

## RVHS 2015 H2 Economics Prelims 2 Essay Question 4

Individual saving is collectively harmful, particularly when the unemployment rate is high. As such, the government is often prepared to incur budget deficit so as to pump-prime the economy.

Discuss how far the level of thriftiness affects the effectiveness of pump-priming in tackling the high unemployment rate.

[25]

The level of thriftiness indicates how much an individual saves while pump-priming often refers to a government undertaking an expansionary fiscal policy as it might result in a budget deficit if the government expenditure outweighs government revenue. Such a policy is usually used to tackle cyclical unemployment which is defined as a fall in AD or SRAS and this could be due to a global recession. Thus, this essay will discuss to what extent the level of thriftiness affects the effectiveness of pump-priming in tackling a high cyclical unemployment rate.

### How pump-priming tackles cyclical unemployment (i.e. expansionary fiscal policy)

- $\uparrow$  government expenditure (G) – give examples
- $\downarrow$  taxes (e.g. corporate income tax, personal income tax)
- Overall:  $\uparrow G, C, I \rightarrow \uparrow AD$  since  $AD = C + G + I + X - M$

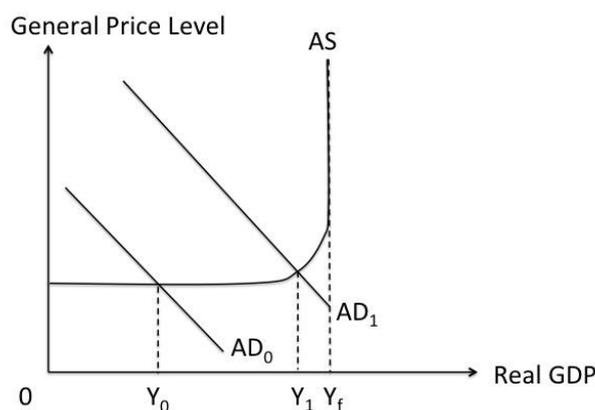


Figure 1: An economy with high cyclical unemployment

- With reference to Figure 1,
- $\uparrow AD$  from  $AD_0$  to  $AD_1 \rightarrow \uparrow$  in NY from  $Y_0$  to  $Y_1$  via the multiplier effect.
- Higher level of production and firms will need to hire more workers, thereby tackling the high level of cyclical unemployment.

### Thesis

- Level of thrift  $\rightarrow$  how much an individual saves  $\rightarrow$  mps value
- E.g. if an individual is very thrifty and saves \$0.70 for every \$1 increase in income, the individual's mps will be 0.70.
- Pump-priming will help decrease the level of cyclical unemployment but the extent of its effectiveness is dependent on the size of the economy's multiplier (k) which is dependent on the size of mps.
- Explain the multiplier process in detail with aid of a table / diagram.

- As seen from the multiplier process, the initial increase in AE due to the pump-priming will cause an eventual increase in national income by multiple times. If the level of thrift is higher, the induced consumption will be smaller in each time period and this will translate into a smaller increase in national income. All this will mean that pump-priming may not be so effective in reducing cyclical unemployment for a thrifty economy. Since the value of mps can be estimated from the level of thrift, the more thrifty an individual is, the less effective pump-priming is in raising the level of employment. This echoes what the preamble mentioned, that individual saving is collectively harmful particularly when unemployment rate is high because it is more difficult for the economy to lower the unemployment rate.

### **Anti-Thesis: Other factors**

#### **1. Value of mpt and mpm**

- A smaller value of mpm and mpt will help offset the larger value of mps. This means that the multiplier will not be as small and thus, will not reduce the effectiveness of pump-priming to a large extent.
- E.g. an economy well-endowed with resources will have a small mpm since it will be less reliant on imports. And an economy with a competitive personal and corporate income tax to draw more foreign talent and investment in to their country will have a small mpt.
- Taken together with a large mps, the multiplier will not be as small since  $k = 1/(mps+mpt+mpm)$ . What this means is that the increase in national income and thus employment will not be of a small extent. In other words, the impact on decreasing unemployment due to the higher the level of thrift will be diminished because of the smaller mpm and mpt value.

#### **2. Amount of G that is pumped into the economy / How much taxes are reduced by**

- If unemployment has been persistently high, which necessitates the need for an urgent solution, this might warrant the need for the government to be aggressive in its spending on projects such as building infrastructure or a huge reduction in taxes to raise C and I.
- In addition, it is important to note that these ultimately are dependent on how much there are in the government coffers.
- For this policy to be feasible, such an economy must have accumulated budget surplus over the years into their reserves. This will then enable the government to spend aggressively or reduce taxes to a huge extent to raise the level of employment.
- Overall, even if the level of thrift is high, an aggressive government spending will help to offset the high mps and thus, the increase in national income and thus employment may not be so small.

### 3. Economic outlook and duration of the fall in corporate income taxes

- If the fall in corporate tax will remain at that rate for the next few years, this might draw in even more investment.
- Coupled with the fact that if the economy is expected to improve in the next few months, FDI will be expecting improved expected demand conditions.
- Thus, the economy might see an increase in investment levels, which will help increase national income and thus employment levels, offsetting the initial impact of the higher level of thrift of the consumers.

### 4. Alternative Answer: time lags

Knowledge, Application, Understanding and Analysis		
L3	Developed discussion of how thrift and three other factors affect the effectiveness of pump-priming in tackling the high unemployment rate. <ul style="list-style-type: none"><li>○ Detailed explanation on how pump-priming works to tackle high unemployment rate.</li><li>○ Detailed explanation on how <b>thrift</b> affect the effectiveness of pump-priming in tackling the high unemployment rate through the multiplier process.</li><li>○ Detailed explanation on how <b>three other factors</b> affect the effectiveness of pump-priming in tackling the high unemployment rate through the multiplier process.</li></ul>	15 - 21
L2	Undeveloped discussion of how thrift and three other factors affect the effectiveness of pump-priming in tackling the high unemployment rate.	10 - 14
L1	Smattering of valid points i.e. answers show some knowledge of pump-priming and thrift.	1 – 9

### Evaluation

E2	For a well-reasoned evaluation.	3-4
E1	For an evaluation with no justification.	1-2