N06/3/ECONO/SP2/ENG/TZ0/XX

88065105

ECONOMICS
STANDARD LEVEL
PAPER 2

Wednesday 8 November 2006 (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.*

Tax rise reduces smoking and boosts revenue

❶ The Center for Disease Control estimates that health costs caused by smoking across America total $7.18 per pack sold in the United States. The University of Wyoming's Survey and Analysis Center reports that in 1998, $106 million was spent in Wyoming on the **negative externalities** directly related to smoking.

❷ A tax increase approved in 2003 has reduced the quantity of cigarettes demanded and increased state revenue, and experts believe another increase would do the same. The indirect tax increase raised revenue from around $500 000 per month to $1.5 million per month. Tax revenue was higher despite the fact that the number of packs sold fell 17.4 % over the year following the increase.

❸ Marc Homer, assistant research scientist with the center's Tobacco Prevention and Control Evaluation team, suggests that another tax increase would further raise revenue while further slowing cigarette consumption. "Raising taxes is a no-cost measure that reduces the health burden," Homer said. "In fact, it is a bonus for the state because it has the added benefit of increasing government tax revenue."

❹ Homer pointed out that taxes are still higher in surrounding states. "Currently the average tax per pack of cigarettes, for Wyoming and the six states on its borders, is 80 cents," he said. In Montana, a recent increase put the indirect tax much higher at $1.70 per pack. "States with cigarette taxes higher than Wyoming's, such as California (87 cents) and New York ($1.50) have successfully reduced consumption while increasing revenue," the report says.

❺ The price of cigarettes in Wyoming has risen steadily since 1997, with a dramatic 2003 increase when the tax increased from 12 cents to 60 cents per pack. That elevated Wyoming's cigarette tax rate from fifth-lowest in the nation to 28th in the nation.

❻ The report quotes studies showing that a 10 % increase in cigarette prices reduces overall smoking among adults by about 4 %. "For every 10 % rise in price, there will be a 7 % decrease among young people smoking," the report says.

❼ However, higher taxes aren't the only means the state should use to reduce **demand** for tobacco. As Homer said, "Although increased taxes are a highly effective means of decreasing tobacco use and raising state revenue, this conclusion should serve as a reminder that increasing taxes is not the only solution".

[Source: adapted from *The Casper Star Tribune,* January 2005]

(This question continues on the following page)

(Question 1 continued)

(a) Define the following terms indicated in bold in the text:

(i) negative externalities (*paragraph* ❶) *[2 marks]*

(ii) demand (*paragraph* ❼). *[2 marks]*

(b) Using an appropriate diagram, explain how cigarette smoking is an example of market failure. *[4 marks]*

(c) Using evidence from the text, explain which group of consumers has the lower price elasticity of demand for cigarettes – adults or young people. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate **two** possible methods of reducing the external costs of smoking. *[8 marks]*

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

New Zealand inflation

❶ The governor of New Zealand's central bank, Alan Bollard, unexpectedly raised the base interest rate on Thursday to a record 6.75 % and said that he might increase borrowing costs again to slow down inflation as a low unemployment rate is resulting in increased wages.

❷ The New Zealand dollar surged to a record high 74.15 US cents after Bollard increased the official interest rate for the seventh time in 15 months.

❸ "There may have to be further tightening in our **monetary policy**," said the governor. "The greater momentum in the economy implies stronger underlying inflation pressures than we expected." Bollard said that while Thursday's rate increase risked slowing down the economy, controlling inflation was more important. Annual inflation will average 3 % until the end of 2006. This is at the upper limit of a target range set for the central bank by the government.

❹ "Not responding to the prospect of stronger inflation pressures now, would create a risk that inflation expectations and wage and price-setting behaviour could make the task of controlling inflation more difficult in the future."

❺ Bollard told reporters that the decision was the toughest he has made since becoming governor in August 2002. "We had to carefully assess the possibility that a further tightening in policy might worsen an eventual slowdown in activity," he said.

❻ Economic growth will probably slow to 2 % by the first quarter of 2006 from 3.5 % a year earlier, the central bank said. That is still stronger than the 1.5 % it forecast on 9 December.

❼ Growth in the economy has been supported by a housing boom and **consumption** spending, which makes up 60 % of the economy. Spending surged after the jobless rate fell to a 19 year low of 3.6 % in the fourth quarter while wages increased. Housing construction rose 7 % in the fourth quarter from a year earlier, according to a government report released on Tuesday. Construction of office buildings, factories and schools rose 22 %. Exports, 30 % of the economy, "are doing well despite the high exchange rate," Bollard said. Exports will probably grow 3.25 % in the year to 31 March, 2006, the central bank said. In December, Bollard projected 2 % growth.

[Source: from an article in the *International Herald Tribune*, 11 March 2005, adapted to allow access for students to topics in the curriculum, and so that the language meets the needs of second-language learners.]

