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**ECONOMICS
HIGHER LEVEL
PAPER 3**

Tuesday 15 November 2011 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions.
- Use fully labelled diagrams and references to the text / data where appropriate.

1. Study the extract below and answer the questions that follow.

Taxes on cigarettes

- ❶ Lawmakers in the state of West Virginia in the United States are proposing an increase in the state tax on cigarettes from US\$0.55 to US\$1.20 per pack.
- ❷ One justification for the increase in the cigarette tax is that cigarettes are a **demerit good**. Smoking can cause premature deaths, and it leads to negative externalities in the form of additional health care costs and health hazards for non-smokers. It is estimated that the tax increase may prevent 6600 smoking-related deaths, and stop 13 200 children from becoming smokers. Some anti-smoking groups claim that increasing cigarette taxes is the most effective smoking prevention measure.
- ❸ Other groups claim that the largest impact on smoking prevention is made by anti-smoking advertising on television and by programmes to help smokers quit. Cigarettes tend to have a lower price elasticity of demand (PED) than most other goods and services. Each 10% increase in the price of cigarettes results in a 6.5% drop in youth smoking, a 2% drop in adult smoking, and a 4% total drop. This means that the increase in the tax may not contribute significantly to smoking prevention, although it does generate large increases in tax revenues for the government. It is expected that the proposed increase in the cigarette tax will more than double annual cigarette tax revenues.
- ❹ Also, the effectiveness of the tax as a smoking prevention measure may be lessened by the availability of cheaper cigarettes in states that are close to West Virginia that have lower cigarette taxes, such as Kentucky.
- ❺ It is further argued that indirect taxes such as those on cigarettes are **regressive taxes**, and impact more strongly on lower income people. Since lower income people also tend to smoke more, they are even more strongly hit by the cigarette tax.

[Source: adapted from “W. Va. cigarette sales likely to fall if tax goes up”, *Charleston Daily Mail*, 13 March 2009]

(This question continues on the following page)

(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) demerit good (*paragraph 2*) *[2 marks]*
 - (ii) regressive taxes (*paragraph 5*). *[2 marks]*
- (b) Calculate the price elasticity of demand (PED) for cigarettes for youths **and** for adults (*paragraph 3*), and explain the significance of the PED figures you have calculated. *[4 marks]*
- (c) Using an appropriate diagram, show how the incidence of tax on cigarettes is likely to be shared between producers and consumers of cigarettes. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the policy of increasing the tax on cigarettes as a measure to reduce the negative externalities caused by smoking. *[8 marks]*

2. Study the extract below and answer the questions that follow.

Anti-monopoly legislation in China

- ① In August 2008, the Chinese government passed an anti-monopoly law. As China is a transition economy, many foreign economists welcomed this law on the grounds that it might encourage China's transition to a **free market economy**.
- ② This law is being applied in the area of acquisitions (or the purchase) of one firm by another, the objective being to prevent the establishment of very large firms that would limit competition. In the six months since the law was passed, the commerce ministry had decided on 25 such cases. All were approved except one: the commerce ministry rejected Coca-Cola's application to buy Huiyuan, China's largest juice company.
- ③ Coca-Cola offered to buy Huiyuan at a price (US\$2.4 billion) estimated to be three times the Chinese firm's value. This purchase would have represented a type of foreign direct investment (FDI) in which a foreign firm acquires control of a domestic firm. Coca-Cola already holds about half the Chinese market for carbonated drinks, but the juice market is far less dominated by a single large firm. If the purchase had gone ahead, Coca-Cola together with Huiyuan would control just over 20% of the juice market.
- ④ The rejection of the acquisition came as a surprise to many who expected the deal to go through. Coca-Cola had offered a very high price, and it has made major investments in China, making it one of the most attractive buyers of local firms. Many economists wondered if this was a government attempt to prevent a popular local brand from falling into foreign ownership.
- ⑤ The Chinese authorities argue that the rejection of the acquisition was based on possible negative impacts on domestic competition. The acquisition would have concentrated too much power in one firm. Coca-Cola's brand name would make it difficult for new firms to enter the juice market because of brand loyalty that acts as a barrier to entry. Coca-Cola's economies of scale and dominant position in the market would hurt small competitors and prevent entry of new firms, while consumers would face higher prices and less choice as a result of Coca-Cola's **monopoly** power.

