



GCE A LEVEL

A520U30-1



MONDAY, 13 JUNE 2022 – AFTERNOON

ECONOMICS – A level component 3
Evaluating Economic Models and Policies

2 hours 30 minutes

ADDITIONAL MATERIALS

A WJEC pink 16-page answer booklet.

INSTRUCTIONS TO CANDIDATES

Use black ink or black ball-point pen.

Answer **one** question from Section A.

Answer **one** question from Section B.

Answer **one** question from Section C.

INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question or part-question.

You are reminded of the need for good English and orderly, clear presentation in your answers.

SECTION A

Answer **one** question from this section.

Either

1. UK fifth most unequal country in Europe

- (a) Explain why governments might intervene to reduce income inequality. [10]
- (b) Evaluate policies that a government could introduce to reduce income inequality in the UK. [20]

Or

2. “Monopolies always abuse their power”

- (a) Explain how firms can sustain their monopoly power. [10]
- (b) To what extent can a natural monopoly ever be efficient? Use a diagram(s) to support your answer. [20]

SECTION B

Answer **one** question from this section.

Either

3. Inflation likely to go above target in the UK

- (a) Explain the main costs of inflation to an economy. [10]
- (b) Evaluate possible policies that could be used to reduce the rate of inflation. [20]

Or

4. Sajid Javid: “Austerity is over” (September 2019)

- (a) Explain why it may be difficult for governments to achieve their macroeconomic policy objectives at the same time. [10]
- (b) Discuss the extent to which the use of expansionary fiscal policy is appropriate during economic downturns. [20]

SECTION C

Answer **one** question from this section.

Either

5. IMF: Weak governance a key obstacle to growth and development

- (a) Explain why poor governance can be an obstacle to economic growth and development in LEDCs. [10]
- (b) Consider how effective the interventionist policies of import substitution and export-led industrialisation are likely to be in raising the levels of economic growth and development in LEDCs. [20]

Or

6. Germany runs permanent current account surplus

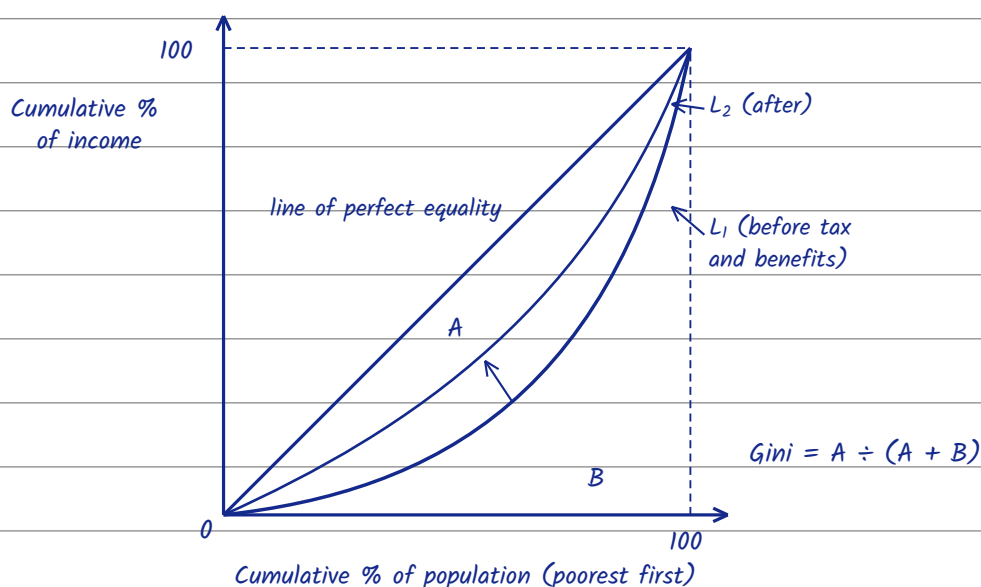
- (a) Explain why some countries have long-term current account surpluses on their balance of payments. [10]
- (b) Evaluate the view that a current account surplus is always beneficial to an economy. [20]

END OF PAPER

Question
number

1 (a)

Income inequality is the unequal distribution of income between households. It is shown by a Lorenz curve and measured by the Gini coefficient, from 0 (perfect equality) to 1 (one household receives all income). The UK has a Gini coefficient of about 0.35 for disposable income, making it the fifth most unequal country in Europe. Governments intervene for several reasons.



