Exercise walk-through

Effectiveness of policy options to meet all macroeconomic objectives ▪ 10.3

eXercise

You must be able to

- explain the strengths and weaknesses of each policy
- explain crowding out and the Laffer curve
- evaluate the best policy mix to meet objectives

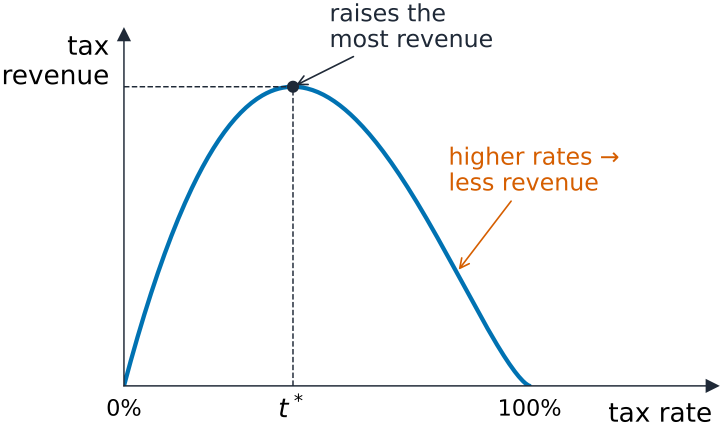
Method — The Laffer curve

Revenue is zero at 0% and 100%; going above t lowers revenue*

- **Fiscal policy:** powerful and targeted, but has **time lags 时滞**, raises **national debt 国债**, and risks **crowding out 挤出效应**.
- **Monetary policy:** flexible, but works with a lag and is weak in a deep slump.
- **Supply-side policy:** raises growth *and* lowers inflation, but is slow and costly.
- **Laffer curve 拉弗曲线**: above the revenue-maximising rate t^*, higher tax rates *cut* revenue.

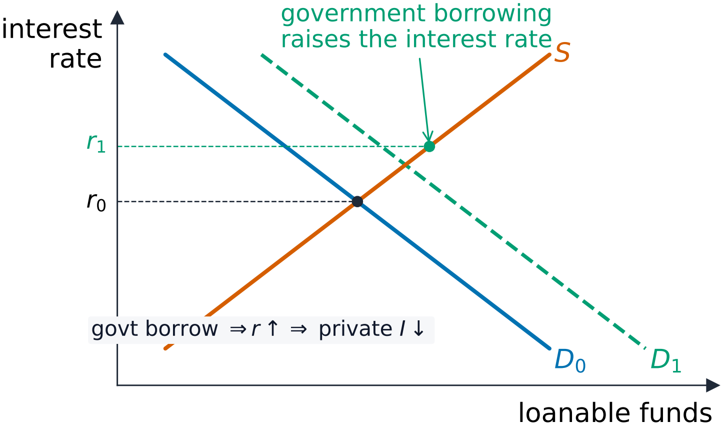
Answer shapes: an **Explain [up to 8]** answer may use a diagram (AO3); **Discuss [12]** adds a judgement (AO4).

Method — The Laffer curve



Tax revenue peaks at a rate t^*, then falls as rates rise further

Method — The Laffer curve



Heavy government borrowing raises the interest rate, crowding out private investment

Practice 2.1 ▪ 2 marks

Define the term *crowding out*.

Solution 2.1

Worked steps

when heavy government borrowing raises interest rates and so reduces private-sector investment (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

State what the **Laffer curve** shows.

Solution 2.2

Method: The Laffer curve

Worked steps

that as the tax rate rises, tax revenue first rises but then falls, because very high rates discourage work and encourage avoidance (2 for a clear statement; 1 for a partial idea).

Practice 2.3 ▪ 1 mark

State one weakness of monetary policy.

Solution 2.3

Method: The Laffer curve

Worked steps

any one of: it works with a long time lag; it is weak in a deep slump (a liquidity trap); it cannot fix structural problems (1).

Exam-style 3.1 ▪ 1 mark

According to the Laffer curve, raising the tax rate **above** the revenue-maximising rate will:

A always raise tax revenue

B lower tax revenue

C leave tax revenue unchanged

D raise the money supply

Solution 3.1

Method: The Laffer curve

A always raise tax revenue

B lower tax revenue ✓

C leave tax revenue unchanged

D raise the money supply

Worked steps

B. Above the revenue-maximising rate, higher tax rates lower revenue.

Exam-style 3.2 ▪ 6 marks

Explain how heavy government borrowing can crowd out private investment.

Solution 3.2

Method: The Laffer curve

Worked steps

[6] AO1 1 + AO3 up to 5 — to fund a deficit the government borrows heavily → this raises the demand for loanable funds → the interest rate rises → dearer borrowing means firms invest less → public spending "crowds out" private investment, reducing the net effect on AD.

Exam-style 3.3 ▪ 12 marks

Discuss which policy a government should rely on most to achieve long-term economic growth.

Solution 3.3

Method: The Laffer curve

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **Supply-side:** the only tool that raises capacity and productivity, giving growth *with* low inflation — but slow and costly. **Demand-side (fiscal/monetary):** quick to raise output but mainly short-run and inflation-prone. Judgement: for *long-term* growth supply-side policy should lead, supported by stable demand-side policy — the best mix depends on the time horizon and the economy's starting point.