

2014 PJC H1 Prelim Suggested Answer for Case Qn 2: Reducing Government Debt

(a)	Compare the government budget balance of USA and France from 2009 to 2012.	[2]
	<p><u>Suggested answer:</u> Both have budget deficit as % of GDP throughout 2009 to 2012 [1] Both budget deficits as % of GDP are falling from 2009 to 2012 [1] US budget deficit as % of GDP fell by a larger extent than France from 2009 to 2012. [1] US budget deficit is always a large % of GDP than France budget deficit. [1]</p>	
(b)	Explain how increasing the tax burden on the companies and executives by the government of France will affect the competitiveness of her economy.	[4]
	<p><u>Suggested answer:</u> Higher tax on companies reduces after-tax profits which reduces firm's ability to invest and hence productivity (1) Higher tax on executives reduces individual's incentive to work and improve and hence reduce productivity (1) A fall in productivity leads to a rise in unit labour cost causing AS curve to shift upwards. This results in a rise in GPL which causes a rise in P_x thus leading to a fall in France's X competitiveness (2)</p>	
(c)	Comment on the effects on standard of living when France chooses to increase tax rather than cut government spending to reduce its national debt.	[4]
	<p><u>Suggested answer:</u> By increasing tax, the disposable income of the French workers will fall and hence causing their purchasing power to consume to fall, thus resulting in a fall in SOL. Furthermore, the rise in tax will be a disincentive to work and may lead to brain drain, affecting the country's growth in GDP and SOL. [2] However, by increasing tax on the higher income workers, this helps to reduce income inequality and enables the government to have sufficient funds to continue with it spending on merit such as healthcare and education and public goods thus maintaining the quality of health, literacy rate and non-material well-being (2).</p>	
(d)	Using the data, explain the negative effects on the US economy if she did not reduce her debt burden.	[4]
	<p><u>Suggested answer:</u> Externally, if US did not reduce her debt burden, this may result in a loss in confidence of investors which will bring about a capital flight out of US causing her BOP deficit to worsen and its ER to depreciate. (2) Internally, the interest rate of US increases as lenders will demand for higher interest rate. ("it wouldn't be prudent to test the market's patience before the market demands much higher interest rates") This will cause C & I of US to fall, hence AD falls causing NY to fall by a larger extent via k effect. This will result in negative economic growth and rising unemployment as US economy falls below full employment. (2)</p> <p><u>Alternate answer:</u> With a rising US debt burden, US government will have to increase its tax rate to pay for</p>	

	the debt in the future. This may lead to a fall in disposable income which causes C, AD and hence NY to fall by a larger extent via the multiplier effect. Thus, US will experience falling or negative economic growth and rising unemployment in the long run. [2]	
(e)	Discuss how far supply-side policies can be used to reduce the problem of high unemployment in the USA.	[8]
	<p><u>Suggested answer:</u> <u>Root causes of unemployment in USA</u></p> <p>Cyclical unN: <i>Evidence: "Demand has grown slowly, despite unprecedented fiscal and monetary stimulus, and that explains why the unemployment rate remains high. Indeed, businesses cite uncertainty about the strength of demand as the main factor holding back job creation. Public sector demand has also contracted, owing to state and local governments' deteriorating budgets."</i> Thus, with the bleak expectations of firms that caused firm's investment to fall and the falling government expenditure, AD of US may be rising at a slow rate, causing real GDP rise at a slower rate. Hence, the demand for the unemployed workers is not increasing causing cyclical unemployment to remain high.</p> <p>Structural unN: <i>Evidence: "Recent reports suggest that there are more than three million unfilled job openings, and about 49% of employers say that they have difficulty filling positions, especially in information technology, engineering, and skilled trades. This has fanned speculation that a "mismatch" between workers' skills and employers' needs is a significant factor behind the elevated unemployment rate."</i> Due to the mismatch between workers' skills and employers' needs in the high technology and high skilled industries, unemployed workers remained structurally unemployed.</p> <p><u>Supply-side policies can help to reduce structural unemployment</u> Supply-side policies such as retraining schemes can help to equip the unemployed workers with the relevant skills and thus reduce the skills mismatch, thus reducing structural unemployment in US.</p> <p>Supply-side policies such as subsidies for R&D and cut in tax rates can help to increase the expected returns to investment of firms in the high technology industries and attract more investment into these industries thus creating more employment in these industries.</p> <p><u>Limitations of SS-side policies</u> Supply-side policies are costly and may worsen the US budget deficit and debt burden in the short run. However, by promoting higher growth and employment in the long run, it can generate more tax revenue in the long run and improve US budget and debt burden.</p> <p>Effectiveness of retraining scheme is subject to willingness of the workers to be retrained as some of them may be unemployed for a long period of time making it difficult for them to pick new skills. In addition, the effectiveness is also dependent on the willingness of the employers to employ the retrained workers. Employers may not be willing to hire these retrained workers who are old and unemployed for long period of time due to the perception that they are less adaptable and productive.</p> <p>Evaluation: Hence, given the limitations of SS-side policies, they may not be the best policies on their own to solve structural unemployment but should be complemented with other policies such as schemes to encourage the employers to retrain the workers and employ older and long-term unemployed workers.</p> <p><u>Need for other policies to address other root causes of unemployment</u> SS-side policies may also not be the best policies to solve cyclical unemployment as they</p>	

