Topic 4 – Government and the macroeconomy

Table of Content

4.1 The role of government

Locally
- Collect taxes to fund local services eg rubbish collection

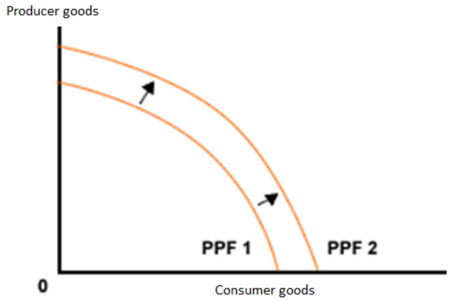
Nationally
- Make decisions to achieve macroeconomic aims

Internationally
- **Trading bloc**: free trade area which promotes free movement of factors of production between member countries

4.2 The macroeconomic aims of government

Aims

1. **Economic growth** - increase in country's GDP
- economic growth has the potential to raise living standards



2. **Full employment / Low unemployment**
- ensure it is making best use of resources
- ↑ employment, ↑GDP, efficiency, standard of living

3. **Price stability / Low inflation**
- create certainty & encourage investment
- Control economics activity
- To reduce -ve consequences of inflation (Ch31)

4. **Balance of payment in equilibrium**

Balance of payment: financial record of country's transactions with the rest of the world for a given time period
- Credit items: all payments received from other countries
- Debit items: all payment made to other countries
- To avoid balance of payment deficit (Ch39)

5. **Redistribution of income**
- To achieve greater equality
- Use of tax, subsidies & welfare benefits

Conflicts between aims

1. **Low unemployment vs Low inflation**
- Lower unemployment means higher incomes, ↑total demand, creating demand-pull inflation
- Lower unemployment means less spare capacity, wage demand ↑, wage-price spiral
- ↑ employment → cost-push inflation, wages inflation & demand-pull inflation (Ch31)

2. **Economic growth vs Balance of payment in equilibrium**
- ↑ consumption, ↑ import expenditure → balance of payment deficit

3. **Low unemployment vs Balance of payment in equilibrium**

↑ employment → cost-push inflation, worsen balance of payment

4. **Economic growth vs Low inflation**
- Production ↑, faster than the ↑in resources, ↑total demand leads to higher prices rather than ↑output & employment
- ↑ investment & consumption → demand-pull inflation

5. **Economic growth vs environment protection**
- Output↑, consumption↑, causing rise in external costs eg pollution

4.3 Fiscal policy

Budget: financial plans in terms of planned revenues & expenditure

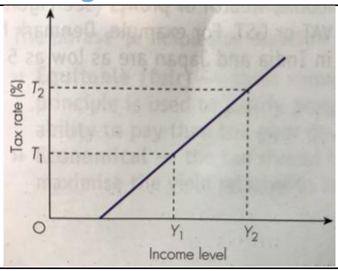
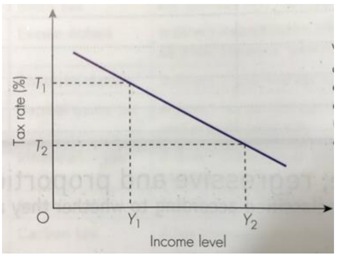
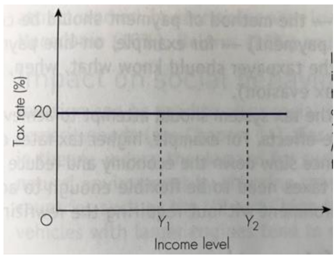
Reasons for gov spending
- Services eg healthcare
- Redistribute income & wealth eg provide welfare benefits
- Correct market failure

Reasons for taxation
- ↑ gov revenue to ↑ spending

Tax: gov levy on income & expenditure

Direct taxation: paid from income, profit of individuals/firms	**Indirect taxation**: imposed on spending on goods/services
Income: on personal incomes	**Sales**: eg VAT
Corporation: on profits of businesses	**Excise duties**: on certain goods/services eg alcohol
Capital gains: on earnings made from investments	**Customs duties**: on foreign imports
Inheritance: on transfer of income/wealth	**Carbon tax**

