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Pearson Edexcel Level 3 GCE

Centre Number | Candidate Number

Economics A

Advanced Subsidiary
Paper 2: The UK Economy – Performance and Policies

Thursday 17 May 2018 – Morning
Time: 1 hour 30 minutes

Paper Reference
8EC0/02

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 two sections in this question paper.
- Answer **all** questions in Section A.
- In Section B, answer **all** of questions 6(a) to 6(e) and **one** question from 6(f) or 6(g).
- Answer the questions in the spaces provided
  – *there may be more space than you need.*

Information

- The total mark for this paper is 80.
- 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 25 minutes on this section.

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

1 The table below shows the UK Gross Domestic Product (GDP) and population, 2013 to 2015.

Year	GDP (£ millions)	Population (millions)
2013	1 739 563	64.1
2014	1 822 480	64.6
2015	1 872 714	65.1

(Source: ONS, https://www.ons.gov.uk/)

(a) Define the term 'Gross Domestic Product'.

(1)

GDP is the total value of goods and services produced in an economy over a given period of time, usually one year.

(b) Calculate the UK's GDP per capita in 2015. You are advised to show your working.

(2)

GDP per capita = GDP ÷ population

= £1 872 714 million ÷ 65.1 million

= £28 766.73 per person

GDP per capita in 2015 = £28 766.73

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(c) Which **one** of the following is the most likely effect of an increase in real GDP per capita?

(1)

- ☒ **A** Increase in living standards
- ☐ **B** Increase in unemployment
- ☐ **C** Lower consumer confidence
- ☐ **D** Lower purchasing power

(Total for Question 1 = 4 marks)

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2 (a) Define the term 'recession'.

(1)

A recession is negative economic growth, a fall in real GDP, for two consecutive quarters.

(b) Explain **one** characteristic of a recession.

(2)

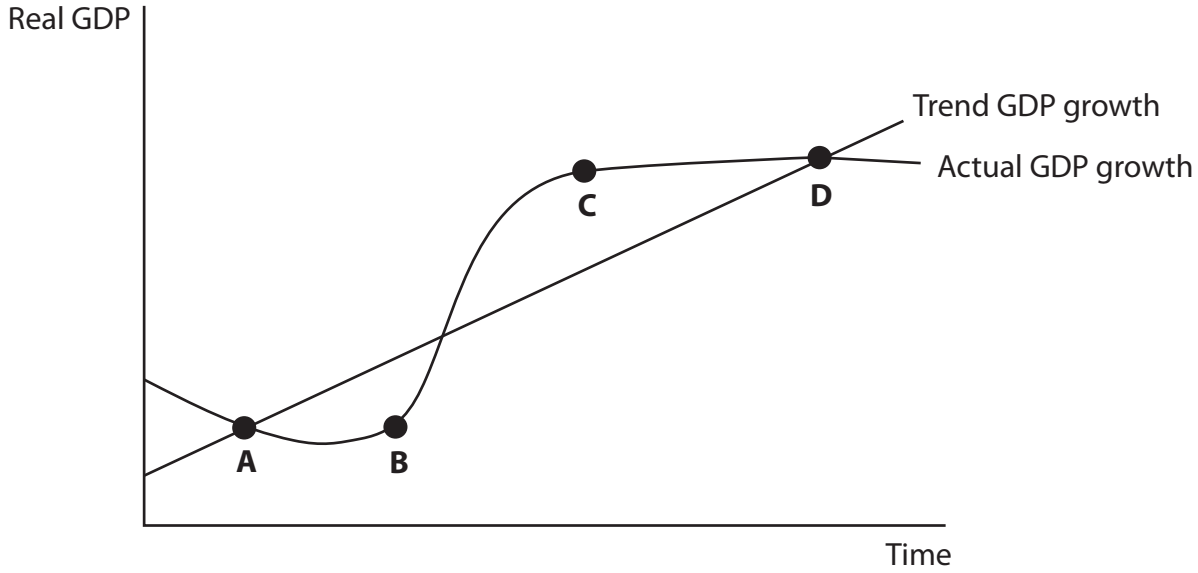
One characteristic of a recession is rising unemployment. The demand for labour is a derived demand, so as consumer spending and real output fall, firms need fewer workers to produce the lower level of output.

Firms therefore make workers redundant and stop hiring, so cyclical (demand deficient) unemployment rises. This also tends to bring falling inflation, as weaker consumer expenditure reduces pressure on prices.

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(c) Which point on the trade cycle diagram illustrates a negative output gap?

(1)

