



MARKSCHEME

May 2010

ECONOMICS

Higher Level

Paper 1

17 pages

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In addition to the assessment criteria, use the paper-specific markscheme below. Award up to the maximum marks indicated.

1. (a) Explain the importance of price elasticity of demand *and* cross-elasticity of demand for business decision-making. [10 marks]

Answers **should** include:

- a definition of PED
- a definition of XED
- the link between PED, price changes and changes in total revenue
- the importance of XED in terms of changes in price of substitutes and complements
- examples of PED and XED in real life (products with high/low elasticities; products related are complements or substitutes).

Answers **may** include:

- an explanation that PED and XED are extremely difficult to accurately measure in reality
- use of diagrams to show the relationship between PED, price changes and changes in total revenue
- use of diagrams to illustrate the complement/substitute relationship.

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

Assessment Criteria

Part (a) 10 marks

Level		Marks
0	Completely inappropriate answer.	0
1	Little understanding of the specific demands of the question Very little recognition of relevant economic theory Relevant terms not defined Significant errors	1–3
2	Some understanding of the specific demands of the question Some recognition of relevant economic theory Some relevant terms defined Some errors	4–6
3	Understanding of the specific demands of the question Relevant economic theory explained and developed Relevant economic terms defined Few errors Where appropriate, diagrams included	7–8
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- (b) **Studies have shown that the demand for tobacco tends to be highly price inelastic. Evaluate the view that governments can best reduce smoking by substantially increasing taxes on cigarettes.**

[15 marks]

Answers **may** include:

- cigarettes as an example of market failure having the characteristics of demerit goods
- use of an MSC/MSB diagram to show the negative externalities associated with the consumption of cigarettes, candidates may use a simple supply and demand diagram
- an explanation of inelastic demand and the implications for a tax on cigarettes; low PED means a tax may not lead to a significant decrease in quantity of cigarettes demanded
- distinction between inelastic demand for tobacco in general and elastic demand for particular brands
- the incidence of taxation may be considered
- consideration of the extent of the tax increase; tax may have to increase a lot to have a major impact
- the problem of relating the tax to the value of the external costs
- the impact on government revenues and spending possibilities; revenue will increase a lot in view of the low PED
- an assessment of alternative policies such as negative/positive advertising and direct controls.

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

Effective evaluation may be to:

- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

Assessment Criteria**Part (b) 15 marks**

Level		Marks
0	Completely inappropriate answer.	0
1	Little understanding of the specific demands of the question Very little recognition of relevant economic theory Relevant terms not defined Significant errors	1–5
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2. (a) Explain why a country may wish to reduce its rate of inflation.**[10 marks]**

Answers **should** include:

- an explanation of the term rate of inflation
- an explanation for wishing to reduce the inflation rate in terms of the various costs of inflation. This **may** include the impact on:
 - international competitiveness
 - the distribution of wealth and income
 - savers and borrowers
 - fixed income recipients suffer reduced real income
 - certainty/uncertainty and the willingness of businesses to invest
 - government finances
 - government interest rate policy
 - purchasing power, pressure on wages and industrial relations
 - “shoe leather” and “menu” costs.

Answers **may** include:

- mention of lower inflation for general economic performance, *e.g.* the growth rate
- mention of the various ways in which inflationary pressures may be reduced
- a distinction between moderate inflation and hyper-inflation.

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- (b) **Evaluate the likely effects on the economy of relying on higher interest rates to reduce the rate of inflation.**

[15 marks]

Answers **may** include:

- an explanation of the use of interest rates to tackle inflation
- an explanation of the linkage between higher interest rates and AD
- the impact of higher interest rates on costs/AS
- the impact on output, growth, employment, the balance of payments and the exchange rate
- use of AD/AS diagrams
- the implications of using higher interest rates in dealing with cost inflation
- other measures to deal with inflation, *e.g.* supply-side policies
- the problem of time lags
- interest rates as a highly flexible tool of economic policy
- the distributional impact of higher interest rates on savers and borrowers
- overall assessment.

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Effective evaluation may be to:

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3. (a) **There has been an increasing trend in different parts of the world for countries to engage in economic integration through the formation of trading blocs. Using suitable examples, explain the different types of trading bloc that may be formed.**

[10 marks]

Answers **should** include:

- an explanation of economic integration through trading blocs
- an explanation of free trade areas
- an explanation of customs unions
- an explanation of common markets
- suitable examples.

Answers **may** include:

- an explanation of preferential trading areas
- an explanation of complete economic integration
- an explanation of progress towards monetary union.

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(b) Evaluate a country's decision to join a free trade area (FTA).

[15 marks]

Answers **may** include:

Advantages:

- possibility of economies of scale
- larger export market
- increased competition leads to efficiency and lower prices in the long run
- productive and allocative efficiency
- possibility of increased foreign investment as a way to get inside market
- greater consumer choice of products
- transfer of labour and capital within the free trade area
- fosters political stability
- trade creation.

Disadvantages:

- increased competition can force inefficient domestic producers out of the market
- domestic workers may be unemployed
- competition may only exist in the short run. In the long run, firms may merge to keep control of their markets and an oligopolistic or monopolistic market structure in the free trade area can result. Higher prices may be the outcome
- the transfer of resources within the free trade area may not be even
- can damage multilateral trading negotiations (WTO).

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Effective evaluation may be to:

- consider short-term versus long-term consequences
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4. (a) **Explain the difference between economic growth and economic development, and how each of these may be measured.** *[10 marks]*

Answers **should** include:

- a definition of economic growth
- a definition of economic development
- an explanation that economic growth is a quantitative concept whereas economic development is more qualitative
- an explanation that economic growth is measured by the increase in real national income over a period of time, whereas economic development, in addition to the latter, could also include a whole variety of other measures such as schooling, life expectancy, provision of healthcare, income distribution, political freedoms *etc.* (just a few examples would suffice).

Answers **may** include:

- a production possibility diagram to illustrate the difference between economic growth and economic development
- a mention of specific indices such as the HDI or HPI.

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- (b) **Evaluate the view that the best way that developed countries can help the growth and development process of very poor, highly indebted countries is through a general cancellation of debts.**

[15 marks]

Answers **may** include:

- a definition of developing, highly indebted countries
- examples of such countries
- arguments for debt cancellation in terms of the problems of debt, *e.g.* the opportunity cost of debt repayments, the impact on development, the gearing of the economy towards exports, the potentially serious implications of the problem on absolute poverty
- arguments against debt cancellation, *e.g.* the danger of moral hazard, debt forgiveness and the creation of a dependency culture, the rewarding of irresponsible governments and penalizing of committed ones, debt as one of just many causes of poverty in developing countries
- alternatives to debt cancellation such as aid or trade agreements
- the role of the IMF and World Bank, *e.g.* through structural adjustment programmes
- an overall assessment as to how the highly indebted countries can best be helped: debt write-offs *versus* effective aid and by industrialized countries lifting trade barriers.

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Effective evaluation may be to:

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