



**ECONOMICS
STANDARD LEVEL
PAPER 2**

Wednesday 10 May 2000 (afternoon)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer one question from Section A and one question from Section B.
- Use diagrams where appropriate.

SECTION A

Answer one question from this Section.

Question 1

Study the extract below and answer the questions which follow.

TRAINS IN ARGENTINA

- (1) At the beginning of the 1990s, the government of Argentina attempted to bring its budget into balance by reducing government expenditure on a variety of public services.
- (2) As part of the process of reducing publicly owned services, a policy of **privatisation** of the railways was introduced through the granting of concessions to private companies to run the system for a 10 year period. There were three main conditions stipulated in the privatisation contracts: firstly, that investment by the private companies to improve the services was mandatory; secondly, that fares could only be raised in line with costs; and thirdly, that the government would provide subsidies to all the companies, with a higher level of subsidy to those transporting commuters in metropolitan areas.
- (3) In the freight market, the privatised rail companies established a policy of reducing fares, on average by 28%, to increase their overall share of the transport market in relation to trucking services. This led to a total increase of rail freight business from 7.4 million metric tonnes in 1991 to 17.1 million metric tonnes in 1997. Total revenue of the rail companies also rose over this period by 130%.
- (4) However, the privatised rail companies argued that a period of 10 years was insufficient for them to obtain an adequate rate of return on their investment and that a longer concessionary period should be granted, during which they should be allowed to raise fares by up to 90%. This, they argued, would allow them to finance a \$1.5 billion investment restoration programme of the rail system. Against this, rail users have argued that any new increase in fares could not be justified by higher costs, and that the rail companies should finance the investment out of their own capital – they have a captive market and are not taking any risks. Inevitably, the rail market has a **monopolistic character**.

[Source: adapted from articles in the *Buenos Aires Herald*, *La Nación* and *La Prensa*, April–May 1998.]

- (a) Explain the meaning of the following terms which are in bold in the text:
- (i) privatisation (paragraph 2). *[2 marks]*
 - (ii) ‘monopolistic character’ of the rail market (paragraph 4). *[2 marks]*
- (b) State how the demand for rail services is linked to the demand for trucking services. *[1 mark]*
- (c) Assuming that the action described in paragraph 3 is successful,
- (i) draw a supply and demand diagram to show the effects on the market for trucking services. *[3 marks]*
 - (ii) explain briefly what your diagram shows is happening. *[2 marks]*
- (d) Using the information in paragraph 3,
- (i) state whether the demand for rail services is elastic or inelastic. *[1 mark]*
 - (ii) explain how you reached this conclusion, using a diagram. *[2 marks]*
- (e) (i) For what reasons would companies in the private sector wish to invest in a privatised railway system? *[3 marks]*
- (ii) What are the arguments for and against government involvement in a country’s rail transport system? *[9 marks]*