Others
- Stamp duty: progressive tax paid on sale of commercial/residential property
- Carbon tax: on vehicle firms that produce excessive carbon emissions
- Windfall tax: on individuals/firms that gain unexpected one-off money eg winning lottery

<table>
<tr><th>Progressive taxation</th><th>Regressive taxation</th><th>Proportional taxation</th></tr>
<tr><td>
</td><td>
</td><td>
</td></tr>
<tr><td>↑ income level
↑ tax</td><td>With specific amount of tax paid
↑ income level
↓ proportion of income, tax</td><td>Same tax rate charged</td></tr>
</table>

Principles of taxation (quality of good tax)

1. **Convenience** - easy to pay
2. **Certainty** - taxpayer know what, when, where & how to pay tax
3. **Efficiency** - avoid -ve side-effects eg ↑tax rate, ↓incentive, ↓long-term tax revenue
4. **Economical** - easy & cheap to collect tax to maximise yield relative to cost of collection
5. **Equitable (fair)** - tax based on taxpayer's ability
6. **Flexibility** - to adapt to change in economic environment without rewriting tax legislation

Impact of taxation

1. **Price & quantity**
2. **Economic growth** - ↑tax rate, ↓incentive, ↓production
3. **Inflation** - ↑tax rate, ↓inflation
4. **Business location** - ↓tax rate countries attract firms
5. **Social behavior**
6. **Tax avoidance & tax evasion**
   Tax avoidance: legal act of not paying tax
   Tax evasion: illegal act of not paying tax
7. **Distribution of wealth**

Fiscal policy: use of taxes & gov spending to affect economic activity & macroeconomic aims

Fiscal policy measures

Expansionary fiscal policy	Contractionary fiscal policy
↓ tax, ↑ spending & demand ↑employment & output, ↓recession	↑ tax, ↓ spending & demand ↑employment & output, ↓price inflation

Others
Redistribute income & wealth

Adv - Effects on gov macroeconomic aims

Economic growth	• ↑ gov spending eg on infrastructure projects • ↓ taxation
Low unemployment	• ↓ tax through subsidies/tax concessions, ↑ incentive, ↑ employment
Low inflation	• ↓ tax, ↑FDI, ↑productive capacity, ↓price inflation • **Contractionary fiscal policy**
Balance of payment in equilibrium	• ↓ tax, firms stay competitive
Redistribution of income	• used progressive taxes & gov spending

4.4 Monetary policy

Money supply: amount of money in economy at particular pt in time

Monetary policy: use of interest, exchange rates & money supply to control amount of spending & investment

Monetary policy measures

- **Interest rates** - ↑interest rates, ↓ borrowing, ↑ saving, ↓ spending, ↓ interest rate

Adv	Dis
• ↑borrowing, ↑consumption, investment, ↓saving, ↑total aggregate demand, ↑economic growth, ↑employment • ↑spending on R&D, ↑productivity, ↑potential growth • Value of currency↓, ↓exports prices, ↑import price, ↑net exports	• May cause inflation due to increase levels of consumption • Value of currency fall, increase import price, decrease choice / purchasing power, decrease standard of living, cost-push inflation

- **Money supply** - allow commercial banks lend more money, ↑ consumption & investment
- **Foreign exchange rates** - buying & selling of foreign currencies affect money supply

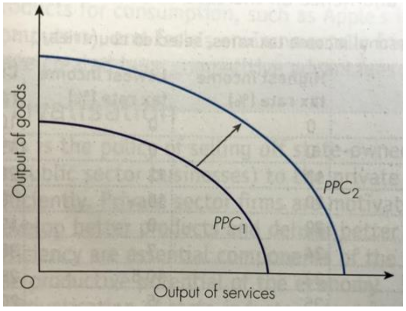
Expansionary monetary policy	**Contractionary monetary policy**
↓ interest rates, ↑ borrowing ↑ spending, ↑ economy	↑ interest rates, ↓ spending & investment ↓ inflation