First, equity and total welfare. Because of diminishing marginal utility of income, an extra £1 gives far more satisfaction to a low-income household that can barely afford food and heating than to a top earner spending on conspicuous consumption. So with high inequality total satisfaction is lower than it could be: resources are misallocated towards luxuries while basic needs go unmet. Redistribution, shifting the Lorenz curve from L₁ towards L₂ and shrinking area A, can raise total welfare.

Second, inequality is strongly correlated with negative social outcomes: lower life expectancy, higher child mortality, poor mental health, addiction, crime and social unrest. These create negative externalities and raise government spending

on benefits, the NHS, social services and the criminal justice system, so reducing inequality can lower these costs in the long run, freeing funds for other uses.

Third, inequality can reduce aggregate demand and long-run growth. Rich households have a lower marginal propensity to consume than poor households, so when income is concentrated at the top, consumption and AD are lower than they would be with a fairer distribution. In the long run, children from poor households receive less education and have worse health, so human capital is wasted and productivity is lower. Rising GDP therefore does not raise living standards as much as it could, and growth itself may be slower.

Fourth, income inequality leads to and perpetuates wealth inequality, because high earners can save and buy assets (property, shares) whose returns increase their income further. This produces an underclass with low social mobility, where poverty is passed between generations. Governments therefore intervene to break this cycle, improving equality of opportunity as well as outcome.

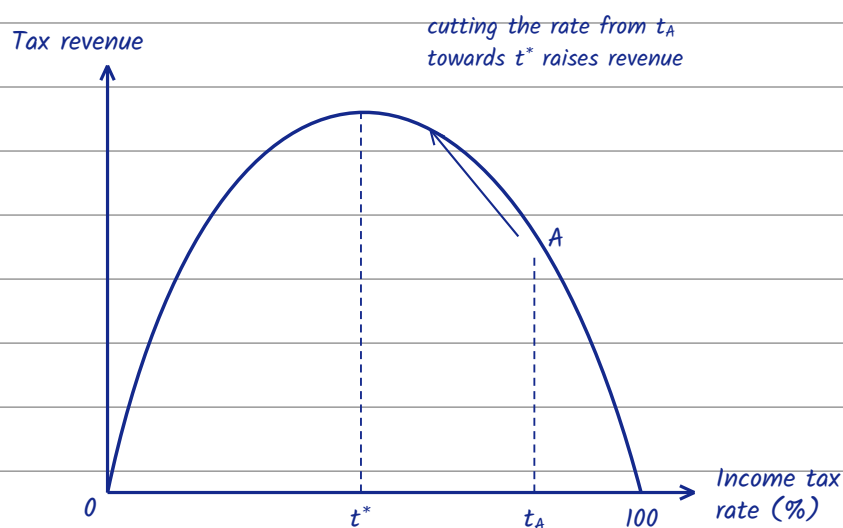
Finally, there is a market failure argument: the free market rewards factors according to their marginal revenue product and bargaining power, not need, so it will not produce a socially acceptable distribution on its own. Voters may also see extreme inequality as unfair, so governments face political pressure to intervene.

1 (b)

Government can reduce income inequality by redistributing income through the tax and benefit system, by raising the incomes of the low paid, and by improving the life chances of poorer groups. The best policy depends on its effectiveness, its cost and its side effects in the UK over the next few years.

