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ECONOMICS

H460
For first teaching in 2015

Component 2
Macroeconomics

Version 1

www.ocr.org.uk/economics

Contents

Introduction

We asked students to answer Section B of the Sample Question Paper for H460/02 Macroeconomics:

http://www.ocr.org.uk/Images/170858-unit-h460-2-macroeconomics-sample-assessment-material.pdf

The sample answers in this resource have been extracted from original candidate work to maintain their authenticity. They are supported by examiner commentary, both in annotations and in summary at the end of the document.

Please note that this resource is provided for advice and guidance only and does not in any way constitute an indication of grade boundaries or endorsed answers.

The Labour Party announced in 2014 that if elected it would restore the 50% income tax rate for high earners in the UK.

Evaluate, with the use of an appropriate diagram(s), whether the UK macroeconomic performance would be strengthened by an increase in the top rate of income tax. [25 marks]

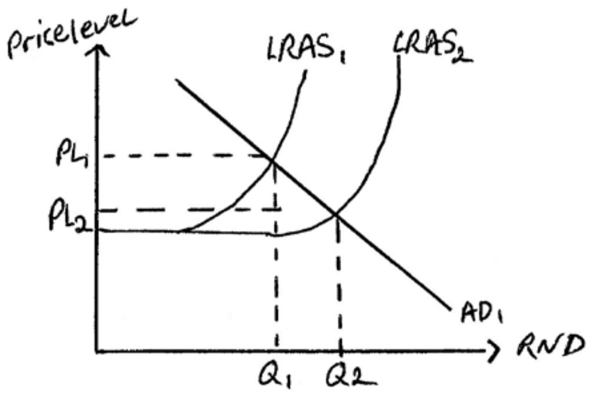
Candidate J

Income tax is a direct tax to households and hence cannot be passed on. It is a progressive tax, meaning the rate increases as your income increases. Macroeconomic performance is measured through five indicators: low unemployment, low and stable inflation, high levels of economic growth, high international trade competitiveness and income inequality. The last one will be the key measure to the success of the Labour party's policy of 50% income tax on high earners.

There is a good initial introduction into how to measure macroeconomic performance which is referred to throughout the answer.

Firstly, a benefit to the economy from increased income tax on high earners would increase government revenue from tax receipts, improving their fiscal position; this could allow greater levels of expansionary fiscal policy if required. For example, subsidies paid to firms to cover the costs of training programmes, as supply side policy. This supply side policy would upskill the workers, giving them greater productivity and hence decreasing the average cost per unit for the firm. This would increase the LRAS curve as shown below. By pushing out the LRAS curve, it reduces cost push inflationary pressure as the capacity of the economy has been increased, and an increase in the trend rate of economic growth.

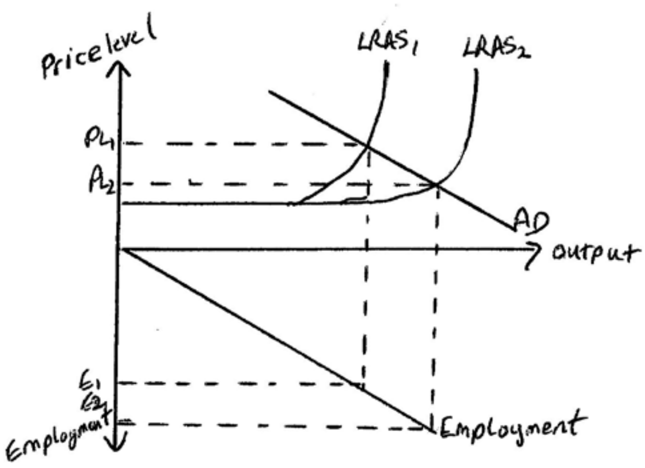
Analysis of the reasons for increasing the top rate of income tax. There is a clear chain of argument which is linked to the accurately drawn diagram below.



This will also be progress towards achieving one of the objectives, low and stable inflation, but also increasing the economy's international competitiveness as export prices will have decreased due to decreased costs. This does depend on relative trading partner's costs and prices however. Firms may also be subsidized to expand their firm allowing them to take on more workers and hence increasing employment. This will mean increased GDP/capita and hence income for lower and middle income earners will also increase. This will result in increased standards of living as individuals have greater disposable income, and hence an increased marginal propensity to consume, resulting in increased consumption of luxury goods, hence an increase in material well-being. The increase in consumption will also increase aggregate demand, depending on the size of the multiplier. This will help aid economic growth. A combination of increased job creation and no increase in income tax for low and middle-income earners will create an incentive to work as it will help pull people out of the poverty trap, and training and education schemes will help with the effect of hysteresis. This will increase the participation rate and reduce unemployment, as see in the diagram below.

