Practice questions

Paper 1: Markets and market failure

Context 1

The UK energy market

[01]

- 52 / 6 × 100 = 866.7% (to 1 decimal place)
- Award 2 marks for the correct answer with no working shown.
- Award 1 mark for correct answer not to 1 decimal place.
- Award 1 mark for correct method but incorrect answer.

[02]

Possible answers include:

- Figure 1 shows continued high reliance on a small number of non-renewable energy sources, around 35% each on gas and oil.
- Renewable energy sources such as wind and hydro are growing but remain at low levels of production of 10% or lower.
- Figure 2 shows that natural gas prices are prone to price spikes, e.g. 100 to 600 pence per therm in 2022.

[03]

Possible answers include:

- Definition/explanation of competition, privatisation, deregulation, efficiency.
- Explanation of how increased competition incentivises firms to cut costs in order to be able to keep prices competitive with rival firms.
- Explanation of how privatisation may lead to firms having to maximise profits in order to give shareholders a satisfactory dividend. This is likely to require greater productive efficiency.
- Relevant diagram(s), e.g. perfect competition, monopoly diagram showing competitive equilibrium price and output, contestable monopoly diagram.

[04]

Possible answers include:

- Definition/explanation of nationalisation.
- Explanation of how privately owned firms set equilibrium price and output, which may lead to insufficient output and high prices.
- Explanation of how a nationalised firm may set a lower price and a higher output than a privately owned one — link to allocative efficiency.
- A nationalised organisation may be less dynamically efficient than a privately run one.
- Analysis of alternative methods of intervention, e.g. maximum prices, subsidies.

- Relevant diagram(s), e.g. monopoly with privatised vs nationalised equilibrium identified.

Possible evaluation points:

- Overall, markets such as for energy may be considered so strategically important that they must be provided by the state — the 'Commanding Heights' argument.
- A nationalised energy industry is arguably more likely to guarantee supply.
- However, a nationalised industry may be less dynamically efficient and so less innovative.

Essay 1

(a)

Possible answers include:

- Definitions/explanations of equality and equity.
- Analysis of how income tax cuts may increase disposable income.
- Analysis of how income tax cuts may affect incentives to work.
- Relevant diagram(s), e.g. Lorenz curve.

(b)

Possible answers include:

- Definitions/explanations of market-based and interventionist policies.
- Analysis of interventionist policies and how these can raise incomes, e.g. education/training, infrastructure.
- Analysis of market-based policies, e.g. reduced income tax, reduced unemployment benefits.
- Relevant diagrams, e.g. *AD*/*AS*, Laffer curve.

Possible evaluation points:

- Advantages and disadvantages of each policy method, e.g. trade-offs, cost, opportunity cost, time lags involved.
- Scope for government failure.
- Consideration of desirability of raising 'incomes of all households'.

Essay 2

(a)

Possible answers include:

- Definitions/explanations, e.g. of average costs, investment, dynamic efficiency.
- Analysis of how investment may lead to lower average costs by increasing productive efficiency.
- Analysis of how investment in large-scale capital equipment may lead to reduced *LRATC*.
- Analysis of how investment may lead to increased sales, e.g. by helping a business gain market share/create barriers to entry.
- Relevant diagram(s), e.g. illustrating technological change/dynamic efficiency with *ATC* curves, economies of scale.

(b)

Possible answers include:

- Definition/explanation, e.g. of profit, profit maximisation.
- Analysis of why profit maximisation is viewed as the main objective of firms, e.g. a reward for taking a business risk.
- Analysis of alternative objectives of the firm, e.g. the significance of the divorce of ownership and control (the principal–agent problem), satisficing, market share, survival, stakeholder objectives.
- Relevant diagram(s), e.g. profit maximisation, sales maximisation, satisficing.

Possible evaluation points:

- Discussion of why, even if firms aim for profit maximisation, they may not be able to achieve this objective.
- Discussion of the possibility of achieving several objectives simultaneously.
- The main objective may depend on the balance of stakeholder power or the size of firm.

Essay 3

(a)

Possible answers include:

- Definition/explanation of property rights, tragedy of the commons, negative externalities, market failure.
- Analysis of how a lack of clearly defined property rights can lead to over-exploitation of common resources, e.g. seas, air, forests.
- Relevant diagram, e.g. negative externalities in production.

