REDSPOT

N e w S o l u t i o n s . N e w M i n d s

About AS LEVEL

ECONOMICS
(P1 & P2)
(TOPICAL)

period	2015 to 2025
contents	June & November, P1 & P2, All variants (2023 - 2025) Worked Solutions
form	Topic By Topic
compiled for	AS Level
special features	HELPS to MCQs

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AS LEVEL

TOPIC 1

Basic Economic Ideas And Resource Allocation

MCQ Section

1.1 • Scarcity, Choice And Opportunity Cost,
• Factors of production,
• Positive and normative statements.

1. In 2013, there was much criticism of a government project to build a new high-speed rail link between two cities.

What is the most likely reason for abandoning such a project?

A The construction cost is greater than the running cost.

B The external cost is greater than the external benefit.

C The future costs are difficult to calculate.

D The opportunity cost is too high.

[J15/P1/Q1]

2. Which question does **not** directly refer to the basic economic problem?

A What goods and services should a firm produce?

B What price should a firm charge?

C What production methods should a firm use?

D Who should receive the goods and services that a firm produces?

[N15/P1/Q1]

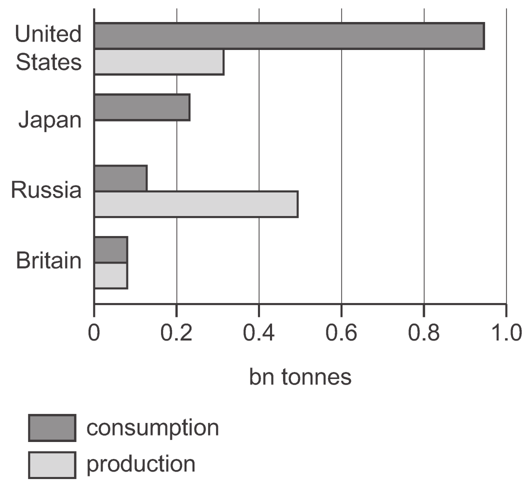
3. What term is used by economists for the income received by the factor of production enterprise?

A capital **B** interest

C profit **D** revenue

[N15/P1/Q4]

4. In 2007 there was a worldwide shortage of oil. The diagram shows the consumption and production of oil (billion tonnes) in 2007 for selected countries.



What can be concluded from the diagram?

A In Britain, oil had zero opportunity cost.

B In Japan, there was self sufficiency in oil.

C In Russia, there was no shortage of oil.

D In the United States, rationing was the only solution to oil shortage.

[J16/P1/Q1]

5. In 2014, the Hong Kong Housing Authority said the waiting time for public sector housing had increased and it would only complete 8900 flats of the 15 000 planned for the year. The reasons were the shortage of workers because they were needed in other public sector projects, the difficulty of finding land, and government regulations.

Which economic concepts are illustrated in this information?

A a market economy and a lack of resources

B economic planning and the price mechanism

C opportunity cost of labour and excess demand

D production possibility and budget deficit

[N16/P1/Q2]

6. Scarcity means that goods need to be rationed between competing consumers.

Which basis for rationing is the most likely to result in the most equal distribution of goods?

A consumer preference

B market price

C political decision

D seller preference

[J17/P1/Q1]

7. A local government is deciding whether to increase parking charges and provide more lanes for bus use only.

One official said that the increase in parking charges should cause more bus travel.

A second official said that an increase in the frequency of bus services will not cause demand for bus travel to rise.

Are these official statements correct or incorrect?

	first statement	second statement
A	correct	correct
B	correct	incorrect
C	incorrect	correct
D	incorrect	incorrect

[J17/P1/Q11]

8. To overcome the problem of scarcity, countries with few natural resources need to concentrate on the quality of human resources.

Which set of policies would be most appropriate?

	natural resources policy	human resources policy
A	develop renewable energy supplies	improve education and training
B	plan the allocation of resources	discourage automation
C	protect land resources	protect jobs in manufacturing
D	restrict imports of raw materials	restrict influx of skilled migrants

[N17/P1/Q1]

9. A government decides to subsidise farms producing milk in its country.

Which question about this decision is a normative question rather than a positive question?

A How much will milk production increase?

B How should essential products, such as milk, be produced?

C How will employment in the milk industry change?

D How will milk prices change?

[N17/P1/Q2]

10. The statements refer to the proposal to build another runway at London's Heathrow airport.

Which statement is normative?

A Heathrow is the UK's busiest airport and has more flights than any other European airport.

B The airport is highly competitive but there is spare capacity.

C The potential net benefit of expansion is around £5 billion over 70 years.

D We should concentrate on improving the use of existing capacity not build another runway.

[J18/P1/Q1]

11. Which statement by a company is normative?

A In the past three years we have carried out the biggest merger acquisition in the group's history.

B The business has fallen behind competitors and needs to improve its ethical standards.

C The growth of the business has been in retail and financial services.

D The structure of the business has been simplified.

[N18/P1/Q1]

12. What is correct about scarcity?

A Scarcity affects low income earners only.

B Scarcity forces individuals to make choices.

C Scarcity is removed by periods of falling prices.

D Scarcity will be abolished by advances in technology.

[N19/P1/Q1]

13. Which is a normative economic statement?

A Money is the least liquid form of wealth.

B Some firms are subsidised by the government.

C Some workers earn more than others.

D Taxes are the best way to discourage smoking.

[N19/P1/Q4]

14. A factory introduces an automated production line to take advantage of division of labour.

What is most likely to increase?

A average cost of production

B job satisfaction of workers

C range of skills of each worker

D worker productivity

[J20/P1/Q3]

15. Which statement is normative?

A A minimum wage is the correct government policy to increase the incomes of the lowest paid workers.

B A minimum wage is the lowest amount that employers can legally pay their workers.

C In Pakistan, a minimum wage of 15 000 Pakistani Rupees per month was set on 1 June 2016.

D Setting the minimum wage rate above the equilibrium will result in an excess supply of workers.

[J20/P1/Q4]

16. Below are two statements.

1 A rise in the price of rice is the best way to give farmers in South-East Asia higher living standards.

2 A rise in the price of rice will lead to a fall in demand.

Which row correctly describes these two statements?

	1	2
A	normative	normative
B	normative	positive
C	positive	normative
D	positive	positive

[N20/P1/Q3]

17. A tourist visits the coast for a holiday.

On her first day, she visits the local tourist office for information, goes for a swim in the sea, spends the evening enjoying the view of the coastline and rents a campsite for an overnight stay.

Which activities involve economic goods and which involve free goods?

	economic goods	free goods
A	camping and information	swimming and sightseeing
B	information and swimming	sightseeing and camping
C	sightseeing and camping	information and swimming
D	swimming and sightseeing	camping and information

[J21/P1/Q1]

18. Which statement would be classified by an economist as a positive statement?

A Balancing the budget cannot be more important than reducing inflation.

B Maintaining the real income of pensioners needs to be a priority.

C The government should increase indirect taxation.

D The government will not increase direct taxation.

[J21/P1/Q4]

19. Which statement about the factors of production is correct?

A The factor capital includes shares and deposit accounts at banks.

B The factor labour includes human-made resources.

C The factor land includes forests and undiscovered copper.

D The factor enterprise takes risks and is rewarded with interest.

[N21/P1/Q4]

20. Which list has the most words that are more likely to relate to a positive statement than to a normative statement?

A describe, better, should, value, emotion

B bias, objective, ought, opinion, tastes

C contestable, is, motive, subjective, moral

D actual, ethics, fact, was, testable

[J22/P12/Q1]

21. What is a normative statement?

A A firm receiving a government subsidy will increase the supply of a good.

B Negative externalities are the most serious market failure.

C A rise in incomes will lead to a rise in demand for normal goods.

D A rise in the additional rate of income tax will decrease the incentive to work.

[N22/P12/Q4]

22. What is the definition of *long run*?

A the time period when all factors of production are specialised

B the time period when all factors of production are variable

C the time period when all key inputs into production are variable

D the time period when at least one factor of production is fixed

[M23/P12/Q2]

23. The table states the consequences of two macroeconomic policies.

What correctly identifies whether the statements are normative or positive?

	a depreciation of an exchange rate will cause the balance of payments to improve	a rise in the minimum wage rate will cause unemployment to rise
A	normative	normative
B	normative	positive
C	positive	normative
D	positive	positive

[M23/P12/Q3]

24. Why does the basic economic problem of scarcity apply to both the rich and the poor?

A The choices people make are not dependent on income inequalities.

B Consumers pay the same prices for goods and services to satisfy their wants.

C Human wants exceed what can be produced from available resources.

D Natural resources are unevenly distributed amongst nations.

[M23/P12/Q10]

25. What is 'a produced means of further production'?

A capital **B** enterprise

C labour **D** land

[J23/P11/Q1]

26. A hospital management board decides to reallocate $800 000 from its $1.2m new buildings budget to spend on cancer care.

What is the opportunity cost of this decision?

A a cost of $400 000

B a cost of $800 000

C the cost of healthcare for cancer patients

D the loss of some new buildings

[J23/P11/Q2]

27. A factory manufactures chairs. The manufacturing process is divided into a number of tasks.

What is a likely **disadvantage** of this division of labour?

A decrease in motivation

B decrease in output

C decrease in productivity

D decrease in quality of the final product

[J23/P11/Q4]

28. Which factor of production is needed first in order to set up a new business?

A capital **B** enterprise

C labour **D** land

[J23/P12/Q1]

29. What is **not** likely to result from the use of division of labour?

A a decrease in average costs

B an increase in motivation

C an increase in productivity

D an improvement in quality of the final product

[J23/P12/Q4]

30. A government decides that all non-essential businesses must close for three months due to a disease pandemic.

What is an opportunity cost of this policy?

A increased leisure time for employees

B lives that are saved due to reduced disease levels

C the production of goods by essential businesses

D the loss of goods from the closed businesses

[J23/P13/Q2]

31. Which economic conditions are likely to encourage an increase in enterprise?

	interest rates	profit tax	consumer confidence	unemployment
A	high	high	high	high
B	high	low	low	high
C	low	low	high	low
D	low	low	low	low

[J23/P13/Q4]

32. What will help solve the basic economic problem?

A the control of the market system

B the efficient allocation of scarce resources

C the preservation of a healthy environment

D the elimination of hunger

[N23/P11/Q1]

33. What is considered the essential requirement for all entrepreneurs?

A attracting customers

B buying stock

C managing staff

D taking risks

[N23/P12/Q2]

34. A factory introduces an automated production line to take advantage of division of labour.

What is most likely to increase?

A average cost of production

B job satisfaction of workers

C range of skills of each worker

D worker productivity

[N23/P13/Q1]

35. The table shows different combinations of rings and bracelets that can be produced by Luke and Zoe in the same time period.

Luke		Zoe	
rings	bracelets	rings	bracelets
18	0	20	0
12	6	16	8
6	12	12	16
0	18	8	24

Which statement is **not** correct?

A Luke has a larger opportunity cost than Zoe for making bracelets.

B The opportunity cost of producing rings is constant for both Luke and Zoe.

C Zoe should specialise in making rings.

D Zoe's opportunity cost for each bracelet is 2 rings.

[N23/P13/Q3]

36. Which statement is a normative statement?

A Aggregate demand will increase following a decrease in interest rates.

B A rise in unemployment will decrease inflationary pressures.

C The incentive to work will rise if benefit payments are reduced.

D Unsustainable economic growth is more harmful to the economy than hyperinflation.

[M24/P12/Q2]

37. Which combination best describes the basic economic problem?

	resources	wants
A	limited	limited
B	limited	unlimited
C	unlimited	limited
D	unlimited	unlimited

[M24/P12/Q3]

38. What is the opportunity cost to a person of spending $20 on a new pair of sports shoes?

A all the other things the person could have bought

B the cost of getting to the sports shop

C the current value of the person's old pair of shoes

D the next best thing that could have been bought with the $20

[M24/P12/Q5]

39. A worker earns $40 per hour. Rather than work, she decides to visit a museum for three hours. The visit costs a total of $40.

What is the opportunity cost of visiting the museum?

A $40 **B** $80 **C** $120 **D** $160

[J24/P11/Q1]

40. The nature of a typical car assembly plant has changed. The industry has fewer firms, operates on larger sites and has more automated machinery.

How is this change most likely to have affected the relative use of factors of production in the industry?

	increased relative use	decreased relative use
A	capital and enterprise	labour and land
B	enterprise and labour	land and capital
C	labour and land	capital and enterprise
D	land and capital	enterprise and labour

[J24/P11/Q2]

41. Which item would be **least** likely to be classed as land?

A fertilisers **B** fisheries
C forests **D** coal

[J24/P11/Q3]

42. Why does the concept of scarcity apply to the use of fossil fuels?

A Demand fluctuates according to price changes.
B Supply is insufficient to meet demand.
C Their use is restricted because of harmful pollution.
D They are being replaced by renewable energy sources.

[J24/P11/Q4]

43. Governments in market economies give different reasons for intervening in the operation of an economy.

Which reason given is a normative statement?

A Average incomes have failed to keep pace with price rises during the past year.
B Energy prices have increased by more than 50% during the past year.
C The distribution of incomes has become more unfair during the past year.
D The poorest 10% of households have suffered the greatest fall in average real income during the past year.

[J24/P11/Q14]

44. Earth observation satellites designed to acquire information are close to the theoretical case of a public good. In 2011, the World Meteorological Organisation estimated that improving satellite observations would cost an extra $1 billion a year.

What is a normative statement about Earth observation satellites?

A The estimated cost of improving satellite observations is $1 billion a year.
B The information received from the satellites is non-rival.
C The satellites are designed to acquire the best possible information on climate change.
D The responsibility for the cost of Earth observation satellites should be shared by all governments.

[J24/P12/Q3]

45. The share of total incomes from profit in a country shows more variation over time than incomes from interest, rent and wages.

What is the most likely reason for this?

A Interest rates are set by government.
B Profit is what is left after interest, rent and wages are subtracted from total income.
C Rent is only the return to the factor and so is always the smallest.
D Wages only change annually.

[J24/P12/Q5]

46. What is essential to eliminate scarcity?

A the existence of sufficient resources to meet all needs and wants
B producers consistently produce in excess of demand
C the government has a surplus budget
D there is equilibrium in all markets

[J24/P13/Q4]

47. What will encourage a higher degree of division of labour?

A firms wishing for a greater level of self-sufficiency
B firms wishing to increase their flexibility in production
C firms wishing to raise their level of productivity
D firms wishing to reduce their level of risk

[J24/P13/Q5]

48. Which statement is a normative statement?

A The annual rate of inflation in Malaysia increased from 2.8% in May 2022 to 3.4%.
B The annual rate of inflation was 3.4% in Malaysia, lower than the 7.7% annual rate of inflation for Thailand.
C The Malaysian Central Bank raised interest rates from 2.0% to 2.25% on 6 July 2022.
D The rise in interest rates in Malaysia in July 2022 is expected to only have a small impact on the rate of inflation

[N24/P11/Q1]

49. A firm operating in country S moved its existing capital equipment to a larger factory in country T. It also installed more of the same equipment and increased the size of its workforce.

From the evidence provided, what must be true?

A The firm is operating in the long run.
B The firm is operating in the very long run.
C The firm's division of labour has increased.
D The firm's supply curve has shifted to the left.

[N24/P11/Q2]

50. In a clothing business, after specialisation, real output per worker increased in the first six months but then output per worker began to fall.

What might be the most likely reason for the reduction in productivity?

A An increase in output per worker in the long run depends on an increase in pay.
B An increase in output per worker requires more capital.
C Specialisation means workers lose skills.
D Workers get bored if they are repeating the same work.

[N24/P12/Q2]

51. A wine producer and bottler wanted to expand its production significantly. To finance the expansion it offered investors discounts on restaurant meals if they bought 2000 shares in the company.

Which factors of production are most likely to be involved in this expansion?

A labour, land, capital and enterprise
B labour, land and capital only
C enterprise and land only
D enterprise only

[N24/P12/Q3]

52. The factors of production earn different rewards.

What identifies the correct economic term for these rewards?

A capital – surpluses
B enterprise – dividends
C labour – interest
D land – rents

[N24/P13/Q3]

53. What is most likely to be an advantage of the division of labour?

A an increase in labour force creativity
B an increase in labour productivity
C an increase in workforce flexibility
D an increase in worker satisfaction

[N24/P13/Q4]

1.1 - ANSWERS to MCQ

1. D Higher opportunity cost implies that the benefits from the next best alternative are higher than those of building the rail link. All other options refer to the process of decision making.

2. B Basic economic problem refers to three basic questions, what, how & for whom to produce. It, therefore rules out options **A**, **C** & **D**.

3. C By definition.

4. C In Russia production exceeds consumption, so there should not be a shortage. Oil is a scarce resource therefore it has an opportunity cost, hence option A is invalid. Japan does not produce oil at all, therefore **B** is incorrect. US can import oil in order to make up for a shortfall; therefore **D** is not necessarily true.

5. C Labour needed in other projects implies both the opportunity cost and shortage of labour.

6. C Options **A**, **B** & **D** are incorrect because markets distribute goods according to the ability to pay that causes unequal distribution of goods. Governments, however, can distribute goods on the basis of equality.

7. B An increase in frequency of bus services will encourage people to use it as much as increasing the parking charges does. Second statement, therefore, is incorrect.

8. A Developing renewable energy resources would increase the overall availability of resources while education & training would improve productivity of workers. Both would result in higher output and therefore will help address scarcity more effectively. Option **D** will further intensify the problem while **B** & **C** will have no impact.

9. B Option **B** involves choices, therefore, refers to value judgment. Options **A**, **C** & **D** can be verified with reference to facts, so they are classified as positive statements.

10. D "Should concentrate" suggests preference i.e. value judgment, a key feature of normative statements. All other statements can be verified by facts as true or false; hence they are positive statements.

11. B The phrase' ethical standards' indicates value judgment. It therefore, makes the statement normative. All the others are positive statements because they can be verified against facts as true or false.

12. B Scarce resources produce limited goods and services, hence individuals must exercise choices. Other options are invalid for scarcity can never be abolished and it affects everyone regardless of market price and consumers' income.

13. D 'Best way to discourage smoking' implies a value judgment – a characteristic of normative statement. We can verify all other statements with facts as correct or incorrect, which make them positive.

14. D Division of labour allows firms to apply specialist workers to perform individual tasks repetitively. Therefore it increases workers' efficiency that results in higher productivity. Other options suggest factors that are more likely to decrease workers' productivity.

15. A The term 'correct' suggests value judgment. Other statements are positive because we can verify them with facts as correct or incorrect.

16. B The term 'best' in statement 1 implies value judgment; hence it is normative while statement 2 is positive for it is verifiable as correct or incorrect.

17. A Both camping and information are economic goods because they use scarce resources with opportunity cost while she does not have to pay a price for sightseeing and swimming in the sea.

18. D It can be verified by facts as true or untrue. The term "more important" in option **A**, "priority" in **B** and "should be" in **C** suggest value judgment.

19. C The term 'land' is used for all natural resources while capital refers to the tools and machinery, hence **A** is incorrect. Labour is a human resource and the reward of enterprise is profit, therefore **B** & **D** are invalid.

20. D We can verify a positive statement as true or false.

	Positive	Normative
A	describe	better, should, value, emotion
B	objective,	bias, ought, opinion, tastes
C	contestable, is,	motive, subjective, moral
D	actual, fact, was, testable	ethics,

21. B The word "serious" suggests opinion or value judgment. Other statements can be verified as right or wrong, hence we identify them as positive.

22. B By definition. Option **D** refers to short run while **A** & **C** are inconclusive.

23. D Both statements are positive because they refer to a cause & effect relationship that can be verified as correct or incorrect.

24. C By definition. Other options are not directly related to the problem of scarcity.

25. A Production of goods & services requires machines and tools (capital) that can be produced by using all other inputs.

26. D Sacrificing construction of any other new building is the opportunity cost. Options **B** & **C** are ruled out for they refer to direct cost while **A** does not suggest cost.

27. A Repetitive task performed by each individual worker causes demotivation. Other choices refer to the advantages of division of labour.

28. B An entrepreneur takes the initiative to set up a business and decides when, where and how much of all other inputs to be used.

29. B Division of labour is more likely to decrease motivation because the workers feel alienated and insignificant. Other options refer to the likely results of division of labour.

30. D Closure of businesses means sacrificing output that could have been produced. Other choices suggest the benefits of closure.

31. C Low interest rates make it cheaper to borrow & invest while low profit tax suggests higher earnings and both low unemployment and higher consumer confidence suggest higher spending. In combination these conditions offer profitable business opportunities.

32. B Efficient allocation helps achieve potential output therefore it is more effective in dealing with the basic economic problem. Other options bear no direct relation with the problem of scarcity.

33. D An entrepreneur is necessarily an owner that makes him a risk taker. Other options suggest the functions that can also be performed by the managers who the entrepreneur hires.

34. D Single repetitive task performed by each individual worker increases productivity and hence it decreases average cost. So, we eliminate **A** & **C** while **B** is incorrect because monotonous work decreases job satisfaction.

35. D $\dfrac{\Delta \text{rings}}{\Delta \text{bracelets}}$ = opportunity cost of bracelets.

For Luke, $\dfrac{-6}{6} = -1$ ring

For Zoe, $\dfrac{-4}{8} = -0.5$ rings

Options **A** & **B** are correct while **C** is incorrect but we cancel this option for being suggestive compared to **D** which is definitely incorrect.

36. D The term "More harmful" implies value judgement. Other statements are positive because they all suggest cause & effect relationships that can be verified as correct or incorrect.

37. B Basic economic problem arises due to the limited resources and unlimited wants.

38. D By definition.

39. C Opportunity cost of visiting museum is \$120 = (\$40 × 3 hrs.). Note the amount spent on the visit is recognized as expenditure.

40. D Both the larger sites and more machinery suggest more use of land & capital while fewer firms and automation refer to a less relative use of enterprise & labour.

41. A Land includes all natural resources such as fisheries, forests & coal while fertilizer is a manufactured resource.

42. B Fossil fuel is scarce i.e., exhaustible. Option **A** refers to the behavior of market while **C** & **D** suggest possible actions to deal with the ill effects of consuming fossil fuel.

43. C The term unfair suggests value judgement - a characteristic of normative statements. We can verify all other statements as true or false - a characteristic of positive statements.

44. D "Should be shared" implies value judgement. Other statements are positive in nature because they can be verified as correct / incorrect.

45. B Profit is obtained by subtracting the fixed amount of rent, wages and interest from the fluctuating total revenues.