There is strong analysis of the reasons for increasing the top rate of income tax which is linked to the accurately drawn diagram below. The analysis of consequences develops most of the links in the chain of argument. There are also some evaluative statements throughout.

Candidate J (cont)



This diagram shows how supply side policies will reduce cost push inflationary pressures, but also increase employment, hence achieving two of the objectives. However, firms may not use the subsidy granted how I suggested. Usually the owner/director of the firm, who makes all the decisions, will be in the top income bracket and hence will have 50% income tax. To cover this up, he may take out a larger salary out of the firm to maintain his original salary in real terms, resulting in reduced profit margins, less supernormal profit made and hence less investment.

Recognition of the negative consequences of increasing the top rate of tax which makes some use of the diagram – this could have been made more explicit.

If the government were to increase taxes on top income earners then the economy will no doubt see less domestic investment from top business owners and entrepreneurs who are placed in this bracket. This is because they will have less discretionary income as 50% has been taxed, and therefore they will invest less in new innovative products and processes. This 50% income tax, unlike an indirect tax which can be passed on, must be completely absorbed by the individual. Hence there will be less of an incentive for high income earners to work as they may find themselves on the backward bending curve.

Further analysis of the negative consequences – recognition of the impact on incentives to work.

This intervention by the government to reduce income inequality could also result in government failure. This is because most wealthy individuals will have the ability to avoid most income taxes due to loop holes in government legislation and tax havens such as Monaco. This makes it very difficult for governments to regulate and ensure people pay their taxes and can be very costly to investigate these kind of situations.

Evaluation of the risks of increasing the top rate of tax.

In conclusion, I believe that the UK economy could potentially benefit hugely from increased income taxes on high income earners as it will increase the government's fiscal position allowing them to either reduce national debt or inject this money back into the economy through expansionary fiscal policy. However, the effects of this taxation will depend hugely on how the top band of tax payers respond to this decision and whether they comply with it. It could be said in economic terms that there is a high level of interdependence in this decision to increase taxes so substantially.

Good evaluation because there is a conclusion which weighs up both sides of the argument.

Overall, this is a well analysed answer, it has clear chains of argument that include good use of economic terms, concepts and models – strong analysis, and there is good evaluation alongside good knowledge and understanding of income tax in the context of macroeconomic performance.

Level: 4

Mark: 19

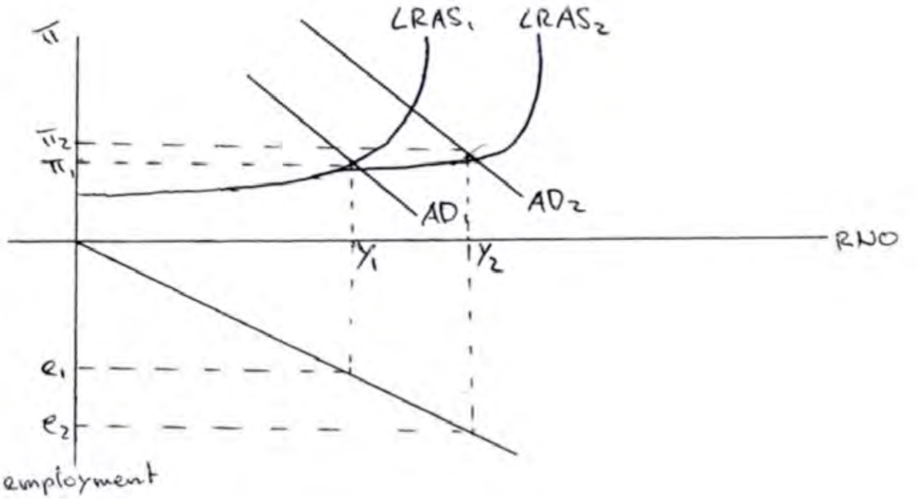
Candidate K

Income tax is a kind of direct tax, which is paid directly to the government by an individual and can therefore not be passed on. In the UK there is a system called progressive taxation, which means that the average rate of taxation increases as income rises, i.e. you will get taxed more on higher earnings. As taxation is the main income of the government, an increase in tax rates could mean a bettering in the UK economy if the extra money received is spent correctly.

