OXFORD AQA

INTERNATIONAL QUALIFICATIONS

Please write clearly in block capitals.

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INTERNATIONAL AS
ECONOMICS

Unit 2 The National Economy in a Global Environment

Friday 17 May 2024 07:00 GMT Time allowed: 1 hour 45 minutes

Materials

For this paper you must have:
- the Source Booklet, provided as an insert (enclosed)
- a calculator, which you are expected to use where appropriate.

Instructions
- Use black ink or black ball-point pen. Pencil should only be used for drawing.
- Fill in the boxes at the top of this page.
- Answer **all** questions.
- You must answer the questions in the spaces provided. Do **not** write outside the box around each page or on blank pages.
- Do **not** write in the Source Booklet.
- If you need extra space for your answer(s), use the lined pages at the end of this book. Write the question number against your answer(s).
- Do all rough work in this book. Cross through any work you do not want to be marked.

Information
- The marks for questions are shown in brackets.
- The maximum mark for this paper is 80.
- You may use a bilingual dictionary for this exam.
- You may **not** use an English dictionary.

For Examiner's Use	
Question	Mark
1–15	
16	
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21	
TOTAL	

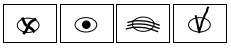
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Section A

Answer **all** questions in the spaces provided.

Only **one** answer per question is allowed.

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

CORRECT METHOD  WRONG METHODS 

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

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

0 1 Which one of the following is an example of conflicting government policy objectives?

[1 mark]

A Reducing inflation may reduce imports. ○

B Reducing interest rates may increase growth. ○

C Reducing the exchange rate may reduce exports. ○

D Reducing unemployment may increase inflation. ●

0 2 Which one of the following is an example of a supply-side improvement?

[1 mark]

A A reduction in tax rates on company profits ○

B A rise in government spending on education ○

C An expansion of capacity due to higher productivity ●

D An increase in the amount of quantitative easing ○

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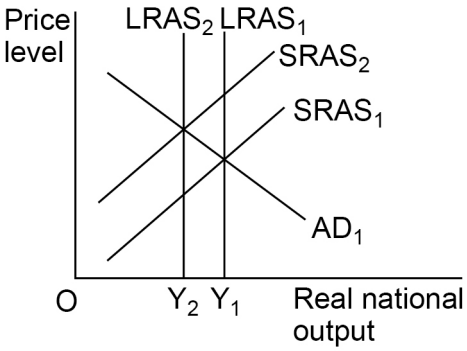
0 3 The diagrams below show an economy's initial aggregate demand (AD_1), short-run aggregate supply ($SRAS_1$) and long-run aggregate supply ($LRAS_1$) curves.

The economy was initially operating at Y_1. As a result of a supply-side shock, it now has a negative output gap and unemployment.

Which one of the following diagrams shows this change?

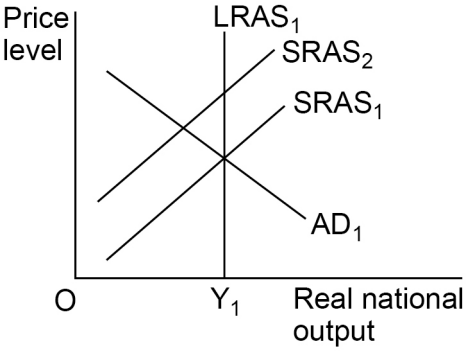
[1 mark]

A



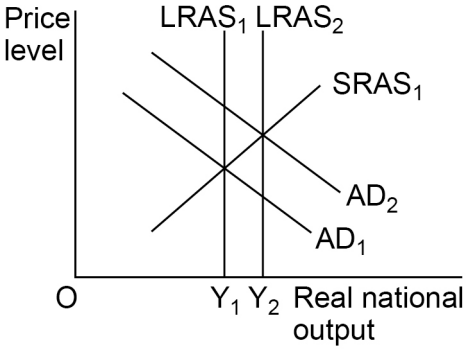
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B



