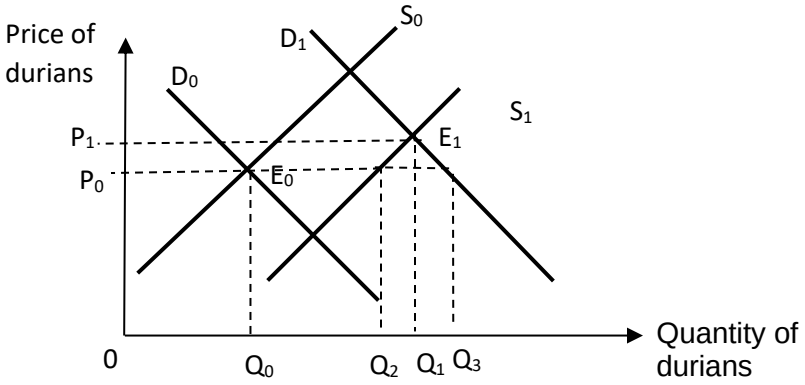
2024 Preliminary Examination

H1 Economics Suggested Solutions and Markers' Comments

Question 1: Agriculture and food

(a) (i)	**With reference to Figure 1, identify the difference in the change in prices between field crops and intermediate foods and feeds. [1]**
	Difference: Change in prices of field crops is greater than change in prices of intermediate foods. (1m)
(a)(ii)	**Using a relevant elasticity concept and with the aid of a diagram, explain how an increase in demand could account for this difference in the change in prices between field crops and intermediate foods and feeds. [4]**
	Price elasticity of supply (PES) measures the degree of **responsiveness of quantity supplied of a good to a change in its price, ceteris paribus.** Using PES, intermediate foods are already processed product and so there are available stocks hence supply is more price elastic than that for field crops. However, field crops require long periods of growth making the supply more price inelastic as well as they are easily perishable and so firms cannot keep large amounts of stocks. With an increase in demand, the shortage can be more easily remove as producers respond to the price increase of intermediate food by increasing quantity supplied by more than proportionately as they have available stocks. Thus, there is a smaller increase in the price of intermediate food than field crops is sufficient to clear the shortage.
(b)	**With reference to Extract 2, use a supply and demand diagram to explain a possible effect on the market for durians of both:** • **China's insatiable demand for durians** • **Farmers of other crops switching to growing durians instead [5]**
	Increase DD + Increase SS (no. of sellers) <u>Demand factor</u> The demand for durians increases due to increase in the tastes and preferences for durians especially from China which accounted for 91% of global demand which surged by 400% between 20021 and 2022. This causes the demand curve to shift rightwards from D_0 to D_1. <u>Supply factor</u> In Extract 2, it is also mentioned that more Thai farmers of other crops are incentivized to grow durians due to expectations of higher profits from durians. This increases the number of sellers in the durian market. This increase in supply is evident by the 80% rise in the area under durian cultivation. This causes the supply curve to shift rightwards from S_0 to S_1.

	The rise in demand and increase in supply of durians will lead to increase in equilibrium quantity. However, the impact on the equilibrium price is indeterminate and will depend on the relative extent of the shifts in demand and supply. <u>Increase in DD > Increase in SS</u> If the increase in demand outweighs the rise in supply for durians as Extract 2 mentioned that China's "craze" for durian has been the driving force behind the 400% surge in global demand for the fruit between 2021 and 2022 but the increase supply may not be as huge because durian trees take a few years before they bear fruits. At the original price P_0, there will be a shortage of Q_2Q_3 units, leading to an upward pressure on prices. As price increases, quantity supplied will increase (movement along S_1) and quantity demanded will decrease (movement along D_1) until a new equilibrium is achieved at the E_1. The equilibrium price of durians will increase from P_0 to P_1 while the equilibrium quantity will increase from Q_0 to Q_1. Students could explain the alternative scenario where increase in SS > increase in DD. They will arrive at an outcome with increase in equilibrium quantity and decrease in equilibrium price. 
(c)	**Comment on how far the price elasticity of demand (PED) concept explains the change in household expenditure on food given the increase in food prices mentioned in Extract 3. [6]**
	Price elasticity of demand measures the degree of **responsiveness of quantity demanded of a good to a change in its price, ceteris paribus.** Total expenditure = PXQ Demand for food is likely to be price inelastic (PED<1) as it is seen as a necessity and there are no close substitutes. Here, food is defined as a broad category. Therefore, when food prices increase, there will be a less than proportionate decrease in quantity demanded. The increase in expenditure from the increase in price is greater than the fall in expenditure from the fall in quantity demanded for food. Hence, this should lead to an overall increase in household expenditure. (Illustrate with a diagram if possible) <u>Comment</u>

