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A-Level · Macroeconomics

ECO.MAC8 Fiscal Policy and the Public Finances

AQA 7136 · Calculators not allowed · about 120 minutes

Total Marks

Name: ________________________________ Date: ____ / ____ / ______

Answer all questions. Full sentences are required for questions worth 4 marks or more. Do not use a calculator.

1 Define discretionary fiscal policy in the context of the UK government's use of spending and taxation to influence aggregate demand.

(Total for Question 1 is 2 marks)

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2 Define automatic stabilisers and give one UK example of such a mechanism.

(Total for Question 2 is 3 marks)

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3 State the difference between an expansionary fiscal policy and a contractionary fiscal policy, giving one policy instrument for each in a UK context.

(Total for Question 3 is 3 marks)

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4 Define the budget deficit and explain how it differs from the national debt in the UK public finances context.

(Total for Question 4 is 3 marks)

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5 State what is meant by the structural budget deficit and contrast it with the cyclical budget deficit, in the context of an economic downturn.

(Total for Question 5 is 3 marks)

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6 Define the Laffer curve concept and state the implied policy implication for tax rates and tax revenue.

(Total for Question 6 is 3 marks)

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7 Explain two reasons why discretionary fiscal policy might be less effective in practice at influencing aggregate demand than theory suggests.

(Total for Question 7 is 3 marks)

8 Data Table for Country A public finances, 2017 to 2021. The table shows Government Spending (G) and Tax Revenue (T) in GBP billion, and the annual budget deficit (Deficit = G - T) computed in the final column.

Year	Government Spending G (GBP billion)	Tax Revenue T (GBP billion)	Deficit (G - T) (GBP billion)
2017	780	800	-20
2018	795	805	-10
2019	820	810	10
2020	920	770	150
2021	900	790	110

Using the data in the table for Country A, explain how the data show a) the effect of a large economic shock on the public finances in 2020 and b) whether the deficit in 2021 is more likely to be structural or cyclical. Use the data to support your answer.

(Total for Question 8 is 9 marks)

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9 Country B has a national debt of GBP 1,800 billion and nominal GDP of GBP 2,400 billion. State the debt-to-GDP ratio as a percentage and briefly explain why policymakers watch this ratio.

(Total for Question 9 is 4 marks)

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10 Explain two ways the size of automatic stabilisers determines how much a recession increases a government's budget deficit.

(Total for Question 10 is 5 marks)

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11 Multiple choice: In the context of fiscal policy, which of the following best describes crowding out? A: Government spending directly increases private consumption by increasing household incomes. B: Government borrowing to finance spending raises interest rates and reduces private investment. C: Automatic stabilisers reduce the volatility of the business cycle. D: A tax cut that is fully offset by an increase in savings. Choose the single best answer for a UK economy.

- ☐ A
- ☐ B
- ☐ C
- ☐ D

(Total for Question 11 is 1 mark)

12 Evaluate the view that discretionary fiscal policy is more effective than monetary policy at closing a negative output gap in the short to medium term. In your answer consider timing, magnitude, crowding out, the state of public finances and interactions with automatic stabilisers, and reach a supported judgement.

(Total for Question 12 is 25 marks)

Mark scheme · ECO.MAC8 Fiscal Policy and the Public Finances

Question 1

- **B1** a deliberate change in government spending or taxation made by policymakers to influence aggregate demand
- **B1** typically used to stabilise the economy, for example by increasing spending or cutting taxes in a recession
- **Answer: A deliberate change in government spending or taxes by policymakers to influence aggregate demand, for example cutting tax or raising spending to stimulate a recession.**

Question 2

- **B1** automatic stabilisers are fiscal mechanisms that change government receipts or spending automatically as the economic cycle moves, without new government action
- **B1** example: unemployment-related benefit spending rises automatically when unemployment increases
- **B1** or example: income tax receipts fall automatically when incomes fall during a downturn
- **Answer: Automatic stabilisers are fiscal mechanisms that automatically change tax receipts or benefit spending with the economic cycle, for example unemployment benefits rise when unemployment increases.**