Introduction to the policy measure. Knowledge of progressive taxation demonstrated.

By using Fiscal policy, i.e. government spending, a strengthening in the UK economy can be achieved through Aggregate Demand (AD) stimulating programs and by giving incentives to firms to invest. Current government spending can be used to subsidize firms, in order to allow these to invest into themselves or raise JSA to increase consumption of the poor, as their MPC is 1 or very close to it. This can lead to a substantial increase in AD, as AD=C+I+G+(X-M), as well as an increase in the productive potential of the UK, due to improved and/or more capital.

Reasonable analysis of the reasons for increasing the top rate of income tax. There is a chain of argument which is linked to the diagram below. The diagram is mostly correct.



The diagram above shows an increase in AD from AD1 to AD2 and a shift to the right of the Long Run Aggregate Supply (LRAS) curve. This leads to an increase in Real National Output (RNO) from Y1 to Y2, however also causes demand-pull inflation from p1 to p2. In addition the diagram shows the employment curve of the economy, where employment increases from e1 to e2, due to the increase in RNO.

This could lead to the national income multiplier effect, which is a disproportionate bigger increase in RNO compared to the increase in AD, however the size of this is completely dependent upon consumer and producer confidence, which may not be very high, due to the current recession/recovery.

There is good analysis which develops most of the chains of argument. This is underpinned by use of some economic concepts, terms and models.

However, the increase in taxes will also decrease in disposable income for the high earners in the UK, which means consumption of those will decrease, so that AD can fall. However, this Is unlikely to make a big difference, as an increase of the tax rate of 5% on income over 150,000 pounds will not have a massive impact on the way high earners will spend their money. Also, a higher rate of tax can disincentivise the unemployed to not try and get a job, as they might have to give up 50% of their income if they do. Therefore you could argue, that tax revenue for the government might actually not increase overall, as it will get more money, however from less people.

However, the high-end income tax will unlikely affect freshly employed people, meaning that low-middle class income earners might actually not mind the increase in tax, so that there is no disincentive, although hearing about an increase in tax will never increase consumers confidence and willingness to work.

Some further analysis of the consequences, negative and positive. This analysis isn't very strong.

Candidate K (cont)

Another problem that could arise is government failure, which would mean that the increase in taxation was unnecessary, as the extra money was not spent correctly, which might be due to information failure. Therefore this could lead to a worsening of the UK economy, due to lower demand and consumer and producer confidence, which would be an extreme set-back in the current recovery.

The other side is not so detailed, but still demonstrates a decent awareness of the key issue.

Overall, increases in tax can be a very successful way of allowing a government to 'spend their way out of a recession', while not increasing their budget deficit and national debt too much. Especially, only a low increase for only the highest income earners is unlikely to have negative effects on AD and will have no effects whatsoever on low-middle class earners, which suffer the most from recession, meaning a general rise in living standards and a strengthening of the economy is likely to occur.

There is also reasonable evaluation because a conclusion is come to which shows some understanding of the influencing factors but there isn't a supported judgement.

Overall, this is an answer with good knowledge and good analysis alongside reasonable evaluation. The analysis isn't good at all times but when read holistically there are enough arguments which contain clear links in the chain to justify L3.

Level: 3

Mark: 15

Candidate L

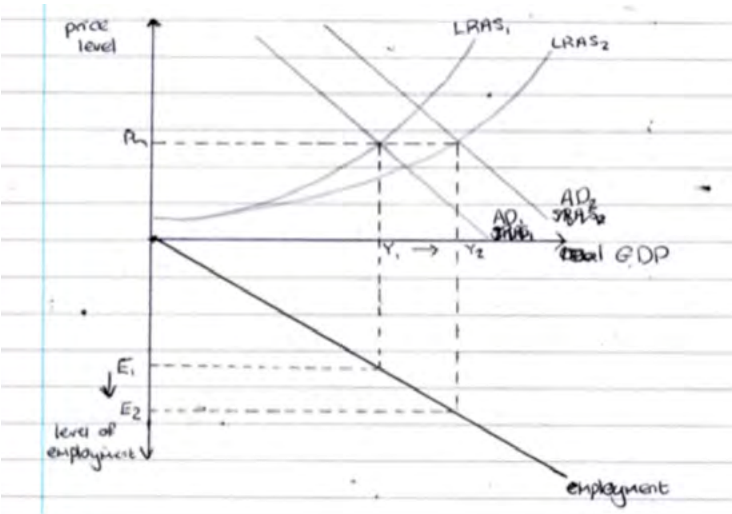
In the UK, the government operates a progressive tax system, meaning that people earning a higher level of income are taxed a greater amount of this income than those on lower incomes. The level of taxation has a direct impact upon the macroeconomic performance of the economy. This impact is analysed using the four main macroeconomic objectives: a high level of employment, stable and low inflation, positive and sustainable economic growth and a satisfactory current account on the balance of payments.