	However, in Extract 3, it is mentioned that actual household expenditure fell despite an increase in food prices. This could be because the ceteris paribus assumption for PED does not hold. For instance, government could have given subsidies to households, like our SG CDC vouchers. Households may be buying the same amount of food, but they pay less because of the subsidies. Other possible reasons - There could be a fall in demand for food due to fall in tastes and preferences for food because of campaigns that create increased awareness of the need to reduce food wastage or how excessive eating is bad for health. Or there could be a fall in real income due to a recession or rise in inflation rates. This would decrease the demand for food. The combination of fall in quantity demanded due to rise in price and fall in the amount bought due to fall in demand would overall cause total expenditure on food to fall. - Since Extract 3 mentioned that households switched to other alternatives, it suggests that the reporters are now defining food in terms of its narrow sense. There are many different items in the grocery basket and each item has substitutes. Although overall food prices increase but prices of some items may not have changed or may have decreased. For example, when price of beef increases, households can switch to chicken if its price did not change as chicken is now relatively cheaper. Similarly, households can switch from a more expensive to a cheaper brand of milk or bread. In this sense, we say that different food items have close substitutes and PED>1. Thus when prices of some food items increase in price, households decrease their quantity demanded for these items by more than proportionately (by switching to relatively cheaper close substitutes) which leads to a decrease in the household expenditure. **Overall Stand:** Presumably, the research findings were based on the original composition of food items in the grocery basket and by right, total expenditure would increase when price increased if food is defined broadly, and PED is price inelastic. But if consumers can switch to relatively cheaper alternative food items, the composition of food items in the basket changes and this could lead to an overall decrease in household expenditure on food. **Marking Guide** *Strong responses are expected to explain the following:* - *Explain why PED for food is < 1 and what is meaning of PED<1* - *Explain effect on total expenditure* - *Provide a relevant comment which should cast some justified doubt on the view expressed.*
(d)	**With reference to Extract 1, discuss whether increase spending on agriculture research and development (R&D) is likely to benefit the macro-economy. [8]**
	Introduction The macro economy is with reference to economic growth (actual, potential, sustainable and inclusive economic growth), inflation and unemployment rate.

R1: Explain how increase spending on agriculture R&D will lead to sustained growth and fall in inflation rate.

Increased R&D leads to more technological breakthroughs where less resources are needed to produce a given output (eg slower farmland expansion). This increases productive capacity as the same amount of resources can produce more goods than before. The LRAS curve shifts rightwards from LRASo to LRAS1 and the maximum output increases and so the country achieves potential growth. This brings about lower cost of production too which results in falling prices of food and livestock (Extract 1). The GPL falls from Po to P1.

The lower prices also lead to increase export competitiveness (for eg, U.S. dominance in global agricultural exports). With increase in (X-M), there will be increase in AD (movement along the AD curve) resulting in increase in actual growth from Yfo to Y1. Thus, the economy experiences sustained growth.

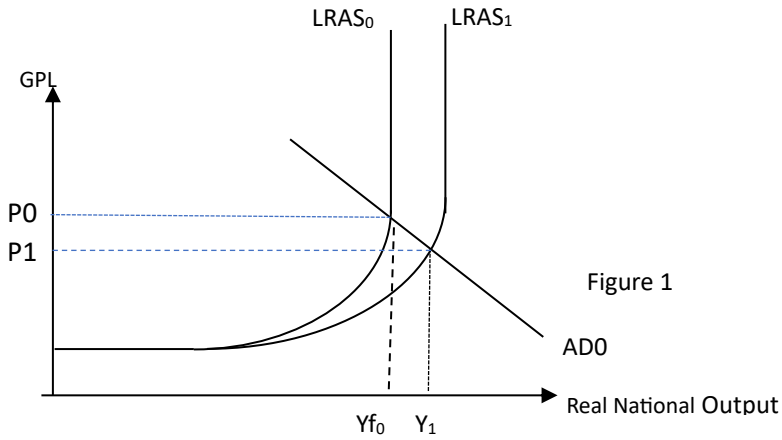


Figure 1

R2: Explain how increase in spending on agriculture R&D leads to sustainable economic growth

Sustainable growth refers to a rate of growth that does not result in significant problems in the future such as the depletion of resources. R&D spending in agriculture results in less carbon emissions and less deforestation. There will not be significant adverse impacts on the quality and quantity of resources eg, less water pollution from the use of fertilizers or rearing of livestock, and there will be more areas under forest as better technology results in increase productivity per acreage of land and thus there is less need to cut down forests for agriculture.

Thus, there is sustainable growth.

