



GCE AS Level – **NEW AS**

B520U20-1



ECONOMICS – Component 2
Exploring Economic Issues

A.M. MONDAY, 23 May 2016

2 hours

B520U201
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ADDITIONAL MATERIALS

In addition to this examination paper, you will need a calculator and a 12 page answer booklet.

INSTRUCTIONS TO CANDIDATES

Answer **all** the questions.

Use black ink or black ball-point pen.

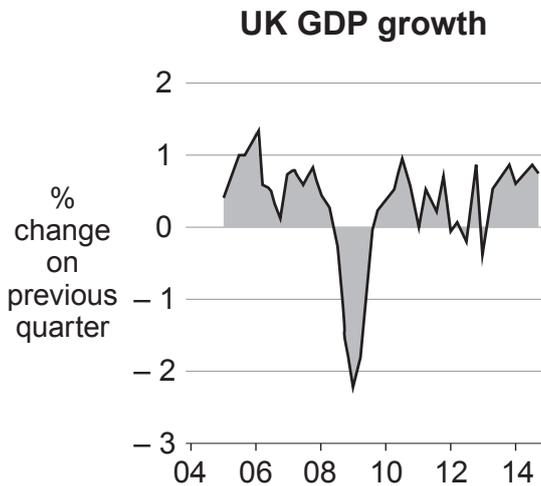
INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question or part-question.

Answer all the questions.

1. MIXED PICTURE FOR UK ECONOMIC HEALTH

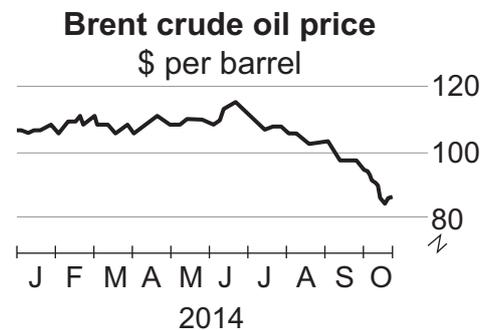
UK economic growth slowed in the three months to September 2014, with the economy expanding by just 0.7%, the Office for National Statistics said.



The figure was lower than the 0.9% increase recorded for the preceding second quarter and raised concerns that growth will continue to slow. With wages falling in real terms, an increase in consumer spending is unlikely and with the Eurozone doing badly and Chinese economic growth slowing, a significant increase in exports is not likely either, particularly given the strength of the pound, which has been driven up by expectations of an increase in UK interest rates. Nevertheless, the UK still looks set to be the fastest-growing advanced economy in 2014.

Shadow Chancellor Ed Balls said that the GDP figures revealed a worrying slowdown in economic growth, and that even when the economy was growing strongly, “most people are still not feeling the recovery”. He also argued that the UK is now the only leading economy where inequality is greater than at the turn of the century. As the rich have got richer, low and middle-income households have been hurt by falling real incomes caused by years of rising household bills and no wage increases. Balls had promised to reintroduce the 50p top rate of income tax for people earning more than £150,000 if Labour had won the 2015 election.

One potential light in the darkness is the price of oil, which dropped sharply in the second half of 2014. These falling prices are caused by shifts in both supply and demand. The world’s slowing economy is reducing the demand for oil. However, thanks largely to America’s shale oil and gas discoveries, oil production since early 2013 has been 2m barrels per day higher than the year before.



The UK imports more oil than it exports, so lower prices mean consumers get to keep more of their money and spend it in the UK economy. But the positive impact on demand is less than it used to be, as spending on oil is now a much smaller part of household expenditure. Cheaper oil could instead make more of a difference to monetary policy; with inflation below its 2% target, falling oil prices could push inflation down further, making it harder to keep inflation within target. At the same time falling oil prices may cause job losses in the UK’s oil and gas industry in Scotland.