Effects on gov macroeconomic aims

Adv	Dis
• **Economic growth** - ↓ interest rates, ↑ economic growth • **Low unemployment** - ↓ interest rates, ↑ spending, ↑ employment • **Low inflation** - ↓ interest rates, ↑ economic growth, ↑ production without ↑ price - ↑ interest rates, ↓ consumption & investment, ↓ inflation • **Balance of payment in equilibrium** - ↓ interest rates, ↑ competition, ↑ balance of payment • **Redistribution of income** - used progressive taxes & gov spending • **Balance of payment in equilibrium** - ↓ interest rates, ↑ competition, ↑ balance of payment • **Redistribution of income** - used progressive taxes & gov spending	• **Time lags** when interest rates changes - make monetary policy less certain & destabilize economy • (**Contractionary**) ↑ interest rates, ↓ spending & investment, ↓ profit, economic growth, employment

4.5 Supply-side policy

Supply-side policy: Policy aimed to increase productive capacity of economy tp encourage economic growth



Supply-side policy measures

1. **Education & training** - raise skills of workers, increasing productivity, lower cop
2. **Labour market reforms** eg ↓ power of trade unions, unemployment benefits & min. wages to ↑ competition & productivity
3. **Lower corporation taxes** - increase funds available for investment, improve tech, raise productivity, lower cop
4. **Lower income tax** - increase motivation of workers, raise productivity, lower cop
5. **Deregulation** - removing laws and rules may reduce firm's costs, enabling them to invest more
6. **Incentives to work / invest** - supply-side policy focus on R&D
7. **Privatisation** - introduce competition, increase profit incentive, encourage firms to be efficient/reduce costs
8. **Subsidies** - encourage firms to invest in advanced tech, engage in R&D or train workers, increase productive capacity
9. **Cuts in direct tax & welfare payment**

Effects on gov macroeconomic aims

Adv	Dis
10. **Economic growth** - ↑ productive capacity, ↑ economic growth 11. **Low unemployment** - ↑ productive capacity, ↑ national output, ↑ employment 12. **Low inflation** - ↑ productive potential, ↑ economic growth without ↑ price 13. **Balance of payment in equilibrium** - ↑productivity & nation output ↑ balance of payment 14. **Redistribution of income**	• Takes time to achieve benefits

4.6 Economic growth

Economic growth: annual increase in level of GDP
Gross domestic product (GDP): total output in a country over a given time period
GDP per capita: total output in a country over a given time period divided by population

Components of GDP

1. **Consumption expenditure (C)**: total spending on goods/services by individuals
2. **Investment expenditure (I)**: total capital spending of firms
3. **Government spending (G)**: total spending by gov

4. **Export earning (X)**: monetary value of all exports sold to foreign buyers
5. **Import expenditure (M)**: monetary value of all payment of import
6. **Net exports**: X-M