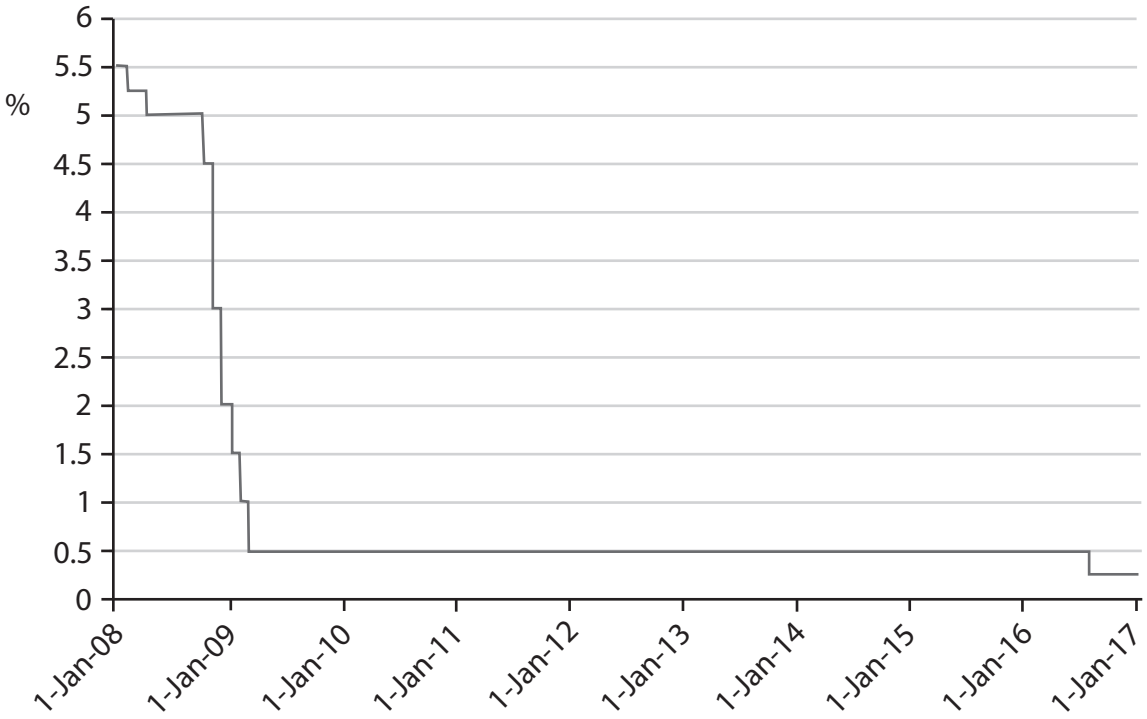


- ☒ **A**
- ☒ **B**
- ☒ **C**
- ☒ **D**

(Total for Question 2 = 4 marks)

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3 UK base interest rate, January 2008 to January 2017



(Source: Bank of England, http://www.bankofengland.co.uk/boeapps/iadb/Repo.asp)

(a) With reference to the chart above, explain **one** factor that the Monetary Policy Committee (MPC) of the Bank of England may have considered when reducing the base interest rate.

(3)

One factor the MPC may have considered is the rate of economic growth and the expected inflation rate. The chart shows that the base rate was cut from 5.5% in 2008 to 0.5% in 2009, a fall of 5 percentage points, during the Global Financial Crisis. At this time real GDP was falling and consumer and business confidence collapsed, so there was a large negative output gap and inflation was expected to fall below the 2% target. Cutting the base rate reduces the cost of borrowing and the reward for saving, which encourages consumption and investment, so AD rises in line with productive potential and inflation returns towards target. Similarly, the cut to 0.25% in 2016 followed the Brexit vote, when confidence was expected to fall.

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In August 2016 the Bank of England extended its existing asset purchases (quantitative easing) programme, from a total of £375 billion to £435 billion.

(b) Which **one** of the following is the most likely effect of the Bank of England's quantitative easing?

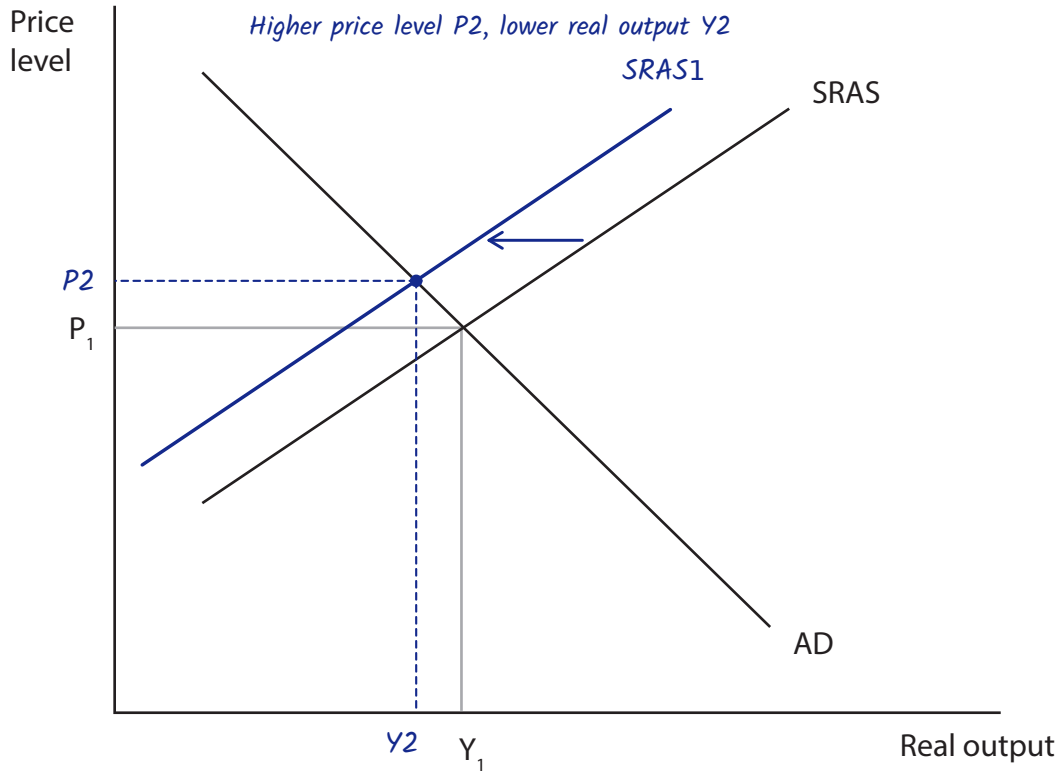
(1)

- ☒ **A** A fall in economic growth
- ☒ **B** A fall in the money supply
- ☒ **C** An increase in the rate of inflation
- ☒ **D** An increase in unemployment

(Total for Question 3 = 4 marks)

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4 The diagram below shows the aggregate demand (AD) and short-run aggregate supply (SRAS) for the UK.