46. A Scarcity exists because resources are insufficient to meet all needs & wants and it persists even when there is excess supply, a budget surplus or equilibrium in markets.

47. C Division of labour often leads to increased productivity. Options **A** & **B** are disadvantages of division of labour while **D** is not relevant in this context.

48. D The term "expected" implies value judgement – a characteristic of normative statement. Other statements are positive because they imply "what is" which can be verified as correct or incorrect.

49. A An increase of both capital & labour suggests long run while the "same equipment" eliminates option **B** because a very long run is associated with changes in technology. Option **C** cannot be determined while **D** is incorrect because increase in scale is likely to shift the supply curve to right.

50. D Specialization increases productivity in the short run, nevertheless, repetition of work leads to boredom that is likely to decrease productivity in the long run. Options **A** & **B** are invalid because they do not reason out fall in productivity while **C** is incorrect because specialization is more likely to improve skills.

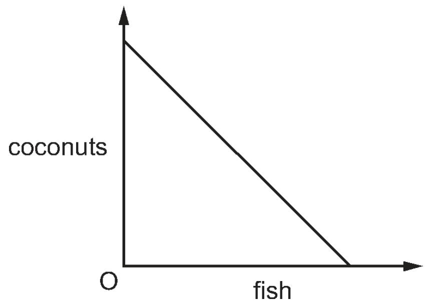
51. A Expansion involves land, labour& capital while buying shares involves enterprise only if investors take part in managing the company.

52. D Other options are invalid because capital receives interest and labour receives wages as reward. Share holders receive dividend as part owners but they are not recognized as enterprise because they are not involved in decision making.

53. B A single repetitive task performed by individuals increases productivity. Other choices refer to the down side of division of labour.

1.2 Production Possibility Curves.

1. The diagram shows the production possibility curve of a desert island economy where the inhabitants live off just two commodities, coconuts and fish.



What explains the shape of the production possibility curve?

A Coconuts and fish are in joint demand.

B Coconuts and fish are perfect substitutes when consumed.

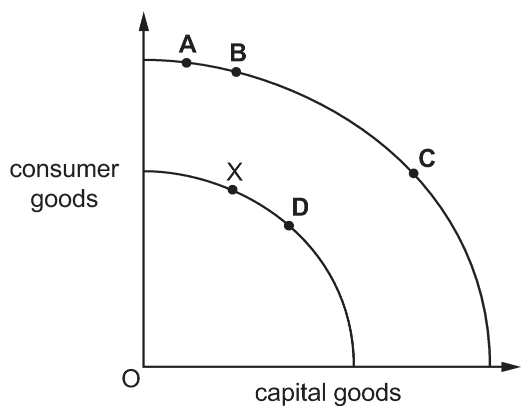
C Fishing and coconut growing are equally efficient.

D The opportunity cost of fish falls as more time is devoted to fishing.

[J15/P1/Q3]

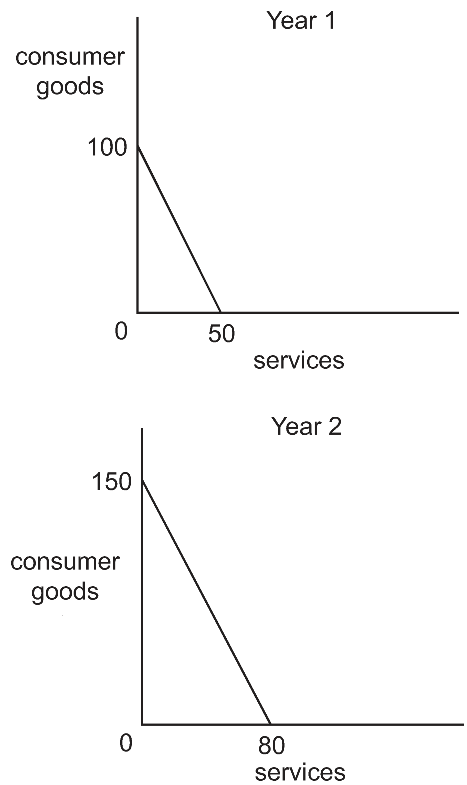
2. The diagram shows the change in an economy's production possibility curve as it grows in the long run.

Which movement from point X is **most** likely to show the highest potential for growth?



[N15/P1/Q2]

3. The diagrams show the change in a country's production possibility curve between Year 1 and Year 2.



What can be concluded from the diagrams?

A Future growth prospects have been harmed.

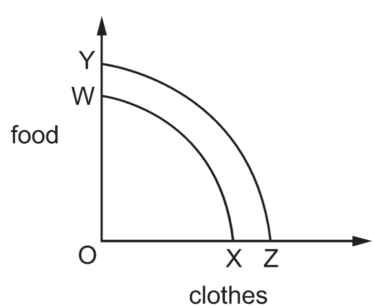
B The level of unemployment has fallen.

C The opportunity cost of consumer goods has risen.

D The proportionate growth in production is greater in consumer goods.

[N15/P1/Q3]

4. The change from WX to YZ in a country's production possibility curve is shown.



What could have caused this shift?

A an increase in employment among the existing labour force

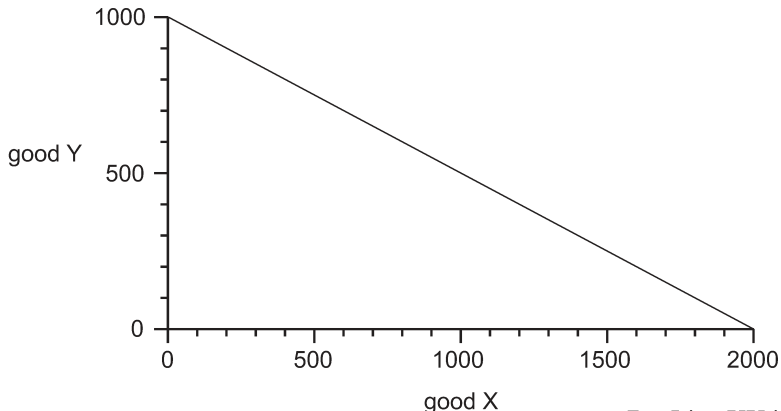
B an increase in the rate of interest

C the closing of an inefficient factory

D the discovery of a new resource

[J16/P1/Q3]

5. The diagram shows a production possibility curve for an economy that produces only two goods, X and Y.



The economy produces 1200 of good X and operates on its production possibility curve.

Which quantity of good Y is given up?

A 400 **B** 600 **C** 800 **D** 1000

[N16/P1/Q1]

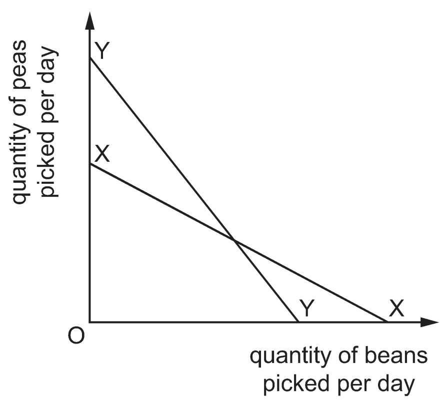
6. An economy can produce only two goods at any one time. These are good X and one other good from **A**, **B**, **C** or **D**. The table shows the outputs of goods **A**, **B**, **C** and **D** with each output of good X when the economy's resources are fully employed.

Which good must be produced with good X to show a production possibility curve with increasing costs?

	units				
X	0	100	200	300	400
A	0	20	40	60	80
B	110	70	40	20	0
C	120	90	60	30	0
D	140	120	90	50	0

[N16/P1/Q4]

7. Line XX is the production possibility curve (PPC) of a worker picking peas and beans in a 10 hour working day.



What would cause the worker's PPC to shift to the line YY?

A a machine that increases the worker's pea picking productivity only

B a new work schedule where the worker spends 6 hours per day picking peas and only 4 hours picking beans

C a reduction in working hours to 8 per day and a machine that increases the worker's pea picking productivity

D a reduction in working hours to 8 per day only

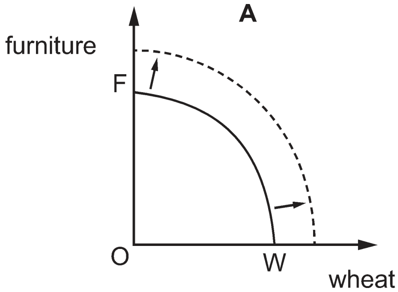
[J17/P1/Q3]

8. Economy X uses its resources in the labour-intensive production of wheat and wooden furniture as shown by the production possibility curve FW.

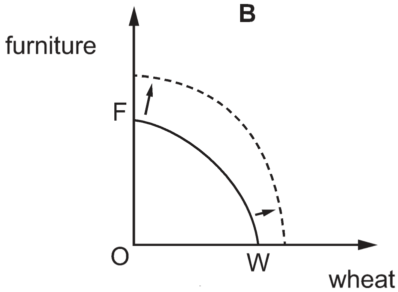
With the help of new strains of wheat seeds, X increased yields and shifted to a new production possibility curve.

Which diagram depicts this change?

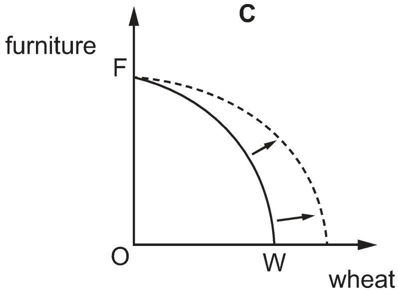
A



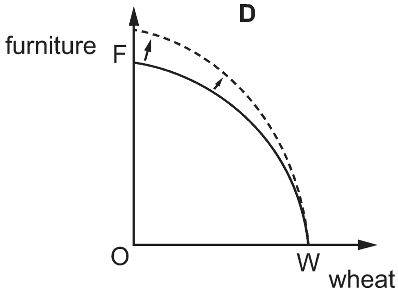
B



C

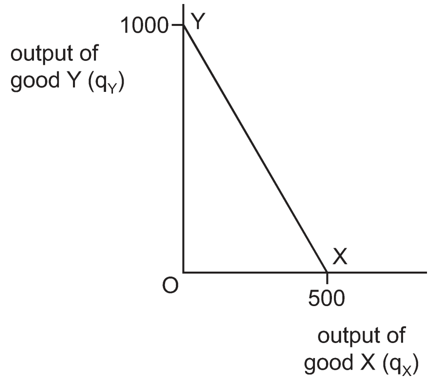


D



[N17/P1/Q3]

9. YX is an economy's production possibility curve (PPC).
The equation of the curve is $q_Y = 1000 - 2q_X$.



What is the opportunity cost of producing one extra unit of good X?

A $\frac{1}{2}$ unit of good Y

B 2 units of good Y

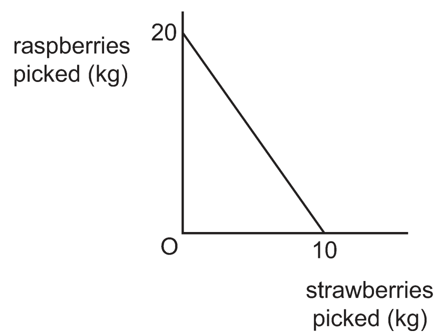
C 500 units of good Y

D 1000 units of good Y

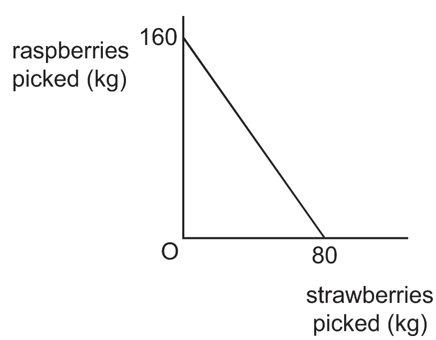
[J18/P1/Q2]

10. A farmer picks 10 kg of strawberries in each hour. The farmer is twice as productive at picking raspberries.
Which diagram shows the farmer's daily production possibility curve when working 8 hours a day?

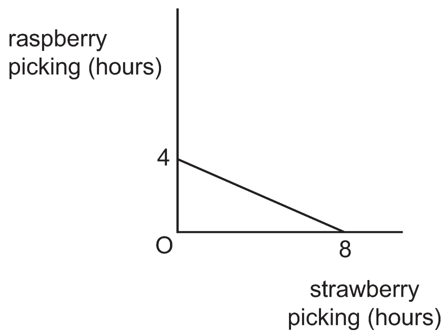
A



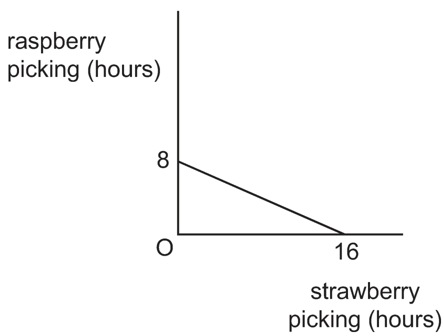
B



C

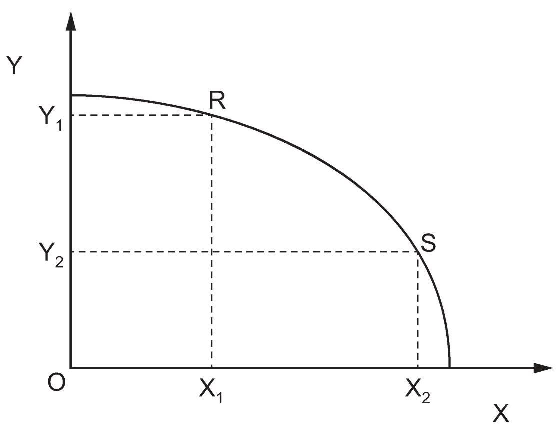


D



[J18/P1/Q3]

11. The diagram shows an economy's production possibility curve for goods X and Y.



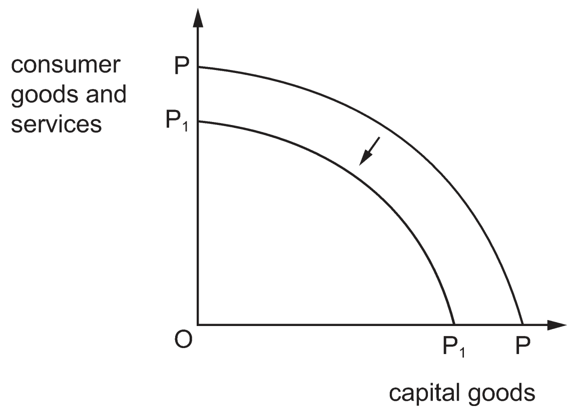
What is the opportunity cost of moving from point R to point S on the production possibility curve?

A OX_1 **B** OY_2

C X_1X_2 **D** Y_1Y_2

[N18/P1/Q2]

12. A production possibility curve for a country is shown.



What would cause the shift from PP to P_1P_1?

A application of more machinery used in manufacturing

B productivity decreases

C scientific methods applied to farming

D switch from production of consumer goods to capital goods

[J19/P1/Q1]

13. What would be a determinant of a country's production possibility curve boundary?

A the capital invested in infrastructure

B the level of price and wage inflation

C the level of unemployed labour

D the volume of imports and exports

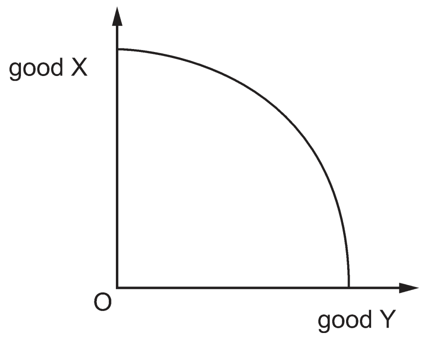
[J19/P1/Q3]

14. Which labels might be used on a production possibility curve diagram?

	Y (vertical) axis	X (horizontal) axis
A	capital input	labour input
B	cost of production	quantity produced
C	output of rice	labour input
D	output of rice	output of sugar

[N19/P1/Q2]

15. The diagram shows a production possibility curve.



What can be deduced from the shape of this curve?

A decreasing marginal returns to consumption

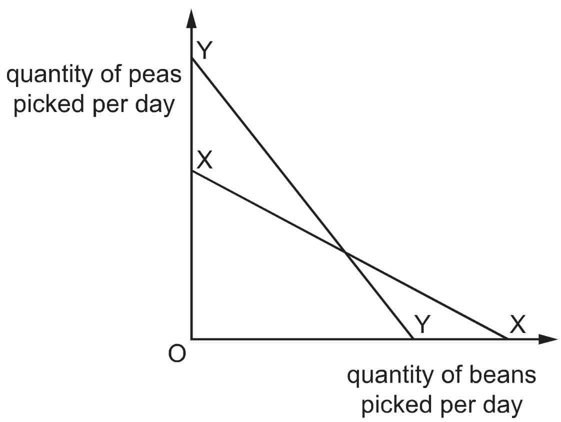
B decreasing opportunity costs of consumption

C increasing opportunity costs of production

D increasing returns to scale

[N20/P1/Q1]

16. Line XX is the production possibility curve (PPC) of a worker picking peas and beans in a 10 hour working day.



What could cause the worker's PPC to shift to the line YY?

A a decrease in working hours to 8 per day and a machine that increases the worker's pea picking productivity

B a machine that increases the worker's pea picking productivity only

C a new work schedule where the worker spends 6 hours per day picking peas and only 4 hours picking beans

D a reduction in working hours to 8 per day only

[N21/P1/Q1]

17. What is the main characteristic of a planned economy?

A All goods and services are produced by privately-owned firms.

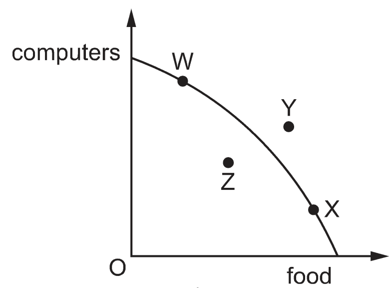
B All goods and services are produced by state-owned firms.

C Privately-owned firms produce private goods and state-owned firms produce public goods.

D The price mechanism allocates scarce resources through the actions of buyers and sellers.

[J22/P12/Q2]

18. An economy produces combinations of computers and food as shown on the diagram of a production possibility curve (PPC).



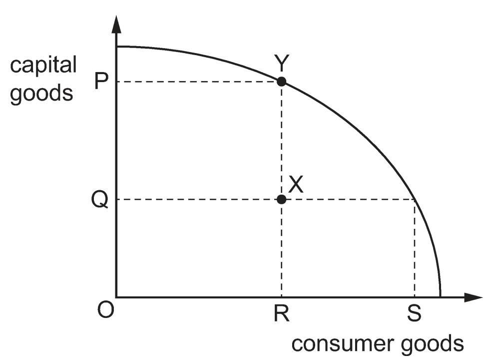
If all available resources were used, which two points on the PPC diagram show the maximum combinations of computers and food that the economy can produce?

A W and X **B** X and Y

C Y and Z **D** Z and W

[J22/P12/Q3]

19. The diagram shows an economy's production possibility curve (PPC). The economy has moved from X to Y.



What can be deduced from the diagram?

A Current living standards have fallen.

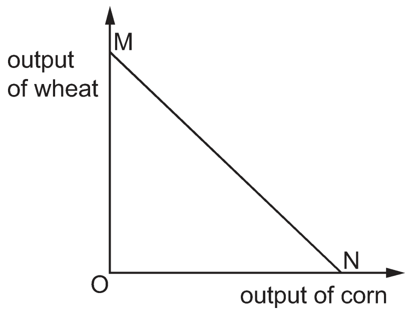
B The economy has become more efficient.

C There has been a rise in unemployment.

D There has been an opportunity cost of OR consumer goods.

[N22/P12/Q5]

20. The diagram shows the production possibility curve for wheat and corn.



What can be deduced from the diagram?

A As the price of corn falls, more of it is demanded.

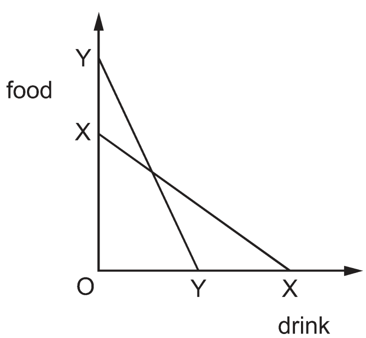
B Resources used in producing corn are more efficient than in producing wheat.

C The opportunity cost of producing corn falls when moving from M to N.

D The opportunity cost of producing corn is constant when moving from M to N.

[M23/P12/Q4]

21. The diagram shows the change in a country's production possibility curve from XX to YY.



What would explain this change?

A Consumers chose to consume more food and less drink.

B Government taxed food production and subsidised drink production.

C Productivity rose in food production and fell in drink production.

D There were more imports of food and more exports of drink.

[J23/P11/Q3]

22. Assuming nothing else changes, which change in an economy's labour market will cause the production possibility curve to shift to the left?

A an increase in worker immigration

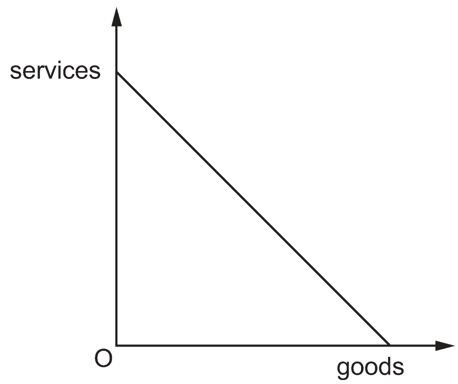
B an increase in the retirement age

C an increase in labour productivity

D an increase in the school leaving age

[J23/P12/Q2]

23. The diagram shows an economy's production possibility curve. The economy produces combinations of goods and services using all available resources.



What does the production possibility curve indicate for goods and services?

A constant returns to scale in the production of both goods and services

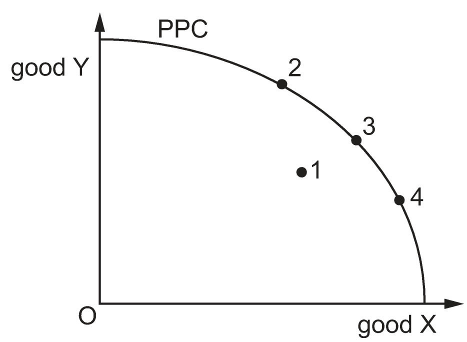
B diminishing returns to scale in the production of both goods and services

C increasing returns to scale in the production of both goods and services

D infinite returns to scale in the production of both goods and services

[J23/P13/Q3]

24. Country Z operates with a production possibility curve (PPC). Currently, output is at combination 1.

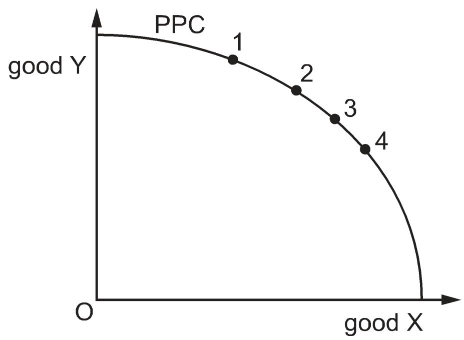


Which movement has zero opportunity cost in terms of the goods produced?