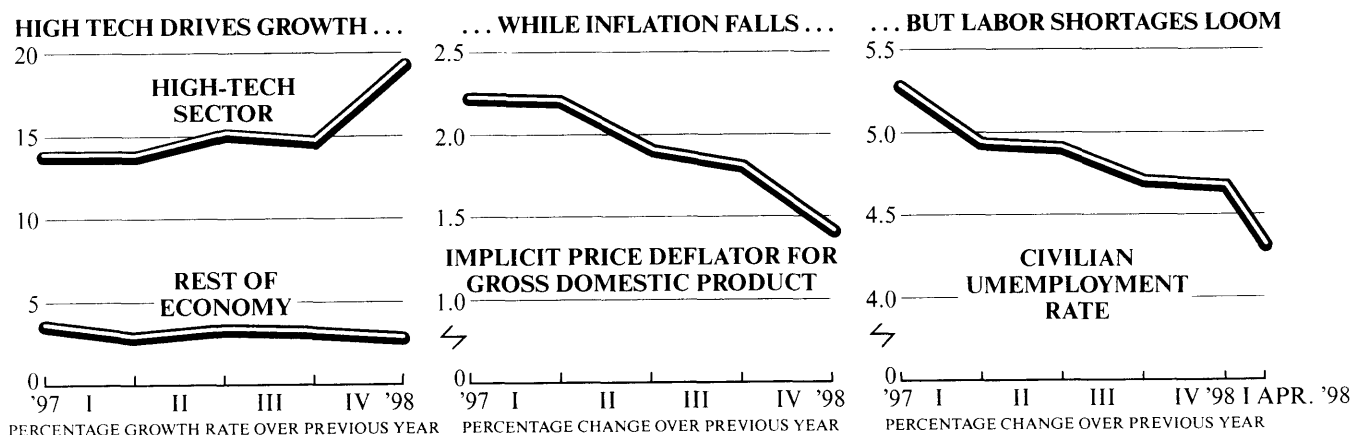
Question 2

Study the following data and answer the questions which follow.

HIGH-TECH GROWTH

High technology isn't just encouraging growth – it's killing inflation

- (1) The US economy continues to steam ahead, growing by 3.6% over the past year. **Productivity** over the past year showed a strong increase of nearly 2%. Inflation, as measured by the **gross domestic product deflator**, is running at only 1.4%. However, there is one piece of economic data that concerns the central bank (the Federal Reserve, or 'Fed').
- (2) The Labor department reported that unemployment in April fell to 4.3%, which is the lowest for 28 years. Based on the experiences of the 1970s and 1980s, the fear of many economists – and several Fed governors – is that the low level of unemployment makes an inflationary outburst inevitable.
- (3) That may be so, if this were the typical economic expansion of the last two decades. But it's not. In today's economy almost 30% of growth is coming from the high-tech sector (computers, information technology, tele-communications, etc.). The beauty of this high-tech-driven growth is that it actually subtracts from inflation rather than adds to it. In previous decades growth was based on the output of goods by heavy industry; today's growth is based on services and high-tech-driven goods.



[Source: adapted from *Business Week* (New York), 25 May 1998.]

- (a) Define the following terms which are in bold in the text:
- (i) productivity (paragraph 1). *[2 marks]*
 - (ii) gross domestic product deflator (paragraph 1). *[2 marks]*
- (b) (i) Carefully draw and label a typical short-run 'Phillips Curve'. *[2 marks]*
- (ii) Explain how the theory of the 'Phillips Curve' can be used to explain why it is often thought that a 'low level of unemployment makes an inflationary outburst inevitable' (paragraph 2). *[6 marks]*
- (c) Refer to the graphs in the data and explain
- (i) why high-tech growth might lead to 'labor shortages'. *[2 marks]*
 - (ii) the effect that 'labor shortages' might have on inflation. *[2 marks]*
- (d) Suggest possible reasons why 'high-tech-driven' growth might actually subtract from inflation rather than add to it when compared to the type of growth of previous decades (paragraph 3). *[9 marks]*

SECTION B

Answer one question from this Section.

Question 3

- (a) Carefully distinguish between merit goods and public goods, illustrating your answer with examples. *[12 marks]*
- (b) To what extent is it desirable that the government should provide merit goods **and** public goods? *[13 marks]*

Question 4

- (a) What are the various factors that determine the value of (i) price elasticity of demand and (ii) income elasticity of demand? *[12 marks]*
- (b) Assess the importance of price elasticity and income elasticity of demand for business decision-making. *[13 marks]*

Question 5

- (a) Explain the various costs of unemployment. *[12 marks]*
- (b) Evaluate the alternative policies aimed at reducing unemployment. *[13 marks]*

Question 6

- (a) Why do growth rates vary between countries? *[12 marks]*
 - (b) Discuss the obstacles that a Less Developed Country might face in attempting to increase its growth rate substantially. *[13 marks]*
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