(a) Define the term 'aggregate demand'.

(1)

Aggregate demand is the total planned spending on goods and services at any given price level in an economy: AD = C + I + G + (X − M).

(b) Annotate the diagram above to show the likely impact of a rise in the cost of raw materials on the UK's equilibrium level of real output and price level.

(2)

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(c) Which **one** of the following factors is most likely to cause an increase in the long-run aggregate supply?

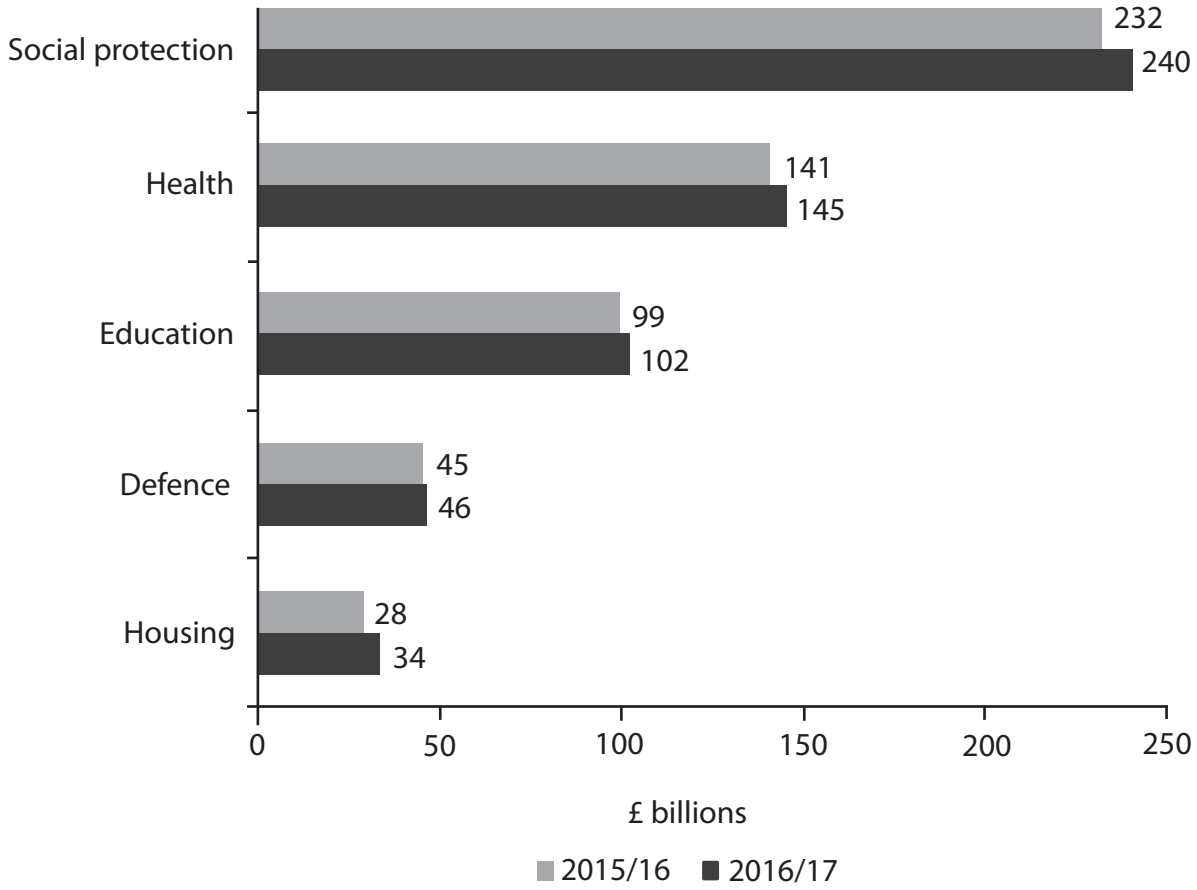
(1)

- ☐ **A** Decrease in investment
- ☒ **B** Increase in relative productivity
- ☐ **C** Increase in the level of unemployment benefits
- ☐ **D** Reduced access to credit for consumers and businesses

(Total for Question 4 = 4 marks)

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5 The chart below shows selected areas of forecast UK government spending for 2015/16 and 2016/17.



(Source: Budget 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416330/47881_Budget_2015_Web_Accessible.pdf; Budget 2016, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508193/HMT_Budget_2016_Web_Accessible.pdf)

(a) Which **one** of the following can be inferred from the chart?

In 2016/17:

(1)

- ☒ **A** the change in forecast UK government spending is highest on education
- ☒ **B** the forecast UK government spending in all areas has fallen from 2015/16
- ☒ **C** the forecast UK government spending on defence is twice as much as the forecast spending on housing
- ☒ **D** the percentage change in forecast UK government spending on health, from 2015/16, is 2.84%

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(b) In 2016/17 total forecast UK government spending amounted to £772 billion and total forecast tax receipts amounted to £716 billion.

Calculate forecast UK government spending on social protection as a percentage of total forecast UK government spending in 2016/17. You are advised to show your working.

(2)

Spending on social protection as a percentage of total spending

= (240 ÷ 772) × 100

= 0.31088... × 100

= 31.1%

(c) Define the term 'budget deficit'.

