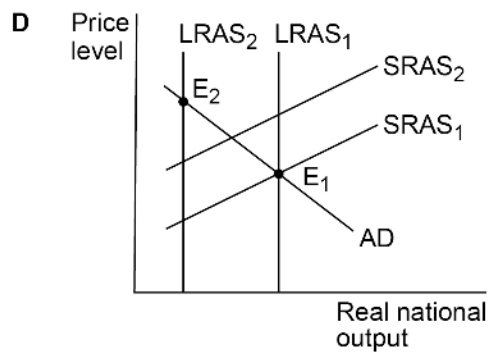
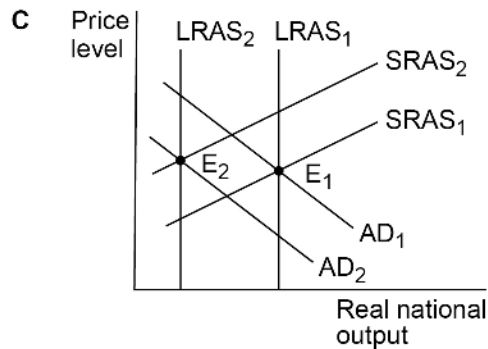
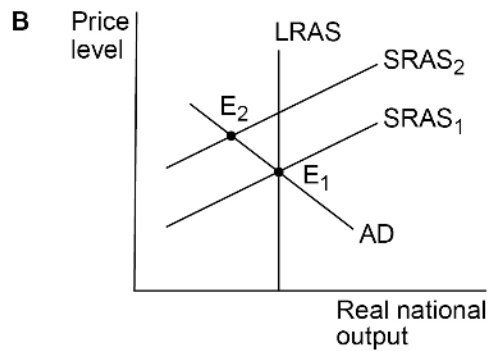
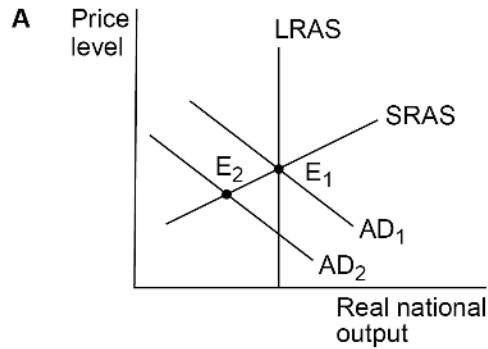
Turn over ►



1 3

A small island economy suffers extensive damage from a hurricane. The following diagrams show aggregate demand (AD), short-run aggregate supply (SRAS) and long-run aggregate supply (LRAS) for the economy. Equilibrium before the hurricane is at E_1 .

Which one of the following diagrams shows the most likely position of E_2 , the equilibrium reached after the hurricane?

[1 mark]

1 4

Which one of the following is an example of expansionary fiscal policy?
A reduction in the

A budget deficit.

☐

B budget surplus.

☒

C trade deficit.

☐

D trade surplus.

☐

[1 mark]

1 5

Table 2 shows the components of aggregate demand in an economy which is in equilibrium.

Table 2

	£ billion
Consumer expenditure	1000
Investment	200
Government expenditure	350
Exports	150
Imports	200

If imports increase to £230 billion and the multiplier is 1.5, then the new level of national income would be

A £1155 billion

☐

B £1455 billion

☒

C £1545 billion

☐

D £1845 billion

☐

[1 mark]

Turn over for the next question

Turn over ►



1 6

A government cuts the rate of corporation tax from 30% to 15%.
This policy is most likely intended to

A decrease the level of savings.

☐

B improve labour mobility.

☐

C reduce investment from overseas companies.

☐

D stimulate supply-side improvements.

☒**[1 mark]****1 7**

An economy has a deficit on the current account of its balance of payments.
Which one of the following sets of circumstances is most likely to cause the deficit to increase?

A A depreciating exchange rate and lower unemployment

☐

B Better supply-side policies and lower interest rates

☐

C Expansionary fiscal policy and a stronger exchange rate

☒

D Increased labour productivity and lower interest rates

☐**[1 mark]****1 8**

An economy experiencing a high rate of short-run economic growth is likely to have an increase in

A firms' spare capacity.

☐

B job vacancies.

☒

C spending on unemployment benefits.

☐

D the real value of money.

☐**[1 mark]**

1 9

In the short run, an increase in government borrowing is most likely to result in lower

A consumer expenditure.

☐

B government expenditure.

☐

C national debt.

☐

D unemployment.

☒

[1 mark]

2 0

A government wanting to use monetary policy to reduce deflation could decrease the

A exchange rate.

☒

B minimum wage.

☐

C money supply.

☐

D rate of indirect tax.

☐

[1 mark]

20

END OF SECTION A

Turn over ►



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.