Alternative R1*: Increase spending on agriculture R&D would have positive impacts on the economy both in the short run and long run.*

Increase spending on agriculture R&D would have positive impacts on the economy both in the short run and long run. To carry out R&D, the government will need to spend on building infrastructure for research, purchase equipment and machinery and employ researchers and other personnel. As G is a component of AD, this will cause AD to increase leading to fall unplanned fall in stocks. Firms respond by increasing production and employ more factors of production. The multiplier effect takes over an eventually, real GDP increased by a multiple with the economy achieving actual growth. As each round of spending will lead to increase in

production and therefore employment, the unemployment rate falls. This will increase real GDP cause by the rise in AD in the SR. Building new infrastructure will increase the quantity of capital in the long run. This will increase the productive capacity in the economy and the LRAS. With the rise in LRAS, it will allow the RNY to continue to increase in the long run when AD increases without inflationary pressure. This will contribute to sustained economic growth.

Evaluation

Increase spending on agriculture R&D may not benefit the macro-economy.

All countries faced the problem of limited funds but many competing demands such as spending on defence, education, healthcare and housing. Increase spending on agriculture R&D may be the least of their priority and so the amount spent is insignificant. Even for a rich country like the US, "public agricultural R&D has fallen by approximately one-third over the past two decades". Thus, the impact on LRAS is very limited.

Even though, there is increased R&D spending, the new technology or innovation may not be adopted by farmers. In Extract 1, "Agtech product adoption is lowest in Asia". Even in developed countries, farmers faced a lot of hurdles in adopting Agtech largely because of high costs, and "complexities of set up". Thus, the benefits of R&D may not materialize.

For countries where agriculture is not the main economic activity but rather manufacturing, the amount spend on agriculture R&D is also very insignificant.

Evaluative conclusion

Without significant increase in spending on R&D and high barriers to technological adoption, the productivity gains will be limited.

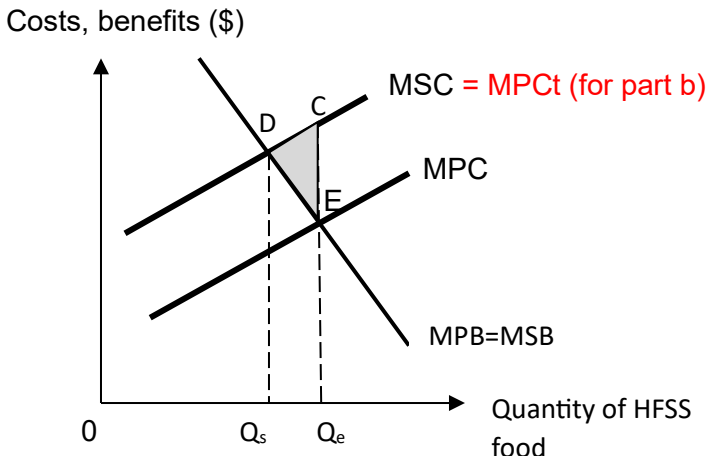
(Recommendation) Governments may need to consider also the type of R&D spending that is more beneficial. For many developing countries, perhaps basic R&D spending on improvement in irrigation, pest control etc may be more beneficial and relevant as compared to very high tech agriculture R&D such as the use of drones or AI. As farmers also faced multiple problems like climate change, poverty and high input prices, government may have to deal with these urgent problems before farmers are willing to adopt new technology.

Mark Scheme

Answer	**Guidance**
Level 2 (4-6 marks) Answer in this level will provide detailed analysis of the way in which the macro economy is affected by agriculture R&D in the context of the agriculture sector.	Any 2 of the following macro-goals • Sustained economic growth • Sustainable economic growth • Inclusive economic growth • Lower inflation rate
Level 1 (1-3 marks) Answers in this level will have some limited understanding of the macro-economy or provide detailed analysis of one of the benefits on the	

	macro economy. There will be limited application to context of agriculture R&D.		
	Evaluation (1-2) Evaluative marks will be awarded for a conclusion reached with respect to the overall impact on the macro-economy.	• Lack of funds • Lack of adoption • Lack of relevance to the context Note: Any one piece of developed evaluation can gain both marks.	

(e)(i)	**With reference to Extract 4, explain what is meant by the "the true cost of cheap food" to society. [2]**
	" the true cost of cheap food' refers to the total costs to society in producing and consuming it. It consists of 2 components. Private cost which are costs of factors of production incurred by producers such as cost of raw materials and wages External cost which are costs to third parties not directly involved in the production or consumption of the good such as firms loss of profits due to workers frequent absenteeism and low productivity due to health problems from consuming cheap food. Or the government which incur additional costs to meet the rising demand for health care due to increase number of people suffering ill health arising from consuming cheap food. (E.g. cost of resources to produce the good + cost of resources that are used to deal with the problems created by the production or consumption of food)
(e)(ii)	**Explain how the overconsumption of high in fat, sugar and salt (HFSS) products causes market to fail. [4]**
	An example of the marginal private benefits (MPB) of consuming an additional unit of HFSS food is the satisfaction derived from consuming the extra unit of HFSS food while examples of marginal private costs (MPC) are the cost of raw materials, wages etc to the producers. In the free market, consumers and producers being rational and self-interested will seek to maximise their own objectives and consider only their private costs and benefits when deciding how much to consume and produce. This means that the free-market equilibrium output of HFSS food is where MPC=MPB at Qe. However, consumption of HFSS food generates negative externalities, i.e. marginal external costs (MEC) to third parties such as the family members having to care for those who have fallen ill from consuming too much HFSS food and incur higher medical bills. This is ignored by the consumers seeking only their own self-interest. The family members are considered third parties as they are not compensated for the medical cost incurred. (Or The third parties are firms where workers who consumed excessive amount of HFSS food suffered from various health problems such as diabetes, high blood pressure etc and who often have to take medical leave or have low productivity. Firms therefore incur higher costs and face lower profits. The 3rd

