Please check the examination details below before entering your candidate information

Candidate surname	Other names
StemUp Model Solution	

Pearson Edexcel Level 3 GCE

Centre Number	Candidate Number

Tuesday 2 June 2020

Morning (Time: 2 hours)	Paper Reference **9EC0/02**

Economics A

Advanced

Paper 2: The National and Global Economy

You do not need any other materials.

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- There are three sections in this question paper. Answer **all** questions from Section A and Section B. Answer **one** question from Section C.
- Answer the questions in the spaces provided – *there may be more space than you need.*

Information

- The total mark for this paper is 100.
- The marks for **each** question are shown in brackets – *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Check your answers if you have time at the end.

Turn over ▶

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SECTION A

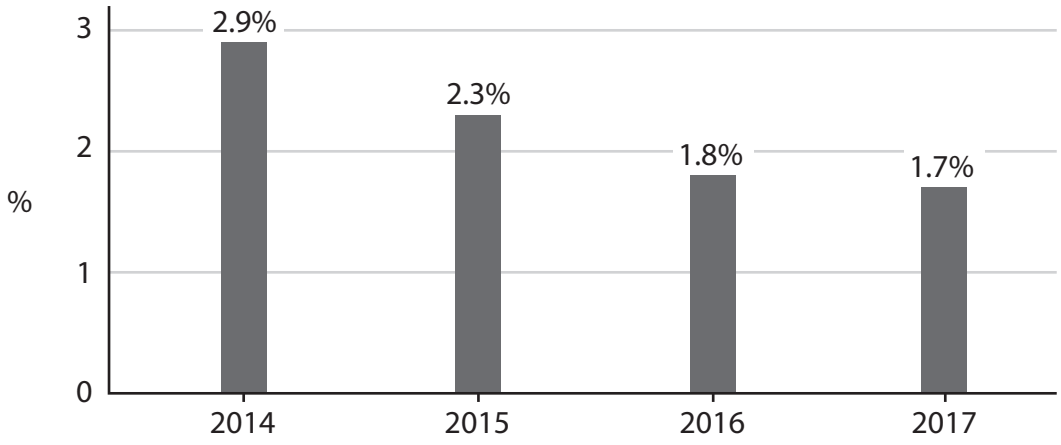
Answer ALL questions. Write your answers in the spaces provided.

Some questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.

You are advised to spend 30 minutes on this section.

Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.

1 UK real Gross Domestic Product (GDP), annual percentage change 2014–2017



(Source: https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ihyp/qna)

(a) Total real UK GDP in 2016 was £200 000 million. With reference to the chart above, calculate the total real UK GDP for 2017. You are advised to show your working.

(2)

Real GDP grew by 1.7% in 2017 (from the chart)

2017 real GDP = £200 000m × (1 + 1.7 ÷ 100) = £200 000m × 1.017

Answer: £203 400 million (£203.4 billion)

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(b) Explain the term 'real gross domestic product'.

(2)

Gross domestic product is the total value of output (goods and services) produced in an economy over a year, which also equals total income and total expenditure.

'Real' means it has been adjusted for inflation, measured at constant prices, so it removes the effect of rising prices and shows the change in the volume of output.

(c) With reference to the chart on page 2, which **one** of the following is correct over the period shown?

(1)

- ☐ **A** GDP per capita was highest in 2014
- ☐ **B** Inflation rose in 2015
- ☒ **C** The UK economy grew at the fastest rate in 2014
- ☐ **D** The UK economy was in recession in 2015

(Total for Question 1 = 5 marks)

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2 The planned investment in the redevelopment of Dover Port will cost £115 million. The Chief Executive said it will lead to many 'new job opportunities for local people and a transformed waterfront experience' with new cafés, bars, and shops.

(Source adapted from: https://www.kentonline.co.uk/dover/news/docklands-redevelopment-work-to-start-118581/)

(a) If the value of the multiplier is 1.8, which **one** of the following will be the total increase in GDP from the redevelopment, assuming other things are equal?

(1)

- ☒ **A** £64 million
- ☒ **B** £115 million
- ☒ **C** £207 million
- ☒ **D** £230 million

(b) Using the example above, explain how the multiplier process leads to an increase in aggregate demand.

(4)

The multiplier effect is where an initial change in an injection into the circular flow, such as investment, leads to a greater final increase in aggregate demand and national income. The multiplier = 1 ÷ (1 – MPC), or 1 ÷ MPW.

The £115 million investment in Dover Port is an injection. It is paid to construction firms and workers as income. The construction workers then spend part of this income, for example eating lunch in local cafés or staying in local hotels, and once the waterfront is open, local people in the new jobs in the cafés, bars and shops spend their wages in the local economy too.

One person's spending is another person's income, so the money goes round the circular flow many times, each time creating further rounds of spending and raising AD again. However, at each round some income leaks out as savings, taxes and imports, so each round is smaller until eventually all of the money has been withdrawn from the circular flow.

With a multiplier of 1.8, the final increase in AD and GDP is £115m × 1.8 = £207 million, greater than the initial £115 million injection.

