Teacher Resource Bank

GCE Economics

Candidate Exemplar Work

ECON4: The National and International Economy

Introduction

Below are selected candidate answers to the AQA GCE Economics **ECON4** questions in the *Additional Sample Questions and Mark Schemes** document (data response) and the Original Specimen Question Paper and Specimen Mark Scheme (essay)**. There are three answers to the data response question and three answers to the selected essay question. For your convenience, the questions have been reprinted.

The answers have been selected to reflect a range of attainment and, for each, a commentary been produced by an experienced examiner, explaining where the marks have been awarded and why.

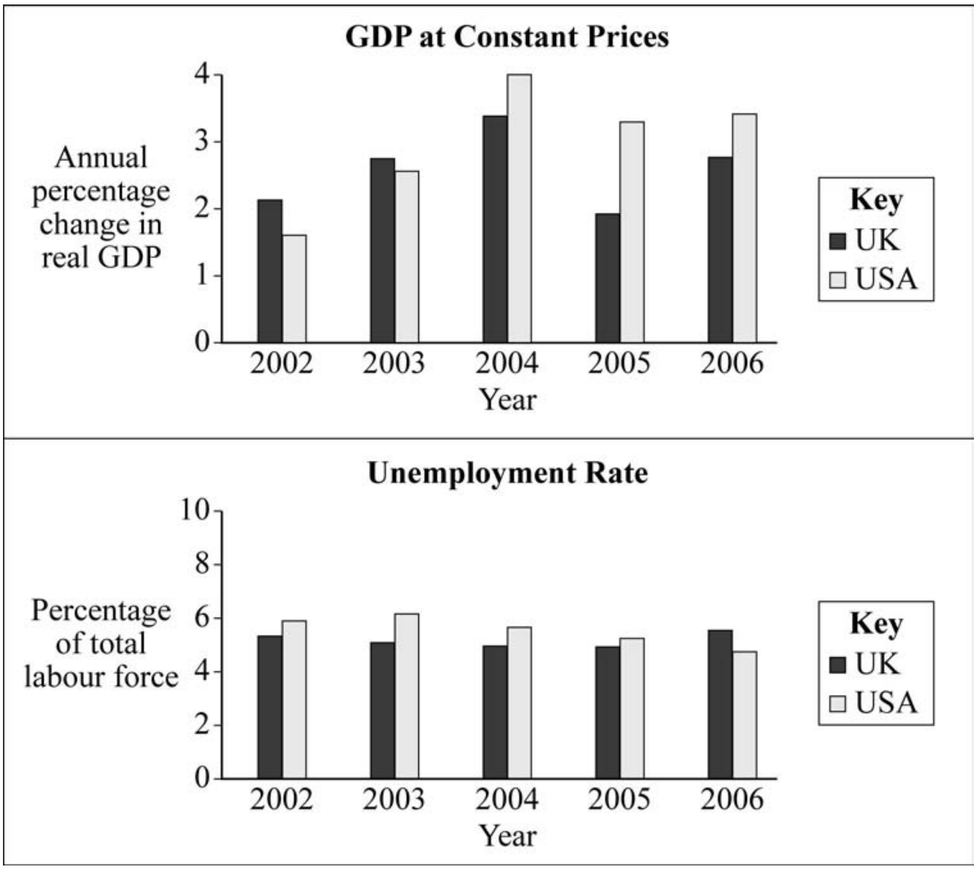
Please be aware that Parts (a) and (b) of the data response and part (a) of the essay are assessed using an issue based mark scheme. Part (c) of the data response and part (b) of the essay are assessed using the A2 levels mark scheme.

* This document does **not** contain complete question papers, only selected sample questions. A copy of the corresponding mark scheme for the data-response question can be found via the following link, pp 24-29
http://www.aqa.org.uk/qual/gce/pdf/AQA-2140-W-TRB-ASQMS.PDF
** http://www.aqa.org.uk/qual/gce/pdf/AQA-ECON4-W-SQP-07.PDF
http://www.aqa.org.uk/qual/gce/pdf/AQA-ECON4-W-SMS-07.PDF

THE GLOBAL CONTEXT **Total for this question: 40 marks**

Study **Extracts A and B**, and then answer **all** parts of the Question which follows.

Extract A: Selected economic indicators for the UK and the USA, 2002 to 2006



Source: adapted from official statistics

Extract B: The world economic outlook, April 2007

Economic activity in Asia continues to expand at a brisk pace, led by very strong growth in both China and India. In China, real GDP expanded by 10.7%. In India, real GDP growth of 9.2% and upward inflationary pressures have prompted the Reserve Bank of India to raise interest rates. With inflationary pressures still strong, a further tightening of monetary policy is likely to be needed.

Activity in western Europe gathered momentum in 2006. GDP growth in the euro area reached 2.6%, almost double its pace in 2005 and the highest rate since 2000. Germany was the principal engine of growth, fuelled by increased exports and strong investment. Growth in France and Italy was somewhat slower. The unemployment rate in the euro area fell to 7.6% by the end of 2006, its lowest level in 15 years. Meanwhile, the expansion gained pace in the UK, driven by an acceleration of domestic demand, especially consumption, while investment and export performance remained solid.

The drop in oil prices from August 2006 helped to bring CPI inflation in the euro area down to just below 2% by the end of 2006. Wage increases remain contained at low levels, despite labour market tightening. However, euro area growth is projected to remain close to or above potential, and there is the possibility of upward pressure on factor prices. In the UK, buoyant demand and higher energy prices have pushed inflation to its highest level in five years. In recent months, both the European Central Bank and the Bank of England have raised interest rates to try to contain inflationary pressures.

At this point, it is too early to judge whether the present expansion in the UK and western Europe reflects an improvement in underlying economic growth or merely a cyclical upswing. Per capita GDP levels in the UK and western Europe have fallen increasingly behind those of the USA since 1995. The growth in labour productivity in Europe has continued to slow whilst productivity in the USA has accelerated. A major factor behind Europe's poor productivity performance compared to the USA relates to the slower take-up of new technologies, particularly rapid advances in information and communications technology. While progress has been made in improving labour utilisation, further reforms are needed to close the gap with the USA. Unemployment is lower and labour force participation rates are higher in the USA than in most European economies. An ageing population is also likely to inhibit growth. Supply-side policies, including reforms to the tax-benefit system that are designed to reduce the replacement ratio (the ratio between benefits received when out of work and the wage earned when in work), may help.

Question

(a) Using the two indicators shown in **Extract A,** compare the economic performance of the UK and the USA between 2002 and 2006. *(5 marks)*

(b) **Extract B** states that the Reserve Bank of India, the European Central Bank and the Bank of England have increased interest rates in response to inflationary pressures.

Analyse how higher interest rates can help to reduce inflation. *(10 marks)*

(c) **Extract B** (lines 22-23) states: 'Per capita GDP levels in the UK and western Europe have fallen increasingly behind those of the USA since 1995.'