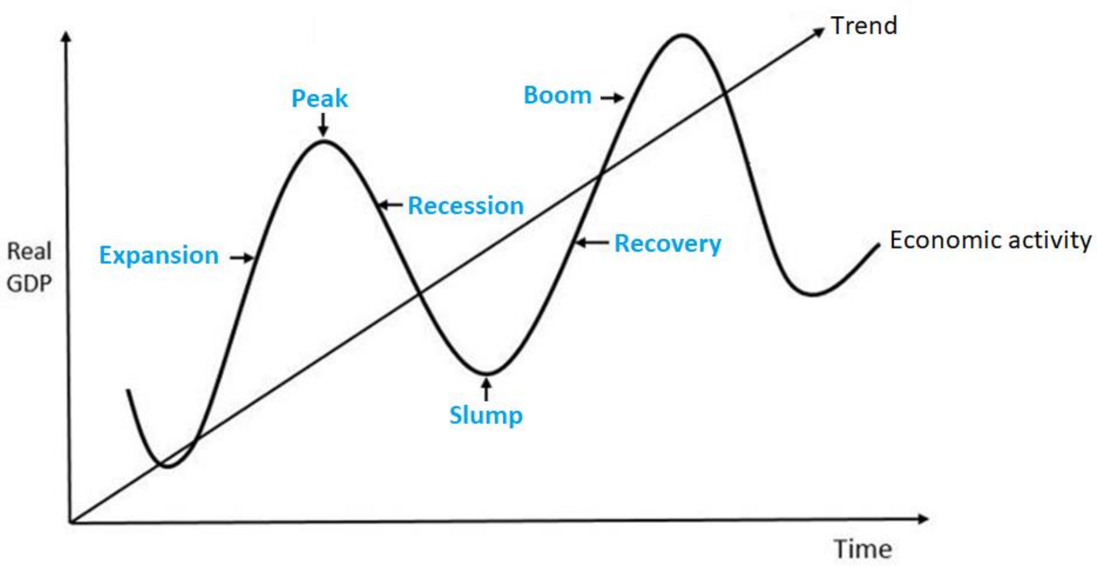
Calculation of GDP

GDP = C + I + G + (X-M)

Measurements of economic growth

1. Change in GDP over a period of time
2. Outwards shift of PPC - ↑productive potential

Business cycle



Recession: when there's a fall in GDP for 2 consecutive quarters

During recession

- ↑ uncertainty in economy, ↓ confident ,↑ unemployment
- ↑ interest rates, ↓ spending
- ↓ income, ↓ spending

Causes of economic growth / boom

1. Quantity & quality of fop
2. Labour force
3. Labour productivity
4. Investment

Consequences of economic growth

Adv	Dis
• ↑ standards of living • ↑ employment • ↑ tax revenue for gov	• -ve environmental impacts eg pollution • Risk of demand-pull inflation • Inequalities in income & wealth • Reduction of resources due to eg deforestation

Policies to ↑ economic growth

1. Expansionary fiscal policy
2. Expansionary monetary policy
3. Supply-side policy

4.7 Employment and unemployment

Employment: use of labour as fop in economy

Unemployment: ppl willing & able to work, and actively seeking employment, but unable to find work
Causes
- High level of education meet the requirements needed for the jobs
- High level of gov spending on subsidising firms can lower cop & encourage output

Changing patterns & level of employment
1. **Employment sector** - as country develops, employment in primary sector ↓ & tertiary sector ↑
2. **Delayed entry to workforce** - ↑ education time
3. **Ageing population** - ↓ labour supply, employ older labour
4. **Formal sector employment**: officially recorded employment where workers pay income taxes & contribute to GDP
   - As country develops, ↑ workers employed in formal economy & ↓ in informal economy
5. **Female participation rates**: proportion of women who are active in labour force
6. **Public sector employment** - as countries move towards market economy, ↓ ppl employed in public sector
7. **Flexible working patterns** - eg employ part-time workers, allow ppl work from home

Explain causes of low unemployment
- High level of education meet the requirements needed for the jobs
- High level of government spending on subsidizing forms can lower cop & encourage output, so more workers needed

Measuring unemployment
1. **Claimant count**: no of ppl who are out of work & claim unemployment benefits
2. **Labour force survey**: uses ILO's standardised household-based survey to collect work-related statistics

Calculation of unemployment rate

$$Unemployment\ rate = \frac{No\ of\ unemployment}{Workforce} \times 100\%$$

Causes & types of unemployment

Frictional	occurs due to time delay when ppl change jobs
Structural	occurs when demand for products produced in a particular industry ↓
Cyclical (demand-deficient unemployment)	Caused by lack of demand, which ↓ national income

Consequences of unemployment
1. Individual become stress, depress

2. Family suffer low income → arguments
3. ↓ consumption, firms ↓ profits → business failure
4. ↓ spending & GDP, ↓ competition
5. Mass unemployment → poverty / ↑ crime rate

Policies to reduce unemployment

1. **Expansionary fiscal policy**
2. **Expansionary monetary policy**
3. **Supply-side policies**
4. **Protectionist measures** eg tariffs & quotas (Ch 37)

4.8 Inflation and deflation

Inflation: sustained rise in general price level of goods/services & fall in value of money in an economy over time

- More frequent problem than deflation in recent years

Causes of inflation

1. **Cost-push inflation**: caused by ↑ cop, firm focus to ↑ price
2. **Demand-pull inflation**: caused by ↑ demand, ↑ general price level
3. **Imported inflation**: caused by ↑ import price, ↑ cop, ↑ domestic inflation

