

MARKSCHEME

November 2001

ECONOMICS

Higher Level

Paper 3

Section A — Data Response Questions — Paper Specific Markscheme

Question 1: Liberalisation backfires on Japan’s Taxi Industry

Partial	Maximum
Mark	Mark

(a) Explain what is meant by the following terms used in the passage:

(i) market liberalisation;

- | | | |
|---|----------|----------|
| • exposure of markets to free market forces | 1 | |
| • removal of state intervention and regulations | 1 | |
| • abolition of price fixing and market rigidities | 1 | 2 |

(ii) cyclical downturns.

- | | | |
|--|----------|----------|
| • part of the trade cycle, a regular fluctuation in actual output relative to potential output | 1 | |
| • downturn is the phase between boom and recession | 1 | |
| • use of a diagram to illustrate the above | 1 | 2 |

(b) If and when the Japanese economy recovers from recession, what would you expect to happen to taxi fares?

In paragraph 5, it is made clear that taxi driving is a form of casual labour adopted during recession by workers from other industries to which they return when the economy recovers. Thus, a recovery would cause a reduction in the availability of taxis just as demand for taxis increases. Thus taxi fares would rise. *Award up to [4 marks] if this is explained clearly with the appropriate use of economic terms. Use of an accurate diagram should be rewarded, showing the demand curve shifting to the right and the supply curve shifting left.*

4

	Partial Mark	Maximum Mark
(c) Using your understanding of business economics, which market structure is indicated by the characteristics of the Japanese taxi industry described in the text?		
<ul style="list-style-type: none"> • the market structure is most akin to perfect competition 1 • justification means relating the evidence in the text to the assumptions of perfect competition, <i>e.g.</i> <ul style="list-style-type: none"> - freedom of entry and exit 1 - large numbers of small firms 1 - homogeneous product 1 - perfect knowledge 1 - firms are price takers. 1 		
<i>An appropriate diagram can be rewarded with up to [2 marks], though these marks may be shared with the next question if the subsequent answer refers back to it.</i>	2	5
(d) In paragraph 6 it is claimed that between a third and a half of Japanese taxi companies are losing money. What would you expect to happen to these loss-making companies in the short run and in the long run? Use diagrams to illustrate your answer.		
Firms can remain in business in the short run as long as they cover variable cost and make some contribution towards fixed cost, but taxi driver incomes are still falling.		
In the long run firms will fail to make normal profit and will leave the industry until it reaches equilibrium.	2	2
Able students may point out that extra taxi drivers are a form of short run casual labour that exist temporarily during a recession only, and that the taxis may cross-subsidise other forms of economic activity.	2	
<i>Diagram illustrating the short and long run position can be rewarded with up to [2 marks] (see 1(c) above).</i>	2	5

- (e) **Using the text and your knowledge of economic theory, explain why the Japanese government is trying to solve the problems of the taxi industry through deregulation (paragraph 3).**

This question should provoke a discussion of the use of deregulation to expose economic activity to greater market forces, resulting in shorter run unemployment, business failure and falling prices, but greater efficiency and stability in the long run. Deregulation should be linked to supply side theory.

Credit can also be earned for showing understanding of the implication of 'untimely' deregulation in recession.

Level 0:	No valid discussion	0
Level 1:	Very few relevant issues recognised with little discussion or basic understanding	1-2
Level 2:	A few issues recognised with some attempt at discussion, or just one issue developed well	3-4
Level 3:	A range of issues developed in reasonable depth with some sensible evaluation. An awareness of alternative viewpoint is shown.	5-7