Using the data and your economic knowledge, assess the policies that could be adopted to improve the underlying rate of economic growth of the UK economy. *(25 marks)*

Candidate A

The National and International Economy

a) The GDP at constant prices for both the UK and China have fluctuated over the period of ~~five~~ 5 years. The UKs' GDP was higher than that of the USA in ~~to~~ 202 and 2003 but the USA to over the UK in 2004 and stayed higher until 2006. The GDP in both countries rose continuosly from 2002 to 2004, then they both fell from 2004 to 2005; and then both rose again in 2005 to ~~2005 to 20~~ 2006.

The percentage of total labour force in unemployment was higher in the USA from 2002 - 2005, which suggests the UK was more productive based on this data. However in 2006 the UK took over USA, ~~which in 2005~~ to about 5.9 % and USA was at about 4.5 %. This suggests that the people in the USA were more productive as more people were in work.

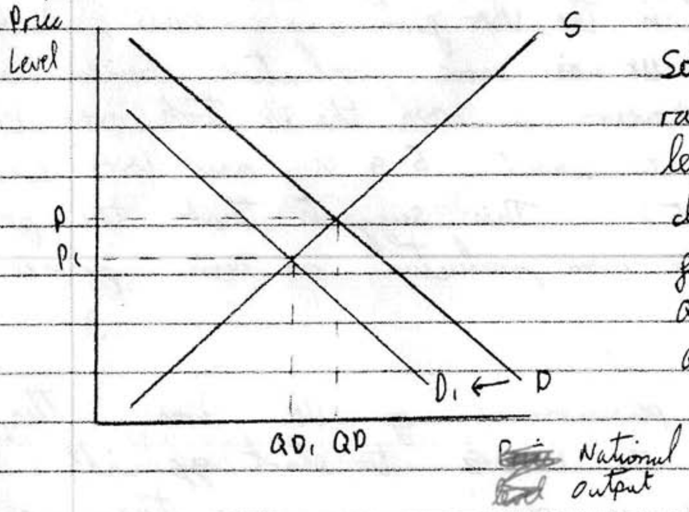
The economic performance of UK was better than that of the USA to start of with, however the USA in recent years has taken over in the amount of GDP at constant prices and has less unemployment.

b) The Reserve Bank of India, the European central Bank and the Bank of England have all increased their interest rates to help them clamp down inflation.

Because the interest rates are so high the spending in the economys is going to decrease.

The interest rate is the price you pay for money so for example if you get a loan of £1000 ~~$~~ and the interest rate is 10% you will have to pay back £1000 + the interest of £100.

Increasing interest rates will make the people in the economy less prosperous. Their spending will decrease and so demand for the goods in the economy will decrease.



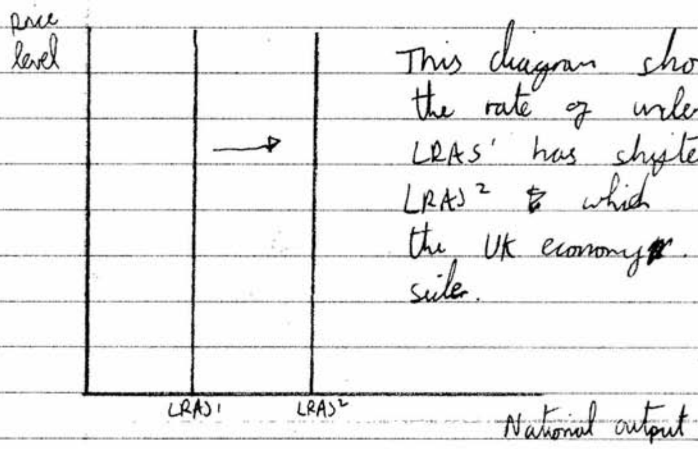
So as the interest rates increase the price level of goods will decrease ~~and the quantity~~ from P to P1 and the QD will decrease from QD to QD1

~~Inflation would mean that firms will would see an~~

If demand was high in the domestic economy firms would see an incentive to increase their prices to get a larger revenue, so with an increase in interest rates consumer demand will decrease and the economy ~~will~~ should deflate.

Although higher interest rates may attract investment from abroad, ~~so~~ this investment could mean an advance in technology which may lead to an increase in demand for some goods. This may then increase inflation.

(C).



This diagram shows an improvement in the rate of underlying growth. The LRAS' has shifted to the right to LRAS² which shows improvements in the UK economy. Especially in the supply side.

The underlying rate of economic growth is to do with supply side policies.

The UK could reduce the replacement ratio, so that it would be less beneficial for unemployed people to stay unemployed, this could ~~improve~~ increase the size of the UK labour force, and so increasing the efficiency of the UK economy.

The UK could provide people in the north with job opportunities ~~jobs~~ for those people that are geographically unemployed / the people that can't work because of the lack of labour in their area and because ~~of the~~ they would find it too expensive to live in the southern parts of the UK). They could do this by decreasing the house prices in the south of certain areas, they could build ~~types~~ more affordable types of housing, so that the people in the northern parts of the UK could then come to ~~are~~ areas where there is a lack of labour but a lot of jobs available.

If the UK can fill up ~~those~~ the areas where there is a lack of labour, they can of increase their per capita levels of GDP so they can ~~inc~~ increase their competitivity against foreign competition.

If the UK can increase its GDP it ~~can~~ may attract foreign investors to invest in new technology to which would make the UK more efficient and so increase their underlying rate of economic growth.

The UK may also want to invest in cheaper raw materials to reduce their unit prices, and so ~~increasing~~ decreasing prices of their goods.

Candidate A Commentary

Part (a)

4 marks were awarded for the first paragraph which compares the changes in the rate of growth of real GDP (despite the errors, e.g. China, 206). However, this was constrained to 3 marks. The comparison of the rates of unemployment in the second paragraph is worth 3 marks. 2 marks were given for the description and 1 mark for the use of figures to support the description. The comments about 'more productive' were ignored. 1 mark was awarded for the final paragraph, this provides an overall conclusion. A problem with this answer is that very limited use is made of the figures to support the comparisons made. However, since there was some use of figures, the constraint was not applied and full marks were awarded. **5 marks *(out of 5)***

Part (b)

2 marks were awarded for the discussion relating to the effect of interest rates on spending and the cost of borrowing. The discussion was not quite as clear as it could have been but the candidate was given the benefit of the doubt. 1 mark was awarded for the diagram. The curves should have been labelled AD and AS but at least the axes were correct. 1 mark was awarded for the penultimate paragraph that shows some understanding of the relationship between demand and inflation; the third paragraph in the mark scheme. **4 marks *(out of 10)***

Part (c)

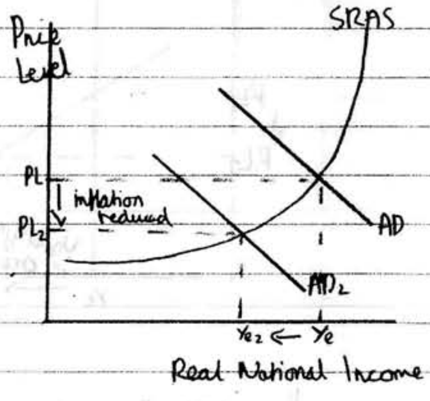
This answer conforms to the overall description that summarises a Level 2 response as 'A poor answer but some understanding is shown'. An appreciation of the concept of 'underlying economic growth' is demonstrated and the AD/AS diagram is worth credit. The comments relating to the replacement ratio and its impact on economic growth also show some understanding. Similarly, the discussion of labour mobility is also of some value although the link with underlying growth is not made clear. The policy of 'building more affordable housing' is reasonable in the context of this discussion. The answer was judged to be towards the top end of Level 2 because the answer contained some features of a Level 3 response. **10 marks *(out of 25)***

