

10.3 Effectiveness of policy options to meet all macroeconomic objectives

Name: _____ Class: _____ Date: _____

Total: 24 marks

KEY WORDS laffer curve 拉弗曲线 • crowding out 挤出效应 • time lags 时滞
• tax revenue 税收收入 • effectiveness of policy options 政策有效性

Objective

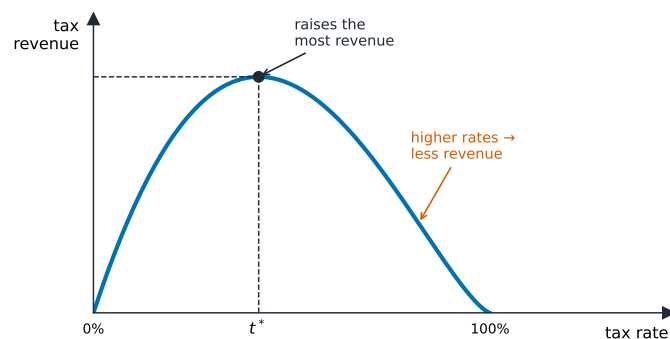
Build the skills to answer exam questions on the **effectiveness of policy options** 政策有效性 — the strengths and weaknesses of **fiscal**, **monetary** and **supply-side** policy, including **crowding out** 挤出效应 and the **Laffer curve** 拉弗曲线.

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

1 Worked examples

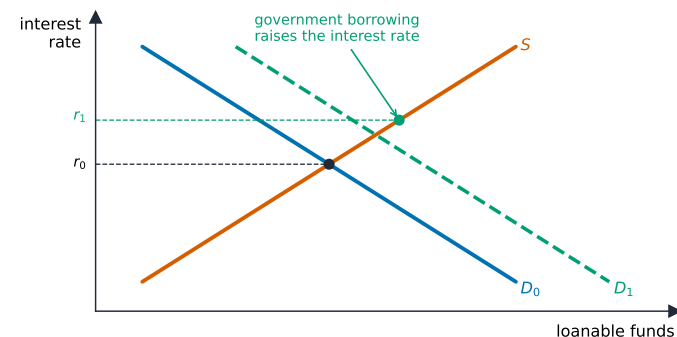
■ The Laffer curve



peak revenue at t^* • beyond t^* : rate ↑ revenue ↓

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.



govt borrow $\Rightarrow r \uparrow \Rightarrow$ private $\downarrow$

A key limit on fiscal policy: crowding out private investment

- **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).

2 Practice

2.1 Define the term *crowding out*.

[2]

2.2 State what the **Laffer curve** shows.

[2]

2.3 State one weakness of monetary policy.

[1]

3 Exam-style questions

3.1 According to the Laffer curve, raising the tax rate **above** the revenue-maximising rate will: [1]

- A always raise tax revenue
- B lower tax revenue
- C leave tax revenue unchanged
- D raise the money supply

3.2 Explain how heavy government borrowing can crowd out private investment. [6]

3.3 Discuss which policy a government should rely on most to achieve long-term economic growth. [12]

Solutions

Economics answers are marked by **level of response** against the assessment objectives: award **AO1** knowledge, **AO2** application, **AO3** analysis and **AO4** evaluation.

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

2.2 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).

2.3 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).

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

3.2 [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.

3.3 [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.