A 1 to 2 **B** 1 to 3
C 2 to 3 **D** 3 to 4

[N23/P11/Q2]

25. PPC is the production possibility curve in country T.



Which changes take place in country T's opportunity costs of producing X as it increases production of X?

A Opportunity costs are constant between points 1 and 2, and between points 3 and 4.

B Opportunity costs decrease between points 1 and 2, and increase between points 3 and 4.

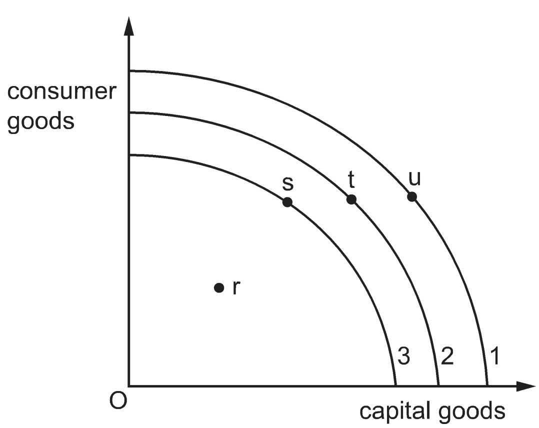
C Opportunity costs decrease between points 1 and 2, and between points 3 and 4.

D Opportunity costs increase between points 1 and 2, and between points 3 and 4.

[N23/P12/Q1]

26. The diagram shows three production possibility curves (PPC) for a country, labelled 3, 2 and 1. The original PPC for the country is 2.

This country experiences a fall in its working population and then this is followed by a long period of recession.



If an increase in GDP then takes place, what is the increase in production?

A r to s **B** r to u
C s to t **D** t to u

[N23/P12/Q23]

27. Why does a production possibility curve exist for every economy?

A Resources are unlimited.

B Resources have alternative uses.

C Some resources can be imported.

D Some resources may be unemployed.

[M24/P12/Q1]

28. An economist knows the current point at which an economy operates within its production possibility curve.

What can the economist conclude about this economy?

A its degree of self-sufficiency

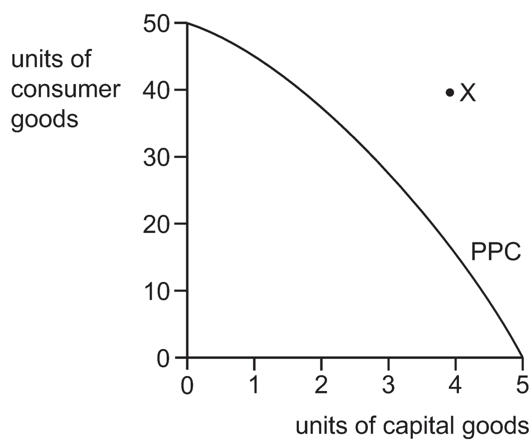
B its international competitiveness

C its level of output of two goods

D its rate of economic growth

[J24/P11/Q5]

29. The diagram shows a production possibility curve (PPC). It indicates the combinations of consumer goods and capital goods produced by an economy using all its available resources.



What does position X indicate?

A a lower ratio of capital to consumer goods is necessary to achieve economic growth

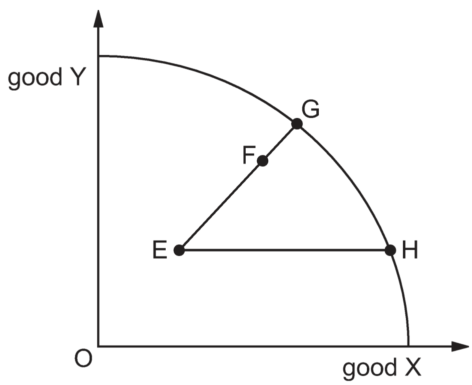
B increasing levels of unemployment

C insufficient factors of production are available

D too many consumer goods are causing a fall in economic growth

[J24/P12/Q1]

30. The diagram shows a production possibility curve for an economy that produces two goods, X and Y.



When will the opportunity cost of producing more of good X be the largest?

A moving from point E to point F

B moving from point E to point G

C moving from point E to point H

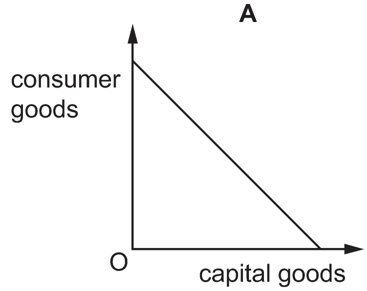
D moving from point G to point H

[J24/P13/Q2]

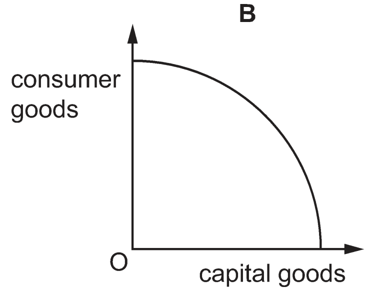
31. The diagrams show production possibility curves.

Which diagram shows constant opportunity costs?

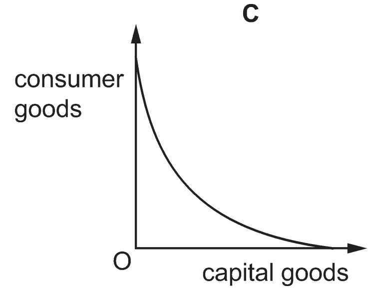
A



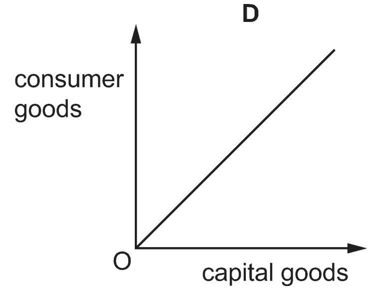
B



C



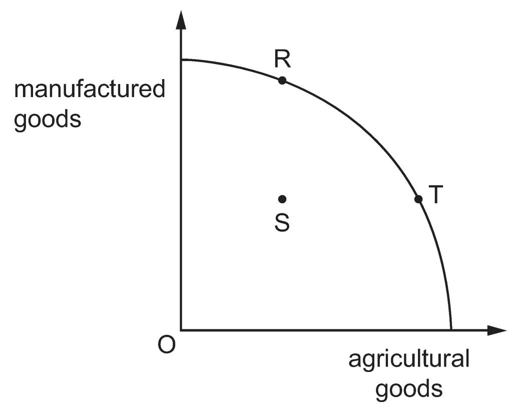
D



[N24/P11/Q4]

32. Farmers using traditional methods lack access to finance and often employ family members on a part-time basis.

If working practices in agriculture could be improved, how would this be likely to be shown on the production possibility curve?



A by a movement from R to T

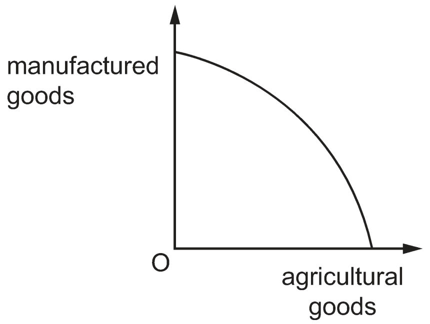
B by a movement from S to R

C by a movement from S to T

D by a movement from T to R

[N24/P11/Q5]

33. The production possibility curve for a country is shown.



What can be determined from the diagram?

A the consumers' preferred combination of output

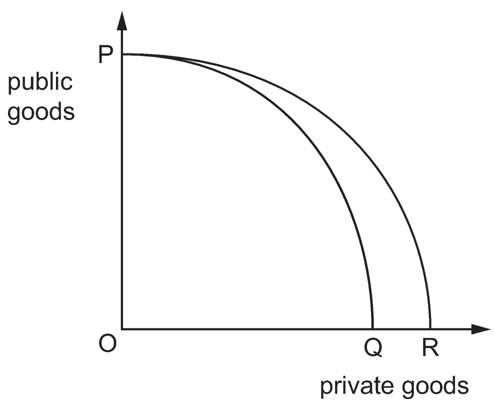
B the level of economic growth

C the opportunity cost of manufactured goods in terms of agricultural products

D the preference for present consumption rather than future consumption

[N24/P12/Q1]

34. The diagram shows the change in a country's production possibility curve from PQ to PR.



What increases as a result of the change from PQ to PR?

A the price of private goods

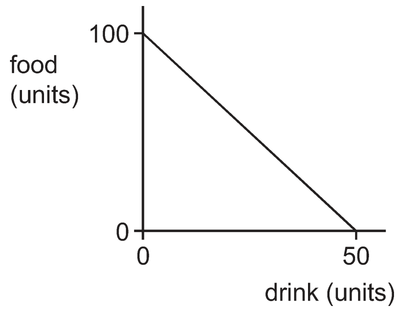
B the price of public goods

C the opportunity cost of private goods

D the opportunity cost of public goods

[N24/P12/Q5]

35. The diagram shows a country's production possibility curve.



What can be concluded from the diagram?

A Food and drink are normal goods.

B The country is self-sufficient in the production of food and drink.

C The opportunity cost of food falls as more drink is produced.

D There is a constant opportunity cost between food and drink.

[N24/P13/Q1]

1.2 - ANSWERS to MCQ

1. C A straight line PPC suggests constant opportunity cost. Thus it rules out option **D**. Also a PPC does not indicate demand therefore options **A & B** are irrelevant.

2. C Potential growth implies an outward shift in PPC this rules out option **D**. Highest potential for growth is achieved with the maximum production of capital goods.

3. C

Year	Opportunity cost ratio		
	consumer goods		capital goods
1	1	:	0.5
2	1	:	0.533

The graphs do not indicate either the production of capital goods to assess future growth or the level of unemployment therefore options **A** or **B** are incorrect. Option **D** is clearly incorrect.

4. D Increase in natural resources can increase the potential as indicated by an outward shift in the PPC. All other options suggest factors that do not shift a country's PPC.

5. B Difference between current output and potential output of good Y = 600 (1000 – 400), thus the economy sacrifices this in order to produce 1200 unit of good X.

6. D

Quantity of other good sacrificed for each 100 units of good X
20
30
40
50

7. C Productivity rise in peas picking would shift the line upwards on Y-axis, while a decrease in no. of hours with no change in productivity in beans picking would shift the curve inwards on X-axis.

8. C New seeds will help increase productivity of wheat production only thus shifting PPC outward on X axis.

9. B The graph shows a straight line PPC, therefore opportunity cost remains the same throughout the curve and it is measured as:

$$\frac{q_y \text{ sacrificed}}{q_x \text{ gained}} = \frac{1000}{500} = 2$$

10. B 10 × 8 = 80 is the maximum quantity of strawberries and twice of this = 160 raspberries.

11. D Opportunity cost refers to the quantity of a good sacrificed in order to produce a larger quantity of another good. So a movement from point R to S on the graph reduces the quantity of good Y from Y_1 to Y_2. This can be identified as opportunity cost of increasing the quantity of good X from X_1 to X_2.

12. B A productivity decline lowers the productive potential (PPC) of an economy. Options **A** & **C** would shift PPC outward while option **D** would bring a movement along the PPC.

13. A A change in the amount of capital can shift the PPC, therefore it is considered as one of the determinants of PPC. Other choices refer to the issues that are not related to PPC.

14. D A PPC is drawn to show output of two different types of goods.

15. C Slope of a PPC between two adjacent points in either direction gives an increasing opportunity cost of production when it is drawn as bowed outward (concave to the origin).

16. A Less number of working hours will decrease the worker's daily productivity of picking both pea & beans. However, the use of machine could more than offset the negative effect on his productivity of pea picking. Option **B** does not explain the decrease in beans picking while **C** will cause a movement along the PPC and **D** will shift PPC inward.

17. B By definition. Options **A** & **D** relate a free market economy while **C** suggests a mixed economy.

18. A All points on the PPC show maximum possible quantities of computers and food that the economy can produce with all its available resources. Thus, point Z is ruled out while Y is currently unattainable.

19. B Any point on the PPC suggests full & efficient use of resources, therefore a point inside PPC indicates inefficiency or unemployment. This eliminates **C** while **A** is incorrect because a higher output should improve current living standard. Also, for the movement from point X to Y the graph shows zero opportunity cost, therefore **D** is invalid.

20. D Opportunity cost remains constant along the linear PPC. This is possible only when resources are equally efficient in producing both goods. Hence **B** & **C** are invalid while **A** is unrelated.

21. C Pivotal inward shift on X-axis suggests a fall of productivity in drink production while the pivotal outward shift on Y-axis indicates productivity rise in food production. Other choices are incorrect because PPC does not reflect consumer choices, effects of tax & subsidy or imports / exports.

22. D A decrease in labour force will shift the PPC to the left. Other choices will shift it to the right for they are likely to increase labour force.

23. A A straight line PPC reflects constant opportunity cost resulting from constant returns to scale. Hence all other options are invalid.

24. B Movement from point 1 to 3 reflects a simultaneous increase in quantities of both goods i.e., zero opportunity cost. Movements between all other points suggest more of one good is obtained by sacrificing the other.

25. D All along the PPC that is drawn as bowed outward (concave to the origin) reflects increasing opportunity cost.

26. A A fall in the working population must have shifted the PPC inward to the curve 3 while a recession would have shifted the point inside PPC. Now an increase in GDP would shift the point (r) from inside to the point (s) on PPC.

27. B PPC exists because every economy can produce alternative but limited quantities of goods from the given resources. This eliminates options **A** & **C** while **D** is incorrect because PPC reflects full employment.

28. C The point inside PPC indicates current output of two goods. Other choices are inconclusive.

29. C PPC exhibits all different combinations of two goods that an economy can attain when it employs all its given resources and technology, therefore any point outside PPC is unattainable. This eliminates options **B** & **D** while **A** is incorrect because less ratio of capital goods could deter economic growth which is required to reach point X.

30. D Only option **D** suggests a sacrifice of good Y for an increased output of good X. Other choices suggest zero opportunity cost as options **A** & **B** demonstrate a simultaneous increase in both X & Y and **C** indicates more of X being produced without sacrificing Y.

31. A Slope between two successive points on a downward sloping straight line PPC gives constant opportunity cost. Diagram **B** measures increasing opportunity cost while **C** represents decreasing opportunity cost and **D** suggests zero opportunity cost.

32. C It will increase the output of agriculture alone.

33. C Slope of a PPC reveals opportunity cost. Other choices are inconclusive because the graph does not indicate any particular point.

34. D Initially, the opportunity cost of OP public goods equals OQ of private goods. After the shift it increases to OR. Hence, it increases by QR. This eliminates option **C** while **A** & **B** are invalid because a PPC is drawn to show output.

35. D On a downward sloping straight line PPC the slope between two successive points (opportunity cost) is constant. This eliminates option **C** while **A** & **B** are inconclusive.

TOPIC 1

Basic Economic Ideas And Resource Allocation

ESSAY Section

OVERVIEW OF THE TOPIC

- **Scarcity, Choice and Opportunity Cost**
- **Positive and Normative Statements**
- **Factors of Production**
- **Resource Allocation in different Economic Systems and Issues of Transition**
- **Production Possibility Curves**
- **Classification of Goods and Services**

LIST OF QUESTIONS

Q1 (M23/P22/Q2)

(a) Explain the functions of price in resource allocation **and** consider the importance of these functions in relation to the potential effectiveness of a market economy. [8]

(b) Assess whether all market economies should become mixed economies. [12]

Q2 (J23/P21/Q2)

(a) With the help of a diagram, explain the difference between the causes of a movement along, and a shift of, a production possibility curve (PPC) **and** consider which is likely to have the most immediate impact on an economy. [8]

(b) Assess whether education should be classified as a public good rather than classified as a merit good. [12]

Q3 (N23/P22/Q3)

(a) With the help of examples, explain the difference between free goods and public goods **and** consider the view that public goods can never be provided in a market economy. [8]

(b) The provision of merit and demerit goods differs from the provision of other private goods.

Assess the view that the consequences of imperfect information are more serious in a market economy than in a mixed economy. [12]

Q4 (N23/P23/Q3)

(a) Explain why the provision of bus and local rail (mass transit) services in cities is classified as a private good not a public good and consider why such services might only be provided by the private sector. [8]

Q5 (J24/P21/Q2)

(a) With the use of examples, explain the difference between public goods and merit goods and consider whether markets will always provide enough of both goods. [8]

(b) Assess whether a planned economic system should always switch to a mixed economy. [12]

Q6 (J24/P23/Q3)

(a) Use a production possibility curve (PPC) diagram to explain how a government in a mixed economy might allocate more resources to consumption and fewer resources to investment **and** consider a limitation of this approach to resource allocation. [8]

(b) Assess whether producers are the only ones to benefit when an economy decides to allocate additional resources to investment. [12]

Q7 (N24/P21/Q3)

(a) With the help of a diagram, explain the significance of a position within a market economy's production possibility curve (PPC) **and** consider whether such a position is likely to be permanent. [8]

(b) Assess whether consumers always benefit when the government of a mixed economy reduces the role of the market mechanism in allocating resources. [12]

Q8 (N24/P22/Q3)

(a) With the help of a production possibility curve (PPC) diagram(s), explain the difference between constant and increasing opportunity costs **and** consider how choices in deciding which type of goods to produce in the short run may influence future economic growth. [8]

(b) Assess whether a market economy is always the best economic system to effectively answer the three basic questions of resource allocation. [12]

Q9 (N24/P23/Q2)

(a) With the aid of examples, explain the characteristics of public goods and free goods **and** consider whether free-of-charge vaccinations offered by a government should be classified as a free good. [8]

Q10 (M25/P22/Q2)

(a) With the help of a production possibility curve (PPC) diagram, explain the terms scarcity and choice **and** consider the extent to which every choice has an equal opportunity cost. [8]

(b) Assess whether the allocation of resources in a market economy is always beneficial. [12]

Q11 (M25/P22/Q3)

(a) Explain the difference between a public good and a private good (economic good) **and** consider the extent to which a beach could be described as a public good. [8]

Question 1

(a) Explain the functions of price in resource allocation **and** consider the importance of these functions in relation to the potential effectiveness of a market economy. [8]

(b) Assess whether all market economies should become mixed economies. [12]

[M23/P22/Q2]

Essay

(a) In a market economy, price mechanism is the term used to describe the means by which many millions of decisions, taken each day by consumers and businesses, allocate scarce resources among competing uses. Invisible hand, so the price mechanism is known" operates in a competitive market through the pursuit of self-interest.

Prices in a market economy perform three key functions: rationing, signaling, and incentivizing. These functions ensure that resources are allocated where they are most needed and that the economy operates smoothly.

First, the "rationing function" of prices ensures that scarce resources are allocated to those who value them the most. For example, during a shortage of wheat, the price of bread might increase. This higher price rations the available bread to those who are willing and able to pay more, ensuring that the limited supply goes to those who need or value it the most. Without this mechanism, shortages could lead to empty shelves and long queues.

Second, prices act as a "signaling mechanism", transmitting information about consumer preferences and market conditions to producers. When price rises, it signals to producers that there is high demand for a good, encouraging them to increase production to Q_1. For instance, if increased consumer interest causes price of electric cars to rise, car manufacturers will allocate more resources to producing electric vehicles. This ensures that resources flow to where they are most valued, aligning production with consumer preferences.

Incentives also play a fundamental role in allocation of resources. Higher prices create intensive for producers to supply more of a good, while lower prices encourage consumers to buy more. For example, if the price of solar panels falls due to technological advancements, more households and businesses may install them, reducing reliance on fossil fuels. This incentive drives innovation and efficiency, as producers compete to offer better products at lower prices.

The importance of these functions becomes clear when we analyze how they interact within a market economy. Without rationing, resources could be exhausted too quickly, leading to shortages. Without signaling, businesses might produce goods that consumers do not want, leading to inefficiencies and wasted resources. And without incentives, producers and consumers would lack motivation to respond to changes in supply and demand, causing stagnation and inefficiencies in the economy.

Ultimately, when we evaluate the importance of these functions, it's clear that rationing and signaling are particularly vital. Rationing prevents resource wastage, while signaling ensures that production aligns with consumer needs. However, incentivizing is equally critical, as it drives innovation and efficiency. Without these functions, a market economy would struggle to allocate resources effectively, leading to inefficiencies and potential market failures. For example, in centrally planned economies like the former Soviet Union, the absence of price mechanisms led to chronic shortages and surpluses.

In conclusion, all three functions of prices are essential to the operation of a market economy. They ensure that resources are allocated efficiently, production meets consumer demand, and innovation thrives. While all three functions are important, rationing and signalling stand out as the backbone of resource allocation, ensuring that markets remain responsive and dynamic.

(b) A market economy is characterized by minimal government intervention, with economic decisions mainly driven by supply and demand. In such economies, competition plays a key role in determining prices, production levels, and resource allocation. One of the main arguments for maintaining a pure market economy is the efficiency in resource allocation. Prices serve as signals, guiding producers and consumers toward the most efficient use of resources. Firms seek to maximize profits, leading to innovation, cost-cutting, and the production of high-quality goods and services. Consumers, driven by their preferences and purchasing power, determine which products succeed in the market. This system encourages competition, which drives down prices and improves product quality. Unlike free market, excessive government intervention in a mixed economy can distort these market signals, leading to inefficiencies.

Another argument for a market economy is that competition fosters economic growth. When businesses compete, they are motivated to develop new products, invest in research and development, and improve efficiency. Countries with market-based economies, such as the United States, have historically experienced high levels of innovation and productivity. By contrast, excessive government intervention in mixed economies can lead to bureaucracy, inefficiencies, and reduced entrepreneurial incentives. Governments may impose regulations that restrict business activity or introduce subsidies that create inefficiencies.

Market economies also provide greater individual freedom. Consumers can choose how to spend their income, while businesses operate based on profitability rather than government mandates. In contrast, a mixed economy may involve government intervention that restricts choices, such as imposing taxes on certain goods or subsidizing industries deemed important by policy makers. While this may serve social objectives, it can also limit personal freedoms and economic dynamism.