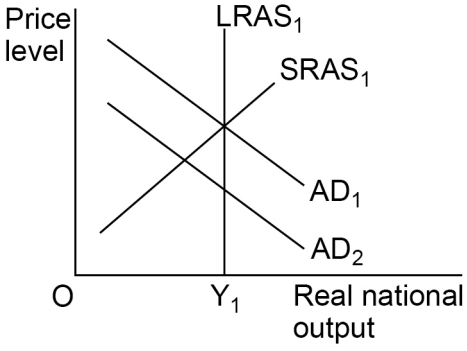
●

C



○

D



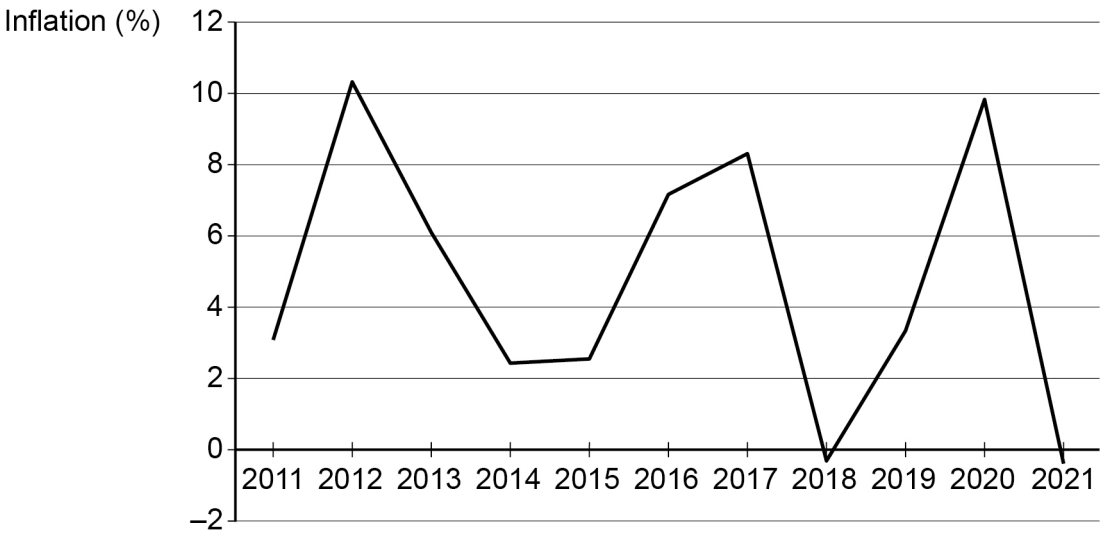
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0 4 **Figure 1** shows the rate of inflation in a country from 2011 to 2021.

Figure 1



All other things being equal, in which two years was the country most likely to experience a recession followed by a recovery?

[1 mark]

	Recession	Recovery	
A	2012	2013	○
B	2016	2017	○
C	2018	2019	●
D	2020	2021	○

0 5 A central bank is using monetary policy to raise the country's exchange rate.

The most likely objective of this policy is

[1 mark]