1. Raising the top rate of income tax. The UK currently has an additional rate of 45% on income above £150,000. Raising it to, say, 50% would make the tax system more progressive: it reduces the post-tax income of the richest, moving the Lorenz curve towards the line of equality, and the revenue could

fund health, education or benefits for poorer households. However, only about 1% of taxpayers pay the additional rate, so the direct effect on the Gini coefficient would be small. Top earners can avoid the tax, for example by taking income as dividends or capital gains, by delaying income, or by moving abroad. The Laffer curve shows that if the tax rate is already beyond t^* , a higher rate reduces work effort and increases avoidance so much that revenue falls. When the UK raised the top rate to 50% in 2010, HMRC estimated it raised very little extra revenue.



2. Raising the personal allowance or cutting the basic rate. The personal allowance is £12,570. Raising it takes more low earners out of income tax entirely and raises the disposable income of all low-paid workers, also improving work incentives. However, it does nothing for those already earning below the allowance, such as pensioners and the unemployed, the poorest groups, and it also benefits higher earners, so it is poorly targeted and expensive.

3. Reforming benefits and tax credits. Increasing Universal Credit or child benefit directly raises the incomes of the poorest. Reducing the Universal Credit taper rate (cut from 63% to 55% in 2021) lets workers keep more of each extra pound they earn, cutting the poverty trap. However, more generous benefits may create a disincentive to work and increase dependency, so a larger underclass could be left behind in the long run. They are also costly

when public debt is already around 100% of GDP after the pandemic.

4. Increasing the National Living Wage (£9.50 in 2022). This raises the pay of the lowest earners without government spending. But if it is set above the market equilibrium wage, it may cause unemployment for low-skilled and young workers, especially if their labour demand is elastic, and those who lose their jobs become poorer. Many poor households have no one in work, so they gain nothing.

5. Cutting VAT and other indirect taxes. Indirect taxes are regressive, taking a larger share of the income of the poor, so cutting them raises the real income of low-income groups proportionately more. However, food and children's clothes are already zero rated, the cut would have to be large to make a real difference, and cutting excise duties on alcohol and tobacco could harm health, increasing inequality in the long run.

6. Spending more on merit goods such as education, training and health, and on childcare support so both parents can work. This raises the human capital and productivity of poorer groups, giving access to high-skilled, high value-added jobs, increasing social mobility and tackling the cause of inequality rather than the symptoms. It also benefits the economy through positive externalities. However, the effects take many years, outcomes depend on many factors besides spending, such as home background, and intergenerational inequality has proved persistent despite improvements in education.

7. More low-rent social housing in cities would cut the large share of income poor families spend on rent and reduce commuting costs, but budget pressures and land shortages make this slow and small scale. Other options include limits on top executive pay, though firms may simply pay more in bonuses or shares.

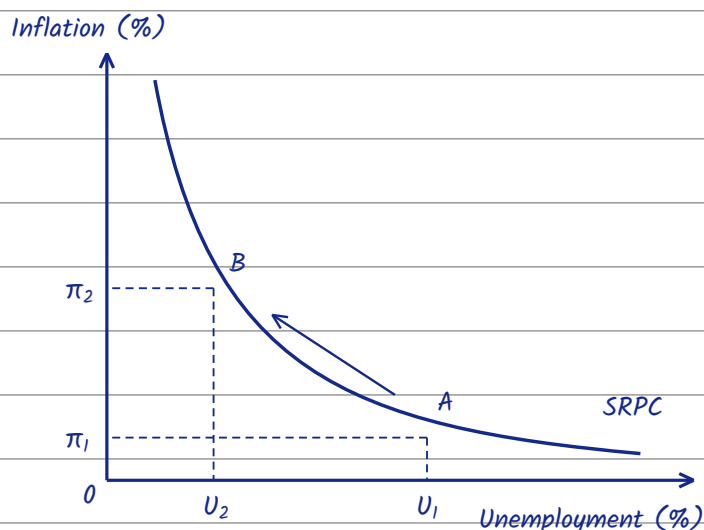
Evaluation. The UK over the next few years faces high inflation, a cost of living crisis and high public debt. This makes expensive, untargeted policies such as raising the personal allowance hard to justify, while a higher top tax rate raises little revenue. Short-term relief for the poorest is best provided by