Consequences of inflation

1. **Menu costs**: cost to a firm resulting from changing its prices
2. **Shoe leather costs**: cost of time and effort that ppl spend prevent inflation, eg holding less cash
3. **Less saving -** ↓ purchasing power, ↑ cost of living, ppl need more money to buy goods/services, ↓ saving, ↑ borrowing & spending, ↓ funds available for investment
4. **Fixed income earner** - ↓ real income
5. **Low income earner** - have high PED
6. **Exports** - ↑ cop, ↓ competitiveness & profits, ↓ economic growth
7. **Importers** - imported inflation
8. **Employers** - workers demand ↑ wages to maintain real income level
- **Wage-price spiral**: when trade unions negotiate ↑ wages to keep in line with inflation, but firms ↑ price to main profit margins, so ↑ inflation
9. **Economic growth** - ↑ uncertainty, ↓ investment, ↓ economic growth

Winners - borrowers & importers
Losers - consumers, lenders, savers, fixed & low income earners, exporters & employers

Deflation: sustained fall in general price level of goods/services & rise in value of money in an economy over time

Causes of deflation

1. **Benign deflation**: caused by ↑ level of supply of goods/services, ↑ productive capacity, ↓ general price level
2. **Malign deflation**: ↓ level of demand, ↓ general price level due to excess capacity

Consequences of deflation

1. **Unemployment** - ↓ demand of goods/services, ↓ demand for labour
2. **Bankruptcies** - ↓ spending, ↓ profit, ↓ repay loads, ↑ bankruptcies

3. **Gov debt** - ↑ unemployment, bankruptcies & economy, ↑ spending coz malign deflation, create budget deficit → ↑ borrowing
4. **Consumer confidence** - ↓ confidence
5. **Deflationary spiral** - firms ↓ profit, ↓ investment,↓ economy, ↓ cop by ↓ workers, ↓ consumption & confidence → deflationary spiral.

Calculation

$$Rate\ of\ inflation = \frac{CPI_{x+1} - CPI_x}{CPI_x}$$

Measurement of inflation & deflation

Consumer Price Index (CPI)

CPI measures changes of prices of a basket of goods/services in a basket based on a survey of households. It compares price index with base year (100) and reflect the importance in buying patterns. CPI also compares price index. Eg if CPI rises from 100 to 105, the inflation rate is 5%.

Eg

Assume 2016 is the base year, when total basket price was $20.

Product	Price in 2017	Price in 2018
Pizza	$9	$10
Cinema ticket	$10	$11
Petrol	$3	$3.5
Total basket price	$22	$24.5

Step 1 - calculate price indices

2017: $\frac{22}{20} \times 100 = 110$

2018: $\frac{24.5}{20} \times 100 = 122.5$

Step 2 - calculate % change in price indices

$$\frac{(122.5 - 110)}{110} \times 100 = 11.36\%$$

Policies to control inflation & deflation

1. **Contractionary fiscal policy**
2. **Contractionary monetary policy**
3. **Supply-side policies**

Exam questions

5 In January 2013, the Portuguese Government increased tax rates. Three months later it cut its spending on health care and education. Between these two periods, unemployment in Portugal rose.

(a) What is meant by 'tax'? [2]

(b) Explain **two** reasons why an increase in unemployment may reduce tax revenue. [4]

(c) Analyse **two** reasons why unemployment may increase. [6]

(d) Discuss whether a reduction in government spending on education will reduce living standards. [8]

5 (a) What is meant by 'tax'? [2]

- a payment/finance (1) to the government/local authority (1) example e.g. sales tax/ income tax (1)

(b) Explain <u>two</u> reasons why an increase in unemployment may reduce tax revenue. [4]

- higher unemployment will reduce people's incomes (1) this will reduce the amount of income tax paid (1)
- higher unemployment will reduce the amount people spend/reduce demand for goods and services (1) this will reduce indirect tax revenue (1)
- higher unemployment will reduce firms' revenue (1) this will reduce corporation tax revenue (1)
- the existence of unemployment may encourage government to cut tax rates (1) in an attempt to reduce unemployment (1)

(c) Analyse <u>two</u> reasons why unemployment may increase. [6]

Up to 4 marks for one reason analysed.

