2.26 The National Debt: Fiscal Sustainability and Fiscal Rules: Test Pack

Total Marks

AQA 7136 · Calculators not allowed · about 25 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 4 marks or more. No calculator is allowed. The final question is worth 25 marks; plan your time accordingly.

1 UK public debt context: multiple choice on debt terminology. Which term best describes the annual difference between government revenue and government spending excluding interest payments in the UK context?

- ☐ A current account deficit
- ☐ B primary deficit
- ☐ C structural debt
- ☐ D fiscal multiplier

(Total for Question 1 is 1 mark)

2 Explain two potential weaknesses of relying on a single numeric fiscal rule, such as a strict debt-to-GDP ceiling, as the primary tool for ensuring fiscal sustainability for Albion.

(Total for Question 2 is 4 marks)

3 Interpretation of debt-to-GDP ratio for a fictional country, Albion. Albion's public sector net debt at the end of the year is £700 billion. Nominal GDP for the same year is £2,000 billion. Calculate Albion's debt-to-GDP ratio and state the ratio as a percentage to one decimal place.

(Total for Question 3 is 4 marks)

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4 Explain how market confidence and the role of credit rating agencies can influence gilt yields and thereby affect the sustainability of public finances for a country such as Albion.

(Total for Question 4 is 4 marks)

5 Explain why it is important to distinguish between the structural deficit and the cyclically adjusted deficit when setting fiscal rules aimed at debt sustainability for Albion.

(Total for Question 5 is 4 marks)

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Mark scheme · 2.26 The National Debt: Fiscal Sustainability and Fiscal Rules: Test Pack

Question 1

Primary deficit is the annual difference between government expenditure and revenue excluding interest payments	**B1**

Answer: B

Question 2

first weakness identified, e.g. procyclicality: a strict ceiling can force cuts in recessions	**M1**
development: forced cuts reduce GDP, shrinking the denominator and potentially making the rule counterproductive	**A1**
second weakness identified, e.g. measurement and timing issues or gaming the rule	**M1**
development: governments can use one-off measures, optimistic forecasts or creative accounting to appear to meet the rule without genuinely improving sustainability	**A1**

Answer: Weaknesses: rules can be procyclical and force harmful cuts in downturns, and they can be gamed or undermined by measurement errors and one-off fiscal measures.

Question 3

method: debt-to-GDP = (public debt / nominal GDP) x 100	**M1**
700 / 2000 x 100	**A1**
= 35.0% correctly computed to one decimal place	**A1**
states the unit as a percentage and interprets that debt is 35.0% of GDP	**B1**

Answer: 35.0% of GDP.

Question 4

identifies that market confidence influences demand for government bonds and thus yields	**M1**
explains that a loss of confidence, perhaps triggered by weak fiscal metrics or fiscal rule breach, reduces bond demand and pushes up yields	**A1**
identifies the role of rating agencies in signalling credit risk through downgrades	**M1**
explains that downgrades can raise borrowing costs and trigger portfolio shifts, increasing the government's interest burden and harming sustainability	**A1**

Answer: Market confidence and ratings affect gilt demand and yields; loss of confidence or downgrades raise yields and interest costs, worsening sustainability and possibly triggering tighter fiscal measures.

Question 5

defines structural (cyclically adjusted) deficit as the deficit after removing the effect of the economic cycle	**M1**
explains that using the structural deficit avoids forcing procyclical tightening during recessions because cyclical shortfalls are excluded	**A1**
identifies measurement uncertainty as a problem in estimating the structural deficit	**M1**
explains that mis-measurement can lead to inappropriate policy if the structural position is estimated incorrectly, undermining credibility	**A1**

Answer: The structural deficit removes cyclical effects so rules based on it avoid procyclical cuts in recessions, but measurement uncertainty can lead to wrong policy and reduce credibility.

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