	parties can also be the government which has to spend on additional health care such as building more hospitals, employ more medical personnel etc.) The MEC results in divergence between MSC and MPC. Hence, the marginal social costs (MSC) curve is above the MPC curve and MSC=MPC+MEC. Hence, the socially optimal level of HFSS food consumption is at Qs where MSC=MSB. As Qe>Qs, there is over-consumption of HFSS food. QsQe represents an over-consumption of HFSS food that is, the price mechanism over-allocates resources to the market for cigarettes. From Qs to Qe, the MSC is greater than the MSB, indicating that the additional cost to society is more than the benefit to society of producing these units. By summing the excess of the marginal social cost over the marginal social benefit for Q_eQ_s, we arrive at a monetary measure of **total deadweight loss to society** equal to the **area CDE**. Thus, society welfare is not maximised when society over-consumed HFSS food. 
(f)	**Discuss the view that the best way for government to reduce consumption of HFSS products is to increase regulation of the food industry.**
	R1: R&R Some of the R&R implemented in UK are prohibiting promotion of HFSS products in key locations, such as checkouts, store entrances, aisle ends and their online equivalents, and no free refills of sugary soft drinks. R&R such as these that reduce their visibility, and constant reminders of their 'attractiveness' will have the effect of removing the temptations HFSS products from consumers. They will also be less likely to be misinformed due to control of promotion of such products. As a result, there will be a fall in demand for such products and the MPB curve shifts to the left which reduces consumption from Qe to Qs and therefore eliminating the deadweight loss. Evaluation

- HFSS foods can still be displayed in prominent locations as there is a problem of non-compliance by supermarkets as it is costly to ensure rigorous enforcement due to lack of funding. Moreover, more people are buying products online which make it even more difficult to ensure compliance.

R2: Indirect taxes are another possible way to discourage consumption of HFSS

An indirect tax per unit = MEC at Qs will increase firms cost of production. As it is now less profitable, producers of HFSS food will reduce supply and the MPC curve will shift leftwards to MPCt which coincides with MSC. Equilibrium output falls from Qe to Qs and there is no more over-consumption and deadweight loss resulting in increase in welfare.

Evaluation

- However, it is difficult to determine the monetary value of the MEC as the health effects of obesity from consuming food high in HFSS may occur in the long run and its impact on firms productivity and other parties are difficult to measure. Too high a tax rate will cause prices to increase excessively causing cost of living to increase and worsens income inequality as the lower income consumers tend to consume more of HFSS.

Evaluative Conclusion

[Stand] Overall, a tax is likely to be more effective because by raising prices, it affects directly consumers ability to consume such goods whereas for rules and regulations, there is no 'deterrence' effect on the consumers. Moreover, tax revenue from indirect taxes help to improve the governments' budget and be used for subsidies of healthy food (recommendation) so cheaper alternatives are available for consumers to switch to so as to healthy foods, which is a necessity stays affordable. R&R would worsen governments' budget. This matters as this would limit the ability of governments to effectively implement R&R.

Mark Scheme

<table>
<tr><td>Answer</td><td>Guidance</td></tr>
<tr><td>Level 2 (4-7 marks): Answers in this level will provide analysis of how rules and regulations and another policy work to successfully tackle market failure created by consumption of HFSS.</td><td rowspan="2">• Explanation of the negative externalities (consumption) that can arise from the consumption of HFSS and how third parties are affected. Explanation of the market failure that is subsequently created when the free market equilibrium (FME) output is greater than the socially optimal output (SOLO).
• Analysis of how the imposition of rules and regulations can achieve SOLO.</td></tr>
<tr><td>Level 1 (1-3 marks): Answers in this level will show an awareness of relevant negative externalities and explain the market failure involve.</td></tr>
<tr><td>Evaluation (1-3 marks): Evaluation marks will be awarded for evaluative</td><td>Evaluation</td></tr>
</table>

	comment with reference to the overall relative effectiveness of each policy, with the top marks awarded for comments that make reference to 'best'.	• The downsides of each policy should be discussed as well as the issue of the 'best' way aspect of the question, to gain the full 3 marks. • The 'best' can be discussed in terms having 'pluses' that outweigh the limitations or costs.	