A to increase economic growth. ○

B to increase the country's exports. ○

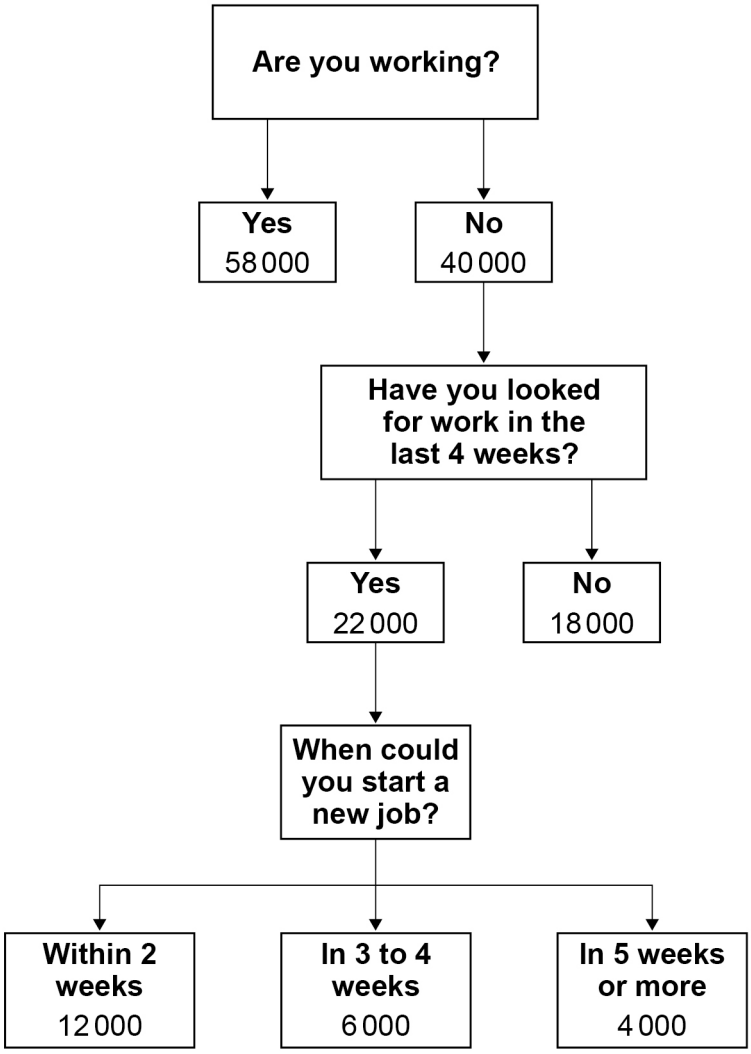
C to reduce the budget deficit. ○

D to reduce the rate of inflation. ●

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0 6 **Figure 2** shows the responses to a labour force survey.

Figure 2



Using the International Labour Organisation (ILO) definition, what percentage of the labour force is unemployed?

[1 mark]

A 17.1% ⬬

B 23.7% ⬭

C 27.5% ⬭

D 40.8% ⬭

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0 7 What is the difference between real national income and nominal national income?

[1 mark]

A Real national income has direct taxes removed. ⬭

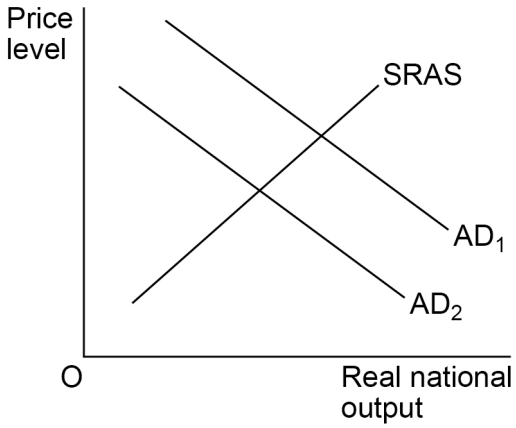
B Real national income includes a measure of well-being. ⬭

C Real national income is divided by the population size. ⬭

D Real national income removes the effects of inflation. ⬬

0 8 **Figure 3** shows an economy's short-run aggregate supply (SRAS) curve, initial aggregate demand (AD_1) curve and new aggregate demand (AD_2) curve.

Figure 3



Which one of the following is most likely to cause the change in aggregate demand?

[1 mark]

A An increase in imports of goods ⬬

B An increase in quantitative easing ⬭

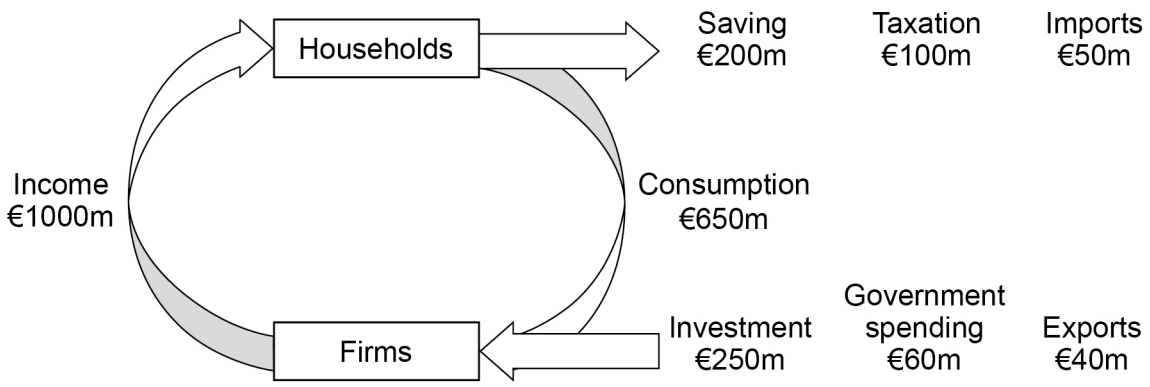
C An increase in the budget deficit ⬭

D An increase in world oil prices ⬭

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0 9 **Figure 4** shows the circular flow of income for an economy.