However, market economies are not flawless, and this is where the argument for transforming into a mixed economy becomes compelling. One of the biggest shortcomings of a market economy is the failure to provide public goods, such as national defense, street lights, and law enforcement. These goods are non-excludable and non-rivalrous, implying that individuals cannot be prevented from using them, and one person's consumption does not reduce availability for others. Since private firms have little incentive to provide these goods, government intervention is necessary to ensure their provision.

Market economies also tend to under-produce merit goods, such as healthcare and education. These goods provide significant positive externalities, meaning their consumption benefits not only the individual but also society as a whole. For example, an educated workforce leads to a more productive economy, and access to healthcare reduces the spread of diseases. Without government intervention, these goods would be underconsumed, as individuals may undervalue their long-term benefits or be unable to afford them. In a mixed economy, the government can subsidize or directly provide these services to ensure wider access.

Another issue in a market economy is the overconsumption of demerit goods, such as alcohol, tobacco, and junk food. These goods create negative externalities for their consumption imposes costs on others. For instance, excessive alcohol consumption can lead to health issues and accidents, increasing the burden on public healthcare systems. In a mixed economy, the government can impose taxes or regulations to reduce the consumption of such goods, promoting overall societal well-being.

Price instability is another concern in a market economy. Prices for essential goods and services, such as housing, food, and fuel, can fluctuate significantly due to market forces. Supply shortages or surges in demand can lead to excessive price volatility, making it difficult for consumers to plan and budget. Government intervention in a mixed economy can help stabilize prices through policies such as price controls, subsidies, or strategic reserves.

A mixed economy also allows governments to address income inequality, which often worsens in a pure market economy. Unregulated markets tend to concentrate wealth in the hands of a few, leaving lower-income individuals struggling to afford basic necessities. Through progressive taxation, social welfare programs, and minimum wage laws, a mixed economy can redistribute wealth and provide a safety net for vulnerable populations.

While these arguments suggest that a transition from the market economy to a mixed economy is beneficial, however, it depends on the extent of government intervention. Excessive regulation and state control can lead to inefficiencies, corruption, and reduced economic incentives. Hence, the success of a mixed economy depends on striking a balance between allowing market forces to operate freely and government intervention to correct market failures.

In short, not all market economies should transit to mixed economies in the same way. Instead, each economy should determine the optimal level of government intervention, as some degree of involvement is generally needed to ensure sustainable and equitable economic functioning.

Question 2

(a) With the help of a diagram, explain the difference between the causes of a movement along, and a shift of, a production possibility curve (PPC) **and** consider which is likely to have the most immediate impact on an economy. [8]

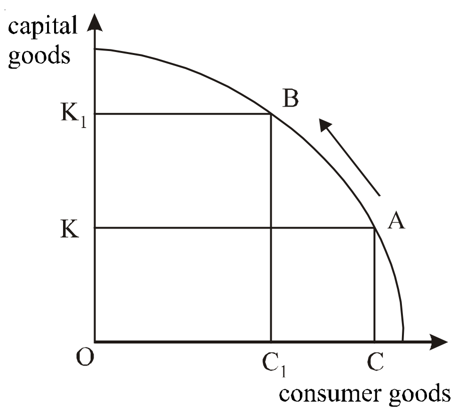
(b) Assess whether education should be classified as a public good rather than classified as a merit good. [12]

[J23/P21/Q2]

Essay

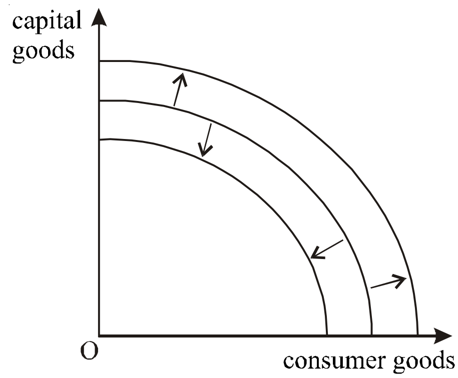
(a) A production possibility curve (PPC) shows all possible combinations of two goods that a country can produce within a specified time period with the given state of technology when all its resources are fully and efficiently employed. A movement along the PPC and a shift of the PPC occur due to different factors, each with distinct effects on an economy.

A movement along the PPC happens when an economy reallocates its existing resources to produce more of one good while reducing the production of another. This is due to opportunity cost — the idea that producing more of one good requires sacrificing the production of another. The graph below illustrates movement along the PPC.



Let's assume that the economy producing both consumer and capital goods decides to produce more capital goods. This means fewer resources will be available for consumer goods, leading to a movement along the curve from point A to B. This does not change the overall productive capacity of the economy but alters how resources are utilized. Such movements occur due to changes in demand, shifts in consumer preferences, or government policies preferring certain industries over others.

On the other hand, a shift of the PPC occurs when there is an actual change in the economy's productive capacity. This can result from an increase in the quantity or quality of resources. For instance, improvements in technology, or better education and training leading to a more skilled workforce. This is illustrated in the graph below.



A rightward shift of the PPC means that the economy can now produce more of both goods without trade-offs, signifying long-term economic growth. Conversely, a leftward shift represents a decline in productive capacity, which could happen due to resource depletion, natural disasters, or economic disruptions.

Of these two types of changes the impact of a movement along the PPC is immediate since it reflects changes in resource allocation within existing limits. It can respond quickly to short-term fluctuations in consumer demand or government policies. For example, during a crisis, a government might give priority to medical supplies over luxury goods, leading to a movement along the PPC. However, a shift in the PPC, although more significant for long-term growth, takes longer to materialize as it requires structural changes such as investments in infrastructure, workforce development, or technological advancements.

While both, movements along the PPC and shifts of the PPC affect the economy, a movement along the PPC has the most immediate impact because it reflects short-term adjustments to resource allocation without altering overall production capacity.

(b) Education is generally classified as a merit good rather than a public good due to its characteristics of being both rival and excludable. A merit good is one that tends to be under-consumed in a free market, leading to potential under-provision unless the government intervenes. Education fits this definition because, while it can be provided through a market and people can be charged for it, not everyone may recognize its full benefits, leading to less consumption than what is socially optimal. This under-consumption justifies government intervention to ensure access for all, particularly in primary and secondary education, which have significant positive externalities for society.

In contrast, a public good is defined as a good that is both non-rival and non-excludable. A non-rival good is one where consumption by one person does not reduce the availability for others, and a non-excludable good is one where people cannot be prevented from consuming it, even if they do not pay for it. Classic examples include street lighting and national defense. The key issue with public goods is the free rider problem, where individuals may benefit from the good without contributing to its cost, leading to potential market failure if left entirely to the private sector.

Education does not fully meet the criteria of a public good because it is both excludable and rival to some extent. In most education systems, individuals must pay fees for private schooling or higher education, which makes it excludable. Additionally, it is associated with rivalry as classroom spaces and other resources used are limited. It means that one student's participation can reduce the availability of resources for another. This differs from pure public goods, where one person's consumption does not impact others at all.

However, education does have certain elements that resemble public goods, particularly in terms of its broader social benefits. An educated population contributes to economic growth, social cohesion, and lower crime rates, all of which benefit society as a whole beyond just the individuals receiving the education. These positive externalities make the case for government intervention, ensuring wider access to education even if the market does not naturally provide it at an optimal level.

While public goods must be provided by the government due to the free rider problem, merit goods like education do not necessarily have to be entirely state-funded. Instead, they can be provided by both private institutions and the state. Governments often step in to subsidize or fully fund education to correct market failure and ensure equitable access. This is why public schooling is common worldwide, even in market-driven economies. However, higher education often remains partially privatized, with students required to contribute through tuition fees.

However, if demand for education is extremely low in a country, a government might choose to provide it entirely through the state. This could happen in economies where private investment in education is minimal due to high costs or low perceived benefits. In such cases, treating education more like a public good, offering it universally at no cost, might be necessary to encourage participation and long-term economic development. However, even in such cases, education remains excludable and rival to some extent, differentiating it from true public goods.

In conclusion, education is more accurately classified as a merit good for it is excludable and rival in nature. Therefore, unlike pure public goods, which require full government provision, education can be delivered through a mix of private and public institutions, making it distinct from goods such as national defense or street lighting.

Question 3

(a) With the help of examples, explain the difference between free goods and public goods **and** consider the view that public goods can never be provided in a market economy. [8]

(b) The provision of merit and demerit goods differs from the provision of other private goods.

Assess the view that the consequences of imperfect information are more serious in a market economy than in a mixed economy. [12]

[N23/P22/Q3]

Essay

(a) Free goods are the gift of nature for they are useful but not scarce. Therefore, all agents can consume them jointly at zero opportunity costs. It means that each one of us can consume these goods in as much quantity as needed without reducing their availability to others. Sunlight, for example, is available to all at zero cost. Other examples include clean air in mountain area or water if one lives next to a river in a low population density. However, a high population density city may mean more water is taken from the river than can be replenished. Therefore, it leads to a rivalry in consumption and hence it makes water to lose its status of free good.

One important distinction is that just because a good is given away for 'free of direct charges' it doesn't necessarily mean that it is a free good. Provision of public goods, for instance, street lights or national defense is not actually free because their production involves scarce resources. This means that there is an economic cost for if they are not provided same resources could have been used to produce something else.

Public goods are indivisible in nature for they are jointly consumed by many individuals and their consumption can be extended to many more without incurring additional cost. These goods are non-excludible and non-rival. Non-excludability entails that once, for instance, street lights have been installed there is no effective way of limiting the benefits to only those who pay for them while non-rivalry means as more and more people consume street lights; the benefit to those already consuming is not diminished.

These two features give rise to the problem known as free rider; people receiving benefits from a good without contributing to its cost. For instance, the provision of street lights could be economically justified if benefits to society are higher than their production costs. But the problem arises when those who choose not to pay cannot be excluded. Therefore, it leads to the situation in which everyone believes that others will take on the burden of payment.

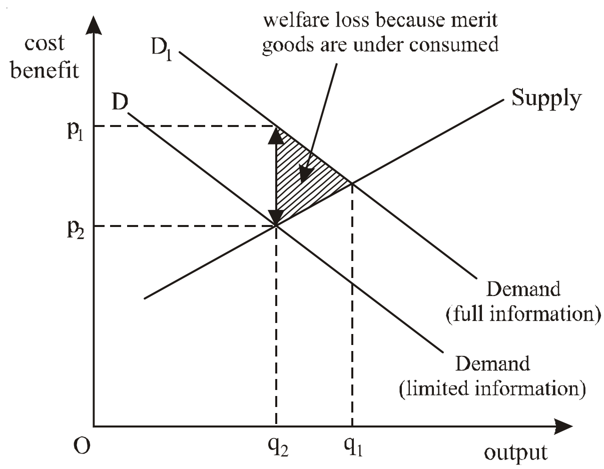
So, the free rider problem develops a situation where people may wish for street lights to be installed but they are not willing to pay for it. This leaves no economic incentive for private enterprises to provide street lights because they cannot sell them through markets for profit. Eventually the market system fails to provide public goods. However, if the society is to enjoy consumption of public goods they must be provided by the government and financed through compulsory charges in the form of taxes.

This leads us to the conclusion that free goods are not scarce therefore they do not have an opportunity cost while public goods may be provided free of direct charges but we pay for them indirectly through taxes and their production requires scarce resources which have an opportunity cost. However the market system fails to provide public goods because of the problem of free ride.

(b) In a market economy, resources such as land, raw material and capital are privately owned. So, the decisions to provide all types of private goods are taken by individual households and firms who are assumed to act in their own self-interest. The essence of such an economy is price mechanism that operates through the market forces of demand and supply. The price system functions as a signal and an incentive for producers to act in the required way to maximise their gain which, in turn, optimises allocation of resources. This means that changes in market forces of demand and supply adjust prices to demonstrate what goods should be provided and how much.

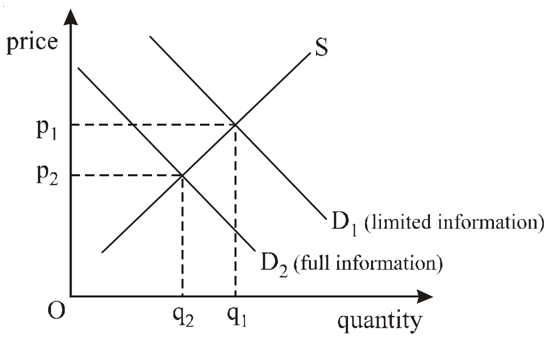
It is believed that price mechanism is the most efficient allocative mechanism as long as there is perfect information. However, even the most competitive outcome of market forces fails to provide socially optimum quantities when consumers are short of necessary information required to make right choices such as in case of merit and demerit goods. This is because the benefits that the market forces confer to individuals and businesses diverge from the benefits to the society.

With the idea of imperfect information a merit good is defined as better for a person than he realizes. Often quoted examples of merit goods include health services, education, work training programmes, public libraries etc. There is nothing inherent in any of these goods that make them different from private goods for they all can be provided through the market exactly in the same way as other private goods. However, due to the lack of information consumers may not be able to purchase or feel the need to consume them up to the socially optimum level. This is illustrated in the graph below.



Here D_1 is the correct level of demand because it represents perfect information. This leads to the optimum consumption q_1. But imperfect information causes consumers to undervalue the good and register D_2 as their actual demand that leads to only q_2 consumption. Hence, it makes the case for under consumption that causes a welfare loss as shown by the shaded triangular area.

Demerit goods, on the other hand, are worse for the consumers than they realize. This is because either they do not have the right information or they simply lack some relevant information. The result is higher demand and overconsumption. Figure below illustrates this.



Here the correct demand is D_2 which should lead to q_2 consumption. However, the actual demand D_1 leads to q_1 consumption that is higher than the socially optimum consumption q_2. It therefore suggests that a market economy provides both merit and demerit goods through the same price system that it uses to provide all other private goods. However the problem arises when imperfect information prevents markets to achieve socially efficient levels.

So, under provision of merit goods and over provision of demerit goods paves the way for government intervention that leads us to a mixed economy. A mixed economy is a mix of free market and planned economic system. It, therefore, could mean anything depending on the degree of mix. The key features include ownership of some of the country's resources publicly and some are owned privately. Price mechanism operates in the private sector while the government plans and runs the public sector with the goal of "common good". In a mixed economy the government goes well beyond its important basic functions. Not only does government directly control part of the economy, but it also intervenes to correct what economists call market failures. For this government can use various measures ranging from financial intervention i.e. indirect tax and subsidy to improving information, regulation and direct provision.

So, in a market economy price system can provide other types of private goods most efficiently but it fails to achieve efficiency when it comes to merit and demerit goods and inefficiency may persist because the market does not offer any solution to deal with it. However in a mixed economy the government can intervene to improve allocation of resources wherever it is required. Therefore, inefficiencies resulting from imperfect information should not be as serious in a mixed economy as in a market economy.

Question 4

Explain why the provision of bus and local rail (mass transit) services in cities is classified as a private good not a public good **and** consider why such services might only be provided by the private sector. [8]

[N23/P23/Q3(a)]

Essay

Bus and local rail (mass transit) services in cities are classified as private goods rather than public goods because they exhibit the characteristics of rivalry and excludability. Rivalry implies that consumption by one person reduces the availability for others and excludability entails that individuals can be prevented from using the good if they do not pay for it.

Mass transit services are rivalrous because, at peak times, buses and trains become crowded, it means that additional passengers may be unable to board or may experience discomfort due to congestion. This contrasts with public goods, which are non-rivalrous, where one person's consumption does not reduce the amount available for others. For example, street lighting remains available to all regardless of how many people use it.

Mass transit services are also excludable since operators can charge fares and restrict access to only those who are willing and able to pay for it. If an individual does not purchase a ticket, they cannot legally use the service. In contrast, a public good is non-excludable, where people cannot be prevented from using it even if they do not pay. A lighthouse, for instance, provides navigation assistance to all ships, regardless of whether they contribute to its maintenance.

Because mass transit services have characteristics of private good, therefore they are often provided by the private sector. Private firms have a profit incentive to offer these services, charging passengers the fares that cover costs and generate returns. Competition can also lead to efficiency improvements, better service quality, and innovation in pricing models, such as subscription services or dynamic pricing.

However, relying solely on the private sector to provide mass transit services can have drawbacks. In cases where profit incentives are insufficient, private firms may choose not to operate routes that are unprofitable, particularly in areas with low population densities. This could leave some communities underserved, leading to transport inequality. Additionally, mass transit has positive externalities, such as reducing road congestion and pollution, which benefit society but may not be considered in private decision-making.

Hence, in some cases, governments intervene through subsidies or direct provision to ensure widespread access to mass transit services. Public funding can make transport affordable, encourage sustainable travel, and reduce reliance on cars. However, government-run services may lack efficiency compared to private firms, potentially leading to higher operating costs and lower service quality.

In conclusion, mass transit services are classified as private goods due to rivalry and excludability, however, they are not always best provided solely by the private sector. Hence private firms operating services with government support or regulation, could be the most effective strategy to ensure efficiency, affordability, and accessibility.

Question 5

(a) With the use of examples, explain the difference between public goods and merit goods and consider whether markets will always provide enough of both goods. [8]

(b) Assess whether a planned economic system should always switch to a mixed economy. [12]

[J24/P21/Q2]

Essay

(a) Public goods are those that people can use without reducing their availability to others and from which no one can be excluded. Examples such as street lighting, national defense, and light house illustrate this concept. Because of their nature, private firms have little incentive to provide them, as they cannot charge individuals directly for their use. This leads to what is known as the free-rider problem, where people benefit without paying, ultimately resulting in missing markets. For instance, in a purely free-market system, it would be difficult for private companies to provide street lighting since they cannot prevent individuals from using the light without paying. Governments, therefore, step in to fund such services through taxation to ensure their availability.

Merit goods, on the other hand, are those that are better for individuals than they might realize, often suffering from under-consumption due to information failure. Education, healthcare, and vaccinations are key examples. Without government intervention, many people may not fully understand their benefits or may be unable to afford them, leading to suboptimal social outcomes. Vaccinations, for instance, protect both individuals and the wider community, yet without incentives or subsidies, some may choose not to get vaccinated. Similarly, education increases productivity and innovation, but without government funding, access can be limited, leading to social inequality and economic stagnation.

In a purely market-driven economy, public goods will not be provided while merit goods are likely to be under-provided. Public goods, lacking a profit motive, would not be produced at all, while merit goods would be available only to those who could afford them. Private companies may offer services such as healthcare and education, but without government support, many people would struggle to access them. This is why many economies adopt a mixed approach, where the government steps in to fund public goods and subsidize merit goods to encourage wider consumption. The extent to which this happens depends on economic policies and available resources. Wealthier nations, with strong taxation systems, tend to provide significant quantities of public goods and ensure broader access to merit goods, while developing countries often struggle due to budget constraints and governance issues.

A mixed economy may produce enough of both types of goods due to government involvement and the welfare motive but even in a mixed economy, challenges remain. Government funding is not limitless, and inefficiencies in public service delivery can lead to shortages or poor-quality provision. On the other hand relying entirely on market forces would likely intensify social inequalities and reduce overall economic welfare. Therefore, a blend of public funding and private sector involvement with regulation offers the best chance of ensuring that both public and merit goods are sufficiently provided to meet the needs of society.

(b) A planned economic system is one in which the government controls most aspects of production, distribution, and resource allocation. This system prioritizes social welfare, ensuring that essential goods and services such as healthcare, education, and infrastructure are accessible to all, rather than being determined by market forces. By eliminating profit motives, planned economies can focus on long-term economic stability and social equity. However, the efficiency of resource allocation in such a system can be problematic, as the lack of competition may lead to inefficiencies, lower productivity, and a failure to meet consumer demands effectively.

In contrast, a mixed economy combines elements of both a planned and a market economy, balancing government intervention with free-market mechanisms. In this system, the government retains control over essential industries while allowing private businesses to operate in other sectors. This creates a more efficient allocation of resources by leveraging market forces, such as competition and consumer choice, while still ensuring the provision of public and merit goods. A mixed economy is often seen as offering the best of both worlds, promoting economic growth while maintaining social welfare and stability.

One of the main drawbacks of a planned economy is the absence of competition. Without competition, firms have little incentive to innovate, improve efficiency, or respond to consumer preferences. This can result in shortages of goods, long wait times for services, and an overall lack of responsiveness to the needs of the population. Additionally, planned economies often suffer from bureaucratic inefficiencies, as decision-making is centralized and may not reflect local realities. The misallocation of resources is common, as production is based on government planning rather than real-time market demand.

A mixed economy addresses many of these issues by allowing private businesses to operate, fostering innovation, competition, and efficiency. Market-driven businesses respond more effectively to consumer preferences, ensuring that goods and services are produced in line with demand. This system can lead to higher productivity and economic growth, as profit motive motivates businesses to improve their products and services. Furthermore, taxation from private sector activities provides governments with revenue to fund public services and infrastructure.

However, the transition from a planned economy to a mixed economy is not always straightforward. One challenge is the potential for increased income inequality, as privatization can lead to wealth concentration among those who control key industries. If not managed carefully, the introduction of market forces can result in economic disparities, with some individuals and businesses benefiting significantly while others struggle. This shift also requires significant regulatory oversight to prevent market failures and ensure that privatized industries do not exploit consumers or engage in monopolistic practices.

Despite these challenges, history has shown that many planned economies have successfully transitioned to mixed economies with positive results. Countries that have moved toward market reforms, such as China and Vietnam, have experienced significant economic growth and improved living standards. However, the degree to which a country should embrace market elements depends on various factors, including its political structure, level of economic development, and societal priorities.

Hence it follows that a planned economy should incorporate market-based elements in selected areas that can help address inefficiencies and drive economic progress without compromising too much on social equity. The key is finding the right balance between government intervention and market forces to ensure both economic growth and social well-being.

Question 6

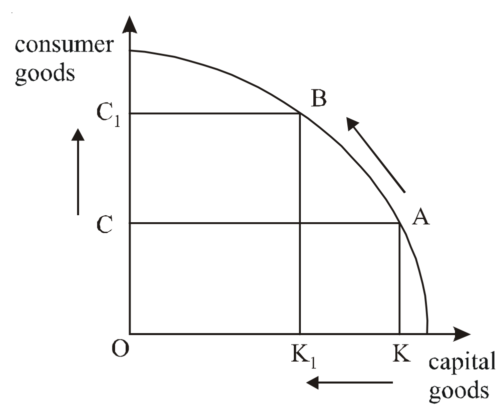
(a) Use a production possibility curve (PPC) diagram to explain how a government in a mixed economy might allocate more resources to consumption and fewer resources to investment **and** consider a limitation of this approach to resource allocation. [8]

(b) Assess whether producers are the only ones to benefit when an economy decides to allocate additional resources to investment. [12]

[J24/P23/Q3]

Essay

(a) A production possibility curve (PPC) demonstrates the maximum potential output of two goods given the available resources and technology. Hence a PPC illustrates the trade-off between consumer goods and capital goods as given below.