- a fall in total (aggregate demand) (1) will cause firms to reduce their output (1) lower their need for labour (1) increase cyclical unemployment (1)
- a reduction in the skills/mobility of workers (1) may result in firms being unable or unwilling to employ workers (1) leading to structural unemployment (1)
- a rise in unemployment benefits (1) may lead to workers taking longer moving between jobs/less willing to search for work (1) causing an increase in frictional/voluntary unemployment (1)
- an increase in a country's exchange rate (1) will make exports more expensive and imports cheaper (1) this will reduce international competitiveness (1) reduce demand for labour in affected industries (1) cause international/structural unemployment (1)
- a rise in wages above the equilibrium level (1) this may be the result of industrial action/ imposition of a national minimum wage (1) workers may be replaced by machines (1) firms may reduce the size of their labour forces in order to cut costs of production (1)
- advances in technology (1) may make certain skills redundant (1) leading to structural unemployment (1)

(d) Discuss whether a reduction in government spending on education will reduce living standards. [8]

Up to 5 marks for why it might:

- it may reduce the quality/availability of education (1) this could reduce the skills of workers (1) lower their chances of getting a job (1) getting a well-paid job (1) reduce income (1) reduce goods and services people can enjoy (1)
- it may reduce people's access to knowledge about good nutrition/health care (1) this could increase illness (1) lower life expectancy (1)
- a less skilled labour force (1) may discourage multinational companies setting up in the country (1) this could reduce employment opportunities/reduce wages (1) reduce incomes (1) reduce goods and services people can buy (1)
- a reduction in government spending e.g. education may reduce aggregate demand (1) lower aggregate demand may reduce output and incomes (1)
- it will reduce the country's HDI value (1) which is an indicator of living standards

Up to 5 marks for why it might not:

- instead of spending money on education, the government might spend money on e.g. health care (1) a healthier population can enjoy life more and live longer (1) a healthier labour force may raise productivity (1) increase wages (1) increase the goods and services people can buy (1) this could increase the HDI value (1)
- instead of spending money on education, the government might spend money on e.g. infrastructure (1) better infrastructure can reduce firms' costs of production (1) make domestic firms more internationally competitive (1) encourage firms to expand (1) raise employment (1) increase incomes (1) increase the goods and services people can buy (1)
- a country's birth rate may be falling (1) so there may be fewer children in education (1) the amount spent per child may still be rising (1) improving productivity (1) raising wages (1) increasing consumption (1)
- less may be spent but it might be spent more effectively (1) this will raise the quality of education (1) raise productivity (1) raising employment (1) increasing consumption (1)

2 Burundi is a country in Sub-Saharan Africa. In 2013 the government of Burundi introduced VAT, an indirect tax, while lowering corporation tax (the tax on firms' profits), from 35% to 30%. The United Nations has encouraged Sub-Saharan African countries to increase their tax revenue in order to have more funds available to spend on reducing poverty. There is, however, a debate about whether imposing more taxes or removing some taxes is more beneficial for an economy.

(a) Define 'an indirect tax'. [2]

(b) Explain how a cut in the rate of corporation tax could result in an increase in tax revenue. [4]

(c) Using a demand and supply diagram, analyse the effect of removing an indirect tax on the market for the product. [6]

(d) Discuss whether an increase in taxes will reduce inflation. [8]