Question 2: Effects of exchange rate on Malaysia and the United States (US)

a) With reference to Table 2, compare the trends in GDP for both United States (US) and Malaysia from 2020 to 2023. (2)

Suggested response:

- Generally, GDP increased for both USA and Malaysia from 2020 to 2023.
- However, there is a larger rate of increase in the GDP of Malaysia compared to the USA over the period.

b) With reference to the Extract 6 and 7, explain why the authorities in Malaysia does not want to raise interest rates while the authorities in the US have increased them. (5m)

- For Malaysia, as suggested in extract 7, increasing interest rates would increase the cost of borrowing to investors and consumers which could lead to a fall in the consumption and investment and subsequently a fall in the AD.
- A fall in AD can lead to a surplus and downward pressure on the general price level. This leads to a more than proportionate fall in the RNY (via multiplier)
- Since production is cut, fewer workers are needed and the derived demand for labour falls. This leads to an increase in demand deficient unemployment. These will worsen the standard of living in Malaysia as more workers receive lower real income and become unemployed hence reducing their purchasing power. There will be a fall in the quantity of goods and services that they can consume leading to a fall in the material standard of living.
- For the US, as suggested in extract 6, there is price inflation as they are trying to stabilize prices and there is risk of overheating in the economy as the economy is operating near full employment output level.
- US would need to raise interest rates to reduce C and I and subsequently AD by increasing the cost of borrowing. This would bring down general price level and moderate demand pull inflation rate. Lower inflation can help consumers maintain the real income and purchasing power. This can ensure they can maintain the quantity of goods consumed and the material standard of living.

From Table 2, Malaysia's real GDP growth is derived by the subtraction of inflation rate from the nominal GDP growth, i.e., -5.5% - (-1.1%) = -4.4%. The data suggests there's a fall in real GDP of Malaysia in 2020. As income of the people falls, their purchasing power falls. They are less able to consume goods and services, resulting in a fall in their material standard of living in 2020.

Extract 8 stated that Malaysia experienced the most severe and persistent pollution problems. The State of Global Air 2020 report states that the PM2.5-related fatalities in Malaysia climbed by almost 30%. The increase in pollution in Malaysia has caused breathing difficulties and other health complications, possibly reducing life expectancy, resulting in lower non-material standard of living in the country.

(d) (i) Explain how upskilling increases the demand for labour.(1)

Upskilling of workers would lead to higher labour productivity and lower per unit costs of production as output per manhour increases. This leads to higher profit per unit of output for firms and they will be incentivised to step up production. This leads to an increase in the demand for workers by firms as more workers are needed to produce the higher output [1m].

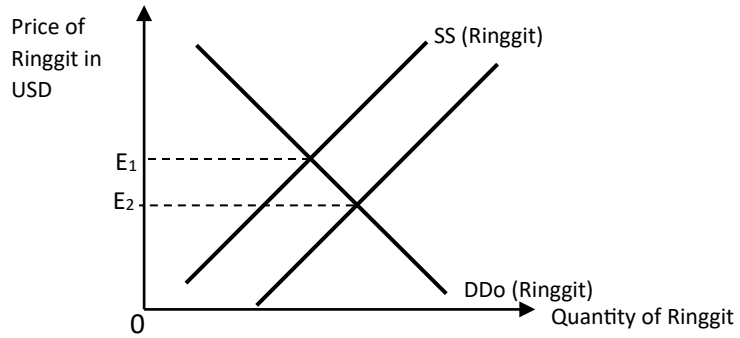
(d)(ii) Using a wage elasticity of supply, explain why it is difficult to obtain large increase in wages in Johor's labour market. (4)

- The rise in demand leads to a shortage and upward pressure on wages [1m]. However, the extent of increment in wages depends on the wage elasticity of supply of workers in Johor.
- WES for workers in Johor is likely to be wage elastic because of high geographical mobility of labour across states. Workers residing in states with high unemployment rate can easily move to Johor to find a job due to proximity and availability. [1m]
- Increase in the demand for worker is likely to lead to a rise in the wages and a more than proportionate increase in the quantity supplied of workers [1m]. Wages will just need to increase by a small proportion to encourage a large proportion of workers to move from other states to find a job in Johor's labour market. [1m]

(e) With reference to Extract 7, comment on the view that external rather than domestic factors is a more likely cause of the weaker ringgit. (6)

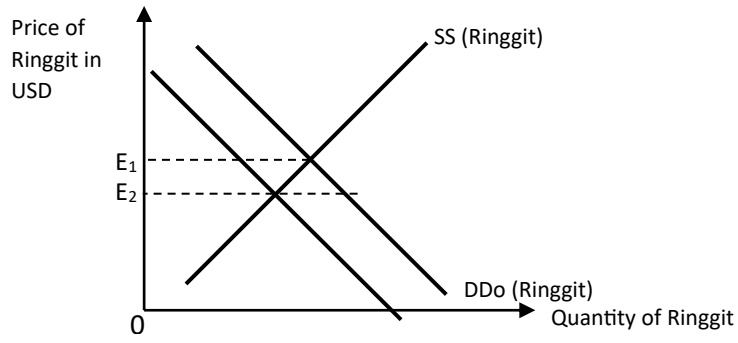
R1 (thesis): An external factor such as the higher interest rate in the US is the cause of ringgit's depreciation.