targeted benefit increases, uprated in line with inflation, combined with a lower taper rate so that work still pays. The effectiveness of each policy depends on its size, on the elasticity of labour supply and demand, and on the time scale. Overall, the most effective long-term approach is a package: targeted benefits and in-work support now, funded partly by closing tax loopholes on wealth and capital gains, combined with sustained spending on early years education and skills, which is the only policy that tackles the root causes of income inequality and raises social mobility.

4 (a)

The government's main macroeconomic objectives are strong and sustainable economic growth, low unemployment, low and stable inflation (2% CPI target), a satisfactory current account balance and control of public sector debt. Achieving them at the same time is difficult because policies that help one objective often worsen another: there are trade-offs.

Growth and low unemployment versus low inflation. Expansionary demand-side policies raise AD, which increases real GDP and employment. But as the economy approaches full capacity, demand-pull inflation rises. Firms face rising factor prices: workers become stronger in pay negotiations because they are less afraid of becoming unemployed and are hard to replace, so money wages rise and firms' costs rise. With buoyant product markets and less competition, firms can pass on these costs as higher prices. Shortages of office space and materials push up rents and prices too. The short run Phillips curve shows this trade-off: moving from A to B lowers unemployment from U_1 to U_2 but raises inflation from π_1 to π_2 . Conversely, raising interest rates to reduce inflation lowers AD, growth and employment.



Growth versus the current account. Higher growth raises incomes, and with a high marginal propensity to import in the UK, consumption sucks in imports, both directly and through imported components, worsening the current account deficit. If growth also raises inflation, UK goods become less price competitive, so exports fall and imports rise further.

Controlling public debt versus growth and unemployment. Reducing the budget deficit through austerity, cutting government spending and raising taxes, reduces AD, and through the negative multiplier, growth slows and unemployment rises, unless the economy was already growing strongly. Lower incomes reduce tax revenue and increase benefit spending, so the deficit may fall by less than planned or even worsen, as happened in Greece, where austerity caused a deep recession and the debt to GDP ratio rose. By contrast, Javid's end of austerity in 2019 supports growth but adds to borrowing.

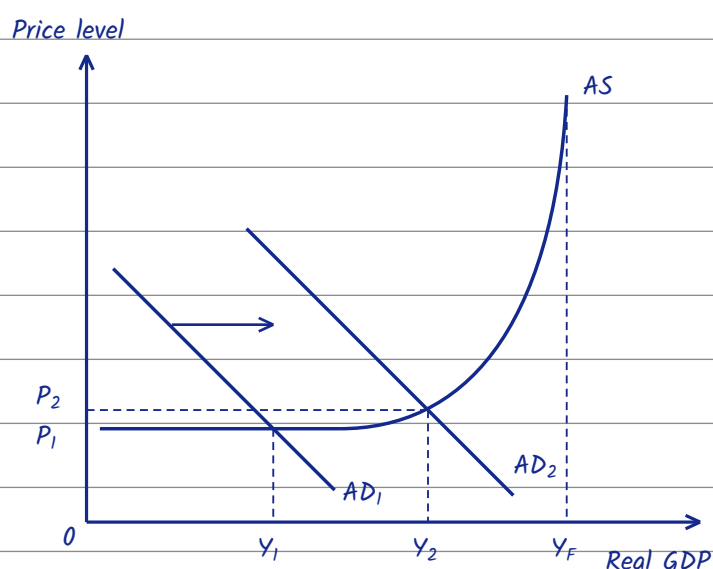
Other conflicts include growth versus the environment (more output means more pollution and resource depletion) and growth versus inequality, if the gains go mostly to the rich. These conflicts are less severe when growth comes from supply-side improvements that shift LRAS right, which can raise output without inflation, but these take a long time, so in the short run governments usually must prioritise.