In a mixed economy, the government can allocate more resources toward consumer goods, which would be shown as a movement along the PPC from point A to B with higher production of capital goods to one with increased consumer goods output.

One way to encourage the production of consumer goods is by reducing income taxes. Lower taxes increase disposable income, allowing households to spend more on consumer goods, driving businesses to focus more on immediate production rather than investment. Additionally, the government can reduce indirect taxes, such as value-added tax (VAT), making goods more affordable and stimulating demand.

Another approach is increasing subsidies for consumer goods. Financial assistance to industries producing essentials such as food, healthcare, and education reduces production costs, encouraging greater output. In contrast, cutting subsidies for capital goods industries, like manufacturing and infrastructure, discourages investment in long-term projects, shifting resources toward present consumption.

The government could also reduce support for business investments. Cutting investment incentives or tax benefits for businesses discourages expansion and infrastructure development. Firms may divert resources to short-term production rather than investing in technology and efficiency improvements. This shift increases consumption but at the cost of reduced future economic growth.

However, there are limitations to this approach. One major concern is time lags. The effects of tax cuts or subsidies may take months or years to significantly impact consumer spending. Moreover, if economic conditions are uncertain, households may save extra income rather than spend it, limiting the effectiveness of these policies. Similarly, businesses may take time to adjust their production based on shifting demand.

Another issue is the potential negative response of businesses. Reducing investment incentives can lower business confidence, discouraging long-term expansion and technological advancements. Over time, this may reduce productivity and competitiveness. Additionally, excessive consumption relative to investment can lead to inflationary pressures, as demand outpaces supply, eroding purchasing power.

A further limitation is the long-term impact on economic growth. Investment in capital goods, such as machinery and infrastructure, is essential for sustained economic development. A decline in capital investment can slow technological progress and reduce productivity, making the economy less competitive globally. If businesses lack resources to expand, maintaining high levels of output and employment in the future could become challenging.

While increasing consumption may provide short-term economic relief, it poses risks to long-term growth. Therefore, the government in a mixed economy must carefully consider the trade-offs to ensure that both immediate economic needs and future prosperity are addressed.

(b) When an economy allocates additional resources to investment, producers are among the primary beneficiaries. Increased investment often leads to improvements in technology, infrastructure, and capital equipment, which reduce production costs and enhance efficiency. With lower costs, producers become more price-competitive, both domestically and internationally, potentially expanding their market share and increasing profits. Additionally, investment in research and development can lead to product innovation, allowing businesses to differentiate themselves and attract more consumers. In the long run, productivity improvements also enable firms to scale up production, benefiting from economies of scale.

However, the extent to which producers benefit depends on several factors. If investment is directed primarily toward large multinational corporations, smaller domestic firms may not experience the same advantages. Additionally, investment in infrastructure or technology may take time to yield results, meaning producers may not immediately see the benefits. If investment is financed through government borrowing or higher taxes, producers might also face increased costs in the short term.

Consumers can also gain from increased investment, particularly in the long run. As businesses invest in technology and efficiency, production costs fall, which can lead to lower prices. Additionally, investment often leads to higher-quality goods and services, improving consumer choice. Infrastructure investments, such as improved transport networks, reduce costs for businesses, allowing them to pass savings onto consumers. Moreover, investment in industries such as healthcare, education, and renewable energy can enhance overall living standards.

However, in the short term, consumers may experience some negative effects. If additional investment is funded through higher taxes, disposable income may decrease, limiting spending power. Similarly, if resources are diverted away from consumer goods to capital goods, fewer goods may be available, potentially driving up prices. If inflation rises due to excessive investment, real incomes may fall, reducing purchasing power.

Governments also benefit from increased investment, particularly in the long run. A more productive economy generates higher tax revenues, allowing the government to invest further in public services. Increased employment opportunities resulting from investment reduce welfare dependency and boost income tax revenues. Investment in infrastructure also enhances economic development, attracting foreign direct investment and promoting long-term stability.

However, governments may face short-term fiscal challenges when allocating more resources to investment. Public investment often requires significant funding, which may lead to increased borrowing or higher taxation. If investments do not yield expected returns, governments may struggle with debt burdens, limiting their ability to implement future policies. Additionally, if investment leads to inflation, policymakers may need to implement contractionary measures, potentially slowing economic growth.

So, the extent to which different economic agents benefit from investment depends on several factors, including the type of investment, the level of government involvement, and the state of the economy. In developed economies with advanced infrastructure, additional investment may primarily benefit businesses through efficiency improvements and global competitiveness. In developing economies, investment in basic infrastructure, education, and healthcare may provide broader societal benefits, improving living standards and economic opportunities.

While producers are among the primary beneficiaries of investment, consumers and governments also experience significant advantages, particularly in the long run. However, short-term challenges, such as increased taxation, inflation, or resource reallocation, must be managed carefully to ensure that investment leads to sustainable economic growth.

Question 7

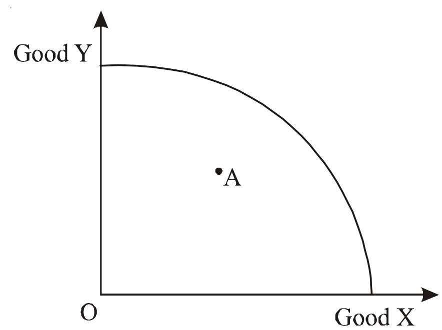
(a) With the help of a diagram, explain the significance of a position within a market economy's production possibility curve (PPC) **and** consider whether such a position is likely to be permanent. [8]

(b) Assess whether consumers always benefit when the government of a mixed economy reduces the role of the market mechanism in allocating resources. [12]

[N24/P21/Q3]

Essay

(a) In a market economy, the production possibility curve (PPC) illustrates the maximum potential output of two goods given the available resources and technology. Any point on the PPC represents full and efficient use of these resources, while a position inside the curve indicates inefficiency as illustrated in the following graph.



A position within the PPC as shown by the point A means that the economy is not reaching its full productive capacity. This can occur for various reasons, such as high unemployment, where a significant portion of the workforce remains idle despite the availability of jobs. Another reason could be inefficient use of resources, where firms do not make full use of land, capital, or technology. Additionally, structural problems in the economy, such as outdated infrastructure or lack of investment in education and training, can prevent full productivity. In such cases, the output of both goods represented on the PPC is lower than what could be achieved if all resources were fully utilized.

The significance of being inside the PPC is that it indicates lost potential output, which can have major economic consequences. If an economy is not producing at its full potential, it means that goods and services that could improve people's standard of living are not being produced. This

TOPIC 6

Government Macroeconomic Intervention

MCQ Section

- **Types Of Policy: Fiscal, Monetary And Supply Side Policy,**
- **Policies To Correct Inflation And Deflation.**

1. A government uses monetary policy to manage its economy.

Which sequence correctly describes the most likely consequence of an increase in the country's inflation rate?

	expectations about future interest rates	→	capital inflows	→	exchange rates
A	fall		decrease		depreciate
B	fall		increase		appreciate
C	rise		decrease		depreciate
D	rise		increase		appreciate

[J15/P1/Q30]

2. A government's budget is balanced at a time when the economy is fully employed, but an aggregate demand shock causes a decline in national income.

What will be the result if the government keeps its tax rates and level of spending unchanged?

A a cyclical budget deficit

B a cyclical budget surplus

C a structural budget deficit

D a structural budget surplus

[J15/P3/Q30]

3. In a time of recession, a governmentdecided to sell a loss-making state-owned industry to a foreign private company.

What is the **most** likely immediate result?

A an improvement in the financial account of the balance of payments

B an improvement in the level of unemployment

C an improvement in the rate of inflation

D an improvement in the trade account of the balance of payments

[N15/P1/Q30]

4. In the absence of offsetting changes, what will result in an increase in a government's fiscal deficit?

A a decrease in household saving

B a decrease in interest rates on government bonds

C a decrease in private sector investment

D a decrease in the country's trade deficit

[N15/P3/Q24]

5. An increase in interest rates is an example of which type of policy?

A contractionary fiscal policy

B contractionary monetary policy

C expansionary monetary policy

D restrictive supply-side policy

[J16/P1/Q28]

6. Possible policies a government might use to reduce a deficit on the current account of the balance of payments include devaluation, government spending cuts, interest rate rises and tariffs.

Which two policies would be classified as expenditure-reducing ?

A devaluation and government spending cuts

B government spending cuts and interest rate rises

C interest rate rises and tariffs

D tariffs and devaluation

[J16/P1/Q29]

7. A newly-built public sector engineering training college received poor inspection reports. The government ceased to pay the college the money that it had usually received as its annual grant.

Which types of government policy does this statement imply?

A fiscal and monetary policies only

B fiscal and supply-side policies only

C fiscal, monetary and supply-side policies

D monetary and supply-side policies only

[N16/P1/Q28]

8. Which measure to correct a balance of payments current account deficit would be classified as an expenditure-dampening policy?

A a reduction in interest rates

B a revaluation of the currency

C an increase in direct taxes

D an introduction of foreign exchange controls

[N16/P1/Q29]

9. A government is faced with rising inflation. It wishes to reduce inflationary pressure while avoiding a rise in unemployment.

Which action is most likely to meet its needs?

A an increase in employment taxes

B an increase in laws to promote competition

C an increase in the budget surplus

D an increase in the exchange rate

[N16/P1/Q30]

10. Which policy pursued by a central bank represents a contractionary monetary policy?

A a reduction in the interest rate at which it will lend to banks

B a reduction in the minimum cash to deposit ratios of banks

C the purchase of foreign currency to influence the country's exchange rate

D the sale of government bonds in the open market

[N16/P3/Q29]

11. Which policy's principal aim is to ensure sound public finances?

A environmental policy

B fiscal policy

C monetary policy

D supply-side policy

[N16/P3/Q30]

12. An economy is currently operating close to its full employment level of national income.

Which combination of macro-economic policies would be most likely to have net deflationary effects?

A a 10% cut in the standard rate of income tax and a 5% devaluation of the currency

B a 10% cut in the standard rate of income tax and a 5% revaluation of the currency

C a 10% rise in the standard rate of income tax and a 5% devaluation of the currency

D a 10% rise in the standard rate of income tax and a 5% revaluation of the currency

[J17/P1/Q30]

13. Monetary policy can be used to increase the level of business activity.

Which action illustrates this?

A curbing consumption through controls on credit

B lowering reserve requirements of banks to increase lending

C reducing government spending to achieve a budget surplus

D stimulating company investments by increasing interest rates

[N17/P1/Q28]

14. When will a country's balance of payments current account deficit be reduced?

A when it lowers tariffs on its imports

B when it raises its rate of income tax

C when it removes export subsidies

D when it revalues its currency

[N17/P1/Q29]

15. What is an example of expansionary monetary policy?

A the central bank buying government bonds in the money market

B the central bank causing an appreciation of the country's foreign exchange rate

C the central bank increasing controls on credit lending

D the central bank increasing the minimum lending rate of interest

[J18/P1/Q28]

16. China had a US$155 billion current account surplus in 2012.

Which combination of policies might the Chinese Government use to reduce the surplus?

A decrease income tax and raise the value of the Chinese currency, the Yuan

B increase income tax and lower the value of the Chinese currency, the Yuan

C increase subsidies to Chinese firms and reduce income tax

D increase tariffs on imports and increase income tax

[J18/P1/Q29]

17. In an economy, prices are rising. The government wishes to limit further increases in prices.

Which policies would it be likely to use?

A decrease goods and services (sales) tax and put a quota on cheap imports

B decrease income tax and decrease interest rates

C increase interest rates and decrease government spending

D withdraw industry subsidies and impose a minimum wage

[J18/P1/Q30]

18. A government wishes to raise the value of the external exchange rate of its currency.

What should it do?

A discourage inward foreign direct investment

B raise interest rates

C raise the level of aggregate demand in the economy

D remove quotas on imported products

[N18/P1/Q23]

19. What is an example of a supply-side policy?

A an import quota to restrict the supply of goods

B a rise in interest rates to encourage the supply of savings

C a specific tax on the supply of goods to raise revenue

D a subsidy to businesses to promote the supply of training courses

[N18/P1/Q28]

20. Which policy mix is most likely to be effective in the short run for reducing inflation in a closed economy?

	fiscal policy	monetary policy
A	decreasing the budget surplus	increasing the interest rate
B	decreasing the budget surplus	increasing the money supply
C	increasing the budget surplus	increasing the interest rate
D	increasing the budget surplus	increasing the money supply

[N18/P1/Q30]

21. The diagram outlines the monetary transmission mechanism following an expansionary central bank intervention (quantitative easing). Key actions have been omitted from the process.

central bank ......1...... government assets

↓

short-term interest rates ......2......

↓

investment demand ......3......

↓

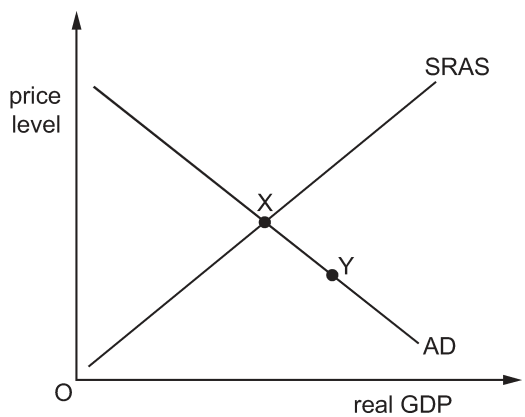
real GDP rises

Which words complete gaps 1, 2 and 3?

	1	2	3
A	buys	fall	rises
B	buys	rise	falls
C	sells	fall	rises
D	sells	rise	falls

[N18/P3/Q26]

22. The diagram shows an economy in equilibrium at point X.



What would be most likely to cause the economy to move from point X to point Y?

A an increase in government spending on transfer payments

B an increase in income tax

C an increase in the average wage rate

D an increase in the productivity of labour

[N18/P3/Q28]

23. A country with a balance of trade deficit raises interest rates.

How may this help to reduce the deficit in the short run?

A by increasing the inflow of foreign direct investment

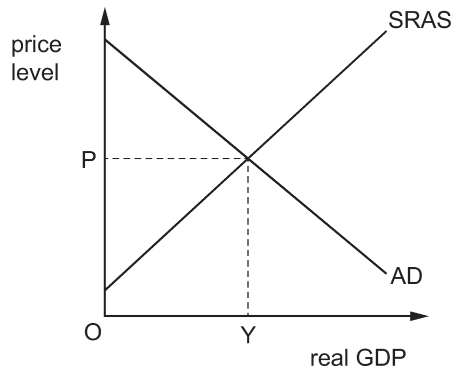
B by lowering the foreign exchange rate

C by raising the level of domestic capital investment

D by reducing the level of domestic aggregate demand

[J19/P1/Q28]

24. An economy is currently in the position PY shown on the diagram.

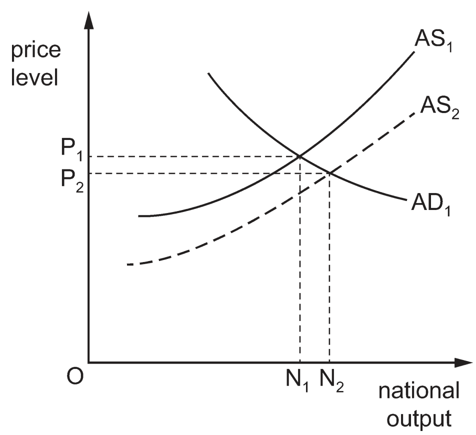


Which short-run effects is government spending on education likely to have on unemployment and inflation?

	unemployment	inflation
A	fall	fall
B	fall	rise
C	rise	fall
D	rise	rise

[J19/P1/Q29]

25. The diagram shows the AD / AS curves for an economy.



Which policy would reduce the price level from P_1 to P_2 as shown?

A depreciating the currency to make imports more expensive

B imposing tariffs on imports to encourage expenditure switching

C increasing labour productivity through training

D raising sales taxes on goods to discourage consumption

[J19/P1/Q30]

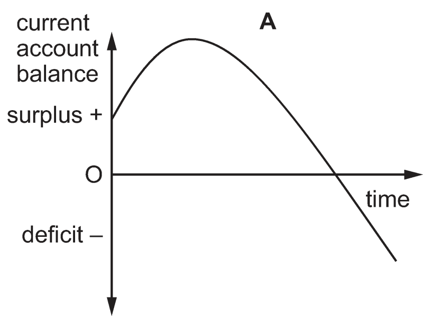
26. Which combination of policies is **most** likely to increase output?

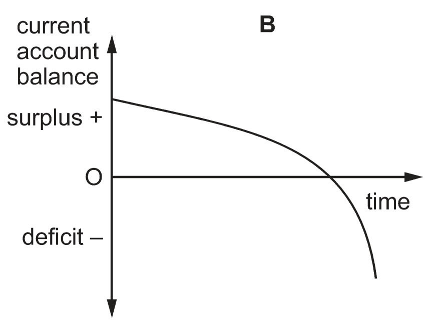
	fiscal policy	monetary policy
A	decrease budget deficit	decrease interest rates
B	decrease budget deficit	increase interest rates
C	increase budget deficit	decrease interest rates
D	increase budget deficit	increase interest rates

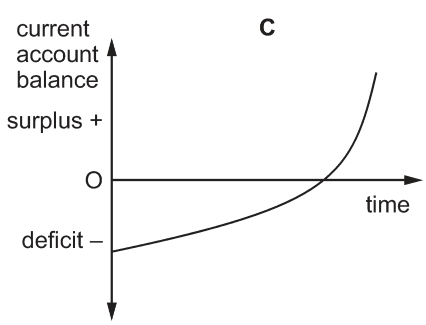
[J19/P3/Q30]

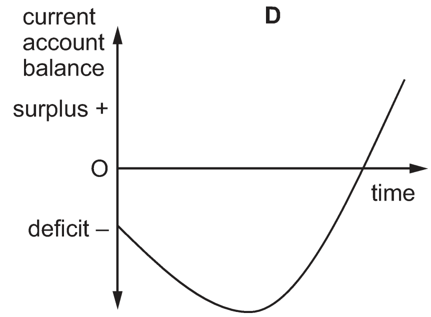
27. An economy's current account on the balance of payments is in surplus. The exchange rate is revalued by the government. Assume the Marshall-Lerner condition holds.

Which diagram shows the impact on the current account balance?









[N19/P1/Q29]

28. What would be increased by an expansionary fiscal policy?

A budget deficit

B exchange rate

C money supply

D rate of direct taxation

[N19/P1/Q30]

29. Which combination correctly classifies an expansionary fiscal measure and its impact on a budget deficit?

	fiscal policy	budget deficit
A	increased quantitative easing	unchanged
B	increased welfare spending	increased
C	lower income tax	reduced
D	lower interest rates	unchanged

[J20/P1/Q28]

30. In 2018 the United States (US) government introduced tariffs on a wide range of imports from China.

Which type of policy was the US government adopting?

A expenditure-reducing

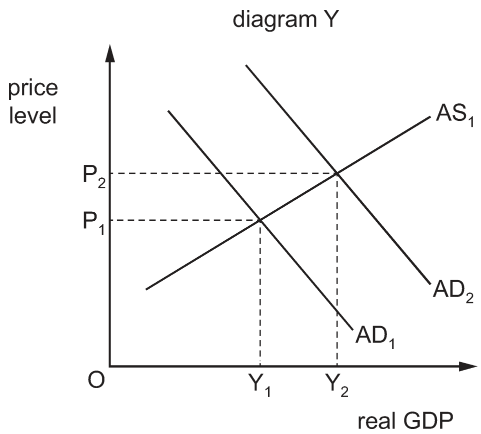
B expenditure-switching

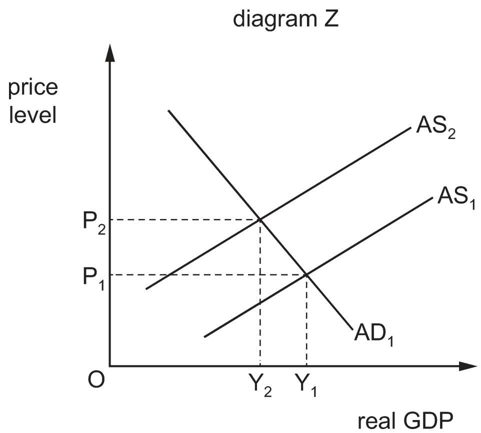
C monetary

D supply-side

[J20/P1/Q29]

31. During the Great Depression the US government believed that deflation was caused by a collapse in the prices of stock and other assets, reducing the levels of wealth and confidence. The diagrams show two approaches to counter deflation.





Given this belief, which policy should the US government have used, in an attempt to remove the deflation and which diagram represents the intended outcome of the policy?

	policy	intended outcome
A	decrease interest rates	diagram Y
B	reduce corporation tax	diagram Z
C	increase interest rates	diagram Z
D	reduce corporation tax	diagram Y

[J20/P1/Q30]

32. The government of an open economy with an overvalued currency decides to abandon its fixed exchange rate in favour of a floating exchange rate.

Which macroeconomic policy aim is **least** likely to be met because of this change?

A a low inflation rate
B a low level of unemployment
C a reduced balance of payments deficit
D a sustainable rate of economic growth

[N20/P1/Q26]

33. A government uses monetary policy and fiscal policy to solve a problem of deflation.

Which policy combination is likely to be the **most** successful?

	monetary policy	fiscal policy
A	increasing interest rates	contractionary
B	increasing interest rates	expansionary
C	reducing interest rates	contractionary
D	reducing interest rates	expansionary

[N20/P1/Q28]

34. A government reduces its expenditure on workplace training, increases the level of indirect taxes, and reduces the rate of interest it pays on government debt.

How would these government macroeconomic policies be categorised?

	supply-side	fiscal	monetary
A	con	con	exp
B	exp	con	con
C	con	exp	exp
D	exp	exp	con

key
con = contractionary
exp = expansionary

[N20/P1/Q29]

35. Between 2011 and 2013, retailers reported that expenditure on domestically-produced and imported goods had reduced. This was because consumers did not take out loans as the economy was in a recession.

What is the likely result of this?