Extract 7 states that higher interest rates abroad would attract foreign investors seeking better returns, leading to financial outflows from Malaysia, thereby weakening the ringgit. There is an increase in the short term capital outflow. Portfolio investors are likely to sell Ringgit denominated financial products with lower interest returns, sell their ringgit to buy foreign currencies such as USD. They need USD to purchase USD-denominated financial products offering higher interest returns. This causes the supply of ringgit to increase resulting in a surplus in the market for ringgit and a downward pressure on the price of ringgit in terms of USD. This leads to a depreciation on the ringgit relative to USD.



Alternative external factor:

More recently, China's weaker growth have also weighed on the ringgit. China has been Malaysia's top trading partner, especially in the export of palm oil and palm-based products. With China's purchasing power falling, there will be a fall in the demand for exports from Malaysia which are normal goods. This will lower the demand for Ringgit in the foreign exchange market resulting in a surplus in the market for ringgit and a downward pressure on the price of ringgit in terms of USD. This leads to a depreciation on the ringgit relative to USD.



R2 (anti thesis): A domestic factor such as political uncertainty is the cause of Ringgit's depreciation

- Extract 7 states that internal factors such as political uncertainty or policy inconsistency could affect investors' confidence and in turn affect the currency.
- Reduction in FDI leading to a fall in demand for Ringgit as less Ringgit is needed for investment in the country and hence a depreciation of the Ringgit.

Overall, whether domestic or external factor is a more likely cause of the weaker ringgit depends on the size of the impact of each factor. Since China is a major trade partner of Malaysia OR Malaysia is very open to short term capital flow, the external factor is a more likely cause of the depreciation.

Marking Guide:

For a strong response, students are expected to provide an analysis on how an external and domestic factor cause the depreciation of the Ringgit and provide a comment which should cast some doubts on the view expressed.

(f) Discuss the impacts of depreciation of the ringgit on standard of living in Malaysia. [8]

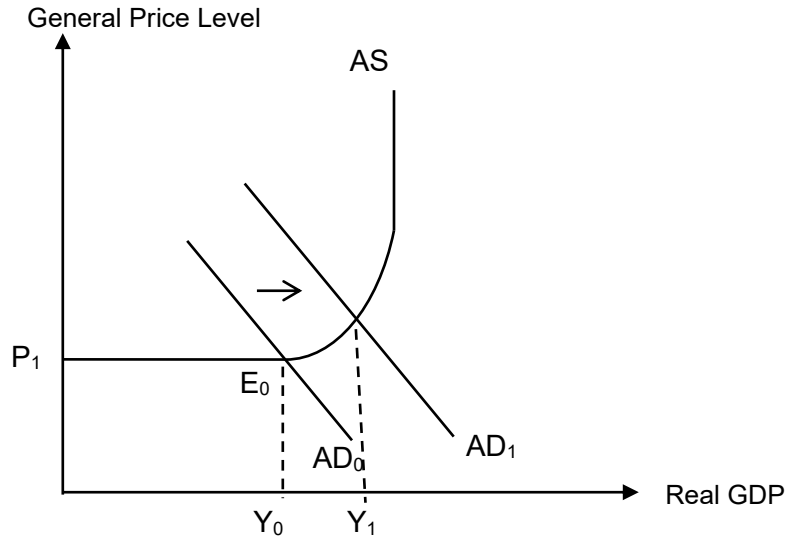
Suggested response:

R1: Depreciation of the ringgit has positive effects on standards of living in MY

Extract: Affordability also helped propel Malaysia into the top ranking among South-East Asian travel destinations last year. The country recorded almost 29 million visitor arrivals — a 100 per cent increase from 2022 — with an expectation that the upward trend will continue.

Depreciations of Ringgit makes it cheaper for foreigners to purchase Malaysia's exported tourism services as fewer foreign currency is needed to purchase 1 Ringgit. Depreciation could lead to an increase in export revenue due to fall in the price of exports in terms of foreign currency leading to a more than proportionate increase in the quantity demanded for exports (assuming that the export demand is price elastic).