Through an increase in the rate of income tax to 50% for high earners, there will be increased revenue for governments. This will mean that there is a greater amount of money which the government can invest and as government expenditure is a component of aggregate demand there will be a resulting increase in the level of aggregate demand in the economy. The government may choose to invest this extra income into merit goods such as healthcare and education. These services produce positive externalities in consumption and will help to increase the long run aggregate supply of the economy. However, for this to be effective the government must ensure that they have perfect information of the markets to ensure they achieve allocative efficiency and these should be sufficient advertising of the services to ensure that information failure does not occur.

The answer begins promisingly with effective use of macroeconomic concepts to analyse the consequences of an increase in the top rate of tax. There is also some valid evaluation in the final few lines regarding information failure.

The government may also choose to use this additional income to create jobs in the order to reduce the level of unemployment in the economy. However, these jobs are likely to be low paid and so may not contribute a large amount through taxation receipts, although they will reduce welfare payments such as job seekers allowance. People earning in the lower income bracket tend to have a higher marginal propensity to consume, meaning an increase in the level of consumption and henceforth an increase in the level of aggregate demand. Also, as more people are employed, there will be an increase in the short run aggregate supply potential of the economy.

There is little economic analysis in this section.



As this diagram shows, there will be an outwards shift in the long run aggregate supply curve from LRAS^1 to LRAS^2. There will also be a shift in the aggregate demand curve from AD^1 to AD^2. However, the price level remains the same meaning the objective of low and stable inflation is achieved. The level of real GDP increases from Y^1 to Y^2, achieving positive economic growth. This has a resulting effect of increasing the level of employment from E^1 to E^2, achieving the objective of high employment.

There is reasonable analysis of the argument(s) for the increase in the top rate of tax. This analysis contains a relevant and correctly labelled diagram.

As the level of taxation increases for higher earners, it means that they will be able to retain less of their wages this will lead to a decrease in their level of consumption which could affect aggregate demand. However, this may not be to a great extent as higher earners usually have a greater marginal propensity to save rather than to consume.

Little analysis of the negative consequences leaves the whole essay incomplete and limits the progression past L2.

Candidate L (cont)

Overall, I believe that an increase in the top rate of income tax would have a net benefit to the macroeconomic performance of the economy. This is providing that the government spend the increase revenue appropriately and efficiently in order to avoid government failure. There should be a resulting increase in the level of consumption, increasing aggregate demand.

There is evaluation throughout the answer but the final judgement doesn't really address the extent to which the UK economic performance would be strengthened by the increase in the top rate of tax. Reasonable evaluation overall because there is an attempt to draw a conclusion and some recognition of the influencing factors.

Level: 2

Mark: 10

Examiner's summary comments

Candidate J

The candidate provides strong analysis and good evaluation of whether an increase in the top rate of income tax would strengthen the performance of the UK economy. There is a good initial introduction into how to measure macroeconomic performance which is referred to throughout the answer.

There is a strong chain of argument, particularly on the arguments for the increase in the top rate of income tax. This is underpinned by economic concepts, terms and models with effective use of two diagrams. The other side is not so detailed, but still demonstrates a good awareness of the key issue.

There is also good evaluation which does address what the effects depend on but lacks sophistication in its delivery. With a little more exploration of the evaluative points and a more robust judgment this would tip into L5.

Candidate K

There is relatively good analysis of both sides of the argument but the candidate hasn't explored points in a lot of depth, limiting their progress through the levels. Evaluation is relatively good but isn't underpinned by strong economic analysis and lacks sophistication in its execution. This is an essay with a lot of potential but it doesn't quite make it.

Candidate L

There is relatively good analysis of the argument(s) for the increase in the top rate of tax which addresses some evaluative points. This analysis contains a relevant and correctly labeled diagram. However, the discussion isn't balanced, the case against is briefly addressed. There is evaluation throughout the answer but the final judgment doesn't really address the extent to which the UK economic performance would be strengthened by the increase in the top rate of tax.

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