Figure 4



The economy's full employment level of national income is €1200 million.

The data show that the economy

[1 mark]

A is at its full employment equilibrium. ○

B is experiencing a positive output gap. ○

C is in disequilibrium and has some unemployment. ○

D is in equilibrium but has some unemployment. ●

1 0 All other things being equal, which one of the following would be most likely to increase short-run aggregate supply?

[1 mark]

A A cut in indirect taxes ●

B A fall in business confidence ○

C A reduction in subsidies ○

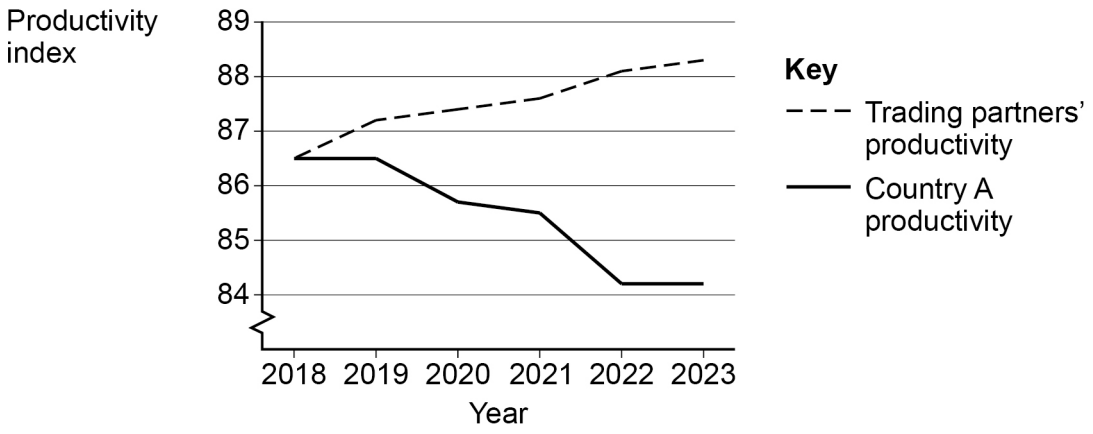
D An increase in average wages ○

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1 1 **Figure 5** shows an index of the productivity in the car industry of Country A and an index of the average productivity in the car industries of its trading partners.

Figure 5



The trend shown in **Figure 5** will affect Country A's balance of payments on current account. Which part of the current account is most likely to be affected negatively?

[1 mark]

A Balance of trade in goods ⬬

B Balance of trade in services ⬭

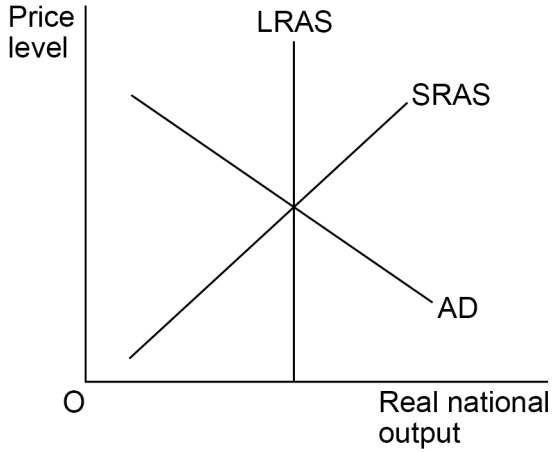
C Primary income balance ⬭

D Secondary income balance ⬭

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1 2 **Figure 6** shows the long-run aggregate supply (LRAS), short-run aggregate supply (SRAS) and aggregate demand (AD) curves for a country.