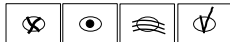
There is a total of 50 marks for either context.

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 GROWTH

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 'price stability' **Extract B** (line 3).

[3 marks]

Price stability means keeping the rate of inflation low and stable over a sustained period of time, so that the general price level rises only slowly and predictably. In the UK this is defined by the government's inflation target of 2% a year (CPI inflation), which the Bank of England aims to achieve.



2 2

If UK GDP was equal to £2073 billion in 2017, use **Extract A** to calculate, to the **nearest billion**, the value of UK GDP in 2018.

[4 marks]

Extract A shows that UK real GDP grew by 1.4% in 2018.

GDP in 2018 = £2073 billion $\times$ (100 + 1.4) / 100

= £2073 billion $\times$ 1.014 = £2102.02 billion

UK GDP in 2018 = £2102 billion (to the nearest billion)

Turn over for the next question

Turn over ►



2 3

Use **Extract A** to identify **two** significant points of comparison between the growth rates of the UK and Germany over the period shown.

[4 marks]

Comparison 1 *The UK grew faster than Germany at both the start and the end of the period: in 2015 UK real GDP grew by 2.4% compared with 1.7% in Germany, and in 2019 the UK grew by 1.4% compared with only 0.6% in Germany.*

Extra space

Comparison 2 *Only between 2016 and 2018 was Germany's growth rate higher than the UK's. For example, in 2017 Germany grew by 2.5% (its highest rate) while the UK grew by 1.9%, and in 2018 Germany grew by 1.5% compared with 1.4% in the UK.*

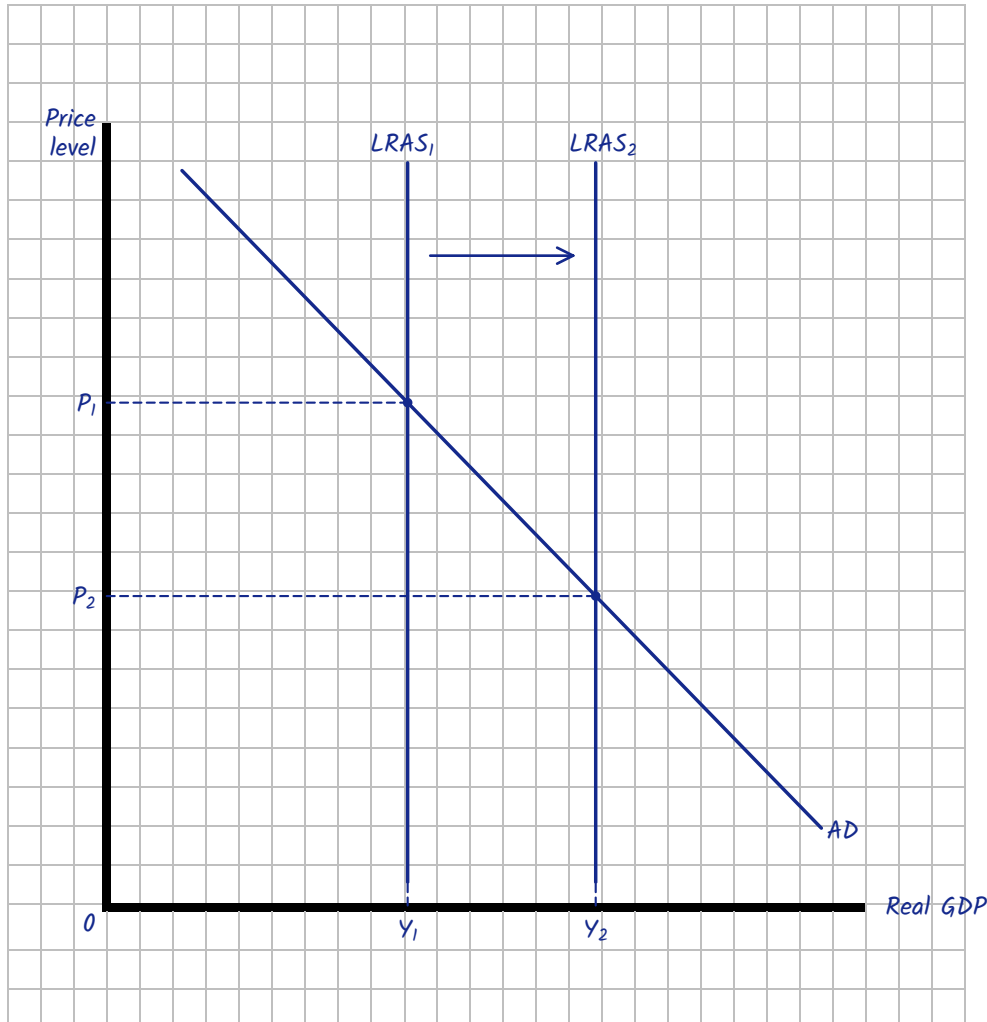
Extra space



2 4

Extract C (lines 16–17) states: ‘An increase in the funds available for education and training should help to improve factor mobility’.