TOTAL MARKS = 19 *(out of 40)*

Candidate B

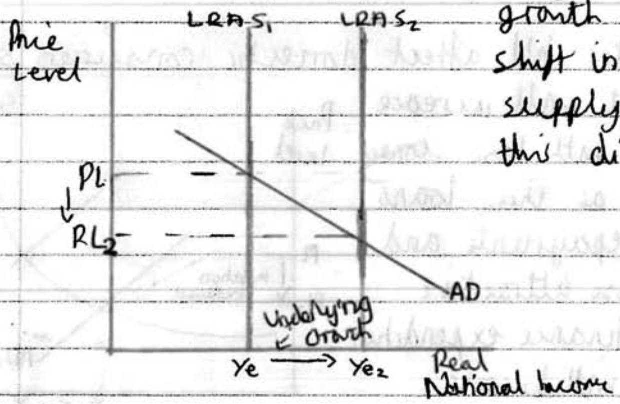
a) At the start of the period, ~~GDP~~ the % growth in real GDP of the UK was just over 2%, higher than that of the US. Following this both economies began to grow at a more rapid rate, the figure reaching 3·5% for the UK, whilst US growth overtook this to reach nearly 4%. A slowdown in 2005 affected the UK economy more severely than the US. Overall despite the rate of growth starting strongly in the UK, the US economy overtook this rate by 2006, fluctuating by about 2·5% compared to only 1% for the UK. In terms of unemployment, the UK economy also started more favourably, but by 2000, unemployment rate had risen in the UK, whilst the US rate steadily fell from 2003 to undercut that of the US. In this variable there was less fluctuation - only around a 1% range, with the US finishing at a low for the period at just over 4·5%. On the whole, the UK economy began at stronger than the US, but by 2006, its performance in terms of these 2 indicators was overtaken by that of the US.

b) Higher interest rates will affect domestic consumers since mortgage repayments will increase leaving homeowners with less money to spend. As well as this, loans will have higher repayments and so these will be less attractive to take out to finance expenditure. Meanwhile savings will become more lucrative since they will have higher returns, so this will increase the incentive to save. Overall this will discourage spending, leading to a fall in aggregate demand and so a relief in inflationary pressures acting on the economy. This will help to reduce inflation. As well as this, since sterling bank accounts will be more lucrative, the demand



for pounds to put in these will increase, raising the exchange rate. This will decrease the competitiveness of UK goods at home and abroad, meaning UK residents will sacrifice domestic consumption for imports that are cheaper in sterling. Meanwhile, demand for UK exports from abroad will fall as their foreign currency price will rise. This will further drop aggregate demand, reducing inflation as seen in the diagram.

c) The underlying rate of economic growth is the % increase in the productive potential of the economy year on year. This will be primarily ~~affected~~ determined by supply side performance and so supply side policies could be adopted to improve this. These policies are aimed at making markets work better and removing their imperfections. ~~Capacity~~ Underlying growth will ~~rise~~ occur through an increase in productivity leading to ~~greater~~ more efficient use of existing capacity, or by increasing capacity itself, perhaps through ~~into~~ reducing unemployment of firms investing. Underlying growth can be illustrated by a shift in the long run aggregate supply curve to the right in this diagram.



By creating a more business friendly environment, the number of firms attracted to the UK may rise, thus increasing the amount the economy could produce. Such policies to achieve this include increasing subsidies or offering grants to firms setting up in the UK. This will contributes to costs the businesses incur and so will enable them to lower prices to become more competitive whilst also maintaining profit margins. This will make firms more profitable, encouraging them to set up in the UK. However, subsidising production is expensive for the government, diverting funds from other initiatives. As well as this, it is possible firms would take the money, but if they had a domestic monopoly, may not be interested in lowering prices so this would not benefit consumers (it may still though be effective in increasing underlying growth). The government could also decrease corporation tax to encourage enterprise. This would lead to reduced tax revenue though ~~and~~ may lead to a budget deficit or require higher taxes elsewhere in the economy. On the other hand, this would allow firms to retain more profit, which could lead to more investment by firms, which would increase capacity. These measures leading to an opportunity cost for the government. However cutting red tape encourages enterprise with little cost, whilst de-regulating industries will also do this. However, firms with this freedom may abuse the lack of rules, which could be disadvantageous for the environment or consumers. Alternatively, there could be privatisation of nationalised industries. Since then making a profit becomes an objective, cost-cutting measures and greater productivity will be introduced meaning more may be produced with the same resources. However, sometimes ~~with merit goods~~ nationalised industries are those that benefit consumers and society, such as the railways, and once privatised, cost cutting measures may reduce consumer satisfaction, eg. Network Rail took cost cutting too far.

As stated in line 31, the government could decrease the replacement ratio, increasing the incentives to work. By decreasing benefits and lowering income tax, ~~tax~~ ~~rev~~ the budget balance may not be run down, whilst this also decreases the negative externalities, such as crime and depression, associated with unemployment. By decreasing unemployment, more people would be working so capacity would increase. Increasing labour participation rates in women would also increase underlying growth, perhaps by ~~subsidising second~~ offering tax relief for second earners in a home.

The government could also invest in human capital to increase productivity. Spending more in schools and universities, and on apprenticeships and re-training schemes could lead to a more highly skilled workforce who could produce more in the same time of other worker. However this would mean an opportunity cost, with perhaps less tax money spent on healthcare. Another policy aimed at the labour market would be to increase mobility of labour, both occupational and geographical, so those unemployed could find work easier and so capacity would rise. Examples include housing market reforms so people from the north could relocate to the dearer south to work. Better communication links could also lead to this, although this may mean lots of investment. More retraining schemes and advertising of jobs could ~~at~~ allow transfer of jobs to be easier.

Since investing in new technology and capital would increase efficiency and thus capacity, the government could try to encourage this. Lowering interest rates would mean loans that firms take out to finance investment would have cheaper repayments, increasing the attractiveness of this. However 66% of investment is financed by retained profit in the UK, whilst since the MPC use interest rates to influence aggregate demand it is unlikely this would happen.

Overall, there are many policies that could be adopted to improve underlying growth. Governments may prefer to be more interventionist by offering subsidies, or act less directly and allow markets to improve themselves. Many policies would ~~lead~~ need ~~public tax revenue~~ tax money to be sacrificed, either through lowering tax revenue or raising consumption, so other initiatives and projects would lose out from this - they would be the opportunity cost. Although supply side performance is the overriding factor in leading to underlying growth, satisfactory demand side performance would also be necessary for firms to want to invest (if policies were intended ~~to~~ for this) for this to be worthwhile.