Figure 6



There is a large rise in the country's exports. Which one of the following is the most likely result in the short run?

[1 mark]

A A fall in cost-push inflation and a negative output gap ⬭

B A fall in the amount of structural unemployment ⬭

C A positive output gap and a rise in demand-pull inflation ⬬

D An increase in the country's productive capacity ⬭

1 3 Which one of the following is an example of investment in the circular flow of income?

[1 mark]

A Firms buying more machines to increase their capacity ⬬

B Firms employing more workers to increase their output ⬭

C Households borrowing money to buy a house ⬭

D Households paying into a bank account that earns interest ⬭

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1 4 A rise in interest rates is most likely to cause an increase in

[1 mark]

A demand for capital goods. ⬭

B demand for consumer goods. ⬭

C short-run aggregate supply. ⬭

D the amount households save. ⬬

1 5 **Table 1** shows the values of an index of real GDP per capita in three countries between 2019 and 2023.

The base year for the index is 2020.

Table 1

	2019	**2020**	**2021**	**2022**	**2023**
Country X	105	100	104	100	98
Country Y	85	100	106	100	105
Country Z	98	100	102	108	110

Based on the data in **Table 1**, which one of the following statements must be true?

[1 mark]

A Country X had the same amount of real GDP as Country Y in 2022. ⬭

B Country Y had the highest average real GDP per capita growth between 2019 and 2023. ⬬

C Country Z experienced the fastest growth between 2022 and 2023. ⬭

D Country Z had the highest real GDP per capita in 2023. ⬭

15

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Section B

Look at the Source Booklet and answer **all** questions in the spaces provided.

Do **not** write in the Source Booklet.

1 6 . 1 Define 'direct tax' (**Extract B**, line 4).

[3 marks]

A direct tax is a tax levied on the income or wealth of a person, or on the profits of a firm, which the person or firm on whom it is levied is legally liable to pay and cannot pass on to someone else, eg income tax or corporation tax (unlike an indirect tax on spending).

1 6 . 2 Define 'aggregate demand' (**Extract C**, line 3).

[3 marks]

Aggregate demand is the total planned spending on all the goods and services produced in an economy in a given time period, by households, firms, the government and overseas buyers, ie AD = C + I + G + (X − M), at each possible price level.

6

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1 7 **Extract A** shows the highest rate of income tax and the labour force as a percentage of the population, aged 15 or over, in selected countries from 2017 to 2021.

You are advised to show your working for the calculations below.

1 7 . 1 Use **Extract A (i)** to calculate for 2021 how much **more** tax a worker in Denmark would pay than a worker in Bolivia if they both had $35 000 of income taxed at the top rate.

Give your answer in dollars.

[3 marks]

Denmark: $35 000 × 55.9% = $35 000 × 0.559 = $19 565

Bolivia: $35 000 × 13% = $35 000 × 0.13 = $4550

Difference = $19 565 − $4550 = $15 015

Answer = $15 015 more tax

1 7 . 2 2017 is the base year for an index that measures changes in the percentage of South Korea's population aged 15 or over who are in the labour force.

Use **Extract A (ii)** to calculate the value of the index in 2020.

Give your answer to **two** decimal places.

[3 marks]

Index (2020) = (value in 2020 ÷ value in base year 2017) × 100

= (62.8 ÷ 63.5) × 100

= 98.8976...

Answer = 98.90 (index points, 2017 = 100)

6

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1 8 **Extract B** (lines 9–10) states: 'high income tax rates can affect the size of a country's labour force.'

1 8 . 1 Explain how income tax rates can affect the size of a country's labour force.

[6 marks]

The labour force is the number of people of working age who are available for work, ie those who are employed or self-employed plus those who are unemployed and actively looking for work. Income tax is a direct tax on the income people receive from factors of production, mainly wages from labour, so it reduces the take-home (net) pay from working.

Higher income tax rates reduce the reward from working compared with not working, so the incentive to work falls. Some people, such as second earners, parents with young children or students, may decide that it is not worth joining the labour force, and older workers may choose to retire earlier because the extra net income from working longer is smaller. If out-of-work benefits are relatively generous, high tax rates may create an unemployment trap. Existing workers may also offer fewer hours. As a result the labour force shrinks, while lower income tax rates have the opposite effect, raising net pay and drawing more people into the labour force.