Draw an AD/AS diagram to show the long-run impact of improved factor mobility on the price level and national income.

[4 marks]

Better factor mobility raises productive capacity: LRAS shifts right, the price level falls from P_1 to P_2 and real national income rises from Y_1 to Y_2 .

Turn over for the next question

Turn over ►



2 5

Extract B (line 2) states: '...there were signs that economies were in the midst of a global slowdown'.

Explain how a global slowdown can affect employment in the UK.

[10 marks]

A global slowdown is when the rate of growth of real GDP across the world's major economies falls, and it may become a global recession if output actually falls. Extract A shows world growth falling from 3.9% in 2017 to 2.9% in 2019, with growth in Germany falling to just 0.6%. Employment is the number of people in paid work, and because labour is a derived demand, it depends on the demand for the goods and services that workers produce. The main way a global slowdown affects the UK is through trade. As incomes in other countries grow more slowly and unemployment rises abroad, households and firms there buy fewer imports, so the demand for UK exports of consumer goods, capital goods and services falls. Exports are a component of aggregate demand ($AD = C + I + G + X - M$), so lower exports shift AD to the left from AD_1 to AD_2 , as shown in the diagram. Real output falls from Y_1 to Y_2 and a negative output gap opens up below the full employment level of output.

Since labour is a derived demand, firms producing less need fewer workers. Exporting industries such as car manufacturing would cut overtime, stop recruiting and make workers redundant, so cyclical (demand-deficient) unemployment rises and employment falls.

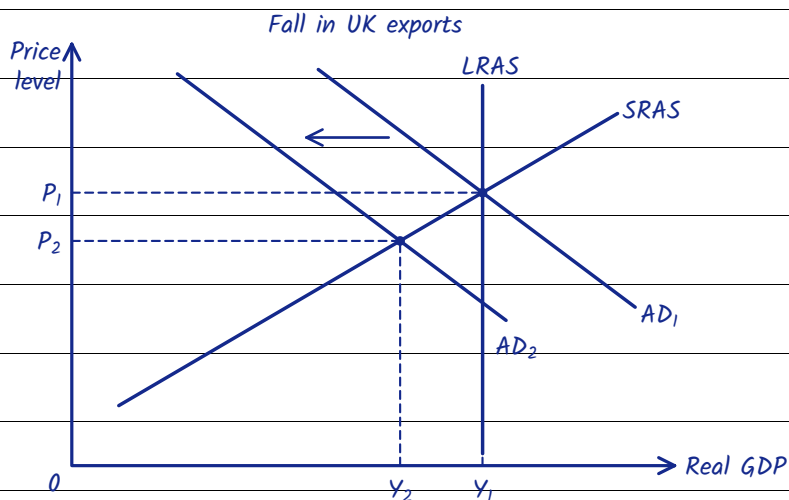
This initial fall in employment is made larger by the negative multiplier effect. Workers who lose their jobs or have their hours cut reduce their

Extra space consumption, which lowers the incomes of other firms, such as shops and restaurants, which then cut jobs too. As a result, the final fall in national income and employment is greater than the initial fall in export



demand.

There is also a confidence and accelerator effect. Extract B says that trade



tensions and Brexit uncertainty 'damaged business confidence, and many firms were reluctant to invest in new capacity'. If firms expect demand to keep falling, investment falls by proportionally more than the fall in output (the accelerator). This reduces AD further and cuts jobs in industries that make capital goods, such as construction and engineering. Foreign multinationals may also invest less in the UK, so fewer new jobs are created.

However, the size of the effect depends on how open the UK economy is, on how severe the slowdown is and on the policy response. Lower world commodity prices reduce UK firms' costs, and a cut in Bank Rate or a fall in the value of the pound would make UK exports more competitive, protecting some jobs. In the short run the extra unemployment is mainly cyclical, but if the slowdown lasts a long time, workers who are unemployed for long periods lose skills and motivation (hysteresis), so cyclical unemployment can become longer-term structural unemployment, keeping employment lower even after the world economy recovers.

Turn over ►



2 6

Extract C (lines 2–4) states: ‘...the Prime Minister, Boris Johnson, had promised to make the 2020s a “decade of prosperity and opportunity”. If this is to be achieved, it will be essential to find ways to boost both short-run and long-run growth’.

Use the extracts and your knowledge of economics to evaluate different policies that can be used to increase the long-run rate of growth of the UK economy.