(1)

A budget deficit is when government spending exceeds tax revenue (receipts) in a given year, e.g. £772bn − £716bn = £56bn in 2016/17.

(Total for Question 5 = 4 marks)

TOTAL FOR SECTION A = 20 MARKS

SECTION B

Read Figures 1 to 3 and the following extracts (A and B) before answering Question 6.

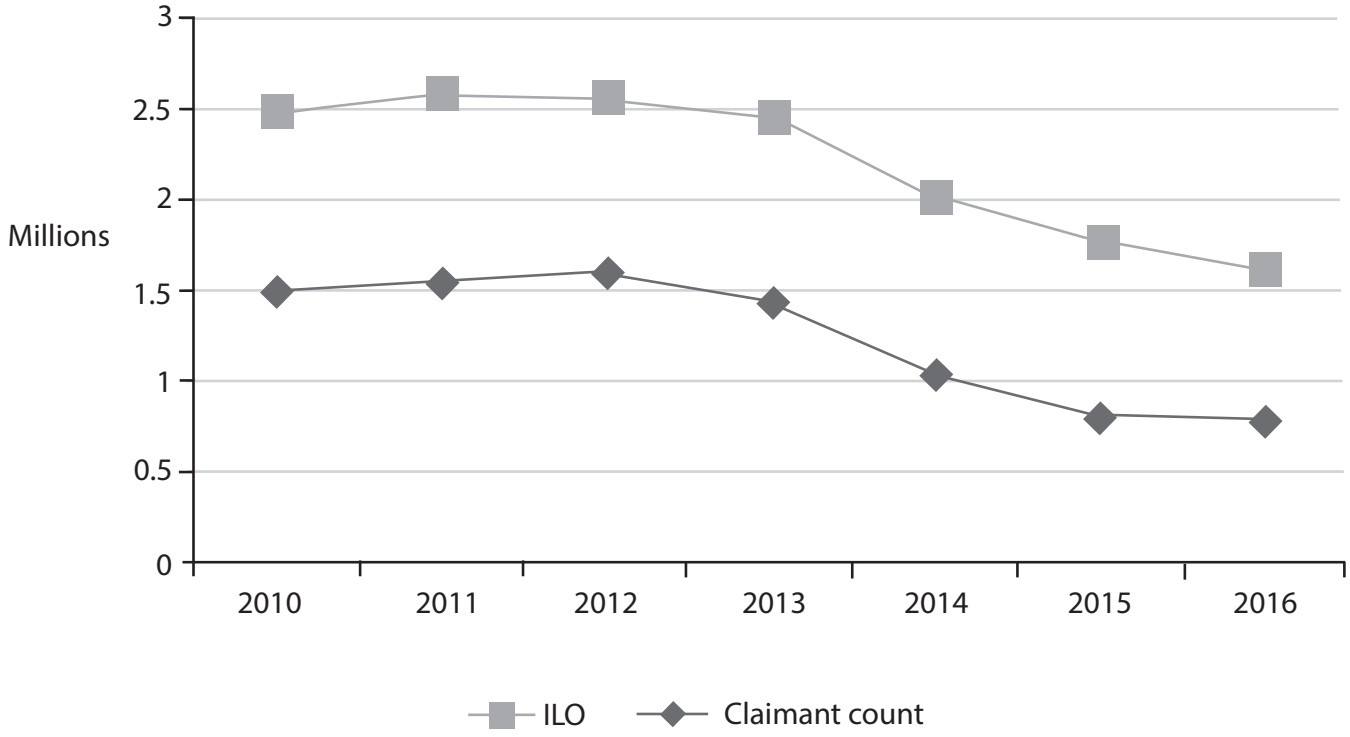
Answer ALL Questions 6(a) to 6(e), and EITHER Question 6(f) OR Question 6(g).

You are advised to spend 1 hour and 5 minutes on this section.

Question 6

The UK economy

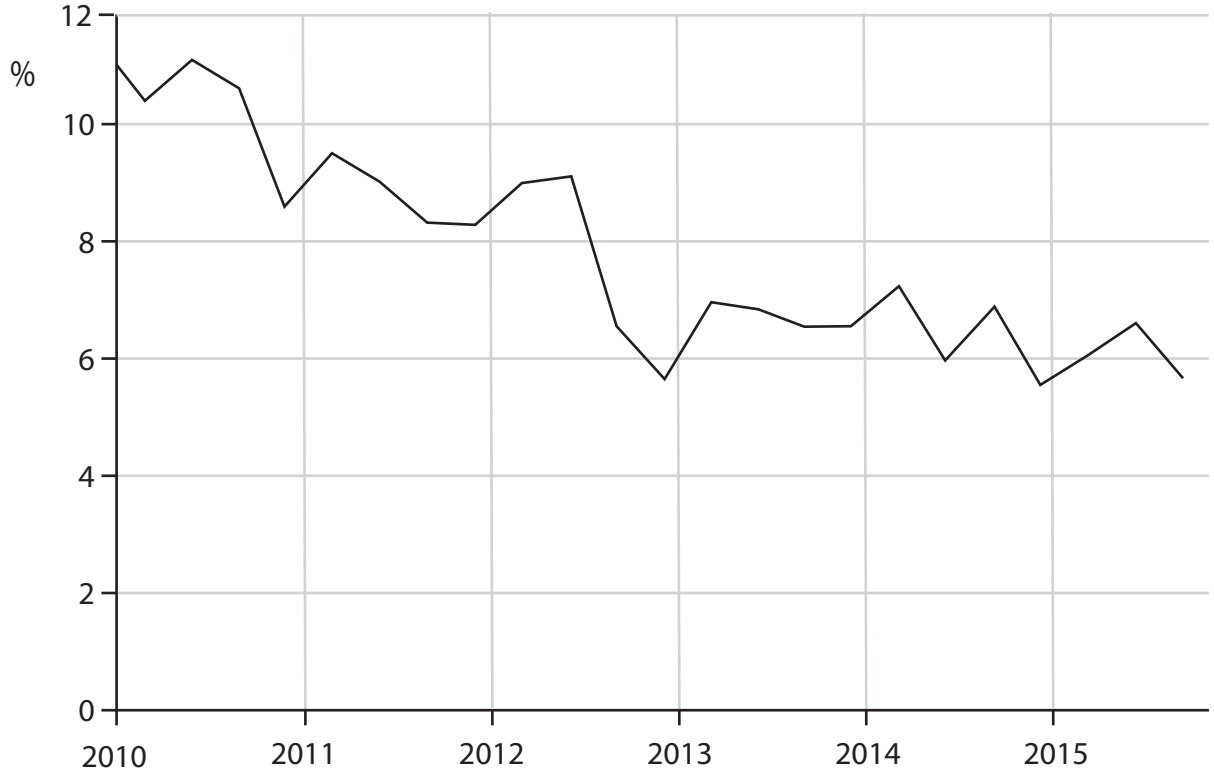
Figure 1: Unemployment – International Labour Organisation (ILO) and the claimant count, millions, 2010-2016