Candidate B Commentary

Part (a)

The candidate's response is worth full marks even though it adopts a slightly different approach to that which is outlined in the mark scheme. The question requires the candidate to *compare* the performance of the two economies and in this answer a comparison is made using both sets of data. Although the comments made by the candidate follow the years from 2002 to 2006 in order, this is NOT a 'blow by blow' account. The candidate appreciates that it is not necessary to comment on every year and the patterns in the data are recognised. An overview has been taken with significant features highlighted. It is clearly recognised that the rate of growth in the UK is initially higher than in the US but that this changes in 2004. It is also clearly stated that growth in the US fluctuates by more than in the UK and figures are quoted to support this assertion (the slight inaccuracy is not important given that it is hard to derive exact figures from the bar chart). The candidate achieves the constrained maximum of 3 marks for the comparison of the annual percentage change in real GDP. The description of the unemployment rates also provides an accurate comparison of both sets of data and gives an overview. It was recognised that unemployment was initially lower in the UK but that, by 2006, unemployment had risen. On the other hand, unemployment had fallen in the US and by 2006 it was lower than in the UK (given benefit of the doubt for the typo). Again, it would have been possible to award the constrained maximum of 3 marks for this part of the answer. It would also have been possible to give a mark for the last statement which provides an overall comparison of the performance of the two economies. **5 marks *(out of 5)***

Part (b)

The candidate was awarded the maximum of 4 marks for explaining how interest rates affect aggregate demand. The diagram was awarded 2 marks. The analysis of the link between interest rates, the exchange rate and inflation was awarded 4 marks. This part of the answer was awarded 4 marks, rather than 5 marks, because the link between the exchange rate, import prices and cost push inflationary pressures was not explored. Despite gaining full marks, there were missed opportunities. For example: there was no attempt to define inflation; the relationship between aggregate demand and inflation could have been explored in more depth. **10 marks *(out of 10)***

Part (c)

The candidate's answer to this part of the question was assessed at Level 5 using the A2 Levels Mark Scheme. It certainly conforms to the overall description of a Level 5 answer: 'Good analysis and evaluation'. The candidate identifies at least 8 distinct policies, more than the minimum of 3 that are required if Level 4 or above is to be awarded. There is also some explicit reference to the data; for example, in the third paragraph which starts "As stated in line 31", the effect of reducing the replacement ratio is discussed. However, more frequent references to the data would have improved the answer. The answer has a clear, logical structure with a sensible introduction and a conclusion. The conclusion includes an overall assessment providing a general perspective that is not just a repetition of previous points. Descriptions and explanations are expressed well, and specialist vocabulary is used competently. Good understanding of economic concepts and principles is shown throughout and the analysis is sound. Evaluative comments are present in abundance; the pros and cons of the individual policy options are considered and, as mentioned above, there is a sensible conclusion. It was decided that this response to the question should be awarded full marks. It is obviously possible to take issue with some of the points raised but examiners do not reserve full marks for a perfect answer. This answer satisfies the assessment criteria in full and hence deserves full marks. Candidates have just over 35 minutes to respond to this part of the question and the time available is an important consideration when assessing the quality of a candidate's work.

25 marks *(out of 25)*

TOTAL MARKS = 40 *(out of 40)*

Candidate C

a) Extract A shows measurements of two economic indicators for the USA, and the Uk since 2002. It shows, 'GDP at constant prices,' and the annual percentage change in real GDP. This will give an indication to the amount of output over this period. The other graph shows the unemployment rate, which is the percentage of total labour force without a job.

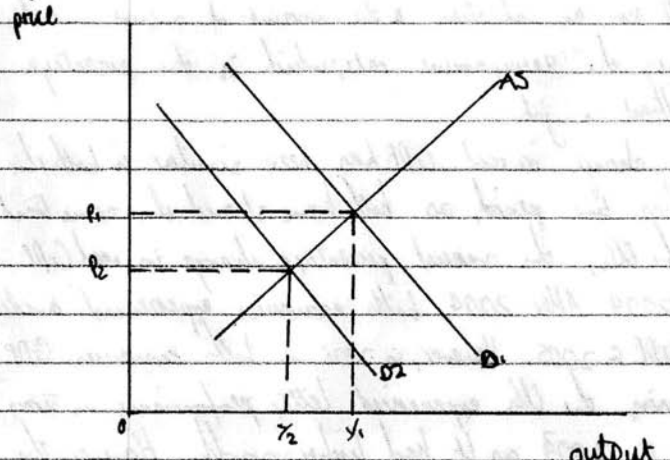
The annual percentage change in real GDP has been similar in both the Uk and the USA in this time period, as both have shared the same trend. In both the USA and the Uk, the annual percentage change in real GDP increased from 2002 to 2004. After 2004, both economies experienced a reduction in the growth of GDP in 2005. However, in 2006, in both economies GDP increased again. In comparison, the Uk experienced better performance in terms of growth from 2002 to 2003 as it had higher growth. However, the USA economy experienced more success from 2004 to 2006 as it bypassed the growth of GDP in the Uk. The USA had the highest growth during this period in a single year in 2004 when GDP increased by 4%.

Overall, the growth rates from both economies was relatively stable during this period.

The unemployment rate during this period in both economies was relatively stable, and it generally decreased, suggesting positive economic performance in both economies. Overall the USA saw a decrease in their unemployment rate from around 6% in 2002 to about 5% in 2006. The Uk also experienced a ~~downturn~~ decrease in the unemployment rate from 5% in 2002 to almost 4.5% in 2005. However, the rate increased in 2006 to its initial rate of 5%. Therefore, in terms of reducing the unemployment rate, the USA's performance can be seen as better as the Uk as it saw a reduction in the rate.

b) Inflation is the annual change in the price of goods and services. Interest rates are set by Banks, in the case of the Uk, the Bank of England, which determine the amount of money that lenders have to pay on borrowed money, mortgages for example.

Interest rates can be used effectively to reduce inflation as the Banks in 'extract B' have stated. Higher interest rates will cause ~~demand~~ aggregate demand in an economy to fall. The graph ~~be~~ below shows this.



The graph shows the effect an increase in interests rates may have on an economy. ~~Interest rates will cause~~ An increase in interest rates will make borrowing more expensive so more people will choose not to purchase expensive items, so they do not have to pay high interest rates. Instead people will be more likely to save their money in banks so they get a higher return. Investors especially will opt to save rather than spend, reducing inflationary pressures.

c) There are many policies which could be used or adopted to improve the underlying rate of economic growth of the UK economy.*

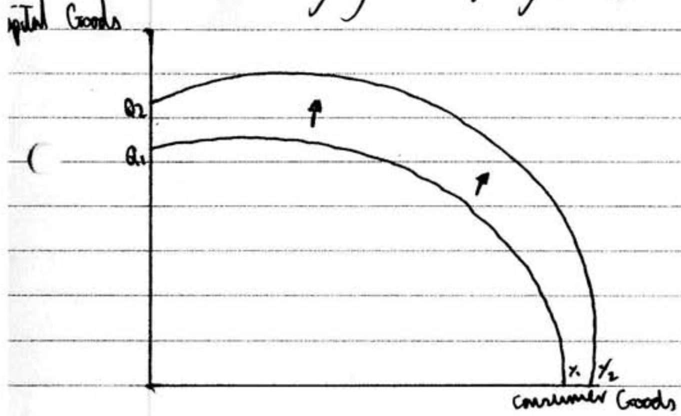
One key problem with ~~the poor underlying~~ which contributes to the poor rate of economic growth is the low labour participation rate. Policies to encourage more people into the labour force could help increase the economic growth of the UK. This could be achieved by reducing income tax, reducing out of work benefits, or increasing the minimum wage in some cases. This will increase the stock of labour and factors of production, and ultimately increase the underlying rate of economic growth.