Question 2: Planned government receipts and expenditure 1999-2000

	Partial Mark	Maximum Mark
(a) Using the data in the table,		
(i) identify an item which is a public good. Justify your choice.		
• for the definition of a public good	1	
• for just writing defence	1	
• for explaining why defence is a public good	2	2
(ii) identify an item which is an indirect (expenditure) tax. Justify your choice.		
• for the definition of an indirect (expenditure) tax	1	
• for just writing VAT or customs / tariffs	1	
• for explaining why VAT and customs duties are indirect taxes	2	2
(b) If the government collected 50 billion dollars in company tax, how much did it collect in value-added tax.		
If company tax, at 50 billion, is 10% of receipts, the total is 500 billion.		
• for an answer that government collected 15% of 500 billion		
• government collected 75 billion dollars in value-added taxes	1	
	2	2
(c) Do you think that the above data comes from the government of a less developed country or a more developed country? Justify your answer with reference to both revenue and expenditure percentages.		
• for saying an MDC	1	
• on revenue side, higher percentage of income tax and welfare contribution plus some explanation	2	
• on expenditure side, high percentage of welfare payments, health and education plus some explanation	2	
<i>Give full marks only to candidates who address both revenue and expenditure.</i>		4

		Partial Mark	Maximum Mark
(d)	Health and education are often referred to as merit goods. Why do governments feel it necessary to spend money on supplying merit goods?		
	<ul style="list-style-type: none"> • for the definition of a merit good • for mention of positive externalities • for use of a relevant diagram • for saying that in a market system, merit goods are undersupplied at the market price 	<p>1 1 1 2</p>	
	<i>An alternative approach to this question might relate merit goods to development strategies.</i>	up to 4	4
(e)	(i) How might this government change its pattern of spending and taxation to bring about more equal distribution of income?		
	<p>Candidates can achieve full marks only if the arguments relate to spending and taxation by government. A maximum of <i>[3 marks]</i> is available for an answer which considers only one of spending or taxation.</p> <p>Taxation: the important distinction is between progressive and regressive taxes. A shift from regressive taxes such as VAT towards potentially progressive taxes such as income tax would promote income equality.</p> <p>Spending: An increase in spending on public or merit goods such as healthcare (received by citizens as of right as part of a ‘social wage’) will promote income equality.</p>	<p>3 3</p>	4
	(ii) To what extent would a supply-side economist support these changes?		
	<p>This question is intended to provoke a general discussion of how a supply-side economist would view the changes suggested in the first half of the question. A supply-side economist would not support higher progressive taxes or corporate taxes on grounds of disincentives, while greater government spending would be opposed on similar grounds.</p>		
Level 0:	No valid discussion		0
Level 1:	Very few relevant issues recognised with little discussion or basic understanding		1-2
Level 2:	A few issues recognised with some attempt at discussion or just one issue developed well		3-4
Level 3:	A range of issues developed in reasonable depth with some sensible evaluation		5-7

Section B Essays: Paper-Specific Guidance

The following comments are intended to provide extra guidance to Assistant Examiners, but they are not meant to be a ‘straitjacket’.

They are meant to indicate some of the main points which the question-setter hoped to elicit, and/or indicate sensible approaches; however, it is often possible for candidates to respond to a question in a way which is unanticipated and yet which contains valid economic arguments, so please keep an open mind.

THE GENERAL MARKING CRITERIA REMAIN THE MAIN BASIS FOR AWARDING MARKS.

Question 3

- (a) **How does a monopoly maintain supernormal (or abnormal) profit in the long run?** *[12 marks]*

The aim of the question is to have candidates show their understanding of monopoly as a market structure. The most essential part of any answer must be that barriers to entry prevent abnormal profit being reduced by competition. Good candidates will develop this point by considering patents, trademarks, product differentiation, cost advantage, *etc.*

For the highest marks expect candidates to identify abnormal profit through a diagram, properly explained.

- (b) **Is monopoly always undesirable?** *[13 marks]*

The question is meant to draw attention to arguments for and against monopoly.

The arguments for monopoly are:

- natural monopoly, and the associated ideas of economies of scale and minimum efficient scale
- the research and development argument, which may be fine in some monopoly markets. This can be linked to innovation and cost saving.

The arguments against monopoly are:

- allocative and productive inefficiency
- higher price and lower output

For the highest marks candidates should include diagrams, properly explained.

Question 4

“What is wanted is not inflation (a rise in the general price level) or deflation (a fall in the general price level) but price stability.” Discuss.