(Source: ONS Datasets, https://www.ons.gov.uk/)

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Figure 2: Household savings*, 2010-2015



* Savings as a percentage of household disposable income

(Source: http://www.tradingeconomics.com/united-kingdom/personal-savings)

Figure 3: UK average house prices, 2005–2016



(Source: http://www.telegraph.co.uk/property/house-prices/the-state-of-the-uk-housing-market-in-five-charts/)

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Extract A

Soaring house prices

House prices are still rising rapidly. The average UK house price was £214 000 in June 2016, according to the Office for National Statistics (ONS). This is £24 000 more than it was at its peak in September 2007, just before the economic downturn. First-time buyers have experienced the largest rise in house prices.

Even the loss of consumer confidence over Britain's vote to leave the EU did not stop house prices from rising – annual growth increased from 5.2% in July 2016 to 5.6% in August 2016. House price growth was the strongest in London, with annual average prices rising by 9.6%. However, in Wales average house prices actually fell by 0.5% during the same period. In its first post-Brexit referendum forecast, estate agency Countrywide said that house prices will fall by 1% across the UK in 2017, before rising by 2% in 2018.

Real household income in the UK fell by 10.4% in the years following the financial crisis. This increased the difference between real income and house prices. In 1997, a house cost little more than twice the average income. By early 2015, the average price of a house was five times the average annual income.

The rate of home ownership for 25 to 34-year-olds has fallen to 35.8% over the last twenty-five years as houses became less affordable. First-time buyers have to wait longer to save up for a house deposit. Conversely, home ownership has risen to 78.6% among those aged 65 to 74.

(Source: adapted from 'The state of the UK housing market in five charts', The Telegraph, http://www.telegraph.co.uk/property/house-prices/the-state-of-the-uk-housing-market-in-five-charts/; 'UK house price growth slows as demand cools after Brexit vote', The Guardian, https://www.theguardian.com/business/2016/sep/30/uk-house-price-growth-slows-demand-cools-brexit-vote-nationwide)

Extract B

UK migration trends in the year ending June 2016

Inward migration levels are among the highest ever recorded with an estimated 650 000 people moving to the UK. This is an increase of around 11 000 from the previous year.

Employment remains the most common reason for long-term migration (312 000) to the UK, with around 182 000 of these coming with a definite job and 130 000 looking for work.

Long-term migration to the UK for study was estimated to be 163 000. In addition, 80 000 long-term migrants arrived in the UK to accompany their families. There were 41 280 refugees applying for asylum, including dependants, of which 10 547 people were granted asylum. Asylum applicants cannot usually accept offers of employment while their case is being processed.

(Source: adapted from 'Migration Statistics Quarterly Report: December 2016', ONS, https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/bulletins/migrationstatisticsquarterlyreport/dec2016)

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6 (a) With reference to Figure 1, explain **one** reason why the claimant count and the ILO measure of unemployment differ.

(4)

(b) With reference to Extract A, assess the likely macroeconomic effects of an increase in house prices. Use an aggregate demand and aggregate supply diagram in your answer.

(10)

(c) With reference to the information provided, explain **one** likely factor, other than changes in house prices, that could influence the level of savings of UK households.

(5)

(d) Explain **two** factors that might cause a rise in the value of the multiplier.

(6)

(e) With reference to Extract B and Figure 1, discuss the likely impact of migration on employment **and** unemployment in the UK.

(15)

EITHER

(f) Evaluate government policies, apart from migration policies, that could be used to increase the employment rate in the UK.

(20)

OR

(g) Evaluate the likely impact of high inflation on the UK government's macroeconomic objectives.

(20)

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6 (a) With reference to Figure 1, explain **one** reason why the claimant count and the ILO measure of unemployment differ.

(4)

One reason the two measures differ is that they are collected for different reasons and by different methods. The ILO measure comes from the Labour Force Survey and counts everyone without a job who has actively looked for work in the past four weeks and is able to start within two weeks. The claimant count only counts people who are actually claiming unemployment-related benefits such as Jobseeker's Allowance.