(b)

Possible answers include:

- Definition/explanation of environmental externalities, market failure.
- Analysis of how an indirect tax could work to reduce production and consumption of goods which contribute to greenhouse gas emissions.
- Analysis of alternative policy tools, e.g. pollution permits, subsidising 'cleaner' alternatives, correcting information failure, behavioural nudges.
- Relevant diagram(s), e.g. indirect taxation, pollution permits, subsidy on 'clean' technology.

Possible evaluation points:

- Consideration of the relative advantages and disadvantages of indirect tax and other methods.
- Discussion of the relative effectiveness of indirect taxation and other methods.
- Scope for government failure/unintended consequences.

Paper 2: National and international economy

Context 2

The return of stagflation

[01]

2021 GDP = £2.04 trillion × 1.0744% = £2.19 trillion

[02]

Possible answers include:

- Economic growth is falling from 7.44% in 2021 to 1.2% in 2023 (forecast).
- Inflation has risen from close to 0% in 2021 to 9.4% in June 2022 and is forecast to go higher.
- Stagflation is the combination of falling or stagnant growth in income and rising prices.
- Stagflation could occur if we think the falling rate of economic growth will continue.
- A recession is forecast for 2023 and inflation will remain high — this would be seen as stagflation.
- Data are based on forecasts which may not prove accurate.
- It depends on whether we consider falling growth to be included in the definition of stagflation or negative growth.

[03]

Possible answers include:

- Supply-side shocks are sudden/unexpected/significant changes to the (long-run) aggregate supply of an economy.
- Sharp rises in commodity prices are often the cause (e.g. oil/gas/food).
- Causes and examples of this would include: Covid-19 pandemic (which was also a demand-side shock), war in Ukraine, famine, extreme weather event etc.
- Shocks can be positive or negative.
- A supply-side shock would shift *AS* leftwards (if negative) or rightwards (if positive).
- Negative supply-side shocks will lead to increased (cost-push) inflation.
- Positive supply-side shocks will lead to (benign) deflation (or disinflation if using inflation on *y*-axis).
- GDP will be affected — increased for positive shock and decreased for negative shock.
- *SRAS* should not be used on diagrams for this — Keynesian *AS* and *LRAS* are the appropriate ones to use.

[04]

Possible answers include:

- Contractionary monetary policy involves measures to reduce *AS* in an economy.
- Examples of contractionary monetary policy include: increases in interest rates, tightening of credit controls, decreases in money supply, quantitative tightening (and possibly increases in exchange rate).
- Stagflation is the combination of stagnated output and (cost-push) inflation.
- Reduction in *AD* (caused by contractionary monetary policy) will reduce inflation as it moves along the *AS* curve to a lower price level.
- Contractionary monetary policy will help reduce inflation but will also exacerbate the fall in national income.
- Cost-push inflation is often temporary due to it being caused by one-off price rises, which eventually fall out of the price index calculation.
- Reducing inflation in this way will conflict with objectives of rising national income and falling or low unemployment.

Essay 1

(a)

Possible answers include:

- Large tax cuts will lead to lower tax revenue if incentives are unaltered.
- Large tax cuts may move the economy towards the peak of the Laffer curve if to the right of the curve already.
- Incentive to work may be increased, so fictional and voluntary unemployment may be reduced — leading to some increase in tax revenue to offset the large tax cuts.
- National debt will probably rise.
- Supply-side effects may occur, which means long-run growth is increased.
- Inflationary impact of tax cut may lead to rising interest rates, which means the cost of servicing the national debt rises.

(b)

Possible answers include:

- Budget deficits may be cyclical and 'disappear' if growth is persistent.
- Budget deficits can be used for long-run growth via supply-side investment.
- Budget deficits may lead to crowding-out of private-sector activity.
- Budget deficits may lead to increase interest rates and increased national debt.
- A structural deficit will persist even with economic growth and will need corrective action.

Possible evaluation points:

- Depends on the type of deficit — cyclical or structural.
- Is the deficit being measured in pounds or as a percentage of GDP?
- Is the deficit increasing or decreasing?