Depreciation would lead to a fall in import expenditure due to the rise in the price of imports in terms of domestic currency and a more than proportionate fall in the quantity demanded for imports (assuming that the import demand is price elastic especially since Malaysia has a large domestic production and wide range of industries. They can produce many goods and services on their own and imports are necessities). Overall, if the Marshall Lerner condition holds where |PEDx + PEDm| > 1, X-M increases and AD increases leading to actual EG. The increase in AD leads to a more than proportionate increase in the RNY from Y0 to Y1 via the multiplier (assuming that there is spare productive capacity in the economy). Unemployment rate falls as the production level in the economy increases and the derived demand for labour increases. More workers will be employed and average real income increases. They can afford more goods and services with higher purchasing power. There will be higher current material SOL.



R2: Depreciation of the Ringgit has negative effects on standard of living in MY.

Extract: The ailing currency … fuelling brain drain, Malaysian prefers to cross over to Singapore to work as the wages in terms of Ringgit increases with the depreciation of the Ringgit. This

leads to a fall in the quantity and quality of labour in Malaysia and a fall in the productive capacity. LRAS falls leading to a fall in potential economic growth in the country. This leads to a fall in future material SOL due to a fall in future output/ full employment output level.

Extract: The ailing currency … has left many individuals and businesses grappling with soaring costs. Depreciation of ringgit causes the price of imported inputs to increase in terms of ringgit. This will lead to higher cost of production which will reduce the SRAS. There will be a shortage leading to upward pressure on GPL. Overall, the real NY falls and cost-push inflation worsens. As real national output falls, there is a reduction in production and fewer workers are needed. Derived demand for worker would fall and unemployment could increase. Purchasing power falls and lesser goods and services are consumed. Overall, these result in a fall in current material SOL.

The higher prices of imported necessities could also cause financial stress for lower income households who may now worry about whether they can continue to afford necessities in the future especially if they expect further depreciation of the Ringgit. This can reduce their non-material SOL.

The increase in quantity of export of palm oil leads to increase production of palm oil and air pollution arising from haze due to slash and burn method used to clear land for palm oil plantations. This leads to poorer air quality and a rise in respiratory problems which would reduce the quality of life for the residents living nearby. This results in a fall in non-material SOL. Overall, the standard of living might not rise as much as expected with the depreciation of the ringgit.

Summative conclusion

Overall, depreciation of the ringgit would negatively impact the SOL in Malaysia. The benefit of the depreciation is largely limited to export-oriented industries. The costs of depreciation are significant and immediate since depreciation would mean all households will face higher prices of domestically produced and imported final goods and service. Overall, the costs outweigh the benefits and SOL will fall in Malaysia due to depreciation of the Ringgit.

Alternative summative conclusion

Consumers can switch from foreign to local brands which mostly uses domestic factors of production. The available of such local brands would mitigate the effect of cost-push inflation due to higher cost of production from imported FOP. Hence, households could still retain their purchasing power as the prices of local brands are not affected and there will not be a significant reduction in their material SOL.

Knowledge, Application, Understanding and Analysis		
L2	Answers in this level will provide detailed explanation supported by economic analysis on the positive and negative effects of depreciation on both material	4-6

	and non-material standard of living in Malaysia. Answers make reference to the case materials.	
L1	Answers in this level will provide some explanation on the positive or negative effects of depreciation on material or non-material standard of living in Malaysia.	1–3
E	Evaluation mark will be awarded for a well-explained overall stand on the impact of depreciation on the standard of living in Malaysia.	1-2

(g) Discuss the view that the best way Malaysia's government to achieve inclusive growth is through reducing income taxes rather than upskilling. [10]

Inclusive economic growth indicates a rate of growth that is sustained over a period of time, is broad-based across economic sectors, and creates productive employment opportunities for the majority of the country's population. It takes income distribution into consideration and does not contribute to worsening income inequality.

Reducing income taxes may be a good way to achieve inclusive growth. Extract 11 stated that the domestic demand will remain the key driver of economic growth in 2023. Cutting of personal income tax by 2 percentage points for those earning between RM50,000 and RM100,000 is likely to ensure sustainable domestic demand. The reduction of income tax for the middle-income group would increase their disposable income, causing an increase in their purchasing power. Consumption spending thus increases. The increase in consumption spending would increase AD from AD_0 to AD_1 shown in the figure below. As the domestic demand will remain the key driver of economic growth, the increase in AD would be significant. The increase in AD would result in an unplanned inventory depletion, signalling firms to step up production. The increase in production and payment of factor income would trigger the multiplier process. The increase in AD would result in a multiplied increase in real national income. Actual growth is thus attained.

In addition, the increase in real national income would ultimately enable the government to collect higher tax revenue and able to provide transfer payments for the low-income group in the form of subsidies for healthcare services, for example. The increase in access to such essential services reduces the effect of income inequality.

The reduction in income tax would also provide an incentive for some people such as housewives to enter the labour force. This would increase the quantity of labour, increasing the productive capacity of the country. This would result in an increase in LRAS and hence potential growth.