(Total for Question 2 = 5 marks)

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3 In 2018, the International Monetary Fund (IMF) lent Argentina $57 billion as part of a bailout package to help prevent the country's government defaulting on its debts. This financial crisis also caused significant capital flight out of Argentina's economy.

(Source adapted from: https://www.ft.com/content/737b48bc-c1c9-11e8-95b1-d36dfef1b89a)

(a) Explain the role of the IMF in providing financial assistance to countries such as Argentina.

(4)

The International Monetary Fund (IMF) promotes international monetary cooperation, global financial and exchange rate stability, and provides temporary loans (credit) to countries facing balance of payments problems or financial crises, helping to prevent a recession and enabling growth.

For example, it lent Argentina $57 billion so that the Argentinian government could continue repayments on its debts rather than default. The money also helps to stabilise the peso, as the central bank can use the funds to support the currency after the capital flight.

Countries such as Argentina rely on the IMF as a lender of last resort because it would be too risky for private financial markets to lend to them, or they would only lend at very high interest rates. In return, the IMF insists on conditions, such as reforms to the economy, cuts in the budget deficit and austerity, as part of the financial assistance.

(b) Which **one** of the following is most likely to happen to Argentina's currency value as a result of capital flight, assuming it is operating with a floating exchange rate system?

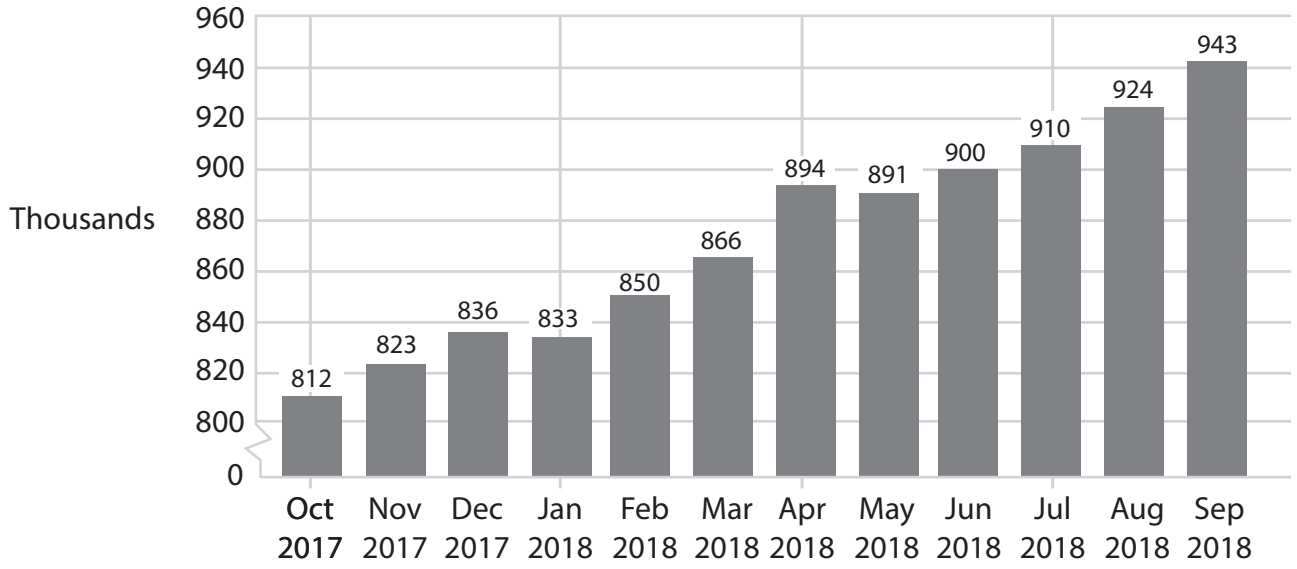
(1)

- ☐ **A** Appreciation
- ☒ **B** Depreciation
- ☐ **C** Devaluation
- ☐ **D** Revaluation

(Total for Question 3 = 5 marks)

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4 Number of unemployed persons, UK, as measured by the claimant count, thousands



(Source: https://tradingeconomics.com/united-kingdom/unemployed-persons)

(a) Calculate the percentage change in the number of UK unemployed persons between April and July 2018. You are advised to show your working.

(2)

April 2018 = 894 thousand; July 2018 = 910 thousand

% change = (new − old) ÷ old × 100

= (910 − 894) ÷ 894 × 100 = 16 ÷ 894 × 100

Answer: a 1.79% increase (to 2 d.p.)

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(b) Explain **one** likely reason for the increase in the number of people unemployed in the UK over the time period shown.

(2)

One likely reason is uncertainty over the process of the UK leaving the EU after the 2016 referendum, which reduced business expectations and confidence. This uncertainty discourages firms from expanding or investing in their businesses, so they recruit fewer workers and may cut jobs, and slower economic growth means less demand for labour, as labour is a derived demand. The claimant count therefore rose from 812 thousand in October 2017 to 943 thousand in September 2018.

(c) Which **one** of the following types of unemployment is most likely to be caused by a technological change in an industry?