* The underlying rate of economic growth is the change in the amount an economy is capable of producing. It is usually measured by calculating an average growth of actual growth over a long period of time.

Advancements in technology can help to increase the underlying rate of economic growth as it can help production become more efficient so that a machine can achieve what five labourers or workers can, for example. The government could therefore

AQA

adopt policies to encourage businesses to invest in research and development in new technologies, and in new methods of production. In this way the economy would be able to produce more and the underlying rate of growth would increase. The government could encourage this investment by offering businesses with grants and subsidies. The production possibility frontier shows the potential increase in the underlying rate of growth.



As you can see, the increase in new technologies and production methods has led to the economy being able to produce more than it could prior to the investment.

The government could also use similar policies to encourage businesses to invest in machines, factories, and raw materials which will also increase the capacity of the economy and will increase the underlying rate of growth.

Through further enhancements in education, or through altering the system, the people could become more skilled in a wider range of areas. Therefore, the workers may be more efficient and innovative, and will be able to help to improve overall productivity and increase output and growth. Through policies such as re-training schemes, people could gain these skills which would reduce the ~~geographical~~ occupational immobility of labour and increase growth.

To reduce the geographical immobility of labour and increase the underlying rate of growth the government could provide re-housing schemes and subsidies.

In conclusion, there are many policies a government may adopt to increase the underlying rate of growth. One of the most important ones may be to suggest a reduction in interest rates, which could be likely to boost investment and the underlying rate of growth. However, this method alone would have other negative impacts such as inflation, so policies to encourage research and development and training schemes would also be required to ensure sustainable underlying growth in the U.K. economy.

Candidate C Commentary

Part (a)

Given that there are only 5 marks available for part (a), this candidate has probably devoted too much time to this part of the question. For example, the introductory paragraph was unnecessary. The paragraph comparing the rate of growth of real GDP is worth 4 marks. It covers two of the points in the mark scheme. The section that compares rates of unemployment is fairly accurate and makes use of figures to support the comparison. It was judged that this part of the answer was worth 3 marks. Hence, overall, full marks were awarded. **5 marks *(out of 5)***

Part (b)

The definition of inflation was awarded 1 mark. 'Percentage' wasn't mentioned and it wasn't explicitly stated that inflation relates to **all** goods and services. 4 marks were awarded for stating that inflation would reduce aggregate demand and explaining why; the effects on borrowing and saving were analysed. No marks were awarded for the diagram because there were too many errors. With the exception of labelling the supply curve as AS, this was a micro demand and supply diagram. Also, there wasn't any attempt to explain why a reduction in aggregate demand is likely to reduce inflationary pressures. **5 marks *(out of 10)***

Part (c)

This is a Level 3 answer that demonstrates some of the qualities needed to achieve Level 4. The limited evidence of evaluation means that it is not possible to award more than 16 marks. The candidate demonstrates a good grasp of the concept of underlying economic growth and identifies a number of factors that are likely to affect underlying growth. The way in which these factors influence growth is explained and the analysis is generally sound. More than 3 policy measures (required for Level 4) are explained but there isn't any attempt to evaluate the individual measures. The final paragraph includes a brief evaluative comment regarding the policy of reducing interest rates to boost investment. This makes it possible to go to the top of Level 3. Overall, this answer demonstrates a firm grasp of relevant economic concepts and principles and includes examples of good analysis. However, the evaluation is 'very limited' and hence it is constrained to Level 3.

16 marks *(out of 25)*

TOTAL MARKS = 26 *(out of 40)*

Unit 4 (ECON4)

The National and International Economy

(A2, Essay)

Question

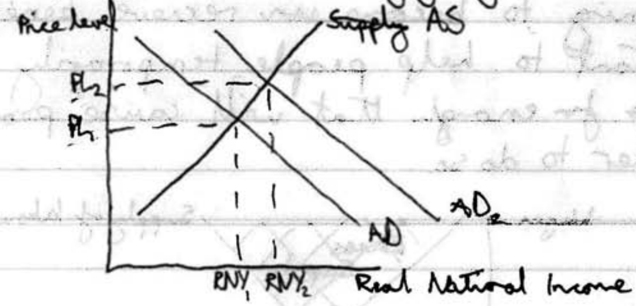
(a) Explain the economic reasons for public expenditure **and** the reasons for taxation other than to finance public expenditure. *(15 marks)*

(b) Within the last ten years or so, the UK budget balance has moved from surplus to deficit. In 1998-9, a surplus of £6.5 billion was recorded, but in 2005, the deficit was £41 billion.

Discuss the possible economic consequences of such a change in an economy's budget balance. *(25 marks)*

Candidate A

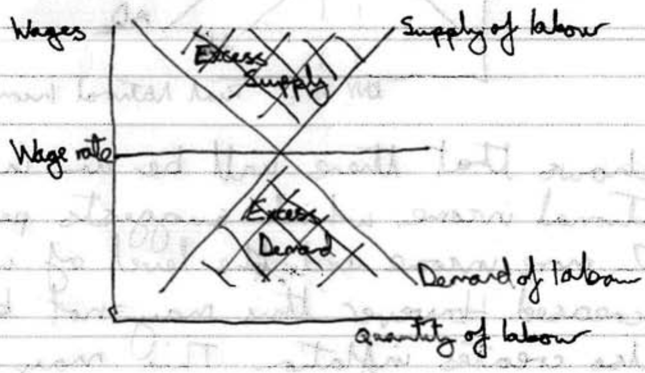
a) Public expenditure is the level of money within the economy that has been spent on goods and services by the public. The reasons why public expenditure is important is because it finances the firms within the economy and therefore creates reasons to work. Taxation is where the government charge people income tax and VAT on goods and services. Other reason why they do this other than to finance public expenditure include raising money for cash injections. In the near future the economy may develop some problems in which only a cash injection can improve the economy. This government spending can create new jobs and therefore boost aggregate demand.



This shows that there will be an increase in real national income, which suggests people are better off with more income and the level of unemployment has decreased. However this may not be the case as this also creates inflation. This may mean people are in fact not better off and the rise in real nationa income may be met by an equal or greater rise in inflation that will actually cause less spending in the economy.
Taxation may also be another way of creating federal exchange reserves. These reserves are so that the economy can inject pounds onto the market if the pound is too high. If the pound is too high this

reduces our level of exports which may create a balance of payments deficit. Therefore by lowering the pound they will benefit again on trade. However this will also result in imports becoming more expensive to purchase.