[Source: adapted from "Hard to swallow: Coca-Cola and China (China's anti-monopoly law)", *The Economist*, 21 March 2009 and "Ministry denies nationalism behind Coke decision", *South China Morning Post*, 25 March 2009]

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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) free market economy (*paragraph 1*) [2 marks]
 - (ii) monopoly (*paragraph 5*). [2 marks]
- (b) Using an appropriate diagram, explain how Coca-Cola’s economies of scale could “hurt small competitors” (*paragraph 5*). [4 marks]
- (c) Using an appropriate diagram, explain how Coca-Cola’s “dominant position” (*paragraph 5*) may enable it to make supernormal (abnormal) profits in the long run. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate China’s commerce ministry’s decision to reject Coca-Cola’s application to buy Huiyuan. [8 marks]

3. Study the extract and data below and answer the questions that follow.

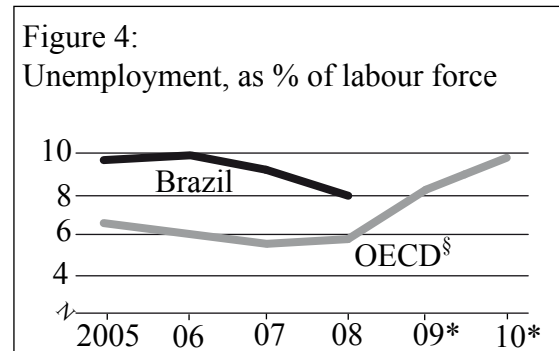
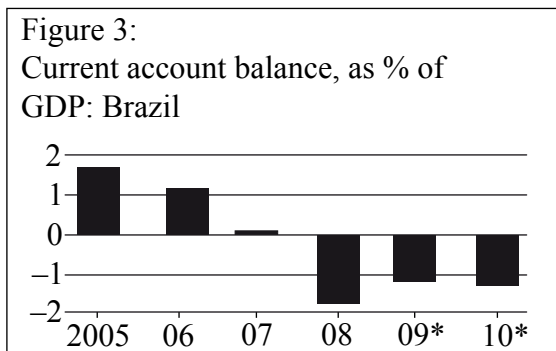
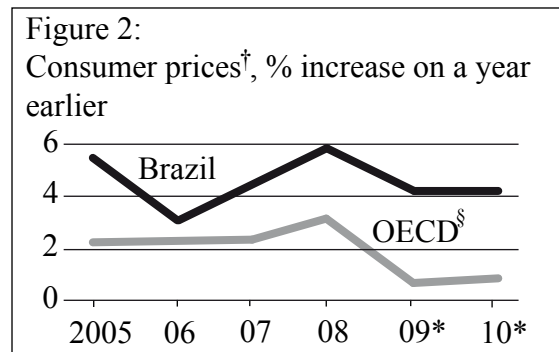
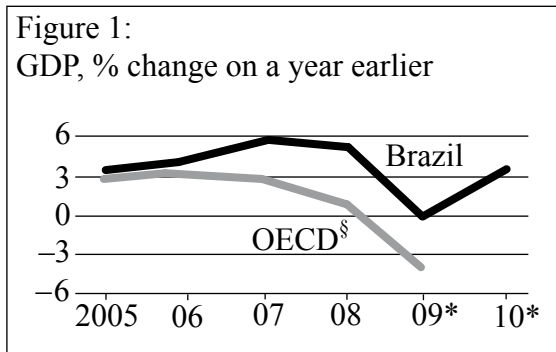
The Brazilian economy

- ❶ In the final quarter of 2008, the Brazilian economy went into recession, although this did not last long. This was partly due to Brazil's ability to follow an expansionary fiscal policy, it was also due to the central bank's policy of lower interest rates. In the past, Brazil used to raise interest rates in times of recession in order to avoid **capital flight**.
- ❷ Positive economic growth has resumed, and the economic expansion is leading economists to expect the central bank to raise interest rates again.
- ❸ At the same time, the real (Brazil's currency) has strengthened, contributing to a widening current account deficit, and leading to complaints from exporters and local manufacturers. There are expectations that the government may try to manage the exchange rate in order to avoid a further **appreciation** of the real. On the other hand, a strong real provides the benefits of lower inflation and cheaper imported capital goods.