(1)

- ☐ **A** Cyclical
- ☐ **B** Real wage
- ☐ **C** Seasonal
- ☒ **D** Structural

(Total for Question 4 = 5 marks)

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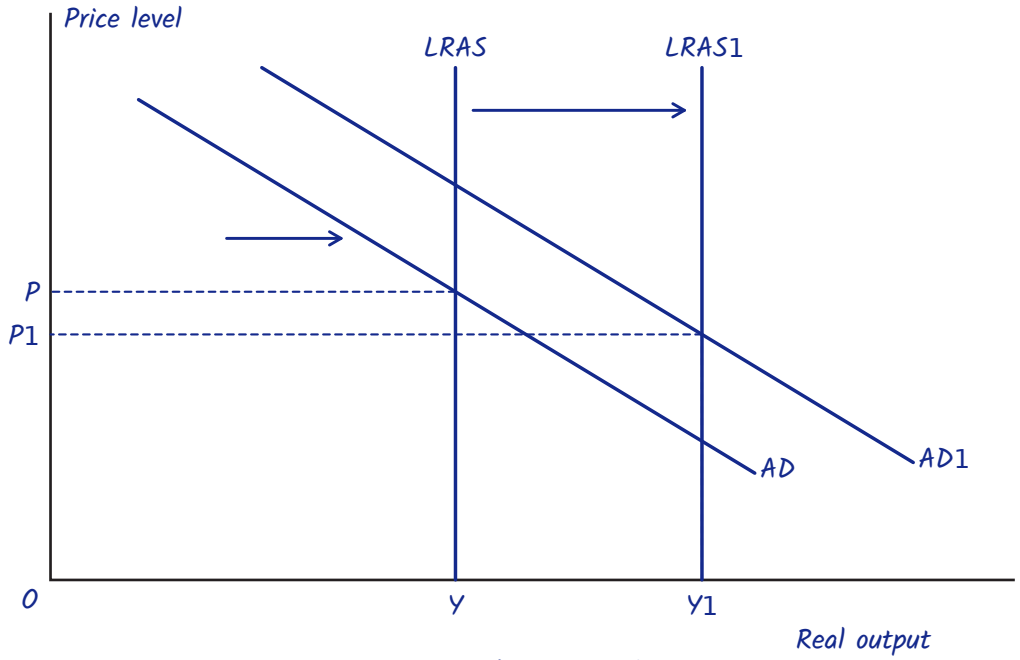
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5 The Hong Kong-Zhuhai-Macau Bridge is the world's longest sea bridge. It reduces the journey time from Hong Kong to Zhuhai from 4 hours to just 30 minutes. It cost the equivalent of $18.8 billion and was government funded.

(Source adapted from: www.theguardian.com)

(a) Draw an aggregate demand and aggregate supply diagram to show the likely impact of this new bridge on the price level and real output in the region.

(4)



Government spending on the bridge raises AD (AD to AD1); shorter journeys cut firms' costs and raise productive capacity (LRAS to LRAS1), so real output rises from Y to Y1.

(b) Which **one** of the following would be most likely to solve a negative output gap problem in a domestic economy?

An increase in

(1)

- ☒ **A** government funding to the World Bank
- ☒ **B** government spending on foreign aid
- ☒ **C** government spending on public transport
- ☒ **D** income tax

(Total for Question 5 = 5 marks)

TOTAL FOR SECTION A = 25 MARKS

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SECTION B

Read Figures 1 and 2 and the following extracts (A and B) before answering Question 6.

Write your answers in the spaces provided.

You are advised to spend 1 hour on this section.

Question 6

Trade and Development Issues in Africa

Figure 1: The Fairtrade scheme in the cocoa industry. How the additional revenue is spent by cocoa farmers.