Essay 2

(a)

Possible answers include:

- More goods produced in the UK will reduce the need for imports.
- Reshoring production may mean more goods are exported.
- Producing more in the UK may mean reduced competitiveness — affecting both imports and exports.
- It may make little difference to the overall balance.
- If reshoring increases UK GDP, this may mean that the UK has more money to spend on imports.

(b)

Possible answers include:

- Shorter supply chain will reduce business costs.
- Less international trade may lead to increased employment opportunities.
- Not buying from overseas may mean increased cost-push inflation as UK goods are more expensive.
- Reducing the availability of foreign goods may improve the balance of trade.
- Shortages may emerge, which slow down production.

Possible evaluation issues:

- Overall impact may depend on how reliant businesses are on imports for inputs into the production process.
- Unemployment may fall but this may take time.
- Inflation is likely to be higher due to less reliance on cheaper imported goods.
- Improvements to trade balance may take time as industry adjusts to changes in supply chains.

Essay 3

(a)

Possible answers include:

- Open-market operations — buying and selling foreign currency.
- Interest rate changes — to affect short-term speculative assessment (aka 'hot money' flows).
- Joining a currency unión.
- Contractionary fiscal policy may restore confidence in the government's economic policy, which may lead to an inflow of currency and an exchange rate appreciation.

(b)

Possible answers include:

- Will lead to a more competitive export sector — this will boost *AD*.
- Will protect/expand employment in export industries.
- Will improve balance on the current account of the balance of payments.

- Will lead to cost-push (imported) inflation.
- Exports may only improve in the long term (and only if the Marshall–Lerner condition is satisfied).

Possible evaluation points:

- There will be potential improvements in some objectives (economic growth, unemployment and the balance of payments) but a worsening of inflation.
- The overall effect depends on the current state of the economy.
- The improvements may take time to work fully.
- If the UK export sector competes on price rather than quality, the effect will be more pronounced.
- It depends on how 'open' the UK economy is — the UK is a fairly open economy, so the effect of the exchange rate change will be more significant.

Paper 3: Investigation question

Poverty in the UK

Fuel poverty

[01]

Relevant points include:

- Figure 1 shows how fast energy bills are rising for the typical household — from just over £1,000 per year in 2019–21 to around £3,500 and then close to £5,000 in late 2022 and early 2023 respectively — indicating that poor households will struggle to pay for anything other than basic goods.
- Figure 2 shows that the biggest fall in discretionary spending is for the poorest households, where the fall in money available for spending is around 7% for the poorest decile, followed by just over 6% for the second poorest decile and so on — again indicating that the poorest households will struggle to buy anything other than basic goods.
- Figure 3 shows that, of the family types shown, all will have the majority within each group in fuel poverty by 2023 – around 90% of families with one parent and two or more children — again, this supports the proposition.
- Limitations of the data are that Figure 1 and Figure 2 do not show income levels, just the rise in fuel costs and fall in spending power – which may have been high before the recent price increases.
- Data do not show the effects of government intervention in the fuel market to cap domestic heating costs.

[02]

Possible causes of poverty would include:

- poor health/old age
- poor education
- low wages — idea of 'working poor'
- unequal distribution of income — for relative poverty — e.g. regressive taxes, low welfare payments
- poverty trap — where tax and welfare system creates dependency on 'welfare state'
- lack of welfare benefits for those on low income
- high unemployment

[03]

Possible points to include:

- Maximum price ('energy price guarantee' as implemented in 2022–23).
- Targeted help — those affected most (using data from extracts), such as subsidies given to those on low incomes.
- Nationalisation of national grid and energy companies — allowing government to set its own (presumably, lower) prices for energy.

- Increased tax on ‘windfall’ profits earned by energy companies, with revenue used to subsidise poorer households.

Possible evaluation points:

- The energy price guarantee helps most people but does not help those hit hardest — and gives the biggest savings to the richest households (assuming they have the biggest heating bills).
- Subsidising fuel costs does not encourage people to be careful with their energy use.
- Other than the tax on windfall profits, all methods are very expensive.
- Windfall taxes may encourage energy companies to ‘hide’ profits.
- Windfall taxes encourage businesses not to be efficient.
- Intervening in markets may lead to a sub-optimal allocation of resources — though it will enable the objective of reducing poverty and inequity.
- Keeping energy prices low may conflict with the objective of managing environmental change.