[Source: adapted from "Juggling technocrats and party hats", *The Economist*, 15 October 2009]

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(Question 3 continued)



Key:

* Forecast

† Private consumption deflator

§ OECD is the Organization for Economic Cooperation and Development (formed in 1961). The members in 2006 were: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

[Source: adapted from http://www.economist.com/markets/indicators/displaystory.cfm?story_id=14045385, 16 July 2009]
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- (a) Define the following terms indicated in bold in the text:
- (i) capital flight (*paragraph 1*) [2 marks]
 - (ii) appreciation (*paragraph 3*). [2 marks]
- (b) Using an appropriate diagram, explain the effect of an expansionary fiscal policy in fighting Brazil's recession (*paragraph 1*). [4 marks]
- (c) Using an appropriate diagram, explain the likely impact of higher interest rates on the value of the real (*paragraphs 2 and 3*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the effect on the Brazilian economy of a decision to raise interest rates (*paragraph 2*). [8 marks]

4. Study the extract below and answer the questions that follow.

Thai farmers and the Thailand-China free trade agreement (FTA)

- ❶ In 2003, Thailand and China entered into a **free trade** agreement (FTA) on farm products, in which they agreed to eliminate all tariffs for 188 types of fruits and vegetables.
- ❷ According to non-governmental organizations (NGOs), farmers' groups and academics, Thai farmers have been negatively affected by the FTA. Many farmers lost their only source of income because they could no longer compete with cheaper Chinese imports. For example, whereas Thai production costs for garlic average 21 baht (Thai currency) per kilogram, Chinese garlic costs only 10 baht. As a result, Thai production of garlic fell.
- ❸ While the government had promised compensation to garlic farmers, the compensation actually paid was very small compared to the losses of the garlic farmers. Many had difficulties switching to other crops, because the soil and weather conditions of garlic-growing areas were not so suited to other crops. Many small farmers went out of business, while the benefits of the FTA went to large commercial farmers who were better able to compete with cheaper imports.
- ❹ Garlic is an important ingredient in Thai cuisine. Consumers and health groups complain that Thai garlic has a better taste and more medicinal properties than Chinese garlic. Yet Thai garlic is now more difficult to find and consumers, as a result, have less choice. There is also concern about safety standards, as some Chinese farm products have high levels of pesticide residues.
- ❺ Recently, farmers' protests led the government to promise a minimum price on garlic to support local production.
- ❻ Supporters of the FTA argue that this is important in order to allow countries to specialize in production according to their comparative advantage. Free trade, they claim, allows consumers to obtain higher quality goods at lower prices, and allows overall output to increase. Some negative consequences for less competitive producers are inevitable. For this reason, the government should provide support and training for those who are affected, including efforts to improve agricultural practices that are consistent with **sustainable development**.

[Source: adapted from "Thailand: Agricultural sector may come under pressure as free trade agreements take effect", *Thai Press Reports*, 27 February 2009 and "Thai food hit by garlic crisis", *The Nation*, 2 March 2008]

(This question continues on the following page)

(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) free trade (*paragraph 1*) *[2 marks]*
 - (ii) sustainable development (*paragraph 6*). *[2 marks]*
- (b) Using an appropriate diagram, explain the effect of a minimum price on the garlic market (*paragraph 5*). *[4 marks]*
- (c) Using an appropriate diagram, explain the impact of removing the tariff on garlic on the quantity of garlic imported. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the consequences of the Thailand-China free trade agreement (FTA) on Thailand's growth and development. *[8 marks]*