Many unemployed people are not eligible to claim benefits, for example because they have savings or a partner in work, or they choose not to claim because of the stigma attached. They are counted by the ILO but not by the claimant count, so the claimant count is lower.

Figure 1 shows the claimant count below the ILO measure throughout 2010 to 2016. In 2010 ILO unemployment was about 2.5 million while the claimant count was about 1.5 million. By 2016 the claimant count had fallen by around 0.7 million (about 47%) to 0.8 million, while ILO unemployment fell by around 0.9 million (about 35%) to 1.6 million, partly because it has become harder to claim benefits.

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(b) With reference to Extract A, assess the likely macroeconomic effects of an increase in house prices. Use an aggregate demand and aggregate supply diagram in your answer.

(10)

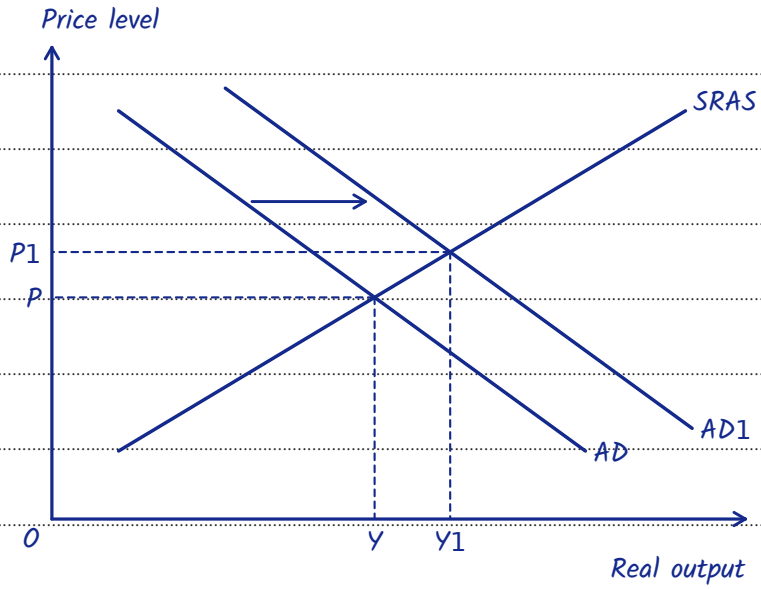
Extract A shows that house prices are rising rapidly: the average UK house price was £214 000 in June 2016, £24 000 more than at its peak in September 2007, and annual growth increased from 5.2% in July 2016 to 5.6% in August 2016. Figure 3 shows prices rising from about £155 000 in 2009 to over £210 000 in 2016.

Higher house prices increase the wealth of homeowners. This positive wealth effect raises householders' confidence and encourages them to consume more and save less, for example by borrowing against the higher value of their homes (equity withdrawal). Higher house prices also make building more profitable, so investment by the construction industry rises. As consumption and investment are components of AD, AD shifts right from AD to AD1 in my diagram, raising real output from Y to Y1, a faster rate of economic growth.

As real output rises, firms need more workers, so unemployment falls, consistent with ILO unemployment falling from about 2.5 million in 2010 to 1.6 million in 2016 (Figure 1). Higher spending also raises tax revenues, such as VAT and stamp duty, which reduces the budget deficit. However, the price level rises from P to P1, causing demand-pull inflation, and some of the extra spending goes on imports, worsening the current account of the balance of payments.

The size of the effect depends on how significant housing wealth is. About 65% of UK households are owner occupiers and consumption is around two thirds of AD, so the impact could be large. However, home ownership is concentrated among older people, 78.6% of those aged 65 to 74, who may not raise their consumption, while ownership among 25 to 34-year-olds has fallen to 35.8%. First-time buyers, facing prices five times average income and a 10.4% fall in real income, must save more for a deposit, so

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their consumption may fall.

The effect also varies by region: prices rose 9.6% in London but fell 0.5% in Wales. It may be short-lived, as Countrywide forecast a 1% fall in 2017, and wealth effects take time to change spending. Finally, if the economy is near full capacity and SRAS is inelastic, the rise in AD will mainly raise the price level rather than real output. Overall, rising house prices are likely to boost AD and growth in the short run, but the effect is uneven and depends on spare capacity.

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(c) With reference to the information provided, explain **one** likely factor, other than changes in house prices, that could influence the level of savings of UK households.

(5)

One factor that influences the level of savings is household income. Saving is the part of disposable income that is not spent, so when real incomes fall households find it harder to save.

Extract A states that real household income in the UK fell by 10.4% in the years following the financial crisis. To protect their standard of living, households tried to maintain their level of consumption, so they reduced the proportion of income saved, a fall in the marginal and average propensity to save. This is shown in Figure 2: the savings ratio fell from about 11% of household disposable income in 2010 to about 5.7% in 2015.

In addition, falling unemployment, with the claimant count down to about 0.8 million by 2016, increased job security and confidence, so households felt less need for precautionary saving, reinforcing the fall in the savings ratio.

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(d) Explain **two** factors that might cause a rise in the value of the multiplier.

(6)

The multiplier is the process by which an initial injection into the circular flow of income, such as investment, leads to a larger final increase in real GDP. Its value is k = 1 ÷ (1 – MPC), or 1 ÷ MPW, where MPW = MPS + MPT + MPM.

Firstly, a fall in the marginal propensity to save (a rise in the MPC) would raise the multiplier. If households save less of each extra pound of income, fewer withdrawals leak from the circular flow, so more is passed on as spending, creating further rounds of income. Figure 2 shows the savings ratio falling from about 11.5% in Q1 2010 to about 5.7% in 2015. For example, if MPW falls from 0.5 to 0.4, k rises from 1 ÷ 0.5 = 2 to 1 ÷ 0.4 = 2.5.