[25 marks]

Long-run economic growth is an increase in the productive potential of the economy, shown by an outward shift of the production possibility frontier or a rightward shift of the LRAS curve. It is different from short-run growth, which is an increase in real GDP caused by higher aggregate demand using up spare capacity. The long-run trend rate of growth depends on the quantity and quality of the factors of production and, above all, on productivity. UK growth was disappointing even before the pandemic: Extract A shows real GDP grew by only 1.4% in both 2018 and 2019, below the US (2.9% and 2.3%) and the world average (3.6% and 2.9%). Raising the trend rate of growth is therefore essential if the 2020s are to be a 'decade of prosperity and opportunity'.

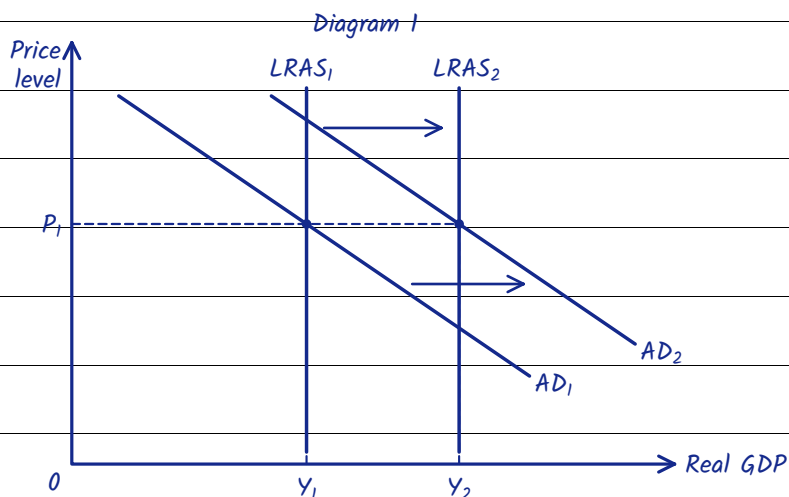
The first policy is increased government spending on infrastructure. Extract C states that more than £600 billion is to be spent on roads, rail and broadband by 2025. Better transport and digital networks reduce firms' costs and journey times, allow firms to reach larger markets and make workers more productive, increasing the productive capacity of the economy. As Diagram 1 shows, LRAS shifts right from $LRAS_1$ to $LRAS_2$. Because infrastructure spending is also an injection into the circular flow, it increases AD from AD_1 to AD_2 in the short run with a positive multiplier effect, so it boosts both short-run and long-run growth, and real output rises from Y_1 to Y_2 without extra inflationary pressure.

However, infrastructure projects have long time lags, so the benefits may not be felt for many years, and projects often run over budget. There is an



opportunity cost, and the spending has to be financed by borrowing, adding to the budget deficit and national debt. Extract C warns that 'taxes may have to rise to pay for the increase in government spending', which could reduce incentives in the future. The success of this policy depends on choosing the projects that raise productivity the most.

Second, the government can increase spending on education and training to



improve human capital. Extract C says this 'should help to improve factor mobility and ensure the labour force has the skills the economy needs'.

Better skills raise labour productivity, and greater occupational mobility allows workers who lose jobs because of structural change, such as the move away from petrol and diesel cars mentioned in Extract B, to move into growing industries. This reduces structural unemployment and increases the effective size of the labour force, so LRAS shifts to the right, as shown in Diagram 2, increasing real output from Y_1 to Y_2 and reducing the price level from P_1 to P_2 . This may be the most important long-run policy because the UK's productivity has grown slowly for many years.

On the other hand, education and training take a very long time to have an effect, perhaps more than a decade, and courses may not match the skills that employers actually need. The quality of the spending matters more than

Turn over ►



Extra space _____

the amount.

Third, the government can encourage innovation by funding research, such as the extra £900 million on nuclear fusion, space and electric vehicles in

Extract C, and by giving tax relief for research and development. New technology raises the productivity of both labour and capital and is the main source of long-run growth in developed economies. However, the results of research are uncertain and governments are often poor at 'picking winners', so some of this money may be wasted, which is a form of government failure.

Fourth, low rates of direct taxation 'help to create incentives to work, save and invest' (Extract C). Lower income tax increases the reward from working, which may increase labour supply and participation, while lower corporation tax raises post-tax profits, encouraging domestic firms to invest and attracting foreign direct investment, which increases the capital stock.

However, the effect on labour supply is uncertain because of the income effect, as some workers may choose more leisure, and investment depends more on expected demand and confidence than on tax rates. With a very large budget deficit after the pandemic, tax cuts may also be unaffordable.