Source: adapted www.economist.com and www.bbc.com

- (a) Using a diagram, explain why, according to the data, the pound appreciated in 2014. [4]
- (b) Discuss whether the slowing growth in the UK, identified in the data, means that the Government should use fiscal policy to boost aggregate demand. [10]
- (c) (i) Using a supply and demand diagram explain why the price of oil fell sharply in the second half of 2014. [4]
- (ii) Discuss how beneficial the fall in oil prices is likely to be for the UK economy. [10]
- (d) (i) Explain, with reference to the data, why rising income inequality might lead to economic and social problems for the UK. [6]
- (ii) Evaluate the extent to which a more progressive tax system will reduce income inequality in the UK. [6]

2. WAR ON SMOKERS CONTINUES

Tobacco is grown all over the world including parts of southern Europe and the Far East. The tobacco plant has to be treated with pesticides which damage the health of tobacco farmers who are often unaware of the dangers associated with tobacco cultivation. These pesticides along with fertilisers end up in soils, waterways and the food chain. Tobacco takes four months to grow and the crop yield is affected by changing weather conditions. Because tobacco is a perishable commodity, it has to be processed quickly following its harvesting to avoid deterioration. The short run price elasticity of supply for tobacco is +0.34.

Figure 1

Tobacco is used to make cigarettes and there are now moves in the UK to introduce plain packaging as part of the latest campaign in the war against smoking (see Figure 1). Over the past decade there has been a ban on smoking in public places and moves to restrict displays in shops. In countries like the UK where there is already a ban on advertising, the packet remains the last major method of promotion by well-known brands. More than 200,000 under 16s start smoking in the UK each year and replacing eye-catching brands with plain packaging will hopefully reduce the appeal of cigarettes to young people.



Figure 2

Smoking in the UK

- 10 million adults smoke
- 22% of men and 19% of women smoked in 2013
- 51% of men and 41% of women smoked in 1974
- 200 000 children aged 11-15 start smoking each year
- The cost of 20 cigarettes has risen from £2.27 in 1993 to £7.98 in 2013

A review of the public health implications of standardised plain packaging last year concluded it was very likely that their introduction would lead to a small but important reduction in smoking. A 2% fall in sales has been predicted. However, UKIP leader Nigel Farage tweeted: "Plain packaging is an appalling intrusion into consumer choice and the operation of the free market. Jobs and tax revenue would suffer."

The Tobacco Manufacturers Association says that their industry directly employs 5,700 people in the UK and a recent study estimated that a further 80,000 jobs among suppliers, and in wholesale, distribution and retailing were dependent on the tobacco industry. Other arguments against plain packaging include suggestions it could lead to a fall in price or an increase in the illicit/black market.

An alternative to plain packaging is a rise in tax on tobacco products. The fiscal effects of a 5% rise in cigarette prices due to higher taxes is shown in Figure 3.

Figure 3

Results from a public finance analysis of a 5% increase in cigarette prices.

Positive numbers = net revenue gain. Negative numbers = net revenue loss.

Cost/benefit	2010-11 £ millions	2014-15 £ millions
Increased tobacco taxation revenue	427.4	439.9
NHS cost savings	23.5	31.9
Income tax/VAT revenues from longer working lives	14.2	15.7
Income tax/VAT revenues from reduced absenteeism	12.6	21.0
Reduced disability benefits paid out	33.0	33.5
Increased pensioner benefits due to longer lives	-3.3	-3.9
Total	504.9	533.5

All figures at 2010 prices

Source: ASH (Action for Smoking and Health)

Tax revenue from tobacco amounted to £12.3bn in 2012-2013 helping to reduce the soaring fiscal (budget) deficit of almost £100bn. However, about 7% of manufactured cigarettes and around a third of all hand-rolled tobacco consumed in the UK is illegal. Tobacco smuggling from European countries, where cigarettes are much cheaper, results in a loss to the Treasury of around £1.6bn a year in tax revenue. Increased subsidies for nicotine replacement therapy – nicotine patches, gum and lozenges – seems much less controversial than plain packaging. There is more evidence globally of their effectiveness in the battle against smoking than plain packaging.

- (a) Explain what is meant by 'all figures at 2010 prices'. (Figure 3) [2]
- (b) Using a demand and supply diagram explain how the revenue of cigarette manufacturers could be affected by the introduction of plain packaging for their brands. [4]
- (c) How does the growing of both tobacco and the smoking of cigarettes produce external costs? [8]
- (d) With the aid of the data discuss the view that the price elasticity of supply of tobacco is inelastic. [6]
- (e) With the aid of a diagram and using the data, evaluate the effects of a 5% increase in the price of cigarettes brought about by a rise in indirect taxes. [10]
- (f) "A subsidy to the producers of nicotine patches, lozenges and gum is the best way to reduce smoking." With the aid of a diagram discuss this view. [10]

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