Secondly, a fall in the marginal rate of taxation would raise the multiplier. If the government cuts income tax rates, less of each extra pound earned is withdrawn as tax, so the MPT falls. Households keep more disposable income from each round and spend more of it, so the final increase in real GDP from an injection is larger. Similarly, a fall in the marginal propensity to import keeps more spending within the UK economy, also raising the multiplier.

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(e) With reference to Extract B and Figure 1, discuss the likely impact of migration on employment **and** unemployment in the UK.

(15)

Migration is the movement of people into (immigration) and out of (emigration) a country. Employment is the number of people in work, while unemployment is the number of people without a job who are actively seeking work. Extract B shows that inward migration to the UK reached about 650 000 in the year to June 2016, among the highest levels ever recorded and an increase of around 11 000 on the previous year.

Migration is likely to increase employment. Employment remains the most common reason for long-term migration (312 000), with around 182 000 migrants coming with a definite job. These migrants fill vacancies that cannot be filled by indigenous workers, for example where there are skills shortages in the NHS, agriculture or construction, so employment rises directly. Migration also increases the supply of labour, which can reduce wage rates and so raise the quantity of labour demanded by firms, creating more jobs. In addition, an increased population means higher consumer spending on goods and services such as housing, food and transport. As labour is a derived demand, this increase in AD creates more jobs for both migrants and UK-born workers. A larger population also increases demand for public services, such as schools and healthcare, raising demand for public sector workers. The 163 000 students also spend on tuition, rent and consumer goods, supporting jobs in universities and local businesses. This is consistent with Figure 1, where ILO unemployment fell from about 2.5 million in 2010 to about 1.6 million in 2016 and the claimant count fell from 1.5 million to 0.8 million while migration was at record levels.

However, migration may increase unemployment. Around 130 000 migrants came looking for work without a definite job. They add to the supply of labour and may displace current indigenous workers, especially in low-skilled jobs where migrants may be willing to accept lower wages. In addition, 80 000 migrants came to accompany their families and

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10 547 people were granted asylum. Some of these may try to join the labour market but with inappropriate skills or language barriers, creating surplus labour and raising structural unemployment. If they fail to find work they are counted as unemployed by the ILO measure.

The overall impact depends on the magnitude and significance of net migration. Extract B only gives inward migration; the figures on emigration have not been provided, so net migration and its effect on the labour force could be much smaller than 650 000. Relative to a UK labour force of over 30 million, even 312 000 work migrants is around 1%, so the impact may be small.

Many migrants may only be short term. Long-term migration for study was 163 000, and these students are not certain to remain in the UK after their studies, so their effect on employment may be temporary. Furthermore, asylum applicants cannot usually accept employment while their case is processed, and only 10 547 of the 41 280 applicants were granted asylum, so their effect on the labour market is limited. Dependants may or may not join the labour force.

The impact also depends on the skills of migrants. Highly skilled migrants who fill shortages complement UK workers and raise productivity, whereas low-skilled migrants are more likely to compete with UK workers. Different industries and regions will be affected differently. The evidence may also be inaccurate: the reason given for migration is self-reported and the data do not show how many actually found work.

Finally, it depends on the state of the economy. If the UK economy is growing, as Figure 1 suggests with falling unemployment, it can take on more labour without increasing unemployment, as AD and the demand for labour also rise. In a recession, however, migrants looking for work are more likely to increase unemployment.

In conclusion, migration is likely to increase employment in the UK, as most migrants come with a definite job, and the evidence from Figure 1 shows unemployment falling

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despite record migration. Any rise in unemployment is likely to be small and concentrated among low-skilled workers in particular areas, and depends on the skills of migrants and whether the economy keeps growing.

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EITHER

(f) Evaluate government policies, apart from migration policies, that could be used to increase the employment rate in the UK.

(20)

OR

(g) Evaluate the likely impact of high inflation on the UK government's macroeconomic objectives.

(20)

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 6(f)** ☒ **Question 6(g)** ☒

Write your answer here:

Question 6(f)

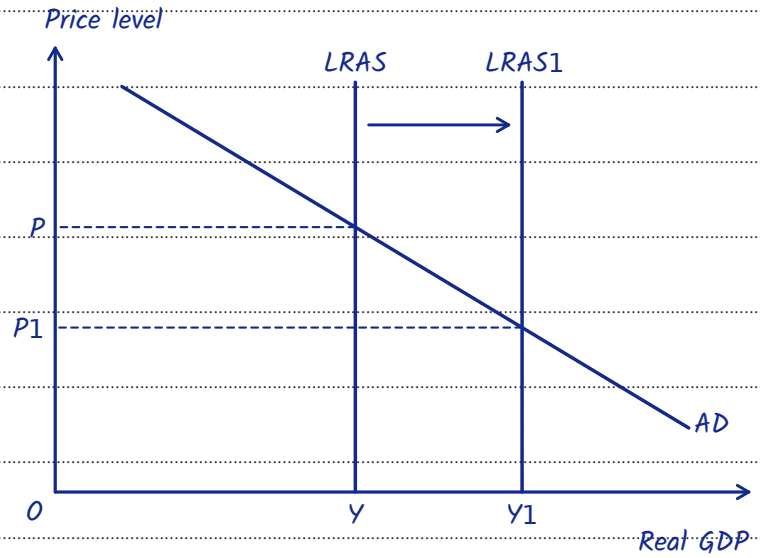
The employment rate is the percentage of the working-age population (16 to 64) in work. Governments can raise it using fiscal policy, which increases AD and so the derived demand for labour, and supply-side policies, which increase the willingness and ability of people to work and the productive capacity of the economy, shifting LRAS right from LRAS to LRAS1 in my diagram, raising real GDP from Y to Y1 without raising the price level.