[25 marks]

The aim of the question is to give candidates an opportunity to display knowledge on the advantages and disadvantages of inflation, deflation and price stability. The list of points given below is not intended to be exhaustive and candidates should be rewarded for bringing in other relevant points. Equally it is not intended that all points should be covered to gain good marks. Note that deflation has been specifically defined to be a fall in the price level to distinguish it from being a fall in the rate of inflation.

Possible points that could be made as to why inflation is not wanted relate to its adverse effects on

- the workings of the market mechanism
- investment and hence growth and development
- the distribution of income
- the balance of payments
- menu costs, shoe leather costs, *etc.*

Possible points that could be made as to why deflation is not wanted relate to its adverse effects on

- the level of economic activity
- increasing the value of real debt
- interest rate policies
- current levels of spending

Possible points that could be made as to why inflation is wanted relate to its beneficial effects on

- profits in times of creeping demand pull inflation
- making real wage changes easier and so increasing labour market flexibility

Possible points that could be made as to why deflation is wanted (do not expect too much in this area) relate to its beneficial effects on

- reducing money illusion
- the belief that if rising prices have a bad effect on the economy then falling prices must have a good effect

Possible points that could be made as to why price stability is wanted relate to its beneficial effects on

- the market mechanism. This can be linked to supply side policies.
- inflation and deflation are undesirable

Possible points that could be made as to why price stability is not wanted relate to its adverse effects on

- interest rate policies
- inflation or deflation having desirable results

Question 5

- (a) **What are the arguments in favour of unrestricted flows of financial capital between countries?**

[15 marks]

The aim of part (a) of the question is to get candidates to write about free trade/protectionist arguments in the context of capital flows rather than goods and services. In part (b) the aim is to give an opportunity to display knowledge about financial and institutional barriers to development in less developed countries. Country specific knowledge of capital flow crises such as those in Europe, Mexico, Asia, S America, Russia or elsewhere, which have taken place in recent years is not required, but the highest marks should be reserved for those candidates who are able to supplement their answers with reference to real world examples.

Possible points that could be made in favour of free capital flows are

- optimum allocation of capital from a global perspective
- making it easier for firms to raise capital
- promoting development of a global free market economy
- disciplining effect on government and firms
- enabling LDCs to gain access to a scarce and expensive factor

- (b) **How might unrestricted capital flows be damaging to less developed countries?**

[10 marks]

Possible points that could be made are

- debt problems exacerbated by capital outflows
- financial and institutional frameworks not as mature and so more vulnerable *i.e.* an infant industry style argument
- exchange rate problems in case of countries with over valued fixed exchange rate
- LDCs might not have the regulatory framework to prevent multinational corporations from exploiting their factor endowment
- LDCs are more vulnerable to global instability, leading to withdrawal of foreign capital
- scale of financial flows provides temptation to local elites to become involved in corporation *etc.*

Question 6

“According to the World Bank, an extra 10 billion dollars in aid could lift 25 million people a year out of poverty - so long as it went to poor countries that manage their economies well. The same sum spent across the current distribution of aid recipients would lift only 7 million out of poverty.”

- (a) What are the economic arguments in favour of using aid as part of a development policy for less developed countries?**

[12 marks]

In part (a) the aim is to give candidates the opportunity to demonstrate knowledge of **economic** arguments for aid (do not reward political, moral and humanitarian arguments).

Much depends on the type of aid and form of development strategy but possible points which could be made are

- lack of financial capital and /or expertise as a barrier to development which aid can fill
- aid as part of a debt relief strategy
- donor as well as receiver benefiting from higher incomes in the recipient country

- (b) How far would you agree with the World Bank view that aid has failed as a development policy because of the poor economic management policies that less developed countries have adopted?**

[13 marks]

The intention is to get students to explain, assess and discuss the idea that aid has failed because of the poor economic policies adopted by recipient countries *e.g.* capital flight, corruption and other reasons for local failure of aid in LDC's. Other factors which possibly could be mentioned are

- development has not always been the target of aid
- inappropriate aid due to the demands of donor countries
- failure of MDCs to liberalise trade restrictions against LDCs

Give credit also to any candidates who construct an argument along the lines that aid has not failed.