4 (b)

An economic downturn is a period of slow or negative growth in real GDP with

rising unemployment and a negative output gap. Expansionary fiscal policy is the use of higher government spending and/or lower taxation to increase aggregate demand, which increases the budget deficit. It can be automatic, through automatic stabilisers, or discretionary. Government spending increases may be current spending (e.g. NHS wages), capital spending (e.g. infrastructure) or transfer payments (benefits). Tax cuts may be direct, on incomes and profits, or indirect, on expenditure, such as the cut in VAT from 17.5% to 15% in 2008.

Arguments for. Automatic stabilisers work immediately: in a downturn, progressive tax revenue falls and benefit spending rises, cushioning household incomes so that the downturn is less severe. Discretionary policy adds to this. Higher government spending (G) directly raises AD , while tax cuts raise disposable income, so consumption rises, and cuts in corporation tax increase post-tax profit, so investment rises. As the diagram shows, AD shifts right from AD_1 to AD_2 . Because there is spare capacity in a downturn, output rises from Y_1 to Y_2 with only a small rise in the price level from P_1 to P_2 , and unemployment falls.



The multiplier magnifies the effect: extra spending becomes income for others, who spend part of it. With a marginal propensity to withdraw of 0.4, the multiplier is $1 \div 0.4 = 2.5$, so a £10bn rise in G could increase GDP by

£25bn. US research suggests infrastructure projects and higher benefit payments have the largest multiplier effects on jobs, because they go to people with a high MPC, while cutting payroll taxes is one of the most effective tax stimuli. Infrastructure also raises productive capacity, shifting LRAS right. Fiscal expansion may be partly self-financing: as GDP rises, tax revenue increases and benefit spending falls, so the deficit rises less than the original stimulus. It is especially valuable when interest rates are near zero and monetary policy is ineffective, as in 2020, when the furlough scheme protected millions of jobs and prevented mass unemployment and scarring.

Arguments against. Fiscal expansion may be unnecessary. Free market (classical) economists argue that if labour and product markets are flexible, wages and prices fall and the economy returns to its natural rate of output on its own, so intervention only adds to debt. It may be ineffective: time lags in recognising the downturn, deciding policy and implementing projects mean spending may arrive after recovery has started, adding to inflation. Crowding out may occur: higher government borrowing can drive up bond yields and interest rates, raising government debt interest costs and reducing private sector investment, which weakens the stimulus and slows long-run growth.

Ricardian equivalence suggests that households expect higher future taxes to repay the debt, so they save the tax cut rather than spend it. A higher national debt, which exceeded 100% of GDP in the UK in 2020, may require long-run tax rises or spending cuts and may worry the bond markets.

Some spending may be wasteful, creating white elephant projects financed by future taxpayers, and tax cuts can be politically hard to reverse, creating a permanent structural deficit like the US. Excessive support can keep inefficient zombie firms alive, so resources are not reallocated to more productive firms when recovery comes. Tax cuts for high earners have small multipliers because the rich save more, and they also widen inequality.

Evaluation. The appropriateness of expansionary fiscal policy depends on the cause and depth of the downturn: in a deep demand-side recession with

near-zero interest rates, the case is strong, but if the downturn is caused by a supply shock, such as the 2022 energy price rise, extra demand mainly adds to inflation. It depends on the size of the multiplier, which is larger in a recession when there is spare capacity and when spending is targeted at low-income households and infrastructure. It depends on the government's starting debt level and borrowing costs: the UK can borrow cheaply in its own currency, unlike Greece in the eurozone. Finally, the time scale matters: a temporary, timely and targeted stimulus is most effective.

Overall, expansionary fiscal policy is appropriate during a serious economic downturn, particularly when monetary policy has little room to act, provided it is temporary and targeted at measures with high multipliers such as infrastructure and benefits. In a mild downturn, automatic stabilisers and monetary policy may be enough, and the government should then reduce the deficit when growth returns.