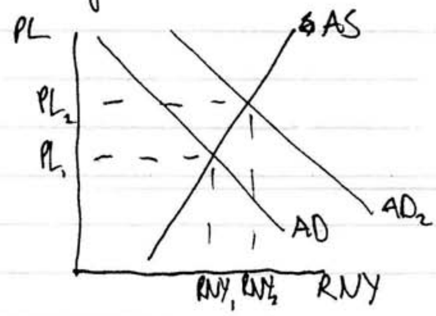
6) Taxes also fund welfare benefits and without the funds raised by taxes, this would not be possible. Those who have been made unemployed will need to temporarily be looked after until they can find work again. However there are problems with welfare benefits. If it is more benefitial to recieve welfare benefits rather than to work, then there will be more and more people resigning to ~~become un~~ recieve benefits. Therefore it is important to help people temporarily unemployed but not ~~to~~ to enough that will cause people to stop working in order to do so.



If the welfare benefit rate is above the ~~tax~~ wage rate people will decide to live on benefits rather than work.

b) The budget balance is the records of all money the government spends or injects into the economy ~~wherea~~ and all the money that the government recieves from the economy through fiscal policy such as taxes.

If the economy has moved from a surplus in 1998 to a deficit in 2005 then this suggests that taxation has fallen and there has been more government expenditure. This ~~oo~~ will have caused a mass increase in ~~go~~ aggregate demand; ~~this~~ due to people being taxed less meaning they still have alot of their income and government spending creates jobs. This aggregate demand would create more consumer consumption and also confidence. ~~If there is an~~



The ~~con~~ increase in consumption is represented by (RNY_2-RN because an increase in income is the same as a increase in output and spending. This will increase consumer confidence. However there will also be an increase in inflation in which case this may not be sustainable

An increase in government spending and a reduction in taxes will create more jobs. This means the economy will have a lower unemployment rate. With more of the population in work this will create greater competition with overseas markets. By creating this competition will mean ~~to~~ we can attract new business and more money coming into the country through exports. However by working internationally and increasing competition we will need expensive capital goods. These goods could cause a large balance of payments deficit or a much smaller surplus depending on the balance of payments situation.

This change from a surplus on the economies budget balance in 1998 to a deficit in 2005 will cause the economy to increase the economies welfare by bringing new businesses and spending to the economy however if we want this, we will have to deal with higher inflation and possible trouble in the ~~bab~~ current account.

Candidate A Commentary

Part (a)

Paragraph 1: The definition of public expenditure is wrong and no marks were awarded. 1 mark was awarded for the attempted definition of taxation – the candidate does little more than just identify two types of tax. 1 mark was awarded to the candidate for identifying 'influencing AD' as a reason for government spending. The associated diagram was awarded 2 marks and a further 1 mark was given for the linked explanation.

Paragraph 2: The content of this paragraph was confused and no marks were awarded.

Paragraph 3: 2 marks were awarded for the discussion relating to welfare benefits and the implicit idea that public expenditure is used to 'redistribute income'. No credit was given for the diagram.

Note that despite the candidate's attempt to do so, the part (a) mark schemes will not allow any marks for evaluation. **7 marks *(out of 15)***

Part (b)

The candidate shows some appreciation of what is meant by the budget balance but the explanation is not particularly clear. The analysis of the way in which a growing budget deficit may increase output and employment is reasonable. The recognition that the growing deficit may also add to inflationary pressures shows some 'weak' evaluation. The discussion in the third paragraph, relating to greater competition in overseas markets, is poor and not worth credit. The conclusion adds little to the previous discussion. This was judged to be a 'level 2' response. It generally fits the description of a 'poor answer but some understanding is shown'. **10 marks *(out of 25)***

TOTAL MARKS = 17 *(out of 40)*

Candidate B

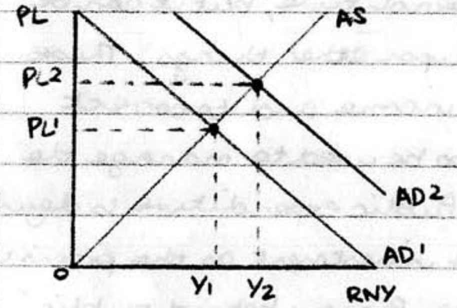
21/1/08

a Explain the economic reasons for expenditure and the reasons for taxation other than to finance public expenditure.

Taxation is defined as being government receipts on persons' and businesses' income, spending, wealth and capital gains, and on properties. It is used primarily in order to fund public expenditure, but it can be levied to have an impact upon other things. These include the distribution of income and to correct market failures, it can also be used to manage the economy in times of need. Public expenditure is defined as government spending and investment on the provision of social goods and services. Reasons behind public expenditure include the provision of public and merit goods and to reduce the amount of negative externalities in the economy.

Public expenditure is undertaken by the central government to provide public and merit goods to the consumer population. Public goods include defence, law and order, street lighting and roads. These goods are non-excludable and non-rival, thus helping society and increasing their living standards. Public goods are also provided by the public sector because they are unlikely to be provided by the private sector. Merit goods such as education and health care are also provided by the public sector. This is because they are positive externalities and it would not acceptable if low income workers could not afford these products and services.

Public expenditure can also reduce the amount of negative externalities existing in the economy. Money can be invested in order to reduce the negative effects of pollution by the introduction of policies, controls and regulations enforcing stricter conditions upon the most polluting industries and firms. Public expenditure can also be used to control the economy and improve efficiency. The govt can spend more money in a recession to increase demand levels (as shown below in the movement of AD' to AD2).



This can help the economy out of a possible recession and may start a recovery led by demand. The expenditure could also be invested in research and development for the economy, thus increasing its productivity level and its net output.

The expenditure by the government can be used to improve the distribution of income. This can be achieved through the benefits system and pensions. Taxation can also be used to improve the distribution of income. Progressive taxation schemes can charge more to people on higher incomes and less to lower income earners, therefore improving to an extent the distribution of income.

Taxation levels can be altered by the government to affect the Balance of Payments. Taxes on imports will discourage consumers and reduce a possible deficit on the current account. It can also be used to correct market failure; they can increase taxes on de-merit goods such as cigarettes and alcohol and on negative externalities such as fuel.

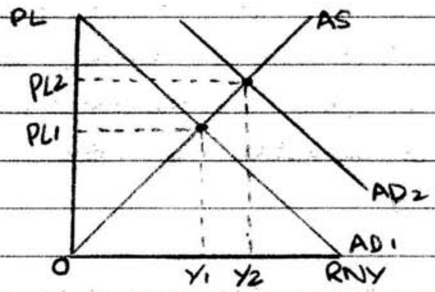
Most importantly taxation can be used to manage the national economy. When demand levels are low, tax levels can be reduced to encourage more consumption and the taxes can be increased if inflationary pressures are too high due to extensive amounts of aggregate demand.

In conclusion, public expenditure is used by the government in order to provide public and merit goods, which otherwise would be under provided by the private sector. They are also used for the reduction of negative externalities and the managing of aggregate demand levels. Taxation is used for (other than to finance expenditure) improving the distribution of income, help the Balance of Payments, reduce spending on de-merit goods and also to manage aggregate demand levels in the national economy.

b. Within the last ten years or so, the UK budget balance has moved from surplus to deficit. In 1998-9, a surplus of £6.5 billion was recorded, but in 2005, the deficit was £41 billion. Discuss the possible economic consequences of such a change in an economy's budget balance.