	<p>are long-term and does not address the root cause of cyclical unemployment directly. Firms are unwilling to invest due to uncertainty about the strength of the aggregate demand. This could be due to uncertain growth in consumption and export demand for the goods produced. Thus, in the short run, demand policies to promote higher growth of consumption and exports will be better. This may include policies such as fiscal policies to reduce tax rate to increase disposable income so that households are more able to consume and also free trade agreements to promote higher exports demand. In the long run, supply side policies to promote higher employment and higher productivity can also help to promote higher consumption and exports as well.</p> <p><u>Conclusion</u> Supply-side policies alone are not sufficient to solve the unemployment problem in US. However, they are necessary but should be complemented with other policies to encourage the firms to hire the long-term unemployed workers and to address the uncertainty of the firms.</p>	
(f)	Assess the extent to which the above problems will limit the ability of the government of France to reduce her national debt.	[8]
	<p><u>Suggested answer:</u></p> <p><u>Explain how the problems occur and why they limit ability of the government of France to reduce its national debt</u> Economic problems occur because when the government tries to reduce G and raise T to reduce the national debt,</p> <ul style="list-style-type: none"> • The fall in G and rise in T leads to falling AD and economic growth. • The fall in G expenditure to subsidise R&D will reduce firms' willingness and ability to find cleaner and greener methods of production to reduce carbon emission and global warming • The fall in G on welfare benefits/pensions to the poor will worsen the income inequality problem <p>These problems will limit ability of the government of France to reduce its debt because:</p> <ul style="list-style-type: none"> • With a falling or negative economic growth, the government may collect less tax revenue which will worsen the government debt. • The falling or negative economic growth will lead to rising unemployment and coupled with a fall in government expenditure on welfare benefits, this will bring about social and political instability as the affected French people may take to the street. Thus, due to the political consideration, the French government may not be willing and able to reduce the debt burden. <p><u>Problems do not limit the ability of France government to reduce its national debt</u></p> <ul style="list-style-type: none"> • Falling or negative economic growth leads to fall in production which reduces the amount of carbon emission, thus reducing the problem of global warming. Hence, there may not be a need for the government to increase spending on the environment which will worsen its debt burden. Evaluation: however, according to extract, the fall in carbon emission is only temporary and government should not put off its plan to reduce carbon emission as it will make it harder and more costly to reduce carbon emission in the long run. • The France government has chosen to increase T rather than decrease G, thus preventing the economic problem of income inequality from occurring. By adopting a more progressive tax system which taxes the rich by a larger proportion, this will reduce the income inequality between the rich and the poor. Evaluation: however, by increasing the tax rate by a large extent, this may be a disincentive to work which will lead to a brain drain and affects the productivity of France. AS and 	

economic growth will be affected which will affect France's tax revenue and its ability to reduce the debt in the long run.

Synthesis → do problems limit the French govt's ability to reduce national debt?

- The problems will likely limit French government's ability to reduce its national debt. However, given the negative impact of a high national debt on the French economy, it is necessary for the French government to reduce its national debt despite the problems. It is thus necessary for the French government to find ways to reduce extent of the problems when reducing the national debt, e.g. the French government can tax on carbon emission to help internalise the negative externality and force the firms to switch to cleaner and greener methods of production, thus reducing the debt and at same time reduce global warming. However, the tax should not increase by a large extent as it will increase the firms' cost of production and reduce the export competitiveness, thus worsening BOP and economic growth.
- The French government should also consider cutting down unproductive government expenditure that has little negative impact on productivity and growth. ('more savings should have been found from cutting public spending so fewer tax rises would have been necessary') Raising T particularly on the rich and large corporations is a good option as they have a low marginal propensity to consume and hence when their disposable income falls, they are less likely to cut back on their consumption. However, there is a need to avoid excessive increase in tax to avoid brain drain and loss of investment which will worsen growth and debt problem in LR.