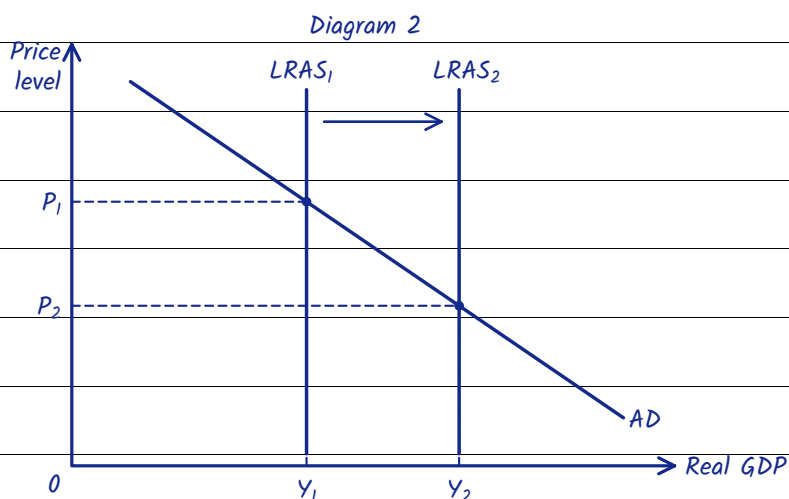
Demand-side policies can also support long-run growth. The cut in Bank Rate to 0.1% and the increase in the supply of money and credit (Extract C) reduce the cost of borrowing, which encourages firms to invest in new capital. Through the accelerator, rising demand encourages investment, which

adds to productive capacity in the long run. Confidence is crucial: Extract B shows that Brexit uncertainty had already led to 'low levels of investment'.

However, with interest rates already close to zero there is little room for further cuts, and if firms are pessimistic, cheap credit may not lead to more investment.



The effectiveness of all of these policies depends on several factors. First, the amount of spare capacity: in 2020 there was a large negative output gap, as UK output shrank by 19.1% in the three months to May (Extract B), so in the short run demand-side policies are needed to restore confidence and use existing capacity; adding capacity that is not used would not raise actual growth. Second, external factors: the UK is an open economy, so a global slowdown, with the IMF forecasting that world output would fall by 4.9% in 2020, and trade tensions such as US import taxes will limit UK growth whatever policy is used. Third, Brexit may reduce access to



EU markets and EU workers, offsetting some of the supply-side gains.

Finally, the state of the public finances may limit how much the government can spend in future.

In conclusion, the best way to increase the long-run rate of growth of the UK economy is a combination of policies rather than relying on a single one. Supply-side policies that raise productivity, especially investment in infrastructure and in education and training, are likely to be the most effective in the long run because they directly increase the quantity and quality of the factors of production, and infrastructure has the added advantage of raising AD in the short run. However, these policies work only

Turn over ►



after long time lags and are expensive, so their success depends on the spending being well targeted and on confidence first being restored through supportive monetary and fiscal policy. Tax cuts are less certain to work and may not be affordable given the size of the deficit. Ultimately, whether the 2020s become a 'decade of prosperity and opportunity' depends as much on the recovery of the world economy and the UK's trading relationships after Brexit as on UK government policy.



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

OR

Context 2

Total for this context: 50 marks

GOVERNMENT SPENDING AND TAXATION

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 'unemployment rate' **Extract E** (line 18).

[3 marks]

The unemployment rate is the number of people who are out of work but willing and able to work and actively seeking work, expressed as a percentage of the labour force (the economically active population). In the UK it is measured using the Labour Force Survey (ILO definition).

2 8 If the government allocated £275 billion to social security spending in 2018–19, use **Extract D** to calculate, to the **nearest billion**, the total amount of government spending in 2018–19.

[4 marks]

Social security spending in 2018-19 = old-age related (17%) + other social security (18%) = 35% of total government spending.

Total spending = £275 billion / 35 × 100 = £785.71 billion

Total government spending in 2018-19 = £786 billion (to the nearest billion)

Turn over ►



2 9

Use **Extract D** to identify **two** significant points of comparison regarding the composition of government spending between 1997–98 and 2018–19.

[4 marks]

Comparison 1 *Social security as a whole accounted for the largest share of government spending in both years: 37% (14% + 23%) in 1997–98 and 35% (17% + 18%) in 2018–19.*

Extra space

Comparison 2 *Health spending increased its share by the most, from 14% of government spending in 1997–98 to 20% in 2018–19 (6 percentage points), whereas debt interest fell from 9% to 5% and was the smallest share in both years.*