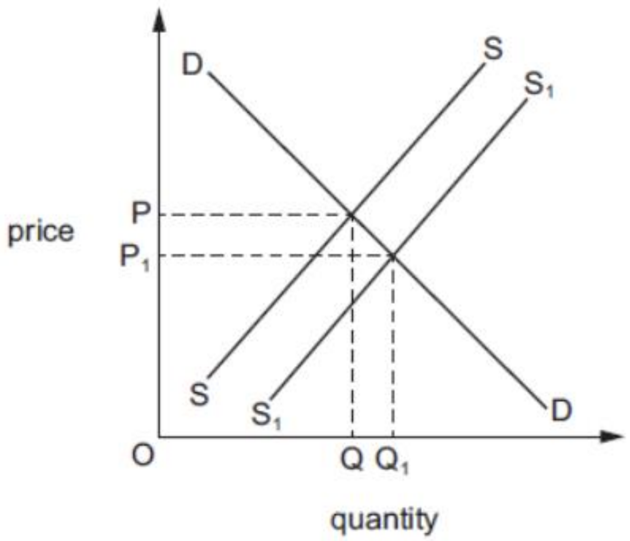
2 (a) Define 'an indirect tax'. **[2]**

A tax on spending / goods and services / consumption (1) the burden of the tax can be moved on to someone else (1) example (1)

(b) Explain how a cut in the rate of corporation tax could result in an increase in tax revenue. **[4]**

- A lower tax will increase the profit firms can keep / lower the cost of production (1) encourage them to increase output (1) increasing employment (1) pay higher wages (1) direct tax revenue would rise (1).
- Spending / consumption may increase (1) more revenue from indirect taxes (1).

(c) Using a demand and supply diagram, analyse the effect of removing an indirect tax on the market for the product. **[6]**



Up to 4 marks for the diagram:
- axes correctly labelled – price and quantity or P and Q (1)
- demand and supply curves correctly labelled (1)
- supply curve shifted to the right (1)
- correct equilibriums identified either by a line drawn to both axes or equilibrium points clearly identified e.g. E and E1 (1).

Up to 2 marks for written comments:
- removing an indirect tax effectively reduces costs of production (1)
- A greater supply will lower price (1).

(d) Discuss whether an increase in taxes will reduce inflation. [8]

Up to 5 marks for why it might:

- Increases in income tax (1) will reduce disposable income (1) spending may fall (1) lower demand will reduce demand-pull inflation (1).
- Increases in corporation tax (1) reduces profits firms can keep (1) reduces demand for capital goods/investment (1).
- Increases in indirect taxes (1) will reduce spending (1) lowering demand-pull inflation (1)

Up to 5 marks for why it might not:

- Consumers and firms may respond by reducing saving (1) rather than spending (1).
- Higher indirect taxes and corporation tax (1) increase costs of production / higher prices (1) may cause cost-push inflation (1).
- Higher income tax may encourage workers to press for wage rises (1) increasing costs of production (1) causing cost-push inflation (1).

4 Increasing demand from China has made New Zealand the world's biggest exporter of dairy products. Its exports of milk to China increased by 45% in 2013. More than 300000 hectares of land in New Zealand have been transferred to dairy use from other forms of farming and forestry use since 2000. The increase in milk production has caused the average cost of its production to fall and changes in production methods have affected the price elasticity of supply of milk.

(a) Why may less wheat be the opportunity cost of producing more milk? [2]

(b) Explain **two** reasons why the supply of a product may be price-inelastic. [4]

(c) Analyse how an increase in exports could increase a country's employment rate and inflation rate. [6]

(d) Discuss whether the average cost of production always decreases when a firm increases the total output that it produces. [8]

(c) Analyse how an increase in exports could increase a country's employment rate and inflation rate. [6]

- An increase in exports may mean a higher total demand (1). Higher demand may encourage firms to increase their output (1) to produce more products firms may take on more workers (1) reducing cyclical unemployment (1).
- Higher demand may cause demand-pull inflation (1). A higher demand for workers may push up wages (1). Higher demand for raw materials may push up the price of raw materials (1). Costs of production may increase (1) causing cost-push inflation (1).

Note: a maximum of 4 marks for analysis of the effect on either the employment rate or the inflation rate.

(d) Discuss whether the average cost of production always decreases when a firm increases the total output that it produces. [8]

Up to 5 marks for why it might:

- The firm may experience economies of scale (1) total cost will rise by less than total output (long run average cost may fall as output increases) (1).
- The firm may experience buying/purchasing economies of scale (1) may be offered a discount price when buying raw materials in bulk (1).
- The firm may experience technical economies of scale (1) larger, more cost efficient technological equipment may be purchased to produce a higher output (1).
- The firm may experience managerial economies of scale (1) specialist staff may be employed when output is high (1)
- The firm may experience financial economies of scale (1) as output increases, it may be able to borrow more cheaply / or sell its shares at a lower price (1)
- The firm may experience R & D economies of scale (1) the R & D expenditure can be spread over a higher output (1).
- The industry may also be growing in size (1) enabling advantage to be taken of external economies of scale (1).