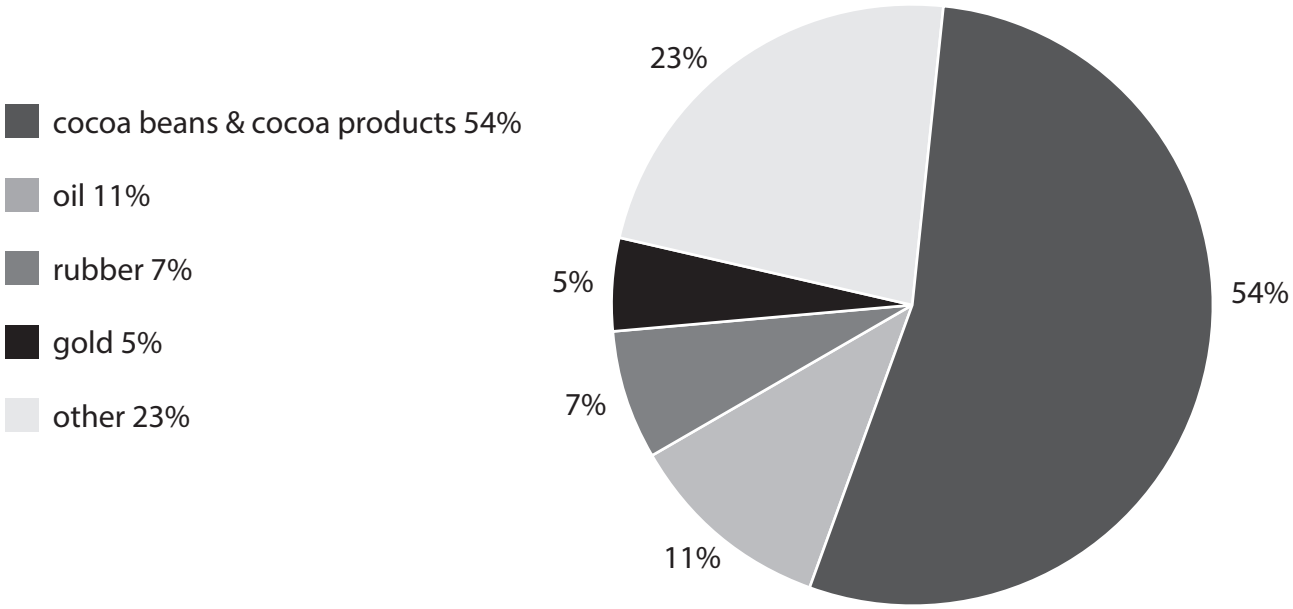


Improving business administration and infrastructure	44%
Investing in farm equipment, training and funding	45%
Supporting social services for the community	10%
Other	1%

(Source: https://www.fairtrade.org.uk/~/media/FairtradeUK/What%20is%20Fairtrade/Documents/Policy%20and%20Research%20documents/Monitoring%20reports/Fairtrade%20Monitoring%20Report_9thEdition%202016.pdf)

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Figure 2: Ivory Coast exports – relative share of main products (%), 2016



(Source: https://atlas.media.mit.edu/en/visualize/tree_map/hs92/export/civ/all/show/2016/)

Extract A

Cheap cocoa is costing farmers dear

The median annual income of cocoa farmers in the west African country, Ivory Coast, is just US$2 600. Research suggests that an annual income of US$6 133 is needed for this country's farmers to have a decent, living income. This situation is even worse for farmers who are not part of a Fairtrade scheme.

World cocoa prices fell by more than a third in 2017. Cocoa farmers have to accept all the risk from price volatility, putting a significant strain on their fragile incomes. On the other hand, cocoa processors and chocolate manufacturers are able to adapt or even make high profit and consumers continue to enjoy their chocolate.

This is still happening despite considerable investment in agriculture to build a sustainable cocoa sector. The focus has been on raising productivity and diversifying crops. The average cocoa farm in the Ivory Coast produces only around half of the output that could be achieved with training and resources such as fertilisers, equipment and replanting. If farmers diversify into other crops, livestock or non-farm activities, they lower the risk they face of fluctuating world cocoa prices.

Even tripling farm output would not provide the average cocoa farmer with a living income. Diversification alone will not always make farms more profitable. If we want farmers to earn a living income, we must also be willing to pay farmers more.

(Source adapted from: https://www.fairtrade.org.uk/Media-Centre/Blog/2018/October/Cheap-cocoa-is-costing-farmers-dear)

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Extract B

Sub-Saharan Africa is becoming more integrated

After two years of negotiations, representatives of a large number of African countries signed the African Continental Free Trade Agreement (AfCFTA) in Kigali on March 21, 2018. This created a trading bloc of 1.2 billion people with a combined gross domestic product of more than US$2 trillion. The agreement committed countries to removing tariffs on 90% of goods and to liberalise services.

This can be seen as a sign of rapid and steady regional integration. Sub-Saharan Africa in particular is much more integrated today than in the past. The level of integration in sub-Saharan Africa is now similar to that in the world's other developing and emerging market economies.

However, the two largest African economies, Nigeria and South Africa, refused to sign the agreement. Nigeria's manufacturers and trade unions are concerned about the potential negative impacts of becoming more open to imports from other African countries with lower labour costs.

Greater interdependence can expose small economies to their partners' recessions. After nearly 20 years of strong economic activity, sub-Saharan Africa experienced the downside of integration in 2015. The collapse in commodity prices and the slowdown in economic activity in Nigeria and South Africa contributed to sub-Saharan African growth slowing sharply. Since 2017 growth has begun to recover. The recovery is mixed, though, and it is unclear to what extent the slow recovery of the larger economies is still affecting the rest of sub-Saharan Africa.

(Source adapted from: https://www.imf.org/ and https://www.pulse.ng/)

6 (a) With reference to Figure 1 and Extract A, explain the likely impact of a Fairtrade scheme on agricultural communities.

(5)

(b) Examine **two** ways, apart from Fairtrade schemes, in which cocoa farmers could boost their incomes despite the falling price of cocoa.

(8)

(c) Discuss the problems for the Ivory Coast of dependency on cocoa for a large proportion of their exports. Refer to Figure 2 in your answer.

(12)

(d) Nigeria is considering joining the African Continental Free Trade Agreement. Assess policies the Nigerian government could use in response to the concerns of the country's 'manufacturers and trade unions' (Extract B paragraph 3) if they join this trading bloc.