Question 3

- **B1** expansionary fiscal policy aims to increase aggregate demand, e.g. higher government spending or tax cuts
- **B1** contractionary fiscal policy aims to reduce aggregate demand, e.g. lower government spending or higher taxes
- **B1** gives one clear instrument for each, e.g. cutting income tax (expansionary) and raising VAT (contractionary)
- **Answer: Expansionary fiscal policy raises AD, for example by cutting income tax or increasing public spending; contractionary fiscal policy reduces AD, for example by raising VAT or cutting public spending.**

Question 4

- **B1** budget deficit = the amount by which government spending exceeds tax revenue in a given year
- **B1** national debt = the total stock of past government borrowing outstanding, accumulated over many years
- **B1** difference explained: deficit is a flow in one year, debt is the accumulated stock resulting from past deficits
- **Answer: The budget deficit is the annual amount by which government spending exceeds tax revenue; the national debt is the accumulated stock of past government borrowing built up from previous deficits.**

Question 5

- **B1** structural deficit is the part of the deficit that would exist at full employment, reflecting permanent policy choices or structural factors
- **B1** cyclical deficit is the part that arises because the economy is below potential, due to the economic cycle
- **B1** contrast: cyclical falls as output gap closes, structural remains unless fiscal policy changes
- **Answer: The structural deficit is the portion of the budget shortfall that would persist at full employment due to policy or structural factors; the cyclical deficit arises because the economy is below potential and will shrink as output recovers.**

Question 6

- **B1** Laffer curve is the idea that there is a non-linear relationship between tax rates and tax revenue, such that very high tax rates can reduce incentives to work or invest, lowering revenue
- **B1** it implies there is some tax rate between 0% and 100% that maximises tax revenue
- **B1** policy implication: cutting tax from a rate above the revenue-maximising point may increase revenue, whereas cutting tax below that point reduces revenue
- **Answer: The Laffer curve describes a non-linear relationship where tax revenue rises then falls as tax rates increase, implying a revenue-maximising tax rate exists and that cutting taxes above that rate could raise revenue while cuts below it would lower revenue.**

Question 7

- **B1** identifies one reason, e.g. long implementation lags and political delays can mean policy arrives too late to affect the current phase of the cycle
- **B1** identifies a second reason, e.g. crowding out: increased government borrowing to finance spending can push up interest rates and reduce private investment
- **B1** develops either point with a brief explanation of how it weakens the effect on AD
- **Answer: Delays in deciding and implementing discretionary fiscal measures can mean stimulus is mistimed, and borrowing to finance spending can crowd out private investment by raising interest rates, both reducing the policy's impact on aggregate demand.**

Question 8

- **Level 1** (1-3): Limited use of the data, simple statements about the 2020 change or 2021 deficit, little or no economic explanation.
- **Level 2** (4-6): Clear use of the data to describe the large rise in the deficit in 2020 and some explanation, and a plausible judgement about 2021 being largely cyclical or structural with limited development.
- **Level 3** (7-9): Detailed use of the data quantifying the 2020 shock and its impact on spending and revenue, and a well-developed, balanced evaluation of whether the 2021 deficit is cyclical or structural with evidence from the table and economic reasoning.
- **Indicative content:**
  - Data: deficit jumps from 10 in 2019 to 150 in 2020, an increase of GBP 140 billion, driven by a rise in G from 820 to 920 (+100) and a fall in T from 810 to 770 (-40).
  - This pattern is consistent with a large economic shock in 2020 that both increased government spending and reduced tax receipts, for example an economic downturn or emergency spending.
  - Quantification strengthens answers: government spending rose by 12.2% (100/820) between 2019 and 2020, while tax revenue fell by 4.9% (40/810) over the same period.
  - By 2021 the deficit falls to 110 from 150, with G falling to 900 and T rising to 790, suggesting partial recovery: spending reduced by 20 and revenues recovered by 20 compared with 2020.
  - Interpretation of structural vs cyclical: because deficit increased sharply in 2020 and then partly reversed in 2021, this suggests much of the 2020 deficit was cyclical, arising from the shock. However, the remaining 110 deficit in 2021, higher than 2019 levels, could include a structural component or continued policy choices.
  - Balanced judgement might note that without further information on potential output or pre-shock trends it is not possible to be certain, but the large swing points to a dominant cyclical element with a possible residual structural deficit in 2021.