5 (a)

Governance is the way in which a country is governed: how public institutions make and enforce decisions, collect taxes, provide services and uphold the rule of law. Poor governance includes corruption, but is wider than corruption: it also covers maladministration, weak judicial systems, political instability and poorly defined property rights. Economic growth is an increase in real GDP; economic development is a sustainable increase in living standards, covering income, health, education and freedoms, as measured by the HDI.

Weak tax collection. If the administrative infrastructure is inadequate, governments fail to raise funds from the tax base, and widespread tax evasion means low revenue. They cannot fund infrastructure, healthcare and education, so productive capacity grows slowly (lower growth) and life expectancy and literacy stay low (lower development).

Weak legal systems and property rights. If contracts cannot be enforced and courts are unreliable, there is little incentive to start businesses or invest, as profits or land may be seized. Domestic investment and FDI fall, reducing the

capital stock and the transfer of technology. A lack of intellectual property rights restricts innovation. So LRAS grows slowly and fewer jobs are created.

Corruption and misallocation of public funds. Tax revenue may be embezzled or spent on vanity projects and the military instead of schools, clinics and roads, a large opportunity cost. Contracts go to firms with political connections rather than the most efficient, so resources support vested interests rather than being allocated optimally, and public services are of higher cost and lower quality.

Bribery raises business costs and limits poor households' access to basic services such as healthcare and education, which increases inequality. It breaks the contract between the government and the governed, so people see little point in paying tax, leading to more tax avoidance, a vicious circle.

Lack of competition. Corruption protects favoured firms from competition, so prices are higher and quality lower than they would otherwise be, lowering households' purchasing power and real living standards and reducing the incentive to innovate.

Corruption in education. If teachers are underpaid and students pay for results, there is little incentive to work hard, so the workforce lacks the skills needed for growth, and human development suffers.

In each case poor governance reduces both the quantity and quality of factors of production, so growth is lower, and directly reduces access to health, education and income, so development is held back, as in many resource-rich countries such as Nigeria, compared with well-governed Botswana.

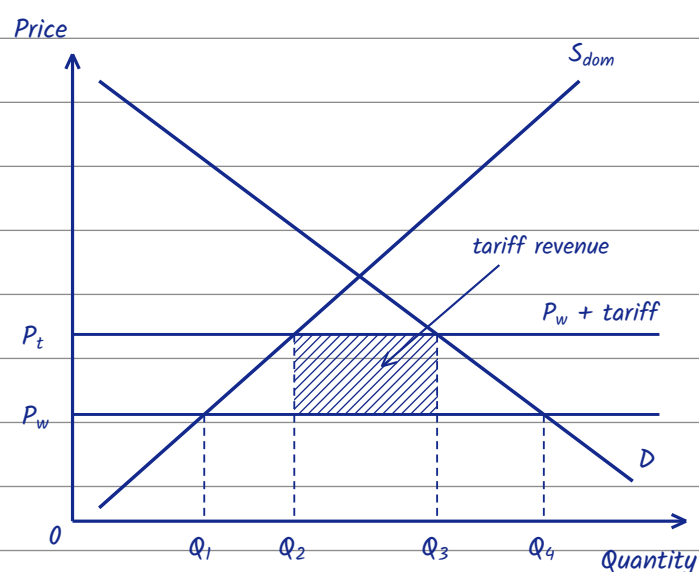
5 (b)

Import substitution industrialisation (ISI) is an inward-looking strategy that replaces imported manufactured goods with domestically produced ones. Its key elements are protectionism (tariffs and quotas) to support infant industries; an active industrial policy supporting strategic industries, which may include nationalising key sectors and state infrastructure investment; an overvalued exchange rate to allow cheap imports of capital equipment and technology; and

discouragement of FDI so domestic firms can grow. It was used in Latin America (Brazil, Argentina) and India from the 1950s to the 1980s.