High income tax rates relative to other countries may also cause outward migration of workers, especially skilled, highly paid workers who pay the top

Extra space rate, reducing the size of the labour force, whereas low tax rates can attract migrant workers from abroad.

However, high income tax rates reduce disposable income, so some households may need to work more, with more family members joining the labour force or working longer hours, to maintain their living standards (the income effect). The overall effect therefore depends on whether this income effect is weaker or stronger than the substitution effect.

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1 8 . 2 To what extent do the data suggest that income tax rates affect the size of a country's labour force?

Use the data in **Extract A** to help support your answer.

[6 marks]

The data give some support to an inverse relationship. Denmark has by far the highest top rate of income tax at 55.9%, more than four times Bolivia's 13%, and its labour force as a percentage of the population aged 15 or over is the lowest of the three countries in all five years, eg 62.5% in 2021. South Korea's top rate of 45% in 2021 is more than three times Bolivia's, and its labour force percentage (63.1% in 2021) is lower than Bolivia's (68.1%) in every year. Also, when South Korea raised its top rate from 40% to 45% between 2017 and 2021, its labour force fell from 63.5% to 63.1% of the population aged 15 or over.

However, the data also contradict the link. Bolivia's top rate stayed at 13% throughout, yet its labour force percentage fell by 3.7 percentage points between 2018 and 2021, a fall of 5.2%. Denmark's top rate stayed at 55.9% between 2018 and 2021, yet its labour force rose from 61.8% to 62.5%. Other factors must matter, such as the pandemic in 2020, participation in higher education, the level of welfare benefits and the income level at which tax rates start. The data only show the top rate, while most people join the labour

Extra space force at incomes well below the top rate, and they show a percentage, whereas the actual size of the labour force also depends on the size of the population. Only three countries over five years are shown.

Overall, the data suggest that income tax rates do have an inverse relationship with the size of the labour force, but only to a limited extent, since other factors clearly have a large influence too.

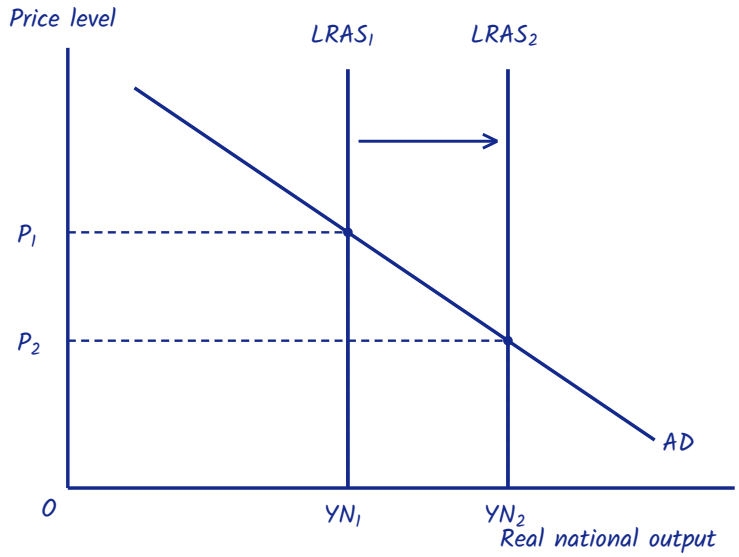
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1 9 **Extract C** (lines 9–10) states: 'lower taxes on company profits affect a country's long-run aggregate supply.'

With the help of a diagram, explain how lower taxes on company profits affect a country's long-run aggregate supply.

[9 marks]



Long-run aggregate supply (LRAS) shows the total real output an economy can produce when all its factors of production are fully and efficiently employed, ie its normal capacity level of output, YN_1 in the diagram. LRAS is vertical because in the long run output depends on the quantity and quality of factors of production and productivity, not on the price level.