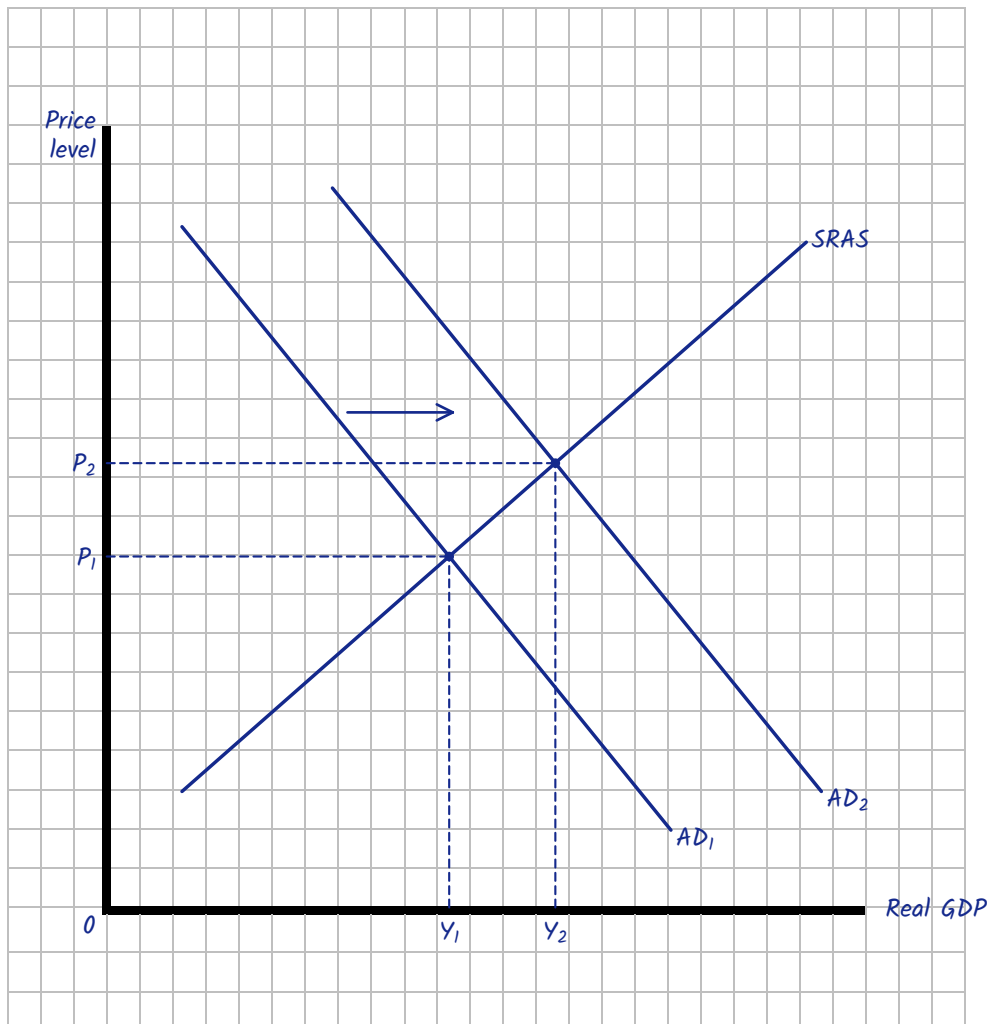
Extra space



3 0

Extract E (line 15) states: 'Government spending acts as an injection into the circular flow of income'.

Draw an AD/AS diagram to show the effect of an increase in injections on the price level and national income.

[4 marks]

Higher injections (G , I or X) shift AD right from AD_1 to AD_2 ; the price level rises from P_1 to P_2 and real national income rises from Y_1 to Y_2 .

Turn over for the next question

Turn over ►



3 1

Extract F (lines 1–2 and 8) states: ‘As part of fiscal policy, government spending can be used to allocate resources to different regions and sectors of the economy and consequently, change the pattern of economic activity...Taxation also has a role to play in affecting the pattern of activity’.

Explain ways in which a government can use fiscal policy to affect the **pattern** of economic activity.

[10 marks]

Fiscal policy is the use of government spending and taxation to influence the economy. The pattern of economic activity refers to what is produced and where: how resources are allocated between different sectors, industries and regions. Fiscal policy can cause some parts of the economy to expand while others contract.

First, the government can change the pattern of activity directly through its own spending. If the government spends more on the NHS, more factors of production, such as doctors, nurses, buildings and equipment, are devoted to health care, so the health sector expands relative to other sectors. Extract D shows that health spending rose from 14% of government spending in 1997–98 to 20% in 2018–19, so activity has shifted towards health care.

Spending can also be targeted at particular regions: building infrastructure in poorer regions creates jobs and incomes there and, through the regional multiplier, attracts private firms, helping to rebalance activity between regions.