A a decline in the deficit in the trade account
B a decline in the level of savings
C a decline in the terms of trade
D a decline in unemployment

[J21/P1/Q26]

36. Increased international competition leads to a worsening in a country's current account balance.

In the absence of any offsetting factors, how is this likely to affect the exchange rate and domestic cost-push inflation?

	exchange rate	cost-push inflation
A	appreciate	decrease
B	appreciate	increase
C	depreciate	decrease
D	depreciate	increase

[J21/P1/Q27]

37. Which policy will **not** cause a reduction in the rate of inflation?

A increasing income tax

B reducing government spending

C reducing interest rates

D removing subsidies

[J21/P1/Q30]

38. A government currently has a balanced budget. It is considering the possible variations in tax revenue and government expenditure shown.

option	tax revenue	government expenditure
W	increase	increase
X	increase	reduce
Y	reduce	increase
Z	reduce	reduce

Which three options are likely to have the potential to move the budget into surplus?

A W, X and Y **B** W, X and Z

C W, Y and Z **D** X, Y and Z

[J21/P3/Q30]

39. Which condition is necessary for a country's balance of payments on its current account to improve if it reduced its exchange rate?

A Both the price elasticities of supply for its imports and its exports must be elastic.

B The importing country will buy all the excess supplies of its trading partner to clear the market.

C The sum of the price elasticities of domestic demand for imports and the foreign demand for exports must be greater than one.

D The trading partners need to agree on the maximum prices to be charged for imports and exports.

[N21/P1/Q26]

40. In 2012, the Indian Government stated that it aimed to reduce its budget deficit to 5.1% of GDP.

Which policy is most likely to help this aim in the short run?

A a decrease in import tariffs

B a decrease in the rate of interest

C an increase in the sale of state-owned assets

D an increase in government pension payments

[N21/P1/Q28]

41. What would make a policy of raising interest rates **less** likely to be effective in reducing inflation?

A Aggregate supply is increasing faster than aggregate demand.

B Consumers expect prices to rise even faster in the future.

C Consumers' spending is largely paid for on credit.

D Interest rates are still higher abroad.

[N21/P1/Q29]

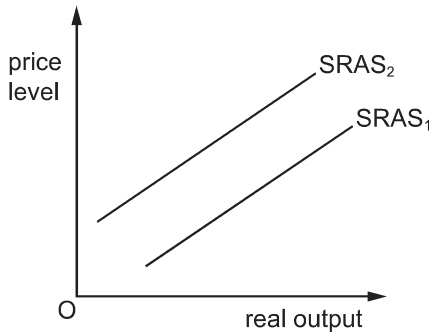
42. Country X is an open economy with a floating exchange rate. It changes to a fixed exchange rate.

Which combination of policy changes would be most effective in reducing inflation?

	fiscal policy	new fixed exchange rate
A	higher direct taxes	above purchasing power parity
B	higher direct taxes	below purchasing power parity
C	higher indirect taxes	above purchasing power parity
D	higher indirect taxes	below purchasing power parity

[N21/P1/Q30]

43. The diagram shows a shift in a country's short-run aggregate supply curve from $SRAS_1$ to $SRAS_2$. The country imports oil.



Why might an increase in the world price of oil have caused this shift?

A A rise in inflation is expected.
B Consumers face a fall in their disposable income.
C Domestic firms' costs have increased.
D The government reduces tax on oil and petroleum products.

[J22/P12/Q27]

44. What, if decreased, will help to reduce the rate of inflation?

A budget deficit **B** direct taxes
C exchange rate **D** interest rate

[J22/P12/Q28]

45. What is an example of contractionary fiscal policy?

A an increase in the budget deficit
B an increase in the budget surplus
C an increase in the interest rate
D an increase in the money supply

[J22/P12/Q29]

46. A country with low unemployment and a managed floating exchange rate has a persistent current account deficit on its balance of payments.

Which policy to reduce this deficit is **most** likely to keep unemployment low, but cause inflation?

A depreciating its currency
B higher direct taxation
C higher import tariffs
D higher interest rates

[J22/P12/Q30]

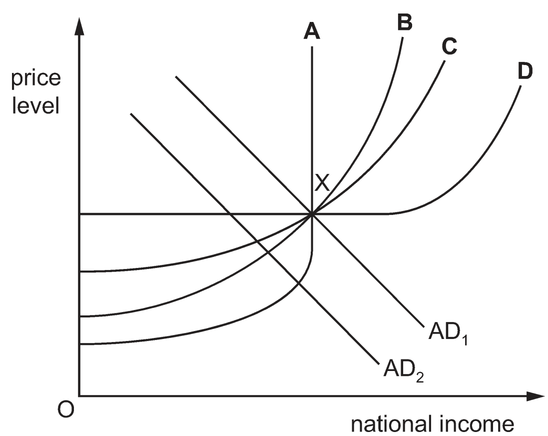
47. Which type of economic policy is likely to be considered the most effective by a government that has greater income equality as its primary aim?

A fiscal policy
B international trade policy
C monetary policy
D supply side policy

[N22/P12/Q29]

48. The diagram shows four possible aggregate supply curves and an equilibrium point X. A government employs deflationary fiscal policy in order to reduce the rate of inflation in its economy. This shifts aggregate demand to AD_2.

With which AS curve would this policy be most effective?



[N22/P12/Q30]

49. Under which current conditions will supply-side policy measures be most likely to achieve a country's key macroeconomic goals?

	unemployment level	price level
A	high	stable
B	high	rising
C	low	stable
D	low	rising

[M23/P12/Q26]

50. What is **least** likely to rise as a result of the use of expansionary fiscal policy?

A aggregate demand **B** budget surplus
C nominal income **D** inflation

[M23/P12/Q28]

51. A government raises interest rates to improve the current account of the balance of payments.

What might reduce the effectiveness of this policy?

A a fall in domestic growth
B consumer pessimism
C increased domestic saving
D price-elastic demand for exports

[M23/P12/Q30]

52. Which measure is aimed directly at promoting international trade?

A decreasing existing quotas
B increasing interest rates
C subsidies paid to export industries
D wage subsidy schemes during recessions

[J23/P11/Q26]

53. What would be classified as a supply-side policy measure?

A a law to reduce the power of trade unions
B a reduction in the government's fiscal deficit
C an open market sale of securities
D the imposition of a tariff on imported goods

[J23/P11/Q27]

54. What is the equivalent of a country's national debt?

A the accumulated borrowing of the government
B the difference between government spending and taxation
C the interest paid by the government on all the money it owes
D the total money owed by all households in the country

[J23/P11/Q28]

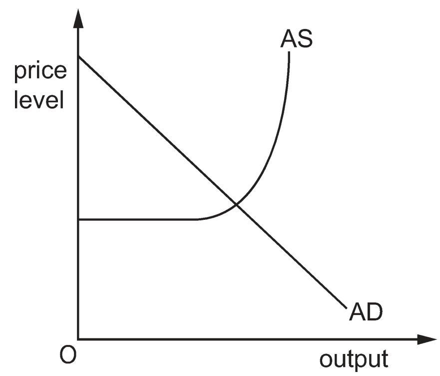
55. Which combination of policies would be most effective in reducing a balance of payments current account surplus?

	a decrease in tariffs on imports	a devaluation of the exchange rate	an expansionary monetary policy
A	no	yes	no
B	no	no	yes
C	yes	no	yes
D	yes	yes	no

[J23/P12/Q23]

56. The diagram shows the current equilibrium of an economy.

The government introduces a contractionary monetary policy.



What is the most likely outcome?

A a fall in investment and a fall in inflation
B a fall in investment and a rise in inflation
C a rise in investment and a fall in inflation
D a rise in investment and a rise in inflation

[J23/P12/Q27]

57. A government wishes to reduce the deficit on the secondary income section of its current account.

Which policy would be most effective?

A an increase in subsidies to exporters
B an increase in the tariffs on imports
C a reduction in the number of migrant workers allowed into the country
D a reduction in overseas aid donations

[J23/P12/Q28]

58. Supply-side policies can be used to correct cost-push inflation.

Which policy would best achieve this aim in the long run?

A allowing trade unions to maintain work practices irrespective of productivity
B encouraging workers to work extra hours for extra pay
C increasing total labour supply by employing more unskilled workers
D supporting the replacement of labour-manned machines by the use of robots

[J23/P12/Q29]

59. Which policy is most likely to help to correct an adverse balance on the current account of the balance of payments?

A abolishing tariffs
B depreciating the currency
C reducing direct taxes
D reducing indirect taxes

[J23/P13/Q19]

60. Which government action is **least** likely to prevent a fall in economic growth?

A additional controls on commercial banks' lending
B relaxation of rules for immigration of adult population
C removal of trade barriers on import of raw materials
D training and education of workforce

[J23/P13/Q24]

61. A country had a current account surplus of $141bn.

Which policy may its government implement to reduce this surplus in the short run?

A a decrease in direct taxes
B a decrease in regulations to encourage more foreign firms to locate in this country
C an increase of import duties
D an increase in interest rates

[J23/P13/Q27]

62. Which approach would a government be most likely to use to eliminate deflation?

A an increase in direct taxes
B an increase in interest rates
C a reduction in indirect taxes
D a reduction in its budget surplus

[J23/P13/Q30]

63. Which combination would represent the most expansionary set of monetary policies?

	credit availability	interest rates	money supply
A	increased	up	reduced
B	increased	down	increased
C	reduced	up	increased
D	reduced	down	reduced

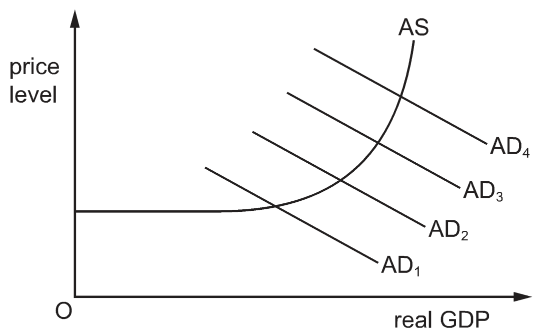
[N23/P11/Q29]

64. Which supply-side measure is most likely to produce short-run growth in a country's aggregate supply?

A easing of controls on immigration of workers
B expenditure on primary education
C expenditure on research and development
D privatisation of public utilities

[N23/P12/Q26]

65. A government wants to reduce inflation. It has decided to cut government spending by $1bn. The diagram shows different starting positions for the country's aggregate demand (AD) curve.



Which starting position for the aggregate demand curve would make this policy **least** effective?

A AD_1 **B** AD_2 **C** AD_3 **D** AD_4

[N23/P12/Q29]

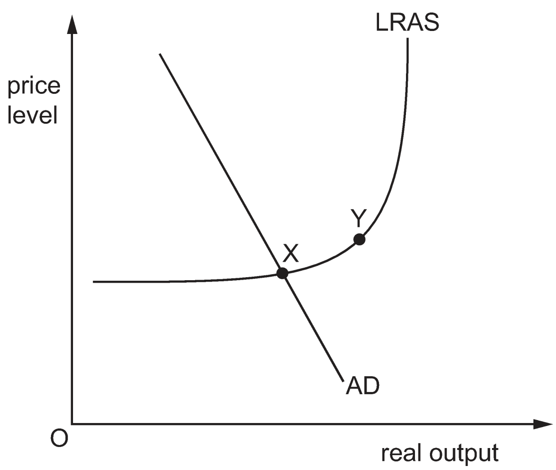
66. A government reduces the rate of tax firms are charged on their land and buildings.

How is this likely to affect the economy's price level and real output?

	price level	real output
A	fall	fall
B	fall	rise
C	rise	fall
D	rise	rise

[N23/P12/Q30]

67. The diagram shows the long-run aggregate supply (LRAS) and aggregate demand (AD) curves for an economy.



The initial equilibrium is at point X.

Which combination of monetary policies will shift the equilibrium position to point Y?

	money supply	rate of interest
A	increase	increase
B	decrease	increase
C	increase	decrease
D	decrease	decrease

[N23/P13/Q26]

68. The government undertakes a policy of financing training and retraining for unemployed workers.

Which terms are most likely be used to classify this policy?

	demand-side	supply-side	fiscal	monetary
A	yes	no	yes	no
B	yes	no	no	yes
C	no	yes	no	yes
D	no	yes	yes	no

[N23/P13/Q27]

69. Which combination of initial equilibrium and supply-side policy is likely to be **least** effective when attempting to increase the real output of an economy?

	initial equilibrium real output	supply-side policy measure
A	below full employment	abolition of national minimum wage
B	below full employment	extra spending on training
C	full employment	extra investment in infrastructure
D	full employment	reduction in the rate of income tax

[N23/P13/Q28]

70. A government aims to reduce unemployment through expansionary fiscal policy and borrows more from the commercial banks, increasing its borrowing requirement.

What will be the result?

A a decrease in the budget deficit

B a decrease in the national debt

C an increase in the balance of payments deficit on the current account

D an increase in the interest rates

[N23/P13/Q29]

71. A government wants to use an expansionary monetary policy.

What should the government increase?

A credit regulations

B the exchange rate

C the interest rate

D the money supply

[N23/P13/Q30]

72. A government has a balanced budget. It decides to increase its spending by 10%.

Which increase in government revenue would produce a budget surplus?

A –10% **B** 0% **C** +10% **D** +20%

[M24/P12/Q20]

73. An economy has an unemployment rate of 8%, an increase of 2% from the previous year. At the same time, the current account deficit rose from 3% of GDP to 4% of GDP.

What would be most likely to reduce both unemployment and the current account deficit?

A decrease government spending

B depreciation of the currency

C increase indirect taxation

D increase interest rates

[M24/P12/Q21]

74. What can be considered an expansionary supply-side policy?

A an increase in government expenditure on training

B an increase in sales tax

C an increase in the rate of interest

D an increase of the exchange rate

[M24/P12/Q23]

75. A government decides to allow the country's currency to depreciate to remove the deficit on its current account of the balance of payments.

What is the most likely reason why this would **not** work?

A The country gains a competitive advantage from the depreciation.

B The country has a surplus on its capital and financial accounts.

C The price elasticities of demand for the country's exports and imports are greater than one.

D There are high trade barriers with the country's main trading partners.

[M24/P12/Q25]

76. To counter deflation a central bank uses expansionary monetary policy.

What is likely to result?

A a higher cost of borrowing

B an increase in aggregate demand

C an appreciation of the exchange rate

D an increase in government debt

[J24/P11/Q20]

77. Which statement about government budget surpluses and deficits is the most accurate?

A A surplus implies that the balance of payments is in surplus.

B A surplus implies that the government is spending too much money.

C A deficit implies that the economy is in decline.

D A deficit implies that the national debt is increasing.

[J24/P11/Q21]

78. What is most likely to decrease if a government uses expansionary fiscal policy?

A a balance of payments deficit

B cyclical unemployment

C the level of wages

D the rate of inflation

[J24/P11/Q22]

79. Sweden had a change in its Consumer Prices Index (CPI) of –0.6%.

Which combination of policies might its government use to restore price stability?

A increase interest rates and increase indirect taxes

B increase interest rates and reduce government spending

C reduce government spending and increase income tax

D reduce interest rates and increase government spending

[J24/P11/Q23]

80. What is true about a government's macroeconomic objectives?

A Economic growth ensures a more even distribution of income.

B Increasing output ensures that more workers are employed.

C Choosing between macroeconomic objectives requires a normative decision.

D A stable rate of inflation means zero inflation is required.

[J24/P12/Q20]

81. How does a government use its central bank to promote an expansionary monetary policy?

A increasing interest rates for commercial banks

B increasing the interest rate on the national debt

C restricting bank credit for consumer durables

D increasing the issue of notes and coins in circulation

[J24/P12/Q22]

82. Which combination of problems would be most likely to cause a country's government to reduce taxation and lower interest rates?

A demand-pull inflation and a balance of payments current account deficit

B demand-pull inflation and a low level of investment

C high unemployment and a balance of payments current account deficit

D high unemployment and a low level of investment

[J24/P12/Q23]

83. What would be the best policy for a country to reduce a balance of payments deficit?

A an increase in interest rates

B an increase in the exchange rate

C a reduction in direct taxes

D a reduction in subsidies to domestic industry

[J24/P12/Q24]

84. Which combination of fiscal and monetary policies is most likely to be effective in the short run to prevent deflation in a closed economy?

	fiscal policy	monetary policy
A	decreasing the budget deficit	decreasing the interest rate
B	decreasing the budget deficit	decreasing the money supply
C	increasing the budget deficit	decreasing the interest rate
D	increasing the budget deficit	decreasing the money supply

[J24/P13/Q20]

85. Which macroeconomic objective is most likely to be achieved by increasing income tax?

A depreciation of the exchange rate

B economic growth

C low unemployment

D price stability

[J24/P13/Q21]

86. What is **not** a supply-side policy?

A increasing government expenditure on infrastructure

B increasing research and development expenditure

C increasing subsidies for education and training

D increasing the supply of money

[J24/P13/Q22]

87. When can a policy be classified as macroeconomic?

A when it focuses on the level of individual welfare

B when it involves economy-wide institutions and behaviour

C when it is based on the control of monopoly markets

D when it relies on the use of buffer stock schemes

[J24/P13/Q23]

88. The demand for a country's exports is price elastic.

If it is experiencing a deficit on the current account of its balance of payments, which combination of policies is most likely to correct the deficit?

	rate of interest	exchange rate	standard rate of income tax
A	decrease	appreciate	keep unchanged
B	decrease	depreciate	decrease
C	increase	keep unchanged	decrease
D	keep unchanged	depreciate	increase

[J24/P13/Q24]

89. Which supply-side policy is most likely to decrease a government's budget deficit?

A cutting tax rates on company profits

B cutting unemployment benefits

C raising spending on education and training

D raising tax-free income tax allowances

[N24/P11/Q21]

90. Which combination of fiscal and monetary policies would certainly be expansionary?

	government spending	taxes	money supply
A	decrease	decrease	decrease
B	decrease	increase	decrease
C	increase	decrease	increase
D	increase	increase	increase

[N24/P11/Q22]

91. The central bank of a country raises interest rates to reduce the general price level.

When is this policy likely to have the biggest impact?

	position of the economy on its production possibility curve (PPC) diagram	responsiveness of aggregate demand to interest rate changes
A	below the PPC	high
B	below the PPC	low
C	on the PPC	high
D	on the PPC	low

[N24/P11/Q23]

92. A government subsidises training to improve the skills of workers in the industrial sector of an economy.

What is the most likely effect on the current account of the balance of payments?

A exports fall
B exports rise
C imports fall
D imports rise

[N24/P11/Q25]

93. What is an example of a macroeconomic policy?

A encourage the consumption of merit goods
B reduce pollution in the steel industry
C maintain general price stability
D reduce unemployment in the service sector

[N24/P12/Q20]

94. Which supply-side policy is likely to lower real output before raising it?

A increased spending on early years education
B increased spending on infrastructure
C reduced import barriers
D subsidies to exporters

[N24/P12/Q21]

95. Which policy is most likely to reduce a balance of payments deficit without causing inflation?

A decreased import quotas
B depreciation of currency
C higher interest rates
D decreased import tariffs

[N24/P12/Q26]

96. If interest rates are reduced, what is most likely to decrease?

A borrowing by firms
B consumer spending
C import prices
D export prices

[N24/P13/Q20]

97. Supply-side policy often has fiscal consequences.

Which statement is **not** correct?

A Increased government spending supporting technical progress has beneficial long-term supply-side effects but may have short-term inflationary consequences.
B Increased government expenditure on training increases a country's long-run aggregate supply (LRAS) and also has an expansionary effect on aggregate demand (AD).
C Reduced government infrastructure spending reduces an economy's LRAS and has a short-term expansionary effect on AD.
D Reduced rates of tax on higher incomes increases an economy's LRAS and has an expansionary effect on AD.

[N24/P13/Q21]

98. Changes in fiscal policy can affect the distribution of income and wealth.

Which combination of fiscal policy would most likely be regressive?

A a fall in the lowest level of income when income tax has to be paid and a fall in the rate of inheritance tax
B a fall in the charge made for visits to a doctor and a rise in the level of unemployment benefit
C a rise in the rate of income tax charged at higher levels of income and a rise in the standard rate of corporation tax
D a rise in the standard rate of income tax and a fall in the standard rate of goods and services tax

[N24/P13/Q22]

99. What does it mean when a government has a budget surplus?

A Government revenue exceeds expenditure.
B Imports exceed exports.

C The government has an expansionary fiscal policy.

D The national debt is increasing.

[N24/P13/Q23]

100. What is **not** a valid explanation of why a government might allow a deficit on the balance of payments current account to continue?

A The balance of payments account must always balance.

B Foreign direct investment might help to finance the deficit.

C The country may have a larger surplus on the other parts of its balance of payments account.

D The standard of living is increased if the level of cheap food imports is significant.

[N24/P13/Q25]

6 - ANSWERS to MCQ

1. D A relatively higher interest rate will attract capital from abroad, it, therefore, causes a rise in demand for the country's currency leading to an appreciation.

2. A The term demand shock suggests cyclical changes while a decrease in NY will result in a decrease in tax revenue leading to a budget deficit.

3. A Foreign investment is recorded in financial account, therefore it improves immediately. Everything else may improve as a subsequent effect.

4. C Government will be required to lower tax rates and increase its spending in order to offset the decrease in AD caused by a fall in private sector investment.

5. B Interest rate is a tool of monetary policy and a rise in it reduces AD i.e. a contractionary effect.

6. B Both devaluation and tariff make imports relatively expensive, therefore both of them switch spending from imports to their domestic substitutes. Other measures reduce overall spending therefore they are expenditure reducing policies.

7. B Government spending is a tool of fiscal policy while training of workers is part of its supply side policy.

8. C It is part of deflationary fiscal policy that reduces people's disposable incomes and hence their overall spending. Option **A** will increase expenditure while **B** & **D** will switch expenditure from foreign to local goods.

9. B Competition reduces prices and therefore reduces inflationary pressure. Option **A** will increase both inflation and unemployment while **C** will increase unemployment. Option **D** may reduce inflation but unemployment may rise due to higher imports.

10. D Contractionary monetary policy requires a decrease in MS while selling bonds in open market operation increases it.

11. B The term public finances refers to fiscal policy.

12. D A rise in tax rate reduces consumption and investment expenditure while revaluation increases imports and decreases exports. Both of them will result in a fall in AD.

13. B It will increase money supply and lower interest rate that is likely to stimulate business activity. Options **A** & **D** are tight monetary measures and they are likely to lower business activity while a surplus budget will also reduce money supply, therefore, **C** is incorrect.

14. B It will lower incomes and hence the level of imports and current account deficit. Options **A** & **D** would increase imports while **B** would reduce exports leading to a rise in trade deficit.