Export-led (export-oriented) industrialisation (EOI) is an outward-looking strategy that encourages export sectors in which the country has a comparative advantage, aiming to sell to rich, developed markets. Its features include a floating or competitive exchange rate, targeted support for key sectors through low-cost loans and infrastructure such as industrial parks and special economic zones, openness to FDI, and an emphasis on education to build skills. It was used by the Asian tigers (South Korea, Taiwan, Singapore, Hong Kong) and later China.

How ISI can raise growth and development. Tariffs raise the price of imports from P_w to $P_w + \text{tariff}$, so, as the diagram shows, domestic production rises from Q_1 to Q_2 and imports fall from Q_1Q_4 to Q_2Q_3 , while the government gains tariff revenue. Local firms come to dominate the domestic market, often in sectors that build on available primary products, so employment and output rise. As they grow they gain economies of scale and learning, which may eventually allow them to compete on world markets. Cheap imported capital, low-cost energy from state producers and government transport infrastructure help kick-start industrialisation, and the economy diversifies away from dependence on volatile primary commodity exports.



Limitations of ISI. Protection means local firms face little competition, so they have little incentive to cut costs or innovate: X-inefficiency and poor quality result, and infant industries never grow up. Consumers pay higher prices, a loss of consumer surplus. The overvalued exchange rate makes exports uncompetitive, so firms are constrained by the size of their domestic market, making ISI more effective in large countries such as Brazil than small ones. Government spending on infrastructure and loss-making nationalised firms leads to budget deficits, rising national debt and crowding out, while imports of capital goods continue, causing current account deficits. In Latin America this contributed to the debt crisis of the 1980s, and India's slow growth under the licence raj led to liberalisation in 1991. Protection also invites rent-seeking and corruption.

How EOI can raise growth and development. By targeting large, rich export markets, firms are not limited by weak domestic demand, so exports, an injection, can grow rapidly, raising AD through the multiplier. Specialising according to comparative advantage, initially in labour-intensive goods such as textiles, raises efficiency. Competing in global markets forces firms to be productive and innovative, and FDI brings capital, technology, management skills and jobs. Export earnings provide foreign currency to pay for imports of capital goods, avoiding balance of payments constraints. Emphasis on growth sectors and education, with targeted support, can cause very rapid growth: South Korea moved from one of the poorest countries in the 1950s to a high-income economy with high HDI, moving up the value chain into electronics and cars.

Limitations of EOI. It often requires a substantial government budget for infrastructure and subsidies. The Asian tigers had positional or political advantages, such as strong links with the US during the Cold War, high savings and strong states, not necessarily available to other countries today. It assumes strong governance and well-informed leaders who can target the right sectors and avoid corruption, which, as S(a) shows, many LEDCs lack. The country becomes exposed to global shocks, such as the 2008 financial crisis or a recession in its main markets, because it depends on export income.

Developed countries may impose protectionism, and as many countries pursue the same strategy, competition in low-cost manufacturing becomes intense.

Growth may not mean development: low wages, poor working conditions, as in the Rana Plaza disaster in Bangladesh, and environmental damage can limit gains in living standards, and multinationals may repatriate profits.

Evaluation. Evidence suggests that EOI has generally been more successful than ISI in raising growth and development: the East Asian economies grew far faster than Latin America in the 1970s and 1980s. However, the success of each depends on several factors. The size of the domestic market matters for ISI. Governance is crucial for both: strong institutions can pick sectors well and withdraw protection over time, while weak ones allow capture by vested interests. The global economic climate matters for EOI, and whether the country has a comparative advantage, skills and infrastructure. In practice, many successful countries combined both: South Korea initially protected its infant industries before forcing them to export, with performance targets. Overall, EOI is likely to be more effective in raising growth and development in most LEDCs, especially smaller ones, because it avoids the inefficiency of protection and is not limited by domestic demand. However, neither strategy will work without good governance, investment in human capital and some temporary, conditional protection for infant industries, so a mixed, well-managed approach is likely to be most effective.