(10)

(e) Discuss the likely benefits of increased economic integration for sub-Saharan African countries.

(15)

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6 (a) With reference to Figure 1 and Extract A, explain the likely impact of a Fairtrade scheme on agricultural communities.

(5)

Fairtrade is a scheme designed to support farmers in developing countries using the market system rather than aid. Fairtrade farmers receive a guaranteed minimum price for their crops, so they are protected when world cocoa prices fall, as when they fell by more than a third in 2017, which reduces fluctuations in their income and price volatility.

Farmers also receive a Fairtrade 'premium', extra financial support on top of the price, which increases their income and profit. Extract A says the median annual income of Ivory Coast cocoa farmers is just US$2 600 compared with the US$6 133 needed for a living income, and that the situation is even worse for farmers not in a Fairtrade scheme, so Fairtrade makes these fragile incomes higher and more stable.

The scheme is democratic, as the community chooses how to spend the premium. Figure 1 shows 45% was spent on investing in farm equipment, training and funding and 44% on improving business administration and infrastructure, so farmers use the additional income to invest in their business, raising productivity and future incomes, while 10% went on social services for the community, improving living standards.

However, even with Fairtrade many farmers still do not earn a living income, as even tripling farm output would not provide one.

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(b) Examine **two** ways, apart from Fairtrade schemes, in which cocoa farmers could boost their incomes despite the falling price of cocoa.

(8)

World cocoa prices fell by more than a third in 2017, so farmers need to raise their incomes in other ways.

The first way is to invest in technology, machinery and better use of resources to raise productivity. Extract A states that the average cocoa farm in the Ivory Coast produces only around half of the output that could be achieved with training and resources such as fertilisers, equipment and replanting. Fertiliser and replanting with higher-yield trees increase the output of cocoa per hectare, so farmers have more to sell, while machinery such as tractors can speed up harvesting and reduce labour costs per unit. Higher output and lower costs per unit raise farm revenue and profit even at a lower price.

The second way is diversification into other crops, livestock or non-farm activities. If a farmer also grows other crops, such as cashew nuts or rubber, or keeps livestock, then a fall in the price of cocoa only affects part of their income. This reduces the risk they face from fluctuating world cocoa prices and gives a more stable income. Farmers could also add value by increasing the processing of cocoa beans within the country, for example into cocoa butter or chocolate bars, which sell at a much higher price than raw beans.

However, the significance of each method differs. If all Ivory Coast farmers raise their yields, world supply of cocoa increases, which will further reduce cocoa prices; with price inelastic demand for cocoa, total revenue could even fall. Also, improvements will only occur in the long term, as new trees take several years to produce beans, and farmers with incomes of US$2 600 may not be able to afford the fertiliser or machinery without access to credit. Extract A also notes that diversification alone will not always make farms more profitable, so diversification is probably the more effective method for reducing risk, but neither alone guarantees a living income.

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(c) Discuss the problems for the Ivory Coast of dependency on cocoa for a large proportion of their exports. Refer to Figure 2 in your answer.

(12)

Figure 2 shows that cocoa beans and cocoa products made up 54% of the Ivory Coast's exports in 2016, far more than oil (11%), rubber (7%) or gold (5%). This means the country is highly dependent on a single primary product.

The main problem is the volatility of cocoa prices. Both demand and supply of cocoa are price inelastic, and supply can change greatly due to the weather, disease or pests, so small changes in supply or demand cause large price fluctuations. World cocoa prices fell by more than a third in 2017. Fluctuating prices make it hard for farmers to plan ahead for future purchases of seeds, fertiliser and equipment, and the uncertainty will discourage investment into farms to improve productivity, keeping yields at only around half of what could be achieved.

Falling cocoa prices also reduce the revenue and profits of farmers, whose median income is already only US$2 600, so poverty increases. Since cocoa is over half of the Ivory Coast's exports, a fall in its price causes a large fall in export revenue, which reduces net exports and therefore AD. Through the negative multiplier effect, this reduces real GDP, employment and tax revenue, so the government has less to spend on health, education and infrastructure. Economic growth therefore becomes very unstable and dependent on the world cocoa market.

A fall in the price of cocoa also worsens the Ivory Coast's terms of trade (the index of export prices ÷ the index of import prices × 100). It must export more cocoa to buy the same quantity of imports, which affects its ability to buy important imports such as capital equipment, machinery and fuel needed for development. The current account will fluctuate and may move into deficit, which may cause the currency to depreciate or require borrowing, adding to the country's debt.

In addition, in the long run, primary product prices tend to fall relative to manufactured goods as incomes rise (the Prebisch-Singer hypothesis), as cocoa has a low income elasticity

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of demand. Over-reliance on cocoa may therefore lead to a long-run decline in the terms of trade. Much of the value is also captured by cocoa processors and chocolate manufacturers abroad, who make high profits, while the Ivory Coast exports low value-added raw beans. However, the Ivory Coast has a comparative advantage in cocoa, due to its climate and soil, so specialising in cocoa maximises output and its export revenue. Cocoa demand is also growing in emerging economies such as China and India, so prices may rise in the long term. The problem is also less severe than it appears, as 46% of exports are other products, including oil and 'other' at 23%, so the economy is partly diversified. Furthermore, the growth of schemes such as Fairtrade will help in the future, as the guaranteed minimum price protects farmers from price falls. The government could also use a buffer stock scheme or a stabilisation fund to smooth prices, and investment in processing could add value.