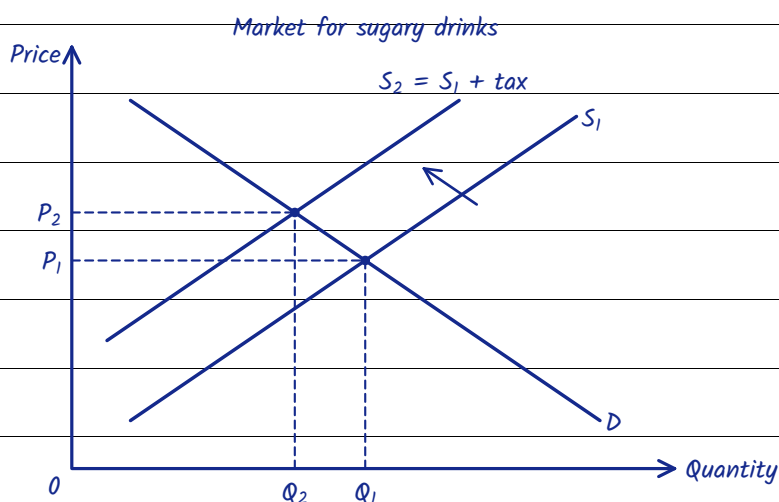
Second, subsidies reduce firms' costs, shifting supply to the right, lowering prices and increasing output in the subsidised industry. For example, the £2 billion subsidy scheme for energy-saving home improvements (Extract F) increases demand for insulation and green technology, so these industries expand, while the £1.6 billion of support for the arts keeps resources in a sector that would otherwise contract. The £2 billion scheme to create jobs for young people and the 30 000 new traineeships help to reduce



Extra space *occupational and geographical immobility, so labour can move into growing sectors and regions.*

Third, direct taxation can create incentives. Corporation tax can be altered to 'create incentives to innovate' (Extract F); for example, tax allowances for research and development lower the cost of R and D, so more resources flow into high-technology industries. Lower taxes in particular areas, such as enterprise zones, encourage firms to locate in deprived regions.

Fourth, indirect taxes change relative prices and therefore consumers' behaviour. The 'sugar tax' raises the cost of producing sugary drinks, shifting supply to the left from S_1 to S_2 , as shown in the diagram. The price rises from P_1 to P_2 and the quantity falls from Q_1 to Q_2 , so fewer resources are used to produce this demerit good and firms reformulate their drinks with



less sugar. In contrast, the temporary cut in VAT for the hospitality industry lowers prices, increases demand and supports output and jobs in restaurants and pubs.

How much the pattern of activity changes depends on the price elasticity of demand and supply: if demand for sugary drinks is price inelastic, the tax causes only a small fall in quantity. It also depends on the size of the measures and on whether the spending is well targeted.

Turn over ►



3 2

Extract E (lines 4–6) states: ‘...the report suggested that significant increases in spending would be required to help improve the wellbeing of the UK population’.

Use the extracts and your knowledge of economics to assess the view that a long-term, significant increase in government spending would be beneficial for the UK economy.

[25 marks]

Government spending is spending by central and local government on goods, services and investment, such as health, education, social care, the police and infrastructure, together with transfer payments such as pensions and benefits. Extract E shows that after a decade of austerity, government spending fell from 46.3% of GDP in 2009–10 to 39.3% in 2018–19, and services such as health, social care and the police face funding challenges. Whether a long-term, significant increase in spending is beneficial should be judged by its effect on the macroeconomic objectives of growth, low unemployment, low inflation and a sustainable balance of payments, and on the wellbeing of the population.

The main argument in favour is that government spending is an injection into the circular flow of income and a component of aggregate demand. Higher spending shifts AD to the right and, through the positive multiplier effect, increases real GDP by more than the initial spending. When there is spare capacity, as in 2020 when employment fell by 649 000 between March and June (Extract E), the extra demand mainly increases real output and employment rather than prices. In Diagram 1 the shift from AD_1 to AD_2 raises real output from Y_1 to Y_2 with the price level unchanged at P_1 . Extract E also notes that spending ‘should help to stimulate private sector investment’, because higher demand and confidence encourage firms to invest (the accelerator), adding further to AD.

A second argument is that, if the extra spending goes on investment in infrastructure, education and health, it also improves the supply side of the



economy. A healthier, better educated workforce is more productive, and better infrastructure reduces firms' costs. As shown in Diagram 2, AD increases from AD_1 to AD_2 and LRAS shifts from $LRAS_1$ to $LRAS_2$, so real output rises from Y_1 to Y_2 without inflation, raising the trend rate of growth. Spending on merit goods and public goods corrects market failure, and spending on health and social care directly improves wellbeing, which GDP figures do not fully capture. Extract F gives examples of well-targeted spending, such as the £2 billion scheme to create jobs for young people and 30 000 traineeships, which reduce structural unemployment.

However, there are strong arguments against. First, a significant increase in spending must be financed. Extract F states it 'will have to be accompanied by increases in taxation and/or even more government borrowing now and in the future'. Borrowing was already expected to reach £350 billion in 2020-21 (Extract E), adding to the national debt and to debt interest payments, which take resources away from public services. Higher taxes in the future would reduce incentives to work and invest, and reduce disposable income, partly offsetting the increase in AD. Higher government borrowing could also push up interest rates and crowd out private sector investment.

