UNIVERSITY OF CAMBRIDGE
INTERNATIONAL EXAMINATIONS General

**ECONOMICS 9708/41** Paper 4 Data Response and Essay (Supplement) **May/June 2011 2 hours 15 minutes**

Additional Materials: Answer Booklet/Paper

**READ THESE INSTRUCTIONS FIRST**

If you have been given an Answer Booklet, follow the instructions on the front cover of the

Booklet. Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

**Section A**
Answer **Question 1**.

**Section B**
Answer any **two** questions.

You may answer with reference to your own economy or other economies that you have studied where relevant to the question.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

This document consists of **3** printed pages and **1** blank page.


 **[Turn over**



## Section A

Answer this question.

**1 High taxes do not help in a recession**

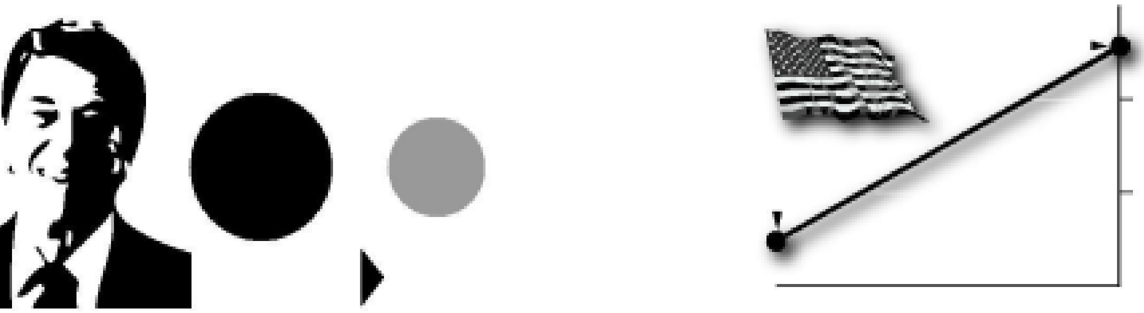
In 2009, there was an economic recession in many countries. One aspect of the recession was that unemployment rose. Governments paid large subsidies to a number of industries to try to stop the rise in unemployment. This increased the governments' debt and affected its other expenditure.

In an attempt to recover part of the extra expenditure, some governments had a policy of increased income tax rates on people who had high salaries.

However, critics of this policy argue that higher tax rates do not work. They say that the proportion of revenue received from top taxpayers falls and does not rise as taxes increase and the higher taxes cause damaging effects on the economy. It is better they say to decrease taxes. The decrease in taxes brings the government more revenue, not less revenue. Their opinion is supported by evidence from the past as is seen in the effect on tax receipts of changing tax rates in the US as shown in Fig. 1.

**FIG. 1 CUTTING TAXES RAISES REVENUE**

**Top-rate income tax cuts What the top 1% paid in tax** **Ronald Reagan**



Proportion of total tax

revenue30% **27.5%**

**US President:**

**1981–1989** 25

**17.6%**

20

**70% 28%**

**1981 1988** *(Source: The Times, May 7 2009 p. 28.)*

15

It is suggested that this opposite policy of reducing tax rates is better. Lower tax rates actually boost both the economy and tax revenues. For example, Russia, Latvia and Estonia reduced their highest tax rate and replaced a complicated system of taxes with a single income tax rate of 10%. They enjoyed a huge economic boost as a result.

Another aspect of the recession was that businesses found it difficult to borrow money from the commercial banks. In order to try and make borrowing easier and help businesses, some central banks lowered their interest rates. The central banks also bought government bonds in an attempt to increase the supply of money in the economy.

**(a)** Explain what is meant by a recession. [3] **(b)** The article states that 'higher tax rates do not work'.

**(i)** What does the article mean by this statement? [3] **(ii)** Is there enough evidence in the article to justify this statement? [6]

**(c)** Discuss why the actions of the central banks mentioned in the article might have been expected to ease the recession. [8]





(a) Recession refers to low economic activity levels. This is when due to some economic, political or social reasons there is lesser production of goods and services in an economy. Lower output levels mean lower national income levels. Hence lower national income mean lower living standards. Therefore policymakers strive to avoid recessions to ensure citizens' decent living standards.

(b) (i) Some people believe in the idea that higher tax rates will help governments earn higher tax revenue but this will be only when we assume no fall in economy's activity levels. But this might be very unrealistic assumption. This is because often due to higher tax rates economy's activity levels are lowered and hence low economic activity result in lower taxes in monetary value.

(c) (ii) According to the information present in the case study when top 1 percent of income earners' tax rates are reduced from 70 to 28 percent their total contribution to national taxation as percentage of total taxes increased. This might be because of higher marginal propensity to consume and invest following decrease in marginal tax rates. This increased consumption and investment following reduction in income taxes will lead to higher aggregate demand level which will result in higher national tax revenue for the countries. This is however often not true and that is why policymakers provide justification for higher marginal tax rates for higher income levels which is known as progressive taxation. Higher marginal propensity to consume of not so wealthy people help economies boost aggregate demand more by taxing richer people higher and providing financial benefits to not so well-off citizens. However too high of marginal tax rates such as what US economy had in place previously like 70 percent would have significantly reduced economic activity levels.

Moreover the case study cites examples of Russia, Latvia and Estonia which replaced progressive taxation system with proportional system which helped their governments to earn higher tax revenues. Hence there is some evidence in favor of reducing marginal tax rates for high income earners. However since relevant data/information is not presenty concerning how quantitative changes expected to occur from using taxation isntruments for income redistribution objectives therefore it will be hard to objectively conclude that whether reducing taxes for rich will better help US to achieve its objective of increase government revenue or not.

© Purchase of government bonds by central bank will inject liquidity in the economy that is expected to positively affect commercial banks' lending ability. This process is known as open market operations. Purchasing back government securities mean that general public is being paid back their money that was previously borrowed by the government. This money is now expected to be kept in commercial banks which will increase their liquid cash and hence will increase their ability to lend to potential borrowers.

Higher lending by commercial banks will help increase aggregate demand levels. Higher borrowing by general public for consumption and investment purposes is expected to increase economy's national income due to higher activity levels.

Hence such open market operations are considered effective in initiating expansionary monetary policy. Reduced borrowing costs encourage higher consumption and investment which boost economic activity levels. Higher economic activity will result in higher national income levels and lower unemployment.

However higher aggregate demand and greater credit creation will result in significant inflationary pressures within an economy. Higher general price level will reduce citizens' purchasing power which will adversely affect their consumption possibilities hence resulting in lower living standards. Similarly expansionary fiscal policy can also be effective in eliminating economy's recession. Higher government expenditure and lower tax rates are expected to boost local economic activity levels. Increased government borrowing that is likely to increase citizens' tax burden are likely outcomes of expansionary fiscal policy. However since demand management strategies are effective and easier ways to manage domestic aggregate demand levels they are often used in preference of supply-side policies that generally have longer time lag but are more effective and sustainable strategies to ensure avoidance of recessions. Enhanced production potential will make local products more competitive and will help boost country's exports hence during even lower domestic demand economy's national income will be comparatively higher.