Question 9

- **M1** calculation: debt-to-GDP = (1,800 / 2,400) x 100
- **A1** = 75%, awrt 75%
- **B1** states that policymakers monitor this ratio as an indicator of the sustainability of public finances and the capacity to borrow
- **B1** development: high ratios may raise concerns about higher interest costs, credit ratings, and reduced fiscal space for future shocks
- **Answer: Debt-to-GDP = (1,800/2,400)*100 = 75%. Policymakers watch it as a measure of fiscal sustainability; a high ratio can increase interest costs and limit future borrowing ability.**

Question 10

- **M1** identifies that larger automatic stabilisers (e.g. more progressive tax system or generous welfare) mean tax receipts fall more and benefit payments rise more during a recession
- **A1** developed: thus a larger automatic stabiliser causes a bigger cyclical rise in the deficit because withdrawals and receipts move more strongly with income
- **M1** identifies a second way: larger stabilisers can smooth demand by supporting incomes, reducing the depth of the recession
- **A1** developed: smoothing reduces the fall in tax receipts and limits spending on benefits compared with an economy with weak stabilisers, so the ultimate impact on the deficit may be smaller per unit of GDP shock
- **B1** linking statement: therefore the net effect depends on the size and design of stabilisers and the initial severity of the

Question 11

- **B1** B is correct: crowding out refers to government borrowing pushing up interest rates and reducing private investment
- **Answer: B**

Question 12

- **Level 1** (1-5): Basic identification of arguments for or against fiscal policy, limited economic analysis, little use of theory or context, and no clear judgement.
- **Level 2** (6-10): Some developed analysis of how fiscal and monetary policy work, with relevant examples; addresses a few evaluation points such as lags or crowding out, but conclusions are limited or one-sided.
- **Level 3** (11-15): Clear and well-developed analysis comparing fiscal and monetary policy, considers timing, magnitude, crowding out, public finance constraints, automatic stabilisers and interactions, and reaches a balanced, supported judgement.
- **Level 4** (16-20): Comprehensive analysis with good application and synthesis: evaluates the conditions under which fiscal policy is superior, discusses counterarguments and trade-offs in detail, and provides a convincing conclusion with evidence and policy nuance.
- **Level 5** (21-25): Excellent, coherent, and balanced evaluation; integrates theory, empirical considerations and political economy; weighs multiple contingencies such as zero lower bound, severity of output gap, debt sustainability and supply constraints, and gives a well-reasoned and justified judgement.
- **Indicative content:**
  - How discretionary fiscal policy works to close a negative output gap: increase G or cut taxes to raise AD directly, multiplier effects, and interaction with automatic stabilisers which amplify fiscal stimulus during downturns.
  - Advantages of fiscal policy: direct impact on demand, can be targeted at specific sectors or groups, effective when monetary policy is constrained (e.g. at the zero lower bound), and may quickly increase government spending on investment with long-term supply benefits.
  - Timing issues: recognition, decision and implementation lags in fiscal policy can delay impact; monetary policy can be adjusted more quickly via central bank decisions.
  - Magnitude and multiplier: the size of the multiplier matters; in severe recessions multipliers may be larger, making fiscal policy powerful, but if crowding out occurs multipliers are smaller.
  - Crowding out: if borrowing pushes up interest rates, private investment may fall, reducing net gain in AD, especially if economy is near full capacity; but when there is spare capacity and low rates, crowding out is less likely.
  - Public finance constraints: high debt-to-GDP may limit scope for large fiscal expansion due to market concerns about sustainability, though low interest rates can reduce immediate constraints.
  - Monetary policy strengths and limits: can be implemented quickly, affects borrowing costs economy-wide, but may be less effective when banks do not transmit lower rates to lending or when consumers save rather than spend; at the zero lower bound conventional monetary policy is limited but unconventional tools exist albeit with uncertain effects.
  - Interaction with automatic stabilisers: strong automatic stabilisers reduce the required size of discretionary fiscal action and provide timely support, while weak stabilisers increase the need for discretionary measures.
  - Political economy and practicalities: fiscal measures may be politically difficult to enact; targeted fiscal investment can have supply-side benefits, improving potential output and reducing the deficit structurally in the long run.
  - Balanced conclusion: the effectiveness depends on context - with large spare capacity, low interest rates and weak automatic stabilisers, discretionary fiscal policy is often more effective; where speedy action is needed and public debt is high, monetary policy or a mix may be preferable. Provide a supported judgement referencing these trade-offs.