Second, if the increase is long-term, the extra spending will continue once the economy has recovered and spare capacity has been used up. Then, as Diagram 1 shows, a shift from AD_3 to AD_4 near full capacity (Y_{fe}) mainly raises the price level from P_3 to P_4 , causing demand-pull inflation. Extract F warns that 'higher spending runs the risk of greater inflationary pressure'. In addition, higher incomes increase spending on imports, which could worsen the current account deficit of the balance of payments.

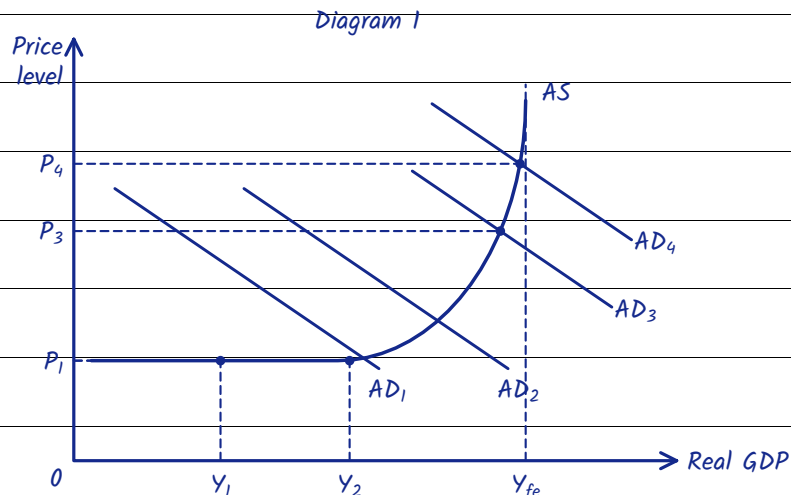
Third, there is the risk of government failure. Without the profit motive, public spending may be inefficient, and money may be spent on projects

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Extra space *that bring few benefits. As Extract F says, 'it will be important to ensure that the increases in spending are used appropriately and are worthwhile'.*

Whether the increase is beneficial therefore depends on several factors. The



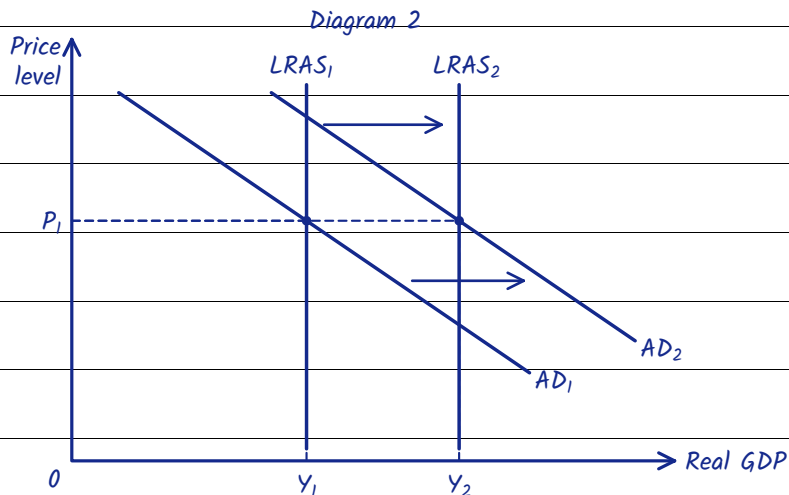
most important is where the money is spent: capital spending on infrastructure, energy efficiency, education and health raises productive capacity and pays for itself over time through faster growth and higher tax revenue, whereas extra current spending that does not raise productivity adds to the deficit without long-run benefits. It also depends on the state of the economic cycle: during a recession, as in 2020, the multiplier is larger and there is little risk of inflation or crowding out, but in a boom the costs are higher. The size of the increase matters: raising spending back towards the 46.3% of GDP seen in 2009-10 is very different from keeping it above 50% permanently. Finally, while interest rates are very low, borrowing to invest is cheap, but if interest rates rise, debt interest would become a much larger burden.

In conclusion, a long-term, significant increase in government spending is likely to be beneficial for the UK economy if it is mainly targeted at investment that improves the supply side, such as infrastructure, education,



health and energy efficiency, because it raises both AD and LRAS, supports employment and improves wellbeing without causing much inflation. After a decade of austerity, some increase is needed to restore public services.

However, it would not be beneficial if it simply raised current spending in an economy at full capacity, financed by ever-increasing debt, as this would lead to inflation, a worse current account and higher taxes in the future. On balance, the case for higher spending is strongest in the short run during the recovery from the pandemic, and in the long run the increase should be limited to spending that is worthwhile and sustainable.



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