(This question continues on the following page)

(Question 2 continued)

(a) Define the following terms indicated in bold in the text:

(i) monetary policy (*paragraph* ❸) *[2 marks]*

(ii) consumption (*paragraph* ❼). *[2 marks]*

(b) Using an AD/AS diagram, explain the type of inflation that the New Zealand economy is facing. *[4 marks]*

(c) Using an appropriate diagram, explain how the New Zealand dollar has been affected by the increased interest rate. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the likely effects of the further tightening of monetary policy on the New Zealand economy. *[8 marks]*

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

Canada

Canada's economy has performed well since its mild slowdown in 2001. In a new report the OECD* forecasts **economic growth** of 3 % this year and 3.5 % in 2005. Canada's **current account surplus** is expected to grow to 4.8 % of GDP next year. The Canadian dollar's strong rise over the past two years has put pressure on companies to increase productivity. The OECD believes that the country could do much to raise labour force participation and reduce its higher than average unemployment rate.

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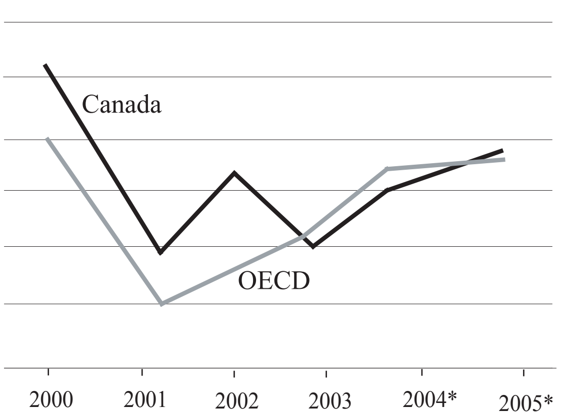
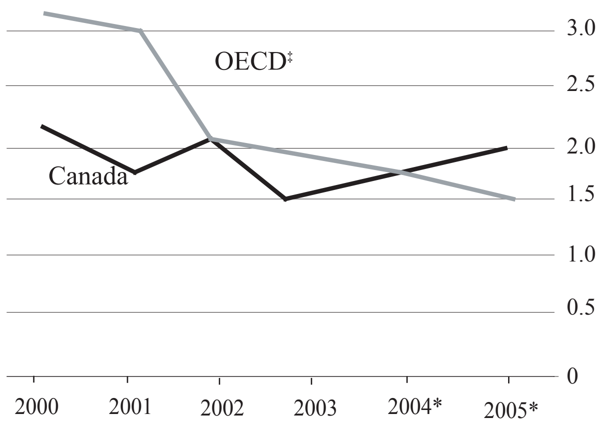
* OECD is the Organization for Economic Cooperation and Development (formed 1960). The members are the EU countries, USA, Canada, Japan, New Zealand, Australia, Mexico, South Korea, Norway, Switzerland and Turkey.

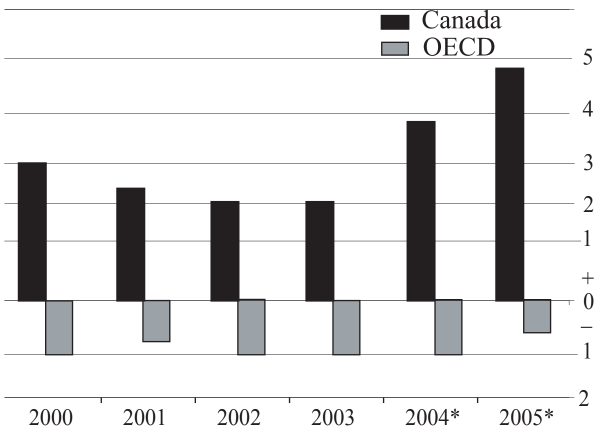
GDP
% increase on a year earlier



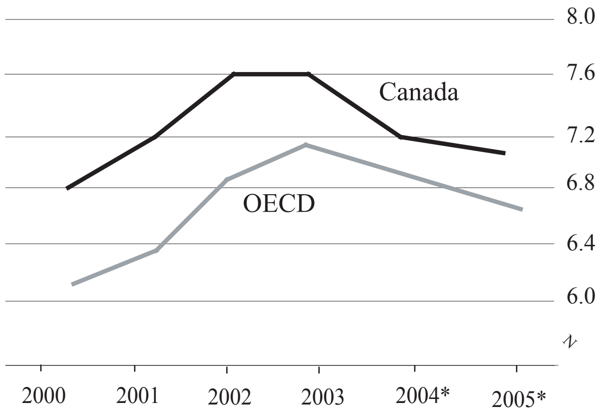
Consumer prices†
% change on a year earlier



Current-account balance
% of GDP



Unemployment
as % of labour force



* Forecast † Private-consumption deflator ‡ Excluding Hungary, Mexico, Poland and Turkey

[Source: adapted from *The Economist*, November 2004,
© The Economist Newspaper Limited, London (11 November 2004)]

(Question 3 continued)

(a) Define the following terms indicated in bold in the text:

(i) economic growth *[2 marks]*

(ii) current account surplus. *[2 marks]*

(b) Using an appropriate diagram, explain how Canada's current account balance is likely to have affected the Canadian dollar. *[4 marks]*

(c) Using an AD/AS diagram, explain **one** possible reason for the increase in GDP suggested by the data. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate **two** supply-side policies that the Canadian government could use to reduce the unemployment rate. *[8 marks]*

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

How Europe's sugar regime is destroying livelihoods in the developing world

❶ European consumers and taxpayers are paying to destroy livelihoods in some of the world's poorest countries. Through the sugar regime of the Common Agricultural Policy (CAP), they are paying for a system that rewards a few sugar producers in Europe, while reducing markets and opportunities for farmers and agricultural labourers in the developing world.