Up to 5 marks for why it might not:

- The firm may experience diseconomies of scale (1) total cost may rise by more than total output (long run average cost may increase as output increases) (1).
- The firm may experience diseconomies of scale (1) this may make the firm slower to respond to changing market conditions / more difficult to keep costs down (1).
- The firm may experience communication problems (1) ideas may not be communicated or may be misunderstood (1).
- The firm may experience poor industrial relations (1) e.g. strikes may increase costs of production (1).
- External diseconomies of scale may occur (1) e.g. pushing up the costs of production (1).
- Allow up to 2 marks for a correctly labelled average cost diagram which shows economies and diseconomies of scale as an alternative to describing average costs rising / falling as output increases

6 In 2013 the Japanese Government used a range of policies, including monetary policy, to increase consumer expenditure and investment to avoid deflation. At the same time, some Japanese politicians were arguing that the government should increase the rate of the country's sales tax from 5% to 10%. Sales tax is an indirect and regressive tax.

(a) Define 'regressive tax'. [2]

(b) Explain **two** influences on the amount firms spend on capital goods. [4]

(c) Analyse how monetary policy could increase the price level. [6]

(d) Discuss whether an increase in the rate of a sales tax would benefit an economy. [8]

6 (a) **Define 'regressive tax'.** **[2]**

A tax that takes a higher proportion of the income of the poor. (2)
A tax that falls more heavily on the poor. (1)

(b) **Explain <u>two</u> influences on the amount firms spend on capital goods.** **[4]**

- the amount of profits earned (1) high profits provide the finance and incentive to invest (1)
- the size of the firm (1) large firms are able to finance large scale capital investment (1)
- the type of firm (1) e.g. a steel producing firm will use a higher value of capital goods than a flower seller (1)
- interest rates (1) low interest rates allow firms to borrow cheaply for investment (1)
- inflation (1) a low rate of inflation gives firms confidence to invest (1)
- economic stability (1) a stable economy gives firms confidence to invest (1)
- corporation tax (1) a lower rate of corporation tax provides the finance and incentive to invest (1)
- advances in technology (1) may encourage firms to replace existing machines (1)
- expectations (1) if firms anticipate selling more in the future, they may expand (1)
- price of labour (1) a rise in wages may cause firms to replace labour with capital (1)

(c) **Analyse how monetary policy could increase the price level.** **[6]**

- a decrease in the rate of interest (1) may increase borrowing (1) reduce saving (1) increase demand (1) cause demand-pull inflation (1)
- increase money supply (1) raise spending/total demand (1) cause demand-pull/monetary inflation (1)
- reduce the exchange rate (1) increase price of imported materials (1) reduce pressure on domestic firms to keep costs down (1) cause cost-push inflation (1)
- reducing the exchange rate will reduce export prices (1) increase total demand (1) cause demand-pull inflation (1)

(d) **Discuss whether an increase in the rate of a sales tax would benefit an economy.** **[8]**

Up to 5 marks for why it might:

- may provide more government tax revenue (1) enable the government to spend more (1) e.g. may raise educational standards (1)
- may discourage consumption of harmful products (1) those that cause external costs (1) may reduce e.g. healthcare costs from smoking (1)
- may discourage the purchase of imports (1) improve current account position (1)
- could be used to reduce a budget deficit/increase a surplus (1)
- could be used to reduce (aggregate) demand (1) thus reducing inflation (1)

Up to 5 marks for why it might not:

- likely to fall more heavily on the poor (1) increase income inequality (1)
- increases firms' costs of production (1) raises price of products (1) causing cost-push inflation (1)
- may reduce spending (1) reducing output (1) increasing unemployment (1)
- may be placed on products that are already under-consumed (1) increase inefficiency (1)