Overall, dependency on cocoa is a significant problem because it makes incomes, export revenue and growth volatile, but its severity depends on the magnitude and length of price falls and on how far the Ivory Coast can diversify and add value over time.

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(d) Nigeria is considering joining the African Continental Free Trade Agreement. Assess policies the Nigerian government could use in response to the concerns of the country's 'manufacturers and trade unions' (Extract B paragraph 3) if they join this trading bloc.

(10)

Nigeria's manufacturers and trade unions are concerned that, if tariffs on 90% of goods are removed under the AfCFTA, cheaper imports from other African countries with lower labour costs will take market share from Nigerian firms, leading to falling output, job losses and pressure on wages.

Firstly, the government could use supply-side policies to improve productivity, such as improved education, training and healthcare. A better educated and healthier workforce is more efficient, so output per worker rises and the cost per unit falls. Nigerian manufacturers could then better compete with cheaper imports on price, protecting jobs, and better skills allow higher wages, addressing the trade unions' concerns. Retraining schemes would help workers who lose jobs to move into growing industries, reducing structural unemployment.

Secondly, the government could invest in infrastructure, such as roads, ports, railways and a reliable electricity supply. This reduces transport and energy costs for exporters and domestic firms, so Nigerian firms can sell more cheaply both at home and in the 1.2 billion person AfCFTA market.

Thirdly, deregulation, such as simplifying labour laws and business regulation, would reduce production costs for firms, so they can compete on price with other African countries. The government could also provide subsidies to help firms adjust to the new competition, for example to purchase new, more efficient machinery, or reduce taxes on businesses, such as corporation tax, which lowers costs and increases their price competitiveness and funds for investment.

However, education investment will take a long time to have an effect, as it is years until those students enter the workforce, so it will not protect jobs in the short run when tariffs are removed. Infrastructure projects are also slow to complete.

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There is an opportunity cost for the government, as spending on subsidies, infrastructure or tax cuts means less money for other priorities such as healthcare, or a higher budget deficit. Subsidies may also protect inefficient firms, reducing the incentive to become more efficient, and could break the agreement's rules.

Deregulation of the labour market has potential side effects for wages and working conditions: lower employment protection may increase job insecurity and lower wages, which is exactly what the trade unions fear, so it may face strong opposition.

Overall, supply-side policies such as education and infrastructure are the most effective long-term response, but subsidies may be needed in the short run, and success depends on the government's ability to finance and implement them effectively.

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(e) Discuss the likely benefits of increased economic integration for sub-Saharan African countries.

(15)

Economic integration is the process by which countries agree to reduce trade barriers and coordinate economic policies, moving from a free trade area to a customs union, common market and monetary union. The AfCFTA is a free trade area of 1.2 billion people with a combined GDP of more than US$2 trillion, removing tariffs on 90% of goods.

The first benefit is trade creation. When tariffs are removed, consumers switch from high-cost domestic producers to lower-cost producers in other member countries. Prices fall, so consumers in sub-Saharan Africa gain from more choice and higher real incomes, and resources are allocated more efficiently.

Secondly, integration allows increased specialisation and trade according to comparative advantage, where a country produces a good at a lower opportunity cost. For example, if Ghana can produce 10 units of cocoa or 5 units of textiles, and Kenya 4 units of cocoa or 4 units of textiles, Ghana has a comparative advantage in cocoa (opportunity cost 0.5 textiles) and Kenya in textiles (1 cocoa). If each specialises and trades, total output of the region increases, raising living standards.

Thirdly, domestic firms now have a much larger market to sell their products to. This allows them to benefit from economies of scale, lowering average costs, and makes them more competitive in world markets. Increased demand for exports increases jobs and pushes up wages, so workers in sub-Saharan African countries earn higher incomes, improving their standard of living and reducing poverty. The multiplier effect of higher exports raises AD and economic growth further.

Fourthly, integration increases competition, which forces firms to become more efficient and innovative, giving dynamic efficiency gains. A larger market is also more attractive to foreign direct investment, bringing capital, technology and skills. Small economies particularly benefit, and Extract B notes sub-Saharan Africa enjoyed nearly 20 years of strong economic activity

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as integration increased. Liberalising services, such as banking and telecommunications, also improves the infrastructure needed for development, and trade among African countries may help them diversify away from primary commodity exports.

However, there may be trade diversion, resulting in a loss of efficiency, as trade switches from low-cost producers outside the bloc, such as China or the EU, to less efficient producers within the bloc, because outside goods still face tariffs. Consumers then pay higher prices, so the net benefit depends on whether trade creation outweighs trade diversion.