❷ Quotas and high tariffs set Europe's sugar prices at almost three times world market levels. Each year, consumers and taxpayers pay €1.6 billion. And each year developing countries suffer the consequences of the resulting unfair trade practices. High guaranteed prices result in huge surpluses and Europe is **dumping** those surpluses overseas. This is only made possible by export subsidies.

❸ Europe should be importing sugar, but because of subsidies, the EU, one of the world's highest cost producers of sugar, is the world's biggest exporter of white sugar, accounting for 40 per cent of world exports last year.

❹ Developing countries are affected by Europe's sugar policies in four ways:

- high tariffs and import quotas prevent some of the world's poorest countries from gaining access to EU markets.
- because Europe dumps its excess production overseas, it prevents LDC exporters from entering foreign markets.
- a few developing countries receive valuable quota access to export their cane sugar to the EU. But even they can only export raw sugar, to be processed in the EU – so inhibiting the development of their own refining industries.
- the effect of European subsidies is that world prices are forced down – often to levels below the costs of production of even the lowest cost producers such as Malawi, Mozambique and Zambia. Such low prices have resulted in **deteriorating terms of trade** for LDC sugar exporters.

❺ As representatives of one of the world's richest and most powerful trading blocs, policy makers in Europe have responsibilities to developing countries. That includes a responsibility to make globalization work for the poor – to make trade fair. Maintaining the current sugar regime is a situation that, in the long run, is bad for both Europe and the developing world.

[Source: adapted from *Oxfam Briefing Paper 27*, August 2002]

(This question continues on the following page)

(Question 4 continued)

(a) Define the following terms indicated in bold in the text:

(i) dumping (*paragraph* ❷) *[2 marks]*

(ii) deteriorating terms of trade (*paragraph* ❹). *[2 marks]*

(b) Using an appropriate diagram, explain how the granting of subsidies to EU sugar producers will give them an advantage over other producers. *[4 marks]*

(c) Using an appropriate diagram, explain how the high tariffs on refined sugar harm developing countries. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the statement that, "maintaining the current sugar regime is a situation that, in the long run, is bad for both Europe and the developing world" (*paragraph* ❺). *[8 marks]*

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

The Tiger in Front

❶ If it were not for two things, India's economic performance would seem remarkable. In 1991, India began to dismantle its import substitution policy, adopting an outward oriented strategy. Since then, the country has achieved average annual economic growth of 6 %. The proportion of people living below the poverty line, 50 % in 1978, fell to 25 % by 2000. Since 1991, average GDP per head (at purchasing power parity) has doubled. However, a significant proportion of the people are still poor and that is one of the things that make India's success less impressive. The number of poor people in India is more than 260 million and nearly half of its children under five are underweight. The World Bank estimates that 35 % of Indians live on less than $1 a day, compared to 17 % of Chinese.

❷ The second thing is China. Comparisons are unavoidable. The two countries are unique in each being home to more than one billion people, many of them poor. Other Asian successful countries, such as Singapore and Hong Kong, are relatively small places. China, however, proves that size is no obstacle to high growth. China has done better than India on almost every measure of economic growth and poverty reduction. India's growth rate of 6 % seems impressive, but then looks ordinary compared to China's growth rate of almost 10 %.

❸ China has received $500 billion in **foreign direct investment** since 1980: India has received less than a tenth of that. Indeed, India lacks **investment** of all kinds. India invests only about one quarter of GDP, whereas China's investment is about 40 %. The gap shows especially in infrastructure such as roads, sea ports and airports, and electricity supply. However, India and China still face similar challenges. Their primary economic problems are unemployment, regional inequality, and the poverty of farmers, who face very low prices, which tend to fluctuate a great deal.

❹ In the Human Development Index, China is 94th out of 177 countries, with a score of 0.745, whereas India, with 0.595, comes 127th. However, there has been a 36 % rise in the Indian index since 1980. In international trade, China leads the way. In 2004, China overtook Japan to become the world's third largest trader behind America and Germany. Although India's trade has been growing at up to 16 % per year, the increase in China's trade in 2004 was bigger than India's total foreign trade.

[Source: adapted from *The Economist,* March 2005

(This question continues on the following page)

(Question 5 continued)

(a) Define the following terms indicated in bold in the text:

(i) foreign direct investment (*paragraph* ❸) *[2 marks]*

(ii) investment (*paragraph* ❸). *[2 marks]*

(b) Explain how allowing for differences in purchasing power may give a more realistic value of the average GDP per head in India. *[4 marks]*

(c) Using an appropriate diagram, explain how the government could help to protect farmers against fluctuating prices. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the effectiveness of adopting an outward oriented strategy to achieve economic development. *[8 marks]*