Lower taxes on company profits (corporation tax) mean firms keep a larger share of their profits after tax. This gives them more retained profit to finance investment, and Extract C explains that lower taxes on profits make it easier for firms to invest in new technology and improve the quality of their capital. Lower taxes also raise the expected post-tax return on new investment, so more projects become worthwhile, increasing the incentive to invest. In addition, lower profit taxes encourage enterprise and the setting up of new businesses, and if they are lower than in other countries they attract foreign direct investment from multinationals.

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More and better capital raises labour productivity, as each worker has more modern machinery and technology, so output per worker rises even if the quantity of labour is unchanged. This increases the productive capacity of the economy, so LRAS shifts right from $LRAS_1$ to $LRAS_2$ and normal capacity output rises from YN_1 to YN_2. With AD unchanged, the price level falls from P_1 to P_2. Higher investment also raises AD and lowers unit costs, shifting SRAS right, and the resulting growth may cause further investment through the accelerator, so long-run growth can be sustained without inflation.

9

2 0 **Extract C** (line 5) states: 'the level of taxation is one reason why consumption may change'.

Analyse reasons why consumption in an economy may change.

[12 marks]

Consumption is spending by households on goods and services for their own use. It is the largest component of aggregate demand, so changes in consumption have a large effect on the economy. The main determinant of consumption is disposable income, ie income after direct taxes and including benefits, and the two have a positive relationship: as disposable income rises, households spend more, according to their marginal propensity to consume.

As Extract C states, the level of taxation is one reason why consumption changes. A rise in income tax or social security contributions reduces households' disposable income, so they have less to spend and consumption falls. A rise in indirect taxes such as VAT raises prices and reduces real incomes, so the quantity bought falls. Tax cuts have the opposite effect, although if households save some of the extra income, consumption rises by less than the tax cut.

Interest rates also affect consumption. A rise in interest rates increases the reward for saving, so households save more and spend less now. It also increases the cost of borrowing, so fewer consumer durables such as cars are bought on credit, and

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households with variable-rate mortgages have higher repayments, which reduces their discretionary income. A cut in interest rates encourages consumption. Similarly, the availability of credit matters: if banks make it easier to borrow, consumption rises even if incomes do not change.

Household wealth is another factor. If house prices or share prices rise, households feel wealthier (the wealth effect) and are able to borrow more against their assets, so they save less of their income and spend more. A fall in asset prices reduces wealth and consumption.

Consumer confidence and expectations are important. If households expect their

Extra space incomes to rise and their jobs to be secure, they spend more; if they fear unemployment, for example in a recession, they increase precautionary saving and cut spending. Expectations of the future price level also change the timing of spending: if households expect high inflation they buy now before prices rise, while expected price falls lead them to delay purchases.

Finally, changes in population structure affect consumption. An ageing population, as in South Korea (Extract C), may change the pattern of consumption towards healthcare and services, and retired people with lower incomes may spend less in total or run down their savings. Population growth increases the number of consumers and so total consumption.

Therefore consumption changes mainly because of changes in disposable income, but also because of interest rates, credit, wealth, confidence, expectations and demographic change.

12

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2 1 **Extract B** (lines 19–20) states: 'fiscal policy can also change the pattern of economic activity.'

Use the extracts and your knowledge of economics to assess the likely effectiveness of fiscal policy in changing the pattern of economic activity.

[20 marks]

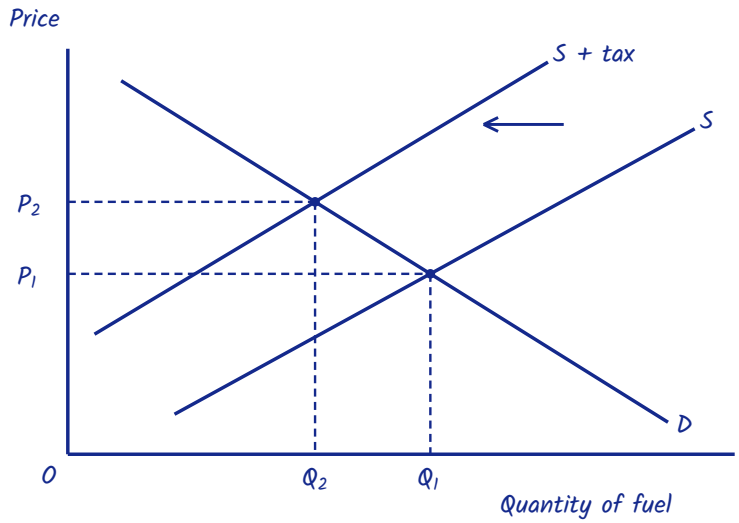
Fiscal policy is the use of government spending, taxation and the budget balance to influence the economy. As Extract B suggests, it is usually used to change the overall level of economic activity, ie aggregate demand, but it can also change the pattern of economic activity: what is produced, how resources are allocated between industries and regions, the balance between the public and private sectors, and how income is distributed between households.

