

MARKSCHEME

November 2007

ECONOMICS

Higher Level

Paper 2

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In addition to the assessment criteria use the paper-specific markscheme below. Award up to the maximum marks as indicated. Each question is worth [10 marks].

1. Explain how scarce factors of production are allocated by the free market.

- factors of production: land, labour (entrepreneurship), capital
- scarcity: the state where wants exceed the amount that available resources can produce
- free market: an allocative mechanism for coordinating economic choices; alternatives would be the command economy and the mixed economy
- demand and supply
- the notion of equilibrium price
- the notions of shortage and surplus
- changes in market forces, *e.g.* an increase in demand
- shifts in demand and supply: equilibrium restored
- diagrammatic representations

To reach levels 3 and 4 candidates should demonstrate clear ability to apply relevant theory and/or to analyse using relevant theory.

Examiners should be aware that candidates may take a different approach, which if appropriate, should be rewarded.

2. With the help of a diagram, explain when a firm should shut down in the short run.

- definition of short run
- explanation that the aim of the firm is profit maximization
- profits maximized where $MC = MR$
- explanations of abnormal profits and losses
- explanation that total costs are the sum of fixed costs and variable costs
- explanation that in the short-run average variable costs must be covered if the firm is to continue in business
- identification of shut down point
- diagrammatic representation and explanation

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3. Explain the concept of a natural monopoly.

- definition: occurs when one large firm can supply the entire market at a lower price than two or more smaller ones
- explanation that the market is characterized by increasing returns to scale at all levels of output
- identification of economies of scale: production, managerial, financial and marketing
- diagram illustrating a market with a continually falling average cost curve and showing that the marginal cost curve lies below the average cost curve
- explanation, using the diagram, that if the market is provided for by two or more firms the average total cost will rise resulting in lower productive efficiency
- examples of markets where natural monopolies are to be found *e.g.* railways

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4. With the use of examples, explain the difference between a progressive and a regressive tax.

- explanation of a progressive tax: one where the average rate of tax rises as income rises; the notion of ability to pay
- example: the direct or income taxes levied by governments
- explanation of a regressive tax: a tax unrelated to income; bears hardest on those least able to pay
- example: the indirect or fixed rate taxes levied on the purchase of goods and services
- explanation: that progressive taxes raise revenue, are difficult to avoid and are used to re-distribute income from rich to poor
- explanation/comparison where regressive taxes raise revenue, are avoidable, are inequitable and represent a “hidden” tax. Very useful in targeting goods and services with inelastic demand (including demerit goods)

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5. Explain *two* reasons for an improvement in a country's terms of trade.

- definition of terms of trade: $\frac{\text{index of export prices}}{\text{index of import prices}} \times 100$
- explanation of an improvement in terms of trade: *e.g.* export prices rise relative to import prices
- simple demonstration: set both price indices at 100; show how if export index rises while the import index remains constant, the terms of trade rises above 100 – it has improved
- explanation of “improvement”: more imports can be bought with same quantity of exports

Reasons for an improvement in the terms of trade:

- a relative rise in the domestic inflation rate will make domestic goods more expensive relative to imported goods. Export prices will rise relative to imported prices and so the terms of trade improves
- appreciation of the domestic currency means, *ceteris paribus*, that exports are more expensive and imports are cheaper. Export prices rise relative to import prices
- a rise in the demand for domestic exports will increase their price and, other things remaining the same, improve the terms of trade.

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6. **Explain the role of fair trade organizations and micro-credit schemes in promoting economic development.**

Answers on the role **may** include:

Fair trade organizations

- explanation of the principles of fair trade organizations which include: minimum price guarantee to the producers (regardless of world prices); recognizing trade unions; no use of child labour; decent working conditions for the workers; and respect for environmental sustainability
- minimum price guarantees to the farmers to help them gain a steady income and receive a legitimate price for their goods. They can then start to invest in education for their children, for example
- workers producing in fair trade organizations have the right to organize and negotiate through free trade unions. This improves their working conditions
- restricting the use of child labour ensures that children are able to go to school, rather than work in the fields or factories
- decent working conditions guarantees that the workers' health is protected
- respect for the environment is maintained as producers in fair trade organizations are becoming increasingly more concerned about damage to the environment and are finding ways to produce without hurting the environment

Micro-credit schemes

- explanation of micro-credit as the small loans that are provided to very poor families to help them engage in productive activities, build small businesses or use for emergency relief
- micro-credit schemes enable the poor to increase their income and protect them from shocks, such as bad weather
- by gaining access to financial services, borrowers can have a stable income, which can then be invested in needed food supplies, a child's education or for medical services
- micro-credit schemes are often used by women and this empowerment of owning a business contributes to the economic development of the community

Answers **may** include:

- definitions of fair trade organizations and micro-credit schemes
- definition of economic development
- explanations of how fair trade organizations and micro-credit schemes promote economic development

To reach levels 3 and 4 candidates should demonstrate clear ability to apply relevant theory and/or to analyse using relevant theory.

If a candidate explains only fair trade **or** only micro credit and relates to economic development then award up to a maximum of **[6 marks]**.

If fair trade organizations **and** micro credit schemes are described but not related to economic development then up to a maximum of **[4 marks]**.

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