Reduction in income tax can therefore attain actual growth, potential growth as well as reduce the effects of inequity. An inclusive growth can thus be attained.

However, there are time lags in implementation of the policy, as it takes time for the government to deliberate on the appropriate policy measure, and for the policy to take effect. By the time the policy takes effect, circumstances may have changed. For example, there could be significant increases in demand for exports of services, as Extract 11 states that the country could be "bolstered by higher tourism". This causes more significant increases in AD than expected. As AD continues to increase when the economy is operating near the full employment level from AD_1 to AD_2, firms will compete for the increasingly limited factor inputs, increasing the cost of production.

A part of the increase in cost is translated to consumers in the form of higher general price level from P_1 to P_2. This increase in inflationary pressure would cause the lower income group to be worse hit.

In addition, the increase in LRAS due to the reduction in income tax is also likely to not be as significant as there are already a high number of dual income families in Malaysia. The extent of further increases in quantity of labour due to reduction in income tax alone is likely to be minimal.

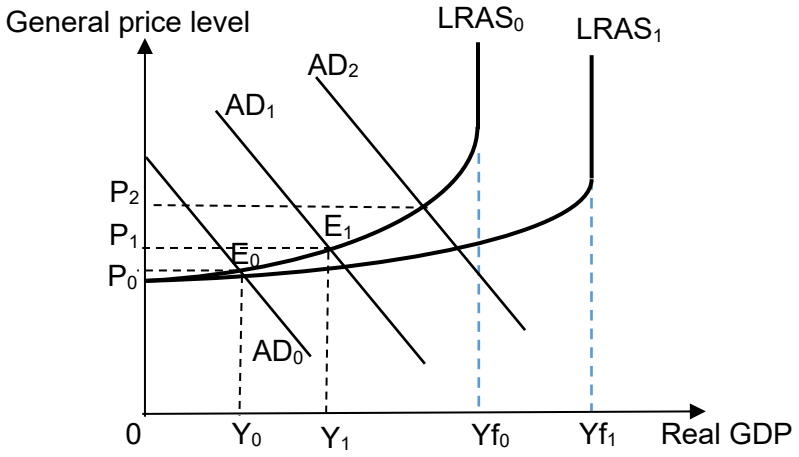


Fig 5

Therefore, it may be better for the Malaysian government to focus on upskilling. Subsidies for upskilling programmes would enable the workers across sectors to acquire higher productivity. This would increase the productive capacity of the country, which is the maximum output that can be produced by the country when all resources are fully and efficiently employed. The LRAS would thus increase from $LRAS_0$ to $LRAS_1$. Hence potential growth is attained. In addition, as the workers become more skilled, they are able to take on the jobs in the sunrise industries, where demand for labour is higher. The workers would be able to obtain higher wages as they take up the more productive employment opportunities. This would reduce inequity in the country. Inclusive growth can thus be attained.

However, workers may not be receptive to the trainings. It is difficult to change their mindset towards attending such upskilling programmes, especially among the older and less educated workers, as they foresee they may face challenges completing the course. In addition, the low-income groups could also be holding on to more than one job of differing shifts to make ends meet. Attending upskilling programmes would cause them to forgo income that could have been obtained had they worked the shift, hence making them unwilling to incur the opportunity cost. It is also challenging for the government to predict the industries that are expanding and would likely continue to expand in future for them to offer the relevant courses, given the rapid advancement of technology and dynamic nature of the global market.

Overall, in the short term, as slow growth is a concern, as stated in Extract 11, reducing income tax may be a better measure for Malaysia in the short term as it can immediately increase AD and attain actual growth. Even though there may be a risk of rising inflation, this may not be a huge

cause of concern as Table 1 indicated that the inflation in 2023 is still within the acceptable low range. Nevertheless, should inflation occurs at a higher rate, the government could channel more targeted efforts to help the low-income group manage the rising cost of living.

However, slowly but progressively, it needs to beef up efforts to encourage workers to upskill. In the long run, upskilling would be the best measure. As it takes time to change workers' mindset, the government needs to continue marketing efforts to encourage people to upskill. Even though this may put a strain on the government's budget, the long-term benefits of such measures would outweigh the short-term costs. Upskilling is a measure that can help the low-income group increase their income by a higher rate and in a more sustainable manner than that acquired via reduction in income tax. Perhaps more incentives can also be provided to both employees and employers to better encourage the workers to take up upskilling courses.

Knowledge, Application, Understanding and Analysis		
L2	Answers in this level provide detailed explanation supported by economic analysis on how the two measures attain inclusive growth. Answers make reference to the case material.	4-7
L1	Answers in this level provide some explanation on how the stated measures attain growth in Malaysia.	1–3
E	Evaluation mark will be awarded for a well-explained overall stand on which is the better measure to attain inclusive growth in Malaysia.	1-3