The government's choice of spending can directly change the pattern of activity. Extract B shows Denmark using high tax revenue to fund extensive public services such as healthcare and education and to spend on infrastructure projects. This shifts resources into construction, transport and public services, and over time a healthier, better educated workforce and better infrastructure raise productivity in other industries too. Spending can also be targeted at particular regions or industries, for example renewable energy, which changes where and what the economy produces.

Taxes and subsidies can change the pattern of consumption and production. A tax on a harmful or polluting good, such as fuel, shifts supply from S to S + tax in the diagram, so the price rises from P_1 to P_2 and the quantity falls from Q_1 to Q_2. The revenue raised can subsidise cleaner goods such as public transport, so factors of production are reallocated from environmentally damaging markets to less damaging ones. Similarly, tariffs or taxes on imports move spending towards domestically produced goods.

Fiscal policy can also change the distribution of income. A progressive income tax, such as Denmark's with a top rate of 55.9% (Extract A), takes a larger share of

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high incomes, and the revenue can fund welfare benefits and free public services that raise the real incomes of the poor. This changes the pattern of spending, since lower-income households spend a larger share of their income on necessities.

Fiscal policy can also change the balance between the public and private sectors: Extract C suggests South Korea is cutting taxes on company profits to encourage private investment, while controlling spending to reduce its budget deficit.

However, the effectiveness of fiscal policy is limited in several ways. First, it depends on how households and firms react. If demand for a taxed good such as fuel or cigarettes is price inelastic, the quantity falls only slightly, so the pattern of consumption hardly changes, although more revenue is raised. Tax cuts for firms only raise investment if business confidence is high; firms may simply pay higher dividends. Higher taxes may also cause tax avoidance or evasion, or skilled workers and firms may move abroad.

Second, it depends on the state of public finances. A government with a high or rising budget deficit, such as South Korea, may be unable to increase targeted spending, and investors may be unwilling to lend to it except at higher interest rates. The rising cost of welfare as the population ages (Extract C) uses up revenue that could otherwise fund infrastructure, so the government may have little room to reshape the economy. The stage of the economic cycle matters: in a

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Extra space

recession, governments may have to focus on supporting overall demand and jobs rather than on changing the pattern of activity.

Third, there are policy trade-offs and information problems. Taxes on harmful goods are often regressive, so a policy that improves the environment may increase inequality. High income tax rates may reduce the incentive to work and the size of the labour force (Extract B), reducing the productive capacity of the economy. Governments may lack accurate data about external costs or which industries will grow, so they may target the wrong areas (government failure). There are also time lags, as infrastructure projects take years to plan and build, and political pressure may lead to spending decisions based on votes rather than efficiency. Finally, other influences on the economy, such as consumer confidence, the amount of spare capacity, changes in the exchange rate and world demand, may outweigh the effects of fiscal policy, so the pattern of economic activity may change for reasons other than government action.

In conclusion, fiscal policy can be effective in changing the pattern of economic activity, especially through targeted government spending on infrastructure and public services, as in Denmark, and through taxes and subsidies that change relative prices. Its effectiveness depends mainly on the price elasticity of demand for the goods targeted, the reactions of households and firms, and the state of public finances. It is most effective when the government has a sustainable budget position and uses a combination of measures over the long term, as Denmark does, and least effective where a large deficit and rising welfare costs, as in South Korea, limit what the government can do. On balance it is a powerful tool, but one that works slowly and with trade-offs.

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