Greater interdependence also exposes small economies to their partners' recessions: more integration means financial crises spread more quickly across the trading bloc. In 2015, the collapse in commodity prices and the slowdown in Nigeria and South Africa contributed to sub-Saharan African growth slowing sharply, and the slow recovery of the larger economies may still be affecting the rest of the region.

There may also be a loss of output and jobs in some countries due to cheaper competition from lower wage cost countries, which is why Nigeria's manufacturers and trade unions are concerned and Nigeria and South Africa refused to sign. The benefits are smaller without the two largest economies in the bloc.

Moreover, the gains depend on the quality of infrastructure, as poor roads, ports and border delays mean high transport costs may limit trade even without tariffs. Many sub-Saharan economies produce similar primary products, so the scope for trade between them may be limited in the short run.

In conclusion, increased economic integration is likely to bring significant benefits to sub-Saharan African countries through trade creation, specialisation, larger markets and higher incomes, especially in the long run. However, the size of the benefits depends on trade creation exceeding trade diversion, on improvements in infrastructure, and on the participation of large economies such as Nigeria, while countries must accept greater exposure to their neighbours' recessions.

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(Total for Question 6 = 50 marks)

TOTAL FOR SECTION B = 50 MARKS

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SECTION C BEGINS ON THE NEXT PAGE.

SECTION C

Answer ONE question from this section.

Write your answer in the space provided.

You are advised to spend 30 minutes on this section.

EITHER

7 In 2018, the United States Government cut the corporation tax rate (tax on company profits) from 35% to 21%. Income tax rates for US citizens were also reduced: for example, the top rate of income tax was cut from 39.6% to 37%.

(Source adapted from: https://www.nytimes.com/)

Evaluate the likely impact of cutting tax rates as a policy to increase economic growth.

(Total for Question 7 = 25 marks)

OR

8 In terms of income distribution and wealth distribution Brazil is one of the most unequal countries in the world. Its income Gini coefficient is 0.449 and it is ranked number 2 in the world for its wealth inequality.

Evaluate possible economic causes of income and wealth inequalities within a country such as Brazil.

(Source: https://www.gfmag.com/)

(Total for Question 8 = 25 marks)

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 7** ☒ **Question 8** ☒

Question 7

Economic growth is an increase in real GDP (short-run growth) or an increase in the productive capacity of the economy (long-run growth). In 2018 the US cut corporation tax from 35% to 21% and the top rate of income tax from 39.6% to 37%, which is expansionary fiscal policy and a supply-side policy.

Firstly, a cut in income tax increases consumers' disposable income, so consumption increases. As consumption is the largest component of AD (AD = C + I + G + (X − M)), AD shifts right from AD to AD1 in my diagram, increasing real output from Y to Y1. Lower taxes

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mean fewer withdrawals from the circular flow of income, so the marginal propensity to withdraw falls and the size of the multiplier increases, so the final rise in real GDP is greater than the initial increase in spending.

Secondly, a cut in corporation tax means firms keep more of their profits. Firms will have more retained profit to reinvest into their companies, for example in new machinery, technology and research. Investment is an injection into the circular flow, so AD increases further. The lower tax rate also raises the post-tax return on investment and may attract multinational firms and FDI to locate in the US instead of in low-tax countries such as Ireland.

Thirdly, investment increases the capital stock and labour productivity, increasing the productive capacity of the economy, so LRAS shifts right from LRAS to LRAS1. This gives long-run, sustainable growth without inflationary pressure, as the price level does not rise.

Lower income tax also increases incentives to work, as people keep more of what they earn, so labour supply and participation rise, and entrepreneurs have more incentive to take risks and set up businesses.

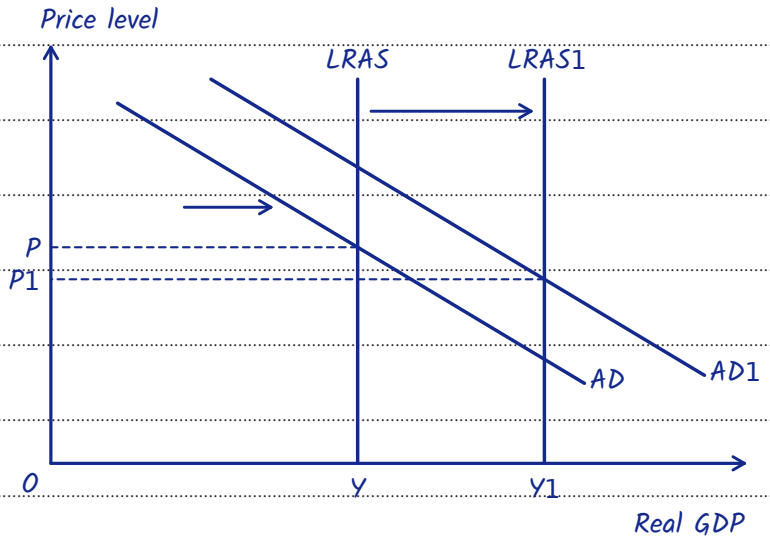
Lower tax rates may also mean less incentive for tax evasion and avoidance, so more income is declared. According to the Laffer curve, if tax rates were above the revenue-maximising rate, cutting them could even increase tax revenue as output rises.