5. Study the extract and data below and answer the questions that follow.

As trade slows, China rethinks its growth strategy

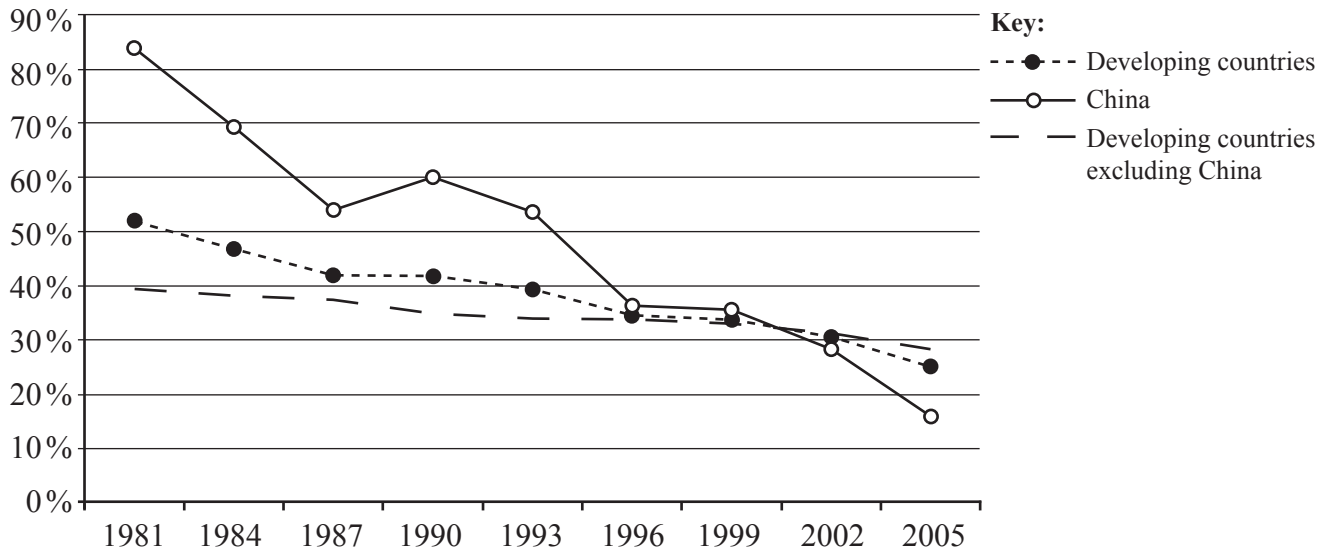
- ❶ Ships are leaving Chinese ports half empty. In the Guangdong province, many factories are shutting down without paying employees.
- ❷ This is the effect of millions of Americans cutting down on their spending. Chinese exports decreased by 9.6% in one month. A drastic decrease in export revenues is a major problem in a country that has relied for many years on exports to pursue its growth and **economic development** goals.
- ❸ For the Chinese economy to rely more on domestic demand instead of export demand is not easy. Chinese families are forced to save a lot and do not spend much on consumer goods and services. They need to save a lot to be able to meet any medical emergencies and to help them in retirement as the government does not currently provide the general population with health care insurance and pensions.
- ❹ To prevent a further increase in unemployment the Chinese government is forced to help increase the exports of low-skill, labour-intensive industries such as textiles. “China will resort to export **subsidies** to help the export of labour-intensive industries,” the minister of industry and information technology said. Increased subsidies by China have the potential to create trade difficulties with the United States (US), particularly regarding textiles, only weeks before American quotas on the import of Chinese clothing are about to expire.

[Source: adapted from “As trade slows China rethinks its growth strategy”, *New York Times*, 1 January 2009]

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(Question 5 continued)

Figure 1: Percentage of population living in households with consumption or income per person below the absolute poverty line (US\$1.25 per day in 2005 purchasing power parity (PPP))



[Source: The World Bank]

Figure 2: China: Human Development Index (HDI) selected years 1975–2007

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- (a) Define the following terms indicated in bold in the text:
 - (i) economic development (*paragraph 2*) [2 marks]
 - (ii) subsidies (*paragraph 4*). [2 marks]
- (b) Using an appropriate diagram, explain the effect on America’s clothing market resulting from removing quotas on Chinese clothing (*paragraph 4*). [4 marks]
- (c) Using an appropriate diagram, explain the effect on China’s aggregate demand of a decision by the Chinese government to provide the general population with health care insurance and pensions (*paragraph 5*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate China’s export-oriented growth and development strategy. [8 marks]