15. A It increases MS and hence brings an expansionary effect. Option **B** is part of exchange rate policy while **C** & **D** suggest contractionary monetary policy.

16. A Both a decrease in income tax and appreciation of Yuan would encourage Chinese to buy more imports. Chinese exports, however, are likely to decrease and in effect both these should decrease Chinese trade surplus. This cancels out option **B**. An Increase in subsidy to Chinese firms or tariff on imports would increase Chinese exports and decrease their imports causing a rise in Chinese trade surplus. Thus options **C** and **D** are ruled out.

17. C Both these measures would lower AD and hence inflationary pressure, thus option B is ruled out. Both **A** & **D** are incorrect because increasing tax or lowering subsidy along with imposing quota and minimum price tend to increase prices in general.

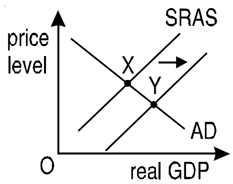
18. B A relatively higher interest rate raises exchange rate via increase in short term capital inflows. Option **A** would reduce demand for its currency causing a fall in exchange rate while **D** would increase demand for foreign currency and supply of local currency again causing depreciation. Option **C** is incorrect because higher AD would increase price level causing a rise in imports and a fall in exports eventually decreasing exchange rate.

19. D Training is one of the tools of supply side policies. Option **A** is a measure of protection while **B** suggests monetary policy and **C** indicates fiscal policy.

20. C Increasing budget surplus involves reducing government spending and/or raising tax rates. Either of them or both will reduce AD and hence would reduce inflation. Increasing interest rate would reduce interest sensitive expenditure causing first AD to fall and then the rate of inflation.

21. A Central bank buying government assets causes an increase in money supply leading to a fall interest rate and hence it encourages firms to raise their investment because lower cost of borrowing increases profitability. Increase in investment increases injections into the economy leading to an increase in the country's GDP.

22. D Increase in productivity causes SRAS to increase i.e. it shifts rightward. Options **A** & **B** will shift AD therefore they are cancelled while **C** will shift SRAS leftward.



23. D Balance of trade deficit refers to a shortfall of inflows resulting from exports and imports of goods & services only. So, an increase in interest rate will reduce overall spending (AD), including imports that should reduce trade deficit in the short run. Option **A** is not related to trade balance while options **B** & **C** are incorrect because an increase in interest rate will increase exchange rate along with a decrease in domestic investment.

24. B In the short run government spending on education is likely to increase aggregate demand leading to a higher rate of inflation followed by a fall in unemployment.

25. C Training that increases productivity of labour would shift AS curve to the right. Other options are more likely to increase AD that should increase price level.

26. C Both, an increase in budget deficit and a fall in interest rate are most likely to increase output by increasing the level of AD.

27. A Current account surplus cancels options **C** & **D** while revaluation is expected to increase current account surplus in the short run before reducing it in the long run. Hence option **B** is invalid.

28. A An expansionary fiscal policy involves a decrease in taxes and an increase in government spending. It therefore increases budget deficit for it reduces government revenues and increases its spending. Hence **D** is invalid while **B** & **C** are not related to fiscal policy.

29. B Increased welfare spending should increase budget deficit. Options **A** & **D** refer to monetary policy while **C** suggests a contractionary fiscal policy.

30. B A widespread increase in tariffs on imports increases their prices and hence it encourages people to switch their spending to local goods.

31. A Deflation results from a fall in AD and a decrease in interest rate might increase AD by encouraging both consumption and investment expenditure. So we eliminate options **B** & **C**. Since a fall in interest rate could have a more wide spread impact than a fall in corporation tax, therefore, **D** is cancelled.

32. A An overvalued currency is likely to depreciate when the country switches fixed to a floating exchange rate. So the resulting depreciation of exchange rate increases prices of imports leading to an increase in the rate of inflation. Other choices suggest aims that are more likely to be achieved.

33. D A decrease in interest rates increases AD by encouraging C & I expenditure while an expansionary fiscal policy increases AD by increasing government expenditure and / or reducing taxes. Hence both these are likely to solve the problem of deflation by raising the AD.

34. A A fall in expenditure on training is likely to decrease AS that makes it a contractionary supply side policy. An increase in taxation suggests a contractionary fiscal policy while a fall in interest rate is an expansionary monetary policy.

35. A A decrease in imports will reduce deficit in trade account. Options **B** & **D** are incorrect because recession increases both savings and unemployment while **C** is inconclusive.

36. D A worsening current bal. decreases demand for a currency and increases its supply in the ER market. So, ER is likely to depreciate that will increase cost-push inflation for it increases price of imported raw material and finished goods.

37. C It lowers incentive for saving, therefore it is likely to increase consumption that fuels inflation. Other choices are more likely to reduce inflation by decreasing overall spending.

38. B Only Y will definitely change budget into deficit and X will definitely change into surplus. However, W & Z can also change it to surplus provided the tax revenue increases by a larger proportion or falls by a smaller proportion than government spending.

39. C A fall in exchange rate improves current account only when the sum of PEDx & PEDm is greater than one .

40. C It will decrease budget deficit for it increases government's revenues. Options **A** & **D** will increase budget deficit while **B** is a tool of monetary policy.

41. B Expectations of even higher future prices encourage higher spending that fuels inflation. Options **A**, **C** & **D** are likely to be effective.

42. A ER above purchasing power parity will reduce prices of imports while higher direct taxes will reduce inflation for it lowers AD.

43. C Rising price of fuel increases cost of production that shifts SRAS to the left. Options **A** & **B** would affect AD while **D** would shift SRAS to the right.

44. A A decrease in budget deficit involves a fall in G and an increase in T, therefore it dampens AD followed by a fall in inflation. Other choice would result in an increase in inflation for they are likely to increase AD.

45. B A fall in G and a rise in T increases budget surplus that is likely to dampen AD and hence it brings a contractionary effect. Option **A** is expansionary fiscal policy while **C** & **D** are related to monetary policy.

46. A Depreciation of currency will increase prices of imported goods and raw material that is likely to decrease imports followed by a fall in current account deficit along with a rise in inflation. However, it will increase exports that should keep unemployment low. Options **B** & **D** are likely to increase unemployment for they are expected to decrease AD. Option **C** is ruled out because its effect on employment is uncertain.

47. A For greater income equality a government can integrate more progressive taxation and higher spending on welfare payments into its fiscal policy as opposed to other policies.

48. A The steeper the AS curve the larger is the fall in inflation rate.

49. B Supply side policies target to reduce both unemployment and price level.

50. B Expansionary fiscal policy involves either reducing budget surplus or increasing budget deficit, therefore it is more likely to increase AD that causes both nominal income and inflation to rise.

51. D Increase in interest rate raises cost of production that causes export prices to rise and demand for exports to fall. However, price-elastic demand worsens current account of BOP because it brings about a proportionately greater fall in exports that causes export earnings to fall. Other choices are more likely to decrease imports that could improve current account.

52. C Subsidy decreases prices of exports and hence it increases exports that promotes international trade. Other choices are likely to decrease imports that could limit international trade.

53. A It will remove supply side disruptions. Option **B** refers to fiscal policy while **C** suggests monetary policy and **D** opposes supply side measures.

54. A By definition.

55. C A decrease in tariff in combination with an expansionary monetary policy will encourage imports therefore they are likely to reduce current account surplus. At the same time the country should avoid devaluation because it can decrease imports.

56. A A contractionary monetary policy operates through increasing interest rate that is likely to decrease investment. So, a fall in investment shifts AD to the left and hence effecting a fall in inflation.

57. D Secondary income section of current account consists of transfers such as aid, grants and donations. Options **A** & **B** would affect trade in goods while **C** would affect primary income section of current account.

58. D It is more likely to reduce cost of production that should decrease cost push inflation. All other choices are more likely to accelerate cost push inflation for they will increase cost of production.

59. B Depreciation increases import prices and hence decreases imports which is likely to improve current balance. Other choices are incorrect because they are more likely to increase imports that could worsen current account.

60. A It is likely to decrease investment that can accelerate the fall in economic growth. Other choices are likely to increase investment and hence they can prevent a fall in economic growth.

61. A Fall in direct taxes is likely to increase demand for imports that can reduce current account surplus. Other choices are more likely to decrease imports and hence they can increase surplus.

62. D Both increased government spending & decreased taxes reduce budget surplus that helps eliminate deflation via increasing AD. Options **A** & **B** will reinforce deflation while **C** alone will be ineffective.

63. B Increased MS and reduced interest rate along with easy credit availability will encourage consumers and firms to increase their spending that would bring an expansionary effect in the economy.

64. A An easy immigration policy can increase labour force in quick time therefore it is likely to increase AS and hence effecting a rise in short term growth. Other options suggest the factors that usually take a long time to come into effect.

65. A A cut in government expenditure would decrease AD. However, it is least likely to reduce inflation below AD_1 where AS curve is horizontal in shape.

66. B Lower tax rate is likely to encourage producers to increase output that will increase AS leading to a fall in price level.

67. C Fall in interest rate and rise in MS will increase aggregate expenditure that will shift AD curve to right where it will intersect LRAS at point Y for a new equilibrium.

68. D Financing training suggests fiscal policy while retraining of unemployed is a supply side measure.

69. A Below full employment suggests deficiency of AD therefore, supply-side measures are likely to increase unemployment because they aim at increasing LRAS. Other choices can be effective for they are likely to increase AD that decreases unemployment.

70. D In order to ensure that funds are available for borrowing the government is likely to offer higher interest rate than the market rate. Options **A** & **B** are incorrect because they are likely to increase both the budget deficit and national debt while **C** is unrelated.

71. D Rise in MS boosts consumption and investment expenditure via reducing interest rate. This increase in aggregate spending causes AD to rise and shifts the economy into an expansionary mode. Other options are more likely to contract the economy.

72. D A 20% increase in revenue will more than offset the 10% rise in spending that would produce a budget surplus. Options **A** & **B** will produce a deficit budget while **C** will maintain the balanced budget.

73. B Depreciation increases prices of imports in local currency therefore it encourages consumers to buy more of relatively cheaper alternatives. Hence, a fall in imports is likely to reduce current account deficit and a higher demand for local goods is likely to increase employment.

74. A Spending on training increases productivity of workers that increases LRAS. Option **A** refers to fiscal policy while **C** & **D** are related to monetary policy.

75. D Depreciation amid high trade barriers is likely to fail to bring a significant increase in exports. Option **C** can work because elastic PED of exports & imports improves current account deficit while **A** can work because it is likely to increase exports. Option **B** has no connection with current account.

76. B Expansionary monetary policy aims at increasing AD. Option **A** & **C** are incorrect because it decreases cost of borrowing and causes exchange rate to depreciate while **D** is unrelated.

77. D Budget deficit necessitates borrowing that increases national debt. Option **A** is unrelated to budget while **B** is incorrect because surplus suggests lower government spending. Option **C** is inaccurate because the government can use budget deficit for higher growth rate in the recovery phase.

78. B Expansionary fiscal policy aims to increase AD that decreases cyclical unemployment. Option **A** is unrelated while **C** & **D** are incorrect because expansionary fiscal policy has an increasing effect on both the level of wages and the rate of inflation

79. D Negative rate of inflation suggests recession therefore lowering interest rate and increased government spending will have an increasing effect on AD that is likely to stabilize price level.

80. C Potential conflicts between macroeconomic objectives require value judgement in their choices. Option **A** is untrue because growth usually leads to uneven distribution of income while **B** is incorrect because increase in output can also be achieved by increasing productivity. Option **D** is not true because zero inflation implies stable prices while stable rate of inflation means a stable rate of increase in prices.

81. D It entails a rise in MS causing interest rate to decrease and hence AD to rise that brings an expansionary effect. All other choices suggest contractionary effects.

82. D Low taxation is likely to increase AD that reduces unemployment while low interest rate reduces cost of borrowing that is likely to increase investment. Other choices are invalid because low rate of interest and taxation are likely to worsen demand pull inflation and current account.

83. A A relatively higher interest rate increases short term capital inflows along with a decrease in domestic consumption of imports. Options **B** & **C** are likely to increase deficit for they can increase imports. Option **D** is incorrect because a decrease in subsidy would erode competitiveness that can decrease exports.

84. C Prevention of deflation requires expansionary fiscal policy that involves increasing budget deficit and expansionary monetary policy involving a decrease in interest rate.

85. D Increasing income tax reduces disposable income that has a decreasing effect on inflation. Other choices are incorrect because it is likely to decrease economic growth, along with an increase in unemployment and appreciation of exchange rate.

86. D Changes in money supply refers to monetary policy. All other choices suggest supply side measures.

87. B By definition.

88. D With no change in interest rate, a depreciation of exchange rate is likely to increase export earnings because it will bring a proportionately larger increase in demand for exports. At the same time increase in income tax is likely to reduce imports.

89. B Cutting unemployment benefit would decrease government spending without affecting its revenues. Options **A** & **D** would decrease revenues which has an increasing effect on budget deficit and **C** would increase government spending again increasing budget deficit.

90. C Expansionary fiscal policy involves increasing government spending and reducing taxes while expansionary monetary policy entails increasing money supply.

91. C General price level increases rapidly when AD is high enough to intersect AS at full employment level of output or in terms of PPC when the economy reaches its PPC.

92. B Improvement in skills increases workers' productivity that is likely to decrease cost of production leading to an increasing effect on the demand for the Country's exports.

93. C General price stability is one of the main macroeconomic policy goals. Other choices refer to micro economic goals.

94. C Reduced import barriers is likely to increase Imports that causes local real output to fall. In the long run, however, it could increase exports that is likely to increase local output.

95. C Higher interest rate decreases spending both on imports & local goods therefore it is likely to reduce both the BOP deficit & inflation. Options **A** & **D** can increase imports that is likely to increase BOP deficit while **B** can lead to a higher inflation.

96. D A fall in interest rate encourages firms to borrow and household to spend there by it increases AD leading to a rise in export prices. This eliminates options **A** & **B** while **C** is incorrect because a fall in interest rate causes exchange rate to fall that increases prices of imports.

97. C Reduced government spending decreases AD. Other statements are valid in their fiscal consequences.

98. A Relatively poor people who were exempted from income tax will have to pay now hence it makes them poorer at the same time a fall in inheritance tax is more likely to decrease tax burden of relatively rich making them better off. Option **B** is incorrect because increase in unemployment benefit favours relatively poorer, while both **C** & **D** suggest progressive measures.

99. A By definition. Option **A** is unrelated while **C** & **D** are incorrect because budget surplus suggests contractionary fiscal policy that is likely to decrease national debt.

100. A Since current account is just one part of BOP, therefore the government may not allow current account deficit in times when the deficit of BOP results from the deficit in current account. However, if current account deficit is offset by surplus in other parts of BOP the government may allow current account deficit to continue. Hence options **B** & **C** are valid. Similarly, option **D** also gives a valid reason.

TOPIC 6

Government Macroeconomic Intervention

ESSAY Section

OVERVIEW OF THE TOPIC

- **Types of Policy: Fiscal, Monetary and Supply Side Policy**
- **Policies to Correct Inflation and Deflation**

LIST OF QUESTIONS

Q1 (M23/P22/Q5)

(b) Assess whether supply-side policies are the most effective way to correct a deficit on the current account of the balance of payments of an economy. [12]

Q2 (J23/P21/Q4)

(b) Assess whether monetary policy or supply-side policy is likely to be more successful in reducing the rate of inflation in an economy. [12]

Q3 (J23/P22/Q5)

(b) Assess whether monetary policy is the only way to control a high rate of inflation. [12]

Q4 (J23/P23/Q5)

(a) Explain how monetary policy may be able to reduce the rate of inflation in an economy **and** consider the likely success of this policy. [8]

(b) Assess how governments use macroeconomic intervention to achieve their macroeconomic objectives. [12]

Q5 (N23/P21/Q4)

(a) Explain the reasons why governments impose taxes **and** consider whether an increase in income tax is fairer than an increase in sales taxes. [8]

(b) Assess whether a government should always aim to balance its budget rather than have a budget surplus or a budget deficit. [12]

Q6 (N23/P23/Q4)

(b) Assess whether supply-side policy is the only way of reducing long-term unemployment in an economy. [12]

Q7 (M24/P22/Q4)

(b) Assess whether contractionary fiscal policy is likely to be the best way to reduce a current account deficit on the balance of payments. [12]

Q8 (J24/P21/Q4)

(b) The Chinese government has re-emphasised its commitment to rebalancing the economy from one focused mainly on investment and exports to one aiming to increase the proportion spent on domestic consumption.

Assess the extent to which it would be possible to achieve this by fiscal policy alone. [12]

Q9 (J24/P21/Q5)

(b) Assess which expansionary macroeconomic policy would be most likely to enable a government to meet its economic objective of a low rate of unemployment. [12]

Q10 (J24/P22/Q4)

(b) Assess whether supply-side policy is the most effective way to achieve long-run economic growth. [12]

Q11 (J24/P23/Q4)

(b) Assess whether increases in aggregate demand are the best way of reducing unemployment in a high-income country. [12]

Q12 (N24/P21/Q4)

(b) Assess whether a government should always aim for an expansionary fiscal policy rather than a contractionary fiscal policy. [12]

Q13 (N24/P22/Q4)

(b) Assess whether supply-side policy is likely to be equally successful in reducing both structural and cyclical unemployment. [12]

Q14 (N24/P22/Q5)

(b) Assess whether the achievement of a balanced budget should always be a main government macroeconomic objective. [12]

Q15 (M25/P22/Q5)

(a) With the help of an AD/AS diagram, explain what is meant by an expansionary fiscal policy **and** consider the extent to which an expansionary fiscal policy will always increase the level of aggregate demand. [8]

(b) Assess the extent to which supply-side policy is the best method to reduce the rate of inflation. [12]

Question 1

Assess whether supply-side policies are the most effective way to correct a deficit on the current account of the balance of payments of an economy. [12]

[M23/P22/Q5(b)]

Essay

Supply-side policies are often seen as a powerful tool for boosting long-term economic growth and addressing structural issues like a current account deficit. These policies aim to increase the productive capacity of the economy by making markets more efficient and competitive. When implemented successfully, they can lead to a rightward shift in the long-run aggregate supply (LRAS) curve, indicating that the economy can produce more goods and services without causing inflation. This shift not only enhances domestic output but also improves a country's competitiveness in international markets, which can help correct a current account deficit by increasing net exports. However, while supply-side policies offer significant benefits, they also come with challenges, such as long implementation times and high costs, which need to be carefully considered.

One of the key ways supply-side policies work is by improving the efficiency of production. For example, investments in education and training can enhance the skills of the workforce, making workers more productive. A more skilled workforce can produce higher-quality goods at lower costs, which makes a country's exports more attractive on the global stage. Similarly, policies that increase labour market flexibility, such as reducing the power of trade unions or making it easier for firms to hire and fire workers, can help businesses adapt more quickly to changing market conditions. This flexibility can lead to lower production costs and higher output, further boosting competitiveness. Additionally, reducing regulations and increasing competition within industries can encourage innovation and efficiency, as firms are forced to improve their products and processes to survive in a more competitive environment.

The impact of these policies on the current account can be significant. By making domestic goods more competitive, supply-side policies can increase demand for exports while reducing reliance on imports. For instance, if a country invests in advanced manufacturing technologies, it may be able to produce high-tech goods that are in demand globally, thereby increasing export revenues. At the same time, if domestic industries become more efficient, they may be able to produce goods that were previously imported, reducing the need for foreign products. Over time, this can help correct a current account deficit by improving the balance of trade.

However, supply-side policies are not without their drawbacks. One major limitation is that they often take a long time to have an effect. For example, improvements in education and training may take years or even decades to translate into a more skilled workforce and higher productivity. This means that supply-side policies are not a quick fix for economic problems and may not be suitable for addressing short-term issues like a sudden current account deficit. Additionally, some supply-side policies can be expensive to implement. For instance, building new infrastructure or reforming education systems requires significant government spending, which could have been used for other priorities like healthcare or social welfare. This raises the issue of opportunity cost, as resources allocated to supply-side policies cannot be used elsewhere.

Another potential downside is that some supply-side policies can be politically controversial. For example, reducing the power of trade unions or cutting regulations may face strong opposition from affected groups, making it difficult for governments to implement these changes. Similarly, policies that increase labour market flexibility, such as making it easier to hire and fire workers, can lead to job insecurity and social unrest if not managed carefully. These political and social challenges can limit the effectiveness of supply-side policies and create additional hurdles for policymakers.

When comparing supply-side policies to other economic tools, such as fiscal or monetary policies, it becomes clear that each approach has its strengths and weaknesses. Fiscal policies, like reducing government spending or increasing taxes, can provide a quicker slump to demand and help address short-term decrease in inflation. However, they may also lead to a slowdown of economic growth and higher unemployment if not carefully managed. Monetary policies, such as increasing interest rates, can dampen borrowing and spending in the economy, but they may have limited impact in the long run if structural issues like low productivity are not addressed. Protectionist policies, such as tariffs or quotas, can reduce imports and improve current account in the short term, but they often lead to trade wars and reduce overall economic efficiency.

In conclusion, supply-side policies can be highly effective in improving a country's long-term economic performance and addressing structural issues like a current account deficit. However, the time lag, high costs, and potential political challenges mean that they are not a panacea. Thus, supply-side policies may not provide immediate solutions, their focus on long-term growth and efficiency makes them an essential part of any economic strategy.

Question 2

Assess whether monetary policy or supply-side policy is likely to be more successful in reducing the rate of inflation in an economy. [12]

[J23/P21/Q4(b)]

Essay

Inflation, can be reduced by using different policy measures, including monetary policy and supply-side policies. Monetary policy is primarily used by central banks to control inflation by influencing the money supply, interest rates, and exchange rates. A contractionary monetary policy aims to reduce inflation by decreasing money supply or raising interest rates, which makes borrowing more expensive and encourages saving rather than spending. Higher interest rates lead to lower consumer and business spending, reducing aggregate demand and easing inflationary pressures. Additionally, if higher interest rates attract foreign investment, the exchange rate appreciates, making imports cheaper and reducing the cost of imported goods, further dampening inflation.

Monetary policy is particularly effective in addressing demand-pull inflation, where excessive demand in the economy leads to rising prices. By raising interest rates, policymakers can curb excessive consumer borrowing and business investment, bringing demand closer to supply. However, monetary policy is less effective against cost-push inflation, which arises from supply-side factors such as rising wages, supply chain disruptions, or increasing raw material costs. In such cases, higher interest rates may reduce demand but do little to address the underlying supply constraints driving prices higher.