Firstly, investment in education and training increases the level of human capital, providing a more skilled workforce. This reduces structural unemployment and occupational immobility, as workers gain the skills needed for available vacancies, so more people can be employed. It also raises productivity, making UK workers more attractive to employers.

Secondly, a reduction in income tax creates a larger incentive to work, as people keep more of what they earn, so more people enter the labour force and economic inactivity falls. Lower taxes also raise disposable income, increasing consumption and AD, so firms demand more workers.

Thirdly, a reduction in unemployment and associated benefits increases the incentive to find work, as the gap between income in and out of work widens, reducing voluntary

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unemployment and the poverty trap. Increasing the provision of free childcare would allow many parents, particularly mothers, to return to work, raising the activity rate. The government could also offer grants, subsidies or tax breaks to firms that set up in depressed areas with high unemployment, or reduce corporation tax to encourage firms to expand in the UK, and improve labour market flexibility by making it easier to hire and fire, encouraging job creation. Help with relocation costs would reduce geographical immobility.

However, the effectiveness of these policies depends on several factors. Education and training involve long time lags; it may take years before workers gain new skills and the effect on employment is seen. Tax cuts and subsidies are costly, and with a large budget deficit the government may find it difficult to pay for large investments or offer significant grants and tax breaks without borrowing more, which depends on the creditworthiness of the UK government. There is an opportunity cost, as spending on training could have gone on the NHS.

The magnitude of the policy also matters: a small cut in income tax may have little effect on work incentives, and some workers may choose to work fewer hours as they can earn the same income in less time (the income effect). Cutting benefits may

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increase poverty and inequality, a conflict with other objectives, and reduced employment protection may lower job security and confidence. Raising AD through fiscal policy only raises employment if there is spare capacity; near full employment it mainly causes inflation.

In addition, external factors beyond the government's control, such as a slowdown in the global economy or uncertainty after the Brexit vote, may reduce the demand for labour regardless of policy. With ILO unemployment already down to about 1.6 million in 2016, remaining unemployment is likely to be structural, so supply-side policies are more suitable than demand-side policies.

In conclusion, the most effective policies are likely to be those that tackle the causes of low employment directly, such as education and training and free childcare, combined with tax incentives to make work pay. They are most effective in the long run, and their success depends on the size of the policy, time lags and the government's ability to fund them.

Question 6(g)

Inflation is a sustained rise in the general price level, measured by the CPI. The UK government's macroeconomic objectives include stable prices (a CPI target of 2%), sustainable economic growth, low unemployment, a balanced current account, a sustainable budget position and greater equality. High inflation, well above 2%, is likely to have a negative impact on most of these.

High inflation reduces purchasing power and real incomes if wages do not rise as fast as prices. Consumers can buy fewer goods and services, so consumption and AD fall, reducing economic growth. Costs of inflation such as menu costs and shoe leather costs, together with uncertainty about future prices, lead to a loss of business and consumer confidence, so firms delay investment, reducing growth in both the short run and the long run. Unemployment may then rise as firms cut output and become less efficient,

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leading to stagflation.

High inflation also harms equality. People on fixed incomes, such as pensioners and those on benefits, are often the poorest and are not protected from rising prices, so the gap between rich and poor widens. Savers lose if inflation exceeds interest rates. Moreover, if UK inflation is higher than in other countries, British goods become less price competitive, so exports fall and imports rise, worsening the current account deficit of the balance of payments.

Inflation can also become self-reinforcing through expectations: as consumers get used to higher inflation, workers demand higher wages to protect the buying power of their incomes, raising firms' costs and causing a wage-price spiral, which makes inflation harder to control.

On the other hand, there may be some positive effects. Inflation makes the national debt smaller in real terms, making it cheaper to finance and pay back, and higher nominal incomes raise tax revenue through fiscal drag, helping to reduce the budget deficit. If high inflation comes from rising AD, unemployment may fall in the short run, as shown by the Phillips curve. Slower growth caused by inflation may even benefit the environment.

The impact depends on the cause of inflation. Demand-pull inflation caused by rising AD is associated with growth and falling unemployment, while cost-push inflation, such as from a falling pound after the Brexit vote raising import prices, reduces real output and raises unemployment at the same time. It also depends on the duration and magnitude: a short period of inflation at 3% to 4% is much less harmful than sustained double-digit inflation.

The impact also depends on relative inflation rates: if the UK's trading partners have similar inflation, competitiveness is unaffected. Inflation might not translate into higher wages and unemployment if the workforce has little bargaining power. The policy response

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matters too: the Bank of England may raise interest rates to bring inflation back to target, which would reduce growth and raise unemployment. Other factors, such as exchange rates and the global economy, may have a larger effect on the objectives. When growth is low, slightly higher inflation may be worth the risk to avoid deflation.

In conclusion, high inflation is likely to have a negative impact on most of the UK government's macroeconomic objectives, particularly real incomes, competitiveness, equality and long-run growth, although it can reduce the real value of debt. The size of the impact depends on its cause, how high and how long it lasts, inflation in other countries and the policy response.

(Total for Question 6 = 60 marks)

TOTAL FOR SECTION B = 60 MARKS
TOTAL FOR PAPER = 80 MARKS

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