A budget balance deficit occurs when more money is being spent by the government, than being received in revenue from taxation. Under the circumstances I would expect high levels of demand in the economy, due to more money seemingly being spent on boosting aggregate demand. The positive effects of the deficit would be that more people are employed and the economy would be growing. However, there are negative consequences of having a deficit; inflation may increase and economic growth may decline if the deficit remains.

In terms of aggregate demand, I would expect there to be high levels during a budget deficit. This is because government expenditure is part of the formula that generates Aggregate Demand (C+I+G+X-M = AD). Also government expenditure spreads confidence around the economy, thus raising consumption and AD. This increase in aggregate demand can increase the rate of economic growth. As more money is being injected into the circular flow of income economic growth is likely to occur. We can see this in the increase in income from Y1 to Y2 after the increase in Aggregate Demand from AD1 to AD2:



With the growth in aggregate demand associated with a budget deficit, unemployment is likely to fall. This is because as firms receive the extra demand and income they will want to expand and in doing so will encompass many more new workers, thus increasing employment levels. In the long run this would help correct the deficit as more workers equals more revenue from income taxation. There would be less spent on benefits for the unemployed and they would receive tax from the successfully operating businesses.

The budget balance deficit will also bring negatives. With the new high level of demand in the economy inflationary pressures will rises. Eventually the govt will have to intervene with a contractionary policy such as higher interest rates and higher levels of taxation. This will counter act any progress from the economic growth and may push the economy into an abrupt recession. The effects will be very negative with increasing unemployment and low economic confidence.

In conclusion, the possible economic consequences of a change towards a deficit in an economy's budget balance are likely to be both positive and negative. The positive consequences include a rise in AD leading to lower unemployment and economic growth. However, the negative consequences are that the deficit may result in inflation and undo the positive effects of the economic growth and result in a rise in unemployment thanks to contractionary policies being adopted by the govt.

Candidate B Commentary

Part (a)

Paragraph 1: The definition of taxation was awarded 2 marks. 1 mark was awarded for public expenditure because the candidate is only really defining through example.

Paragraph 2: 4 marks were awarded for the discussion linked to the provision of public goods. This is broken down as follows:

- recognising that the provision of public goods is a reason for public expenditure (1 mark)
- providing accurate examples of public goods (1 mark)
- recognising that public goods are non-excludable and non-rival (1 mark)
- stating that they are unlikely to be provided by the private sector (1 mark)

4 marks were also awarded for the discussion relating to merit goods.

Paragraph 3: 2 marks were awarded for the use of public expenditure to reduce negative externalities. 3 marks were awarded for the diagram and the discussion relating to aggregate demand. 1 mark was awarded for the final sentence where the candidate gives an example of using public expenditure to provide 'support for business'.

Paragraph 4: 3 marks were awarded for the explanation of the way in which taxation and public expenditure can be used to influence the distribution of income.

Paragraph 5: 2 marks were awarded for the use of taxation to discourage imports and improve the balance of payments. 2 marks were given for de-merit goods and externalities

Paragraph 6: An additional mark was awarded for discussing the way in which taxation can affect aggregate demand. This adds to the 3 marks that were awarded in paragraph 2.

In effect, the final paragraph just repeats points that have been mentioned earlier and hence no additional marks were awarded. In most cases, it is unlikely that a conclusion will gain additional marks when answering part (a) of the essay questions. This is in contrast to part (b), where a reasonable conclusion will help to show the candidate's ability to synthesise arguments and make judgements. (The total was constrained to the maximum of 15 marks.) **15 marks *(out of 15)***

Part (b)

The candidate understood what is meant by a budget deficit and recognised that this is likely to boost aggregate demand. The beneficial, short-run effects of high levels of demand on economic activity were explained and the possible adverse consequences for inflation and growth were mentioned. It was also understood that increasing economic activity will, over time, automatically reduce the size of a budget deficit. There was a conclusion which summarised the previous discussion but it didn't add anything new. The scope of the answer was fairly narrow but the candidate showed good understanding of some economic concepts. There were examples of reasonable analysis and a limited attempt to evaluate. The answer had a logical structure and explanations were easy to follow. This was judged to be a 'level 3' response. It was 'an adequate answer with some correct analysis but very limited evaluation'. **14 marks *(out of 25)***

TOTAL MARKS = 29 *(out of 40)*

Candidate C

a) Public Expenditure refers to government spending out of it's annual budget, this can take many forms such as financing health care, education ~~etc~~ along with welfare benefits and is part of fiscal policy along with taxation.

The main use of public expenditure is thought to be to increase levels of Aggregate demand (AD). Public expenditure may contribute to this in a number of different ways. ~~from~~ firstly government investments in capital such as Hospitals for healthcare will provide jobs in both the manufacturing sector and the jobs for those in the hospitals and thus the multiplier effect may well occur. As a result, in theory, people should become more better off and thus be able to spend more on goods & services provided by the economy, causing levels of aggregate demand to increase, as a result, levels of unemployment may fall also.

Government Spending part (G) of the equation

Another way of affecting the levels of AD, indirectly, would be through a change in the distribution of income and more importantly the welfare benefits provided to those who are unemployed or have children or handicapped. The expenditure from the government here may well allow certain people to be better off and allow them to consume. ~~###~~ Therefore allowing the levels of AD to be boosted, in comparison to if ~~they~~ the govt. were ~~not~~ not supplying welfare benefits.

Yet unemployment may be tackled through supply side reasons - as government spending on training schemes or job seeker services may allow those out of work to find employment and therefore reduce levels of unemployment whilst boosting the level of potential output of the economy (this is also true for government spending on existing employees for additional training to increase efficiency. Growth (underlying) may be a reason due to the fact government expenditure in giving subsidies to certain companies may provide the incentive to increase output potential through buying new capital machinery etc – yet this may only be attractive if levels of AD are high (which govt. spending is also designed to do.)

Taxation can be indirect (passed on, i.e. VAT) or direct (income, corporation etc) and is usually a way of producing revenue for the government. However there may also be other ~~method~~ reasons for taxation not solely linked to ~~the~~ financing government expenditure.

Taxes may be imposed to influence the distribution of income within a society, a progressive income tax is an example of this. This may help to reduce the spread of income within the economy by taxing higher incomes more and those on lower incomes less bringing together the 2 earners closer than to what it may have been. As a result those on lower incomes may be able to spend more (in comparison to if they were taxed the same, high rate of those on higher incomes) due to increased disposable income and thus the levels of AD may well increase.