A key strength of monetary policy is its relatively quick implementation. Central banks can adjust interest rates frequently to respond to inflationary trends, and financial markets tend to react immediately to policy changes. However, there are limitations, particularly if the economy is experiencing stagflation, where inflation is accompanied by slow growth and high unemployment. In such cases, raising interest rates could further dampen economic activity and worsen unemployment. Additionally, the effectiveness of monetary policy depends on the responsiveness of consumers and businesses. If confidence remains high, businesses may continue investing, and consumers may keep spending despite higher interest rates, reducing the policy's impact.

In contrast, supply-side policies aim to increase the productive capacity of an economy by improving efficiency and reducing costs. These policies include investment in education and training, labor market reforms, deregulation, tax incentives, and measures to boost competition. By increasing productivity and reducing production costs, supply-side policies can help moderate inflation in the long run. For example, better education and training programs enhance workforce skills, leading to higher output and efficiency. Labor market reforms, such as reducing union power or increasing workforce flexibility, can help prevent wage-driven inflation by ensuring that wage growth aligns with productivity gains.

Supply-side policies are particularly effective in addressing cost-push inflation, as they tackle the root causes of rising costs rather than just dampening demand. By making production more efficient, these policies help keep prices stable even when demand increases. Additionally, supply-side measures can create long-term economic growth by increasing output and employment, unlike monetary policy, which may slow down growth when tightening is required.

However, supply-side policies have significant limitations. They often take a long time to yield results, as structural changes in education, labor markets, and industries require years to take full effect. Governments may also face challenges in implementing these policies effectively, particularly in economies with rigid labor laws or political opposition to deregulation. Moreover, supply-side reforms may not always be successful in controlling inflation if external shocks, such as rising global commodity prices or supply chain disruptions, are the primary causes of inflation.

The relative success of monetary and supply-side policies in reducing inflation depends on the nature of the inflationary pressures. If inflation is primarily demand-driven, monetary policy is more effective because it can quickly reduce excessive spending and borrowing. If inflation stems from supply-side factors, then monetary policy may be insufficient, and supply-side reforms become necessary to address cost pressures.

Overall, while monetary policy is more immediate in tackling demand-pull inflation, it has limitations when inflation is caused by supply-side shocks. Supply-side policies, on the other hand, provide long-term solutions to inflation but take time to implement and show results. In most cases, a combination of both policies is needed to achieve sustainable inflation control without harming economic growth.

Question 3

Assess whether monetary policy is the only way to control a high rate of inflation. [12]

[J23/P22/Q5(b)]

Essay

When controlling a high rate of inflation is the main priority, the authorities usually choose a deflationary monetary policy that aims at decreasing the rate of growth in AD through a contraction of money supply and/or an increase in interest rate and exchange rate.

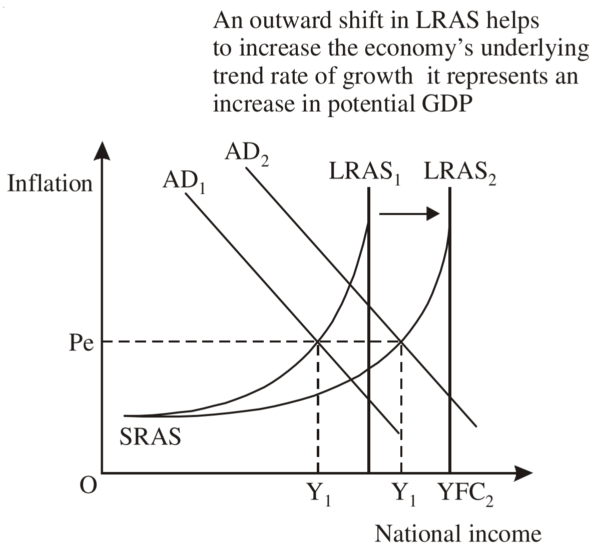
These measures influence prices via changing aggregate demand in several different ways. Central bank, for instance, can increase its lending rate, sell government securities and tighten regulations on reserve ratios and special deposits. All controls on mortgage, deferred payments and hire purchases can be tightened. These measures operate through what is known as the transmission mechanism of monetary policy. One of those channels operates via increasing the lending and borrowing rates charged in the financial markets. When, for instance, central bank's base rate goes high, commercial banks typically increase how much they charge on loans and the interest that they offer on savings. This discourages businesses for taking out loans for investment and encourages consumers to spend less and save more. Less spending decreases aggregate demand and hence it helps control inflation.

However, it is argued that monetary policy is not an exact science – what happens in the macroeconomy is the result of millions of decisions taken by households and businesses. So, we cannot predict with great accuracy the extent to which a rise in interest rate will achieve the desired rate of inflation. For instance, when demand for money is infinite elastic i.e. the economy operates in a liquidity trap, any contraction in MS will fail to increase interest rate and hence it will fail to have an impact on inflation. Similarly a monetary stimulus would fail to achieve the desired results if investment and consumer spending is largely interest inelastic. Furthermore, when it comes to addressing inflation there are many factors that are outside of the central bank's direct control e.g. optimism of consumers and businesses and changes in international commodity prices. A real problem arises when at higher interest rate consumers stop borrowing to spend and firms also reduce borrowing to invest. Exports become less competitive and the economy may well drop into a recession leading to a slowdown of economic growth and a rise in unemployment. Lastly, the time lags time between implementing policy measures and for them to take an effect should always be considered. For all these reasons monetary policy is believed to be less effective in controlling inflation.

Alternatively government can use a deflationary fiscal policy or supply side policies. A deflationary fiscal policy involves a cut in government expenditure and/or an increase in direct taxes. Increasing taxes result in lower disposable income for households leading to a fall in consumption. Moreover, increased taxes also result in lower profits for firms and hence they revise investment plans downward. It is believed that fiscal policy is more precise and accurate than monetary policy because it uses a shorter transmission mechanism to bring changes in AD. However it also results in slowing down growth rate and a rise in unemployment. Also, it could take a long time for economy to respond to these measures– the response lags may run into years not months. Furthermore, the effectiveness of fiscal measures largely depends on the availability of accurate key data. Usually the key data on the economy is often delayed and is subject to revisions.

So, both fiscal and monetary policies provide a short term solutions to controlling demand pull inflation. However in the long run an economy can control both demand pull and cost push inflation by working through supply side policies. These policies focus on increasing AS through encouraging investment in physical capital as well as spending on education and training of general population that contributes to a higher productivity.

Unlike monetary and fiscal policy, supply-side policies have the advantage of controlling both demand pull and cost push inflation without necessarily compromising on growth and employment. Following figure illustrates the impact on output and price level.



Note that supply side policies aiming a productivity rise can produce a higher level of output by improving workers' skills and incentive to work. Hence increases in aggregate demand are matched by increases in aggregate supply and there will be little or no upward pressure on the price level.

Hence it follows that monetary policy is not the only workable solution to control a high rate of inflation. In fact it could be counterproductive in case of cost push inflation. This is where authorities find fiscal or supply side measures offering better solutions.

Question 4

(a) Explain how monetary policy may be able to reduce the rate of inflation in an economy **and** consider the likely success of this policy. [8]

(b) Assess how governments use macroeconomic intervention to achieve their macroeconomic objectives. [12]

[J23/P23/Q5]

Essay

(a) Monetary policy plays an important role in controlling inflation within an economy by regulating the supply of money, interest rates, and credit controls. Central banks, such as the State bank of Pakistan, Federal Reserve or the Bank of England, use these tools to influence economic activity and maintain price stability. When inflation rises above a desirable level, contractionary monetary policy is often implemented to slow down the economy and bring inflation under control.

One of the primary tools used in monetary policy is the adjustment of interest rates. By increasing interest rates, borrowing becomes more expensive for consumers and businesses, reducing their willingness to take on debt for consumption and investment. Higher interest rates also encourage saving, as returns on deposits become more attractive. As a result, aggregate demand in the economy declines, reducing upward pressure on prices. For instance, if businesses face higher borrowing costs, they may delay expansion plans, leading to reduced demand for labor and capital goods, which in turn lowers overall spending.

Another tool is the regulation of money supply. Central banks can directly limit the amount of money circulating in the economy by implementing measures such as increasing reserve requirements for banks or selling government bonds in open market operations. When banks are required to hold a larger portion of their deposits as reserves, they have less money available to lend, which reduces credit creation. Selling government bonds absorbs excess liquidity from the market, making money scarcer and slowing down excessive spending. These measures help control inflation by restricting excessive money growth, which is often a key driver of rising prices.

However, while reducing inflation contractionary monetary policy may also lead to a fall in output and employment. For instance, a reduction in aggregate demand due to higher interest rates and a tighter money supply can lead to lower business revenues and reduced production. Consequently, firms may cut jobs or slow down hiring, leading to an increase in unemployment. While this can be a downside, it is sometimes a necessary trade-off to prevent inflation from spiraling out of control. Therefore central banks should aim to strike a balance where inflation is controlled without causing a severe economic downturn.

The success of monetary policy in reducing inflation depends on several factors. One critical element is how consumers and businesses respond to higher interest rates. For instance, inflationary pressure may persist if demand for goods and services remains strong despite rising borrowing costs, Additionally, if inflation is driven by external factors such as supply chain disruptions, rising energy prices, or geopolitical instability, monetary policy alone may not be sufficient to bring it under control. In such cases, a combination of fiscal policy measures, such as reducing government spending or increasing taxes, may be required to complement monetary policy efforts.

The overall effectiveness of monetary policy also depends on the starting point of inflation and the speed at which policy changes take effect. In some cases, there may be a lag before interest rate hikes fully impact spending and inflation. If inflation expectations are deeply entrenched, businesses and workers may continue to anticipate higher prices and demand wage increases, making it harder for monetary policy to achieve its objectives.

Despite these challenges, monetary policy remains a key tool for managing inflation. It is often preferred over fiscal policy because it can be implemented more quickly and adjusted more flexibly in response to economic conditions. However, policymakers must carefully assess economic conditions to ensure that the measures taken do not lead to excessive economic contraction.

(b) Governments play a crucial role in shaping the economy by using various macroeconomic interventions to achieve their key objectives. These objectives typically include price stability, low unemployment, economic growth, and a fair distribution of income. To influence economic conditions, governments rely on fiscal, monetary, and supply-side policies, each with its own strengths and limitations.

One of the primary concerns for governments is price stability. Inflation can erode purchasing power, reduce savings, and create uncertainty in the economy. To control inflation, governments often use monetary policy, which involves adjusting interest rates and money supply. Central banks may raise interest rates to curb excessive spending and borrowing, thereby reducing demand-driven inflation. Conversely, if inflation is too low or if the economy is at risk of deflation, lower interest rates can stimulate demand and encourage investment. However, the effectiveness of monetary policy depends on external factors such as global commodity prices, exchange rate fluctuations, and consumer confidence.

Another major objective is maintaining low unemployment. High unemployment can lead to lower consumer spending, reduced economic output, and increased strain on government finances due to higher welfare payments. Fiscal policy is often used to address this issue. By increasing government spending on infrastructure projects, education, and healthcare, governments can create jobs and boost economic activity. Tax cuts can also encourage businesses to expand and hire more workers. However, excessive government spending can lead to budget deficits, requiring careful balancing to ensure long-term sustainability.

Economic growth is another key goal, as it leads to higher living standards and increased government revenue. Governments use a combination of fiscal, monetary, and supply-side policies to encourage growth. Lower interest rates can make borrowing cheaper, leading to higher investment in businesses and housing. Fiscal stimulus, such as increased public investment in infrastructure, can boost productivity and economic output. Supply-side policies, such as investing in education and reducing business regulations, can enhance long-term growth by improving labor productivity and encouraging innovation. However, rapid growth can sometimes lead to inflationary pressures, requiring careful management of policies.

Apart from growth, employment and price stability a satisfactory balance of payment (BOP) position is essential to maintain macroeconomic balance. BOP is a summary of all economic transactions of a country with other nations over one year time period. A persistent BOP deficit initially results in a decline of a nation's foreign currency reserves and a run on its exchange rate. Ultimately, it necessitates borrowing and the country accumulates foreign debts which have to be repaid with interest in future. To improve BOP position, governments often use monetary policy, which involves adjusting interest rates and exchange rate. Central banks may raise interest rates to curb excessive spending on imports or devalue exchange rate, thereby making imports expensive and exports more competitive. However, the effectiveness of exchange rate policy depends on external factors and elasticities of demand for exports and imports.

Governments also intervene to ensure a fair distribution of income. Without intervention, market forces may lead to growing income inequality, where the wealthiest benefit disproportionately while lower-income groups struggle. Progressive taxation, where higher earners pay a larger percentage of their income in taxes, helps redistribute wealth. Welfare programs, such as unemployment benefits and housing assistance, provide a safety net for those in needs. While these measures improve social equity, critics argue that high taxes can discourage investment and economic efficiency, highlighting the need for a balanced approach.

Despite various interventions, achieving macroeconomic objectives is not always straightforward. Different policies can sometimes have conflicting effects. For example, policies aimed at stimulating growth and reducing unemployment may lead to inflation and worsening of BOP, while measures to control inflation may slow down economic activity. Additionally, global factors such as trade disruptions, oil price fluctuations, and geopolitical instability can limit the effectiveness of domestic policies. Governments must constantly adjust their strategies in response to changing economic conditions.

The effectiveness of macroeconomic intervention also depends on how well policies are implemented. Poorly designed fiscal policies can lead to inefficient government spending, while abrupt changes in monetary policy can create uncertainty for businesses and consumers. Supply-side policies, such as education reforms, may take years to show results, requiring long-term commitment and consistency. Policymakers must carefully consider the timing, scale, and coordination of interventions to maximize their impact.

In a nutshell, government intervention plays a vital role in managing the economy and achieving key macroeconomic objectives. However, no single policy can address all challenges, and trade-offs are often necessary. Therefore a combination of fiscal, monetary, and supply-side policies, tailored to specific economic conditionsin different times can prove to be more effective.

Question 5

(a) Explain the reasons why governments impose taxes **and** consider whether an increase in income tax is fairer than an increase in sales taxes. [8]

(b) Assess whether a government should always aim to balance its budget rather than have a budget surplus or a budget deficit. [12]

[N23/P21/Q4]

Essay

(a) Governments impose taxes to generate revenue for public services, redistribute wealth, and influence economic behavior. Taxation is essential for funding education, healthcare, infrastructure, and social welfare programs, ensuring the smooth functioning of society. Without sufficient tax revenue, governments would struggle to provide essential services that benefit both individuals and the economy as a whole. By adjusting tax policies, governments can address income inequality, stabilize the economy, and influence consumer and business decisions. Taxes also serve as a tool to manage inflation, reduce excessive consumption of harmful goods, and encourage investment in certain sectors through incentives and relief programs.

Taxes come in different forms, but two of the most commonly debated types are income tax and sales tax. Income tax is a direct tax levied on an individual's earnings, often structured as progressive. It means that higher earners pay a larger proportion of their income in taxes. This system is designed to redistribute wealth and ensure that those with greater financial resources contribute more to public services. In contrast, sales tax is an indirect tax imposed on goods and services at the point of purchase. Since everyone pays the same rate regardless of their income level, it is considered regressive because it places a heavier burden on lower-income individuals, who spend a larger share of their earnings on necessities.

The debate over whether increasing income tax is fairer than raising sales tax centers around the principles of equity and efficiency. An increase in income tax is often seen as fairer because it aligns with the ability-to-pay principle, ensuring that wealthier individuals contribute more to government revenues. It does not directly affect consumption patterns and allows lower-income households to retain more of their earnings, improving their financial stability. Additionally, a progressive tax system can help reduce income inequality by redistributing wealth from high earners to lower-income groups through public spending on education, healthcare, and social programs.

However, increasing income tax has its drawbacks. Higher income taxes can discourage work, investment, and entrepreneurship if individuals feel that a significant portion of their earnings is taken away. This could reduce incentives for productivity and innovation, potentially slowing economic growth. Furthermore, high-income individuals may seek ways to avoid taxation through loopholes, tax shelters, or relocating their wealth to lower-tax jurisdictions. This could ultimately reduce the effectiveness of income tax increases in generating revenue.

On the other hand, raising sales taxes affects everyone equally at the point of purchase, making it simpler to implement and harder to evade. Sales tax collections are more stable and easier to administer, as they do not require complex income calculations. Governments can also use sales tax increases as a way to manage inflation by discouraging excessive consumer spending. Additionally, sales taxes can be adjusted to target specific industries or products, such as luxury goods, in an attempt to ensure that wealthier individuals contribute more.

However, the regressive nature of sales taxes remains a major concern. Since low-income households spend a greater proportion of their income on essential goods, they end up paying a higher percentage of their earnings in sales tax compared to wealthier individuals. This can increase financial strain on families struggling to afford basic necessities. While some governments introduce exemptions or lower tax rates for essential items such as food, medicine, and education-related expenses, the overall burden still falls disproportionately on lower-income groups.

From an economic standpoint, the choice between increasing income tax or sales tax depends on the government's objectives. If the goal is to promote equity and reduce income inequality, raising income tax is generally the fairer approach. It ensures that those who can afford to contribute more do so while protecting lower-income earners from additional financial strain. However, if the government seeks a more stable and easier-to-administer source of revenue, an increase in sales tax may be preferable, despite its regressive effects.

Ultimately, both forms of taxation have their advantages and drawbacks. While increasing income tax is generally fairer because it considers individuals' financial capacity, it must be implemented carefully to avoid economic disincentives such as reduced productivity and capital flight. Likewise, sales taxes are easier to administer but they can disproportionately affect lower-income groups unless mitigated by exemptions or targeted tax relief. A balanced tax system that incorporates both direct and indirect taxes, along with measures to protect vulnerable populations, is likely the most effective approach to ensuring fairness.

(b) A government's approach to fiscal policy plays a crucial role in economic stability and growth. A balanced budget occurs when government revenue equals government expenditure. While balancing a budget may seem responsible, it is not always the best approach in all economic circumstances. Governments may need to run deficits or surpluses depending on prevailing economic conditions and policy objectives.

A balanced budget ensures fiscal discipline, reducing the risk of excessive public debt accumulation. It fosters investor confidence, as it demonstrates the government's ability to manage finances prudently. Additionally, it may prevent inflationary pressures that arise from excessive public spending. However, strictly adhering to a balanced budget can limit a government's ability to respond flexibly to economic fluctuations. In times of economic downturn, maintaining a balanced budget may require reducing public expenditure or increasing taxes, which could further dampen economic activity and prolong recessions.

As opposed to a balanced budget a budget deficit occurs when government expenditure exceeds revenue. This is often linked to expansionary fiscal policy, where increased government spending or tax reductions stimulate economic growth. Deficit spending can be beneficial during periods of economic slowdown or recession, as it helps boost aggregate demand. By investing in infrastructure, education, or healthcare, governments can create jobs, increase consumer confidence, and drive private sector growth. Additionally, a budget deficit can help reduce unemployment by directly increasing public sector jobs or stimulating private-sector employment through increased demand for goods and services.

However, persistent budget deficits can lead to rising public debt, which may become unsustainable over time. High debt levels could result in higher interest payments, reducing funds available for essential public services. Moreover, if deficit spending leads to excessive demand, it may cause inflationary pressures. In the long run, an economy with continuous deficits may struggle with debt repayment, potentially leading to higher borrowing costs and reduced investor confidence.

Conversely, a budget surplus occurs when government revenue exceeds expenditure. This is associated with contractionary fiscal policy, which involves reducing public spending or increasing taxation. A surplus can be beneficial in times of economic overheating when inflation is high. By reducing government spending or increasing taxes, a government can help curb inflationary pressures by decreasing aggregate demand. Additionally, a surplus enables a government to reduce national debt, lowering interest payments and freeing up resources for future public investments.

A budget surplus can also help improve a country's trade balance. By reducing disposable income through higher taxation or lower government spending, domestic demand for imports may decrease, leading to a reduced trade deficit. Furthermore, a surplus provides financial flexibility for future economic downturns, allowing a government to deploy resources when needed without excessive borrowing.

Despite these advantages, maintaining a budget surplus for prolonged periods may come at a cost. Excessive fiscal restraint can slow economic growth by reducing public investment and consumer spending. If a government consistently collects more revenue than it spends, it may result in underfunded public services, lower infrastructure development, and weaker social welfare programs. Additionally, high taxation, as a means to sustain a surplus, may discourage business investment and reduce disposable income, potentially leading to lower economic growth.

The choice between a balanced budget, a deficit, or a surplus depends on the macroeconomic conditions and policy objectives of a country. In times of economic downturn, running a budget deficit may be necessary to stimulate growth and reduce unemployment. Conversely, when inflation is high, a budget surplus may help in cooling down the economy. A balanced budget is desirable in stable economic conditions but may not always be appropriate during periods of economic volatility.

Overall, governments should adopt a flexible fiscal policy approach rather than rigidly aiming for a balanced budget at all times. The appropriate fiscal stance depends on the economic context. A pragmatic strategy that allows deficits during downturns, surpluses during periods of strong growth, and fiscal prudence in stable times is the most appropriate way to ensure long-term economic stability and growth.

Question 6

Assess whether supply-side policy is the only way of reducing long-term unemployment in an economy. [12]

[N23/P23/Q4(b)]

Essay

Supply-side policies are often considered a key approach to reducing long-term unemployment in an economy. These policies focus on improving the productive capacity of the economy by enhancing efficiency and flexibility of the labor market.

Supply-side policies work by improving the employability of workers and increasing the incentives for businesses to hire. One of the most effective methods is investment in education and vocational training, ensuring that workers have the necessary skills to meet labor market demands. For example, in economies experiencing rapid technological advancement, supply-side policies can help workers transition from declining industries to emerging ones, thereby reducing structural unemployment. Additionally, policies that improve labor market flexibility, such as reducing employment protection laws and lowering income tax rates, can make hiring workers more attractive for businesses. Providing better information on job vacancies and offering incentives for business start-ups also contribute to reducing unemployment by creating new job opportunities.

One major advantage of supply-side policies is that they are non-inflationary. Unlike expansionary monetary or fiscal policies, which can lead to higher inflation if aggregate demand rises too quickly, supply-side policies increase the productive potential of the economy without necessarily pushing up prices. They also offer long-term benefits, ensuring that the workforce remains adaptable and competitive. Furthermore, these policies address deep-rooted causes of unemployment, such as a mismatch between skills and job vacancies, rather than providing only short-term relief.

However, supply-side policies also have limitations. They take a long time to show results, as improvements in education and training require years to have a meaningful impact. There is also a significant opportunity cost, as governments must allocate substantial financial resources to implement these policies. Moreover, supply-side interventions may not be effective if the main cause of unemployment is weak demand rather than labor