However, firms may not reinvest the extra profit. Many other factors affect investment decisions, such as business confidence, interest rates and expected demand, and many US firms instead used their tax savings for share buybacks and higher dividends, which mainly benefit wealthy shareholders and do little to increase productive capacity.

Similarly, consumers may save any extra disposable income, especially if they are uncertain about the future, so it is withdrawn from the circular flow and AD rises by less. The cut in the top rate of income tax mainly benefits high earners, who have a lower marginal propensity to consume, so the increase in consumption may be small; a cut from 39.6% to

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37% is only a small change.



The impact also depends on the state of the economy. In 2018 the US economy was already close to full employment, with unemployment below 4%, so a large increase in AD may mainly cause demand-pull inflation rather than real growth. The Federal Reserve may then raise interest rates, offsetting the boost to growth.

Furthermore, tax cuts are likely to result in lower tax revenue and a larger budget deficit, increasing government debt. Higher government borrowing may push up interest rates, leading to crowding out of private sector investment. The government will also have less money to spend on infrastructure, education and healthcare, which may negatively affect long-run economic growth.

Tax cuts may increase income inequality, as the rich gain the most, and higher consumer spending may also suck in imports, worsening the current account deficit and reducing the multiplier. There are time lags too: supply-side benefits of higher investment take years to appear.

In conclusion, cutting tax rates is likely to increase economic growth in the short run by boosting consumption and investment, and may increase productive capacity in the long run. However, its effectiveness depends on whether firms invest rather than pay dividends, the size of the cuts, the spare capacity in the economy and how the deficit is financed. As the

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US was near full capacity, the cuts are likely to have only a modest, short-lived effect on growth, at the cost of higher debt.

Question 8

Income is a flow of money received over a period of time, such as wages, interest, rent and profit, while wealth is a stock of assets, such as property, land, savings and shares, measured at a point in time. Inequality is the uneven distribution of income or wealth. The Gini coefficient measures this from 0 (perfect equality) to 1 (perfect inequality), and Brazil's income Gini coefficient of 0.449 shows high income inequality.

One cause of income inequality is inequality in access to, and the quality of, education and healthcare. In Brazil, wealthy families send their children to private schools and universities, while many poor children attend low-quality state schools or leave early to work. Those with fewer skills and qualifications have lower productivity, so their marginal revenue product and wages are lower, while skilled workers earn high wages. Poor health also reduces the ability to work, so inequality persists across generations.

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A second cause is the rural and urban divide. People in urban areas such as São Paulo have a much greater variety of job opportunities and higher wages than people in rural areas, especially in the north-east, who often work in low-paid agriculture or the informal sector. Weak trade unions also reduce the power of workers to insist on higher wages, so a large share of income goes to profits instead.

A third cause is the tax and benefit system. A lack of redistributive fiscal policy, such as low progressive income taxes and limited benefits, means the gap between market incomes is not reduced. Brazil relies heavily on high indirect taxes, such as taxes on consumption, which tend to be regressive, as the poor spend a higher proportion of their income on them. High levels of corruption lead to government inefficiency and a failure to act in the best interests of the general population, so spending does not reach the poor.

For wealth inequality, a key cause is high levels of inheritance that are not significantly taxed, so land, property and businesses are passed on to future generations of the same families, concentrating wealth. In Brazil, land ownership has historically been held by a small number of large landowners. Ownership of financial assets is also concentrated amongst the wealthy, with a lack of public share ownership, so the returns on these assets, such as dividends, rent and capital gains, go to the rich.

Income and wealth inequality are also linked. The rich can save a larger share of their income and buy assets, which earn further income, so wealth inequality grows over time, while the poor have no savings and may need to borrow at high interest rates. This explains why Brazil is ranked number 2 in the world for wealth inequality, even worse than its income inequality.

However, the significance of each cause differs. Education is perhaps the most significant cause of income inequality because it affects lifetime earnings, while inheritance is the most significant cause of wealth inequality. Some causes, such as lack of redistribution and corruption, are a result of government failure, while others reflect market forces.

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Some inequality reflects differences in effort, talent and risk-taking, and this may be desirable to maintain incentives, so not all inequality is caused by unfair factors. Brazil has also introduced policies such as the Bolsa Família cash transfers, which reduced income inequality, showing that the causes can be addressed.

Furthermore, according to the Kuznets curve, inequality tends to rise in the early stages of development and then fall as the economy grows and income levels rise, so some causes may be solved over time as Brazil develops and education spreads. Global factors, such as commodity price booms benefiting landowners, may also matter more than domestic causes.

The data must also be treated with caution: a Gini coefficient of 0.449 measures only income, and the large informal economy in Brazil means many incomes are not recorded accurately.

In conclusion, inequality in Brazil is caused by a combination of unequal access to education, the rural and urban divide, weak trade unions and a regressive tax system for income, and untaxed inheritance and concentrated ownership of land and financial assets for wealth. The most significant causes are unequal education and inheritance, and because income and wealth inequality reinforce each other, inequality is likely to persist unless the government uses stronger redistributive policies.

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