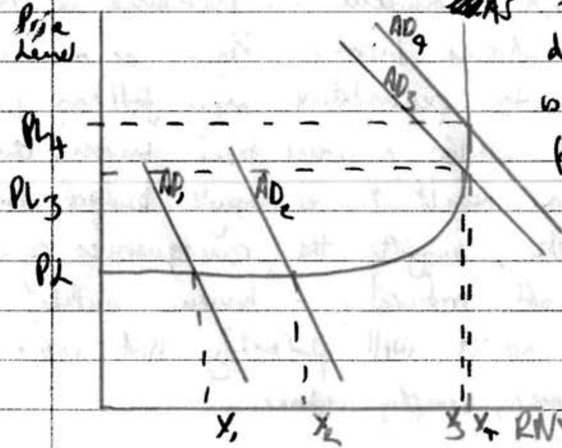
Taxation may also be used to discourage people from buying de-merit goods and make them aware of the negative externalities – bringing these in to the final cost. As a de-merit good may be harmful to the individual or society (i.e. cigarettes) increased taxation on such goods may provide the economic incentive not to consume, although it must be noted that the economic dis-incentive may often not be enough (i.e. due to cigarettes addictive chemicals of Nicotine).

Another possible reason for taxation may be to discourage exports by placing higher duties on imported goods - providing the incentive to buy domestically and feed the domestic economy.

To conclude Public expenditure is generally linked with boosting levels of Aggregate Demand but also has Supply side and Social reasons (i.e. government increasing opinion of itself or providing for society). Taxation may well be used to fund this but also can be used as a dis-incentive from some goods or to attempt to make the distribution of income more equal. Finally taxation may be used to control AD and reduce inflationary pressure - e.g. higher income tax reduces disposable income and therefore probably the levels of AD.

b) ~~Such~~ A budget Surplus is where a government receives more in taxation money and the sources of revenue than it spends ~~of~~ on government expenditure whilst the reverse is true for a deficit.

Such an increase in the size of a deficit suggests ~~that~~ government spending has increased or taxation decrease or a mixture of the two. As both govt. spending and taxation affects the levels of Aggregate demand (AD) it may be wise to assess the possible ~~economic~~ effects ~~that~~ the deficit or reduction in taxation will have upon AD. An increase in govt spending usually will create a boost in AD due to increased jobs or increased Money spent on welfare benefits. As a result the levels of Aggregate demand may well increase. The effects that ~~EEAS~~ the increase in AD may have depends on how the economy is operating. If working at and full capacity at Y_1 the increase in $AD_1 \Rightarrow AD_2$ will cause a large increase in the levels of National Income also ~~and~~ suggesting a decrease in unemployment along with further increases in AD through the multiplier



However if the Economy is working towards full capacity the increase in $AD_3 \Rightarrow AD_4$ may only have a slight increase in National income $Y_3 \Rightarrow Y_4$ accompanied with a large rise in the price level $PL_3 \Rightarrow PL_4$ suggesting substantial levels of inflation.

However this is where the government spending ~~though~~ in order to boost the supply side may have an effect. If government subsidies to corporations or training scheme

~~as~~ they will provide the incentive to increase the size / efficiency of the working population and size of capital for companies an increase in the underlying rate of growth may appear, boosting levels of supply and helping to nullify the levels of inflation. However government spending usually involves welfare benefits, if the ~~spe~~ expenditure on the ~~of~~ unemployment benefit is high (causing replacement ratio to be high) this may prove an incentive for people not to work, reducing levels of working population and underlying rate of growth - as a result it may be wise to shift ~~expendit~~ the pattern of government expenditure away from ~~welfare~~ bonus unemployment benefits.

However this shift may occur naturally as the economy self adjusts. A deficit indicates an increase in AD and a 'boom' period where incomes rise, as a result the levels of governments expenditure may fall as less benefits are required whilst revenue from income taxes may well rise. As a result the economy's budget balance may begin to re-alter, suggesting the consequences can be dealt with almost naturally - however unlikely this is in practice as it will probably not cause the deficit to disappear, simply reduce.

Large government expenditure may also cause a crowding out effect ~~of~~ in the private sector. As ~~of~~ the govt increases interest rates on gilts to pay for finance its spending, interest rates may well increase in the private sector ~~so~~ creating less incentive for consumers to spend, what may happen is the erosion of the private sector being replaced by the public sector. Yet keynesians argue against this that public expenditure 'primes the pumps' for private sector as it produces income for the economy and raises levels of national income which may be used in the private sector.

To conclude ~~the~~ a large budget deficit may well cause AD to rise and increase levels of employment. However a sustained deficit may well cause the crowding out of the private sector along with increases in the national debt, causing interest rates to be ~~too~~ raised to finance this. As a result, the positive effect government spending and a reduction in taxation may have may be eroded by higher interest rates which dampen down demand. However unlikely the view that the economy self adjusts is, it may have some use - yet government interference may allow the natural correction to ~~move~~ have a greater effect. a budget deficit should be carefully managed and not over-lengthened.

Candidate C Commentary

Part (a)

Paragraph 1: The definitions of public expenditure was awarded 2 marks and 1 mark was given for the indirect reference to fiscal policy

Paragraph 2: 1 mark was awarded for recognising that public expenditure can be used to influence aggregate demand. A further 3 marks were given for development, including the multiplier effect.

Paragraph 3: 2 marks were awarded here for identifying a reason and then mentioning welfare spending with examples.

Paragraph 4: This paragraph covered a range of relevant issues that could be categorised as ‘support for business’ e.g. training, job seeking services, subsidies for investment. 4 marks were awarded.

Paragraph 5: 1 additional mark was given for defining taxes. It was worth 2 marks but the constraint of 4 marks, in total, for definitions was applied.

Paragraph 6: 3 marks were given for the discussion of the way in which taxation is used to influence the distribution of income even though the definition of a progressive tax was not accurate.

Paragraph 7: 3 marks were given for the discussion of the way in which taxation can be used to discourage the consumption of de-merit goods.

Paragraph 8: 1 mark was awarded despite the lack of clarity regarding exports and imports.

21 marks could have been awarded for this candidate’s answer to part (a) but the total was constrained to the maximum of 15 marks. **15 marks *(out of 15)***

Part (b)

The candidate provides an accurate definition of a budget surplus and explains concisely why the budget balance may move from a surplus into a deficit. There is good analysis of the possible impact of a growing deficit upon national income, employment and the price level. This is supported by a suitable diagram. The candidate also recognises that the impact of a growing deficit is most likely to be favourable if the economy is operating below capacity. Sound analysis supports the judgement. Paragraph 3 recognises that the impact of higher government expenditure depends on the type expenditure. Whilst it is possible to debate some of the detail in the answer, in general, the analysis is sound and the discussion is evaluative. Paragraph 4 recognises that if the budget deficit results in a rise in economic activity, in the long run, the budget deficit may be self-correcting. The use of words such as: ‘however’, ‘may’ and ‘probably’ indicate that an attempt has been made to evaluate alternative scenarios. Paragraph 5 introduces two other relevant issues i.e. the ‘crowding-out effect’ and ‘pump-priming’. Again, the analysis is sound, different possible outcomes are considered and the general thrust of the discussion is evaluative. The final paragraph brings together the various arguments that have been explored but it doesn’t add a great deal. Overall, the answer is well-organised and the arguments are presented clearly. Good understanding of economic concepts is demonstrated throughout. Alternative outcomes are explored and supported by sound analysis. Some ability to synthesise arguments and present a conclusion is demonstrated. This answer was judged to just get into ‘level 5’. It included ‘good analysis and evaluation’. **22 marks *(out of 25)***

TOTAL MARKS = 37 *(out of 40)*