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**ECONOMICS
HIGHER LEVEL
PAPER 3**

Wednesday 21 November 2012 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions. Each question is worth *[20 marks]*.
- Use fully labelled diagrams and references to the text / data where appropriate.
- The maximum mark for this examination paper is *[60 marks]*.

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

Taxes on junk food and sugary drinks

- ❶ Some countries are considering **indirect taxes** on junk food or sugary drinks to reduce their consumption and increase government tax revenues. Over-consumption of goods with a high fat or sugar content has negative externalities, because it leads to obesity, serious health problems and additional health care costs. The principle behind such taxes is the same as taxes imposed on cigarettes and alcohol. These taxes are known as “fat taxes”.
- ❷ In the United Kingdom (UK), discussions focus on a tax on processed foods, snacks and sugary drinks. Another possibility would be to impose a tax on full-fat milk, butter and cheese, in order to induce consumers to switch to less fattening substitute products with a lower fat content. Foods with a high fat content are linked to heart disease and premature death.
- ❸ In the United States, some states are considering imposing a tax on sugary drinks to raise funds for health care. Denmark already has a tax on these drinks and is planning a new tax on some high-fat dairy products.
- ❹ However, research indicates that such taxes would have a disproportionately large effect on low income households. One reason is that low income individuals tend to consume a larger amount of foods with a high fat content because these are cheaper. This is an important reason why low income individuals tend to be less healthy than wealthier people. It has also been argued that low income individuals respond to higher food prices by eating smaller quantities of healthy food.
- ❺ Food manufacturers have been angered by the idea of a “fat tax”, arguing that the public would rebel against it.
- ❻ Studies have shown that the demand for most categories of foods and beverages is **price inelastic**. According to a representative of the Food and Drink Federation in the UK, “the fat tax may be a perfectly sensible issue to debate, but such a regressive taxation policy would reduce the purchasing power of consumers”. He argues that it would be better if food manufacturers voluntarily improved their products.

[Source: adapted from ‘Fat tax on junk food as prices may rise to boost the war against obesity.’ *UK Daily Mail*, 11 May 2010, ‘The impact of food prices on consumption: a systematic review of research on the price elasticity of demand for food.’ (2010) *American Journal of Public Health*, 1 February 2010; and ‘Hard truths about soda taxes.’ *Human Events*, 6 July 2010.]

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(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) indirect taxes (*paragraph 1*) [2 marks]
 - (ii) price inelastic (*paragraph 6*). [2 marks]
- (b) Using an appropriate diagram, explain how consumption of unhealthy foods creates negative externalities (*paragraph 1*). [4 marks]
- (c) Using an appropriate diagram, explain how a tax on foods with a high fat content is expected to impact on the market for substitute products with a lower fat content (*paragraph 2*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the likely consequences of indirect taxes applied to junk food and sugary drinks. [8 marks]

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

High milk prices in Cyprus

- ❶ Complaints that milk prices in Cyprus are too high have led the government's Competition and Consumer Protection Service to investigate whether a **cartel** exists in the milk industry. There are indications that farmers are selling their milk at an identical high price to milk companies (processors) and distributors. Also, the milk companies and distributors themselves may be uniformly raising their prices, resulting in the most expensive milk in the European Union (EU).
- ❷ Cyprus has very limited grass pastures for cows to graze on, and fodder (food for cows) is imported and sold to farmers by a government monopoly. Farmers complain that if competition existed in the supply of fodder, fodder prices would come down, and this would allow milk prices to fall. They sell milk at identical prices because they all buy fodder at the same price from the government monopoly.
- ❸ Milk processing is dominated by two firms, which have also been accused of collusion as they sell milk at an identical price. The firms claim that the reason for this is that they buy it at the same price from the milk farmers.
- ❹ The only real competition appears to be at the retail level, where prices range from about 1.15 euros per litre (in supermarkets) to 1.30 euros per litre (in bakeries and kiosks). According to the Ministry of Commerce, 70 % of milk is bought from the higher-price bakeries and kiosks. A consumer association is urging consumers to buy milk from the lower price retailers.
- ❺ The Ministry is urging retailers to cut milk prices voluntarily. Many supermarkets have responded with price cuts, but bakeries and kiosks refuse to lower their prices, claiming that the high price they pay to buy milk would result in selling at a loss. The Ministry has received permission from the EU to impose a **price ceiling** on milk for approximately 40 days, until the situation is resolved. Critics of the government argue that its policies are ineffective because they do not attempt to solve the problem by increasing competition and creating free market conditions.

[Source: adapted from "Our view: Are milk prices really an issue?", *Cyprus Mail*, 14 August 2010 and "Green light from EU on milk price ceilings", *Cyprus Mail*, 20 August 2010

First article: ©Cyprus Mail. Used with permission

Second article: <http://www.cyprusdirectory.com/cyprusguide/cyprus.aspx?ID=20546>]

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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) cartel (*paragraph 1*) *[2 marks]*
 - (ii) price ceiling (*paragraph 5*). *[2 marks]*
- (b) Using a supply and demand diagram for the milk market, explain why the elimination of the government monopoly in fodder could result in a lower price of milk (*paragraph 2*). *[4 marks]*
- (c) Using an appropriate diagram, explain which market structure comes closest to describing the collusive behaviour practised by the milk companies (processors) (*paragraph 3*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the policies the Cyprus government could use to lower prices in the market for milk. *[8 marks]*

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

Unemployment in the United States

- ❶ Though there are signs that the United States (US) economy is emerging from recession, unemployment remains high at close to 10% (*Figure 1*). According to the chairman of the Federal Reserve (the US central bank), the US recovery will bring only a “slow reduction” in unemployment, and consumer confidence will improve only slowly. In this environment, inflation is likely to remain low (*Figure 2*). These comments are taken to mean the central bank does not plan to tighten monetary policy soon.
- ❷ Interest rates remain at near-zero levels (*Figure 3*). Therefore, some economists argue that more fiscal stimulus is needed. Others fear that large increases in the budget deficit, due to higher government spending and lower tax revenues, could create a new crisis leading to more job losses.
- ❸ Workers are fearful that long-term unemployment will result in a deterioration of their human capital, making it even more difficult to find jobs in the future. Some types of jobs in sectors such as car manufacturing, hard-hit by the recession, might disappear.
- ❹ An economic stimulus package passed in 2008 did little to reduce unemployment. For example, the unemployment rate for young workers (aged 18–24) has increased to over 52%. Supporters of the fiscal stimulus argue that without it unemployment would have been even higher. Opponents insist that the benefits of the fiscal stimulus are exaggerated. At the heart of the disagreement lies an argument over the value of the **multiplier**. For the multiplier to translate into large increases in economic activity, consumers must spend rather than save, and budget deficits must not lead to **crowding out**.
- ❺ Some economists favour supply-side policies, such as tax benefits for firms that create new jobs. Another policy is to provide tax benefits to all firms pursuing research and development, in order to stimulate technological innovation and rapid economic growth.

[Source: adapted from ‘Bernanke sees “subdued” inflation but persistent unemployment.’ *Christian Science Monitor*, 9 June 2010; ‘Restarting the job machine.’ *Newsweek* (US edition), 26 October 2009; and ‘The growing job crisis needs solutions now.’ www.usnews.com, 13 October 2009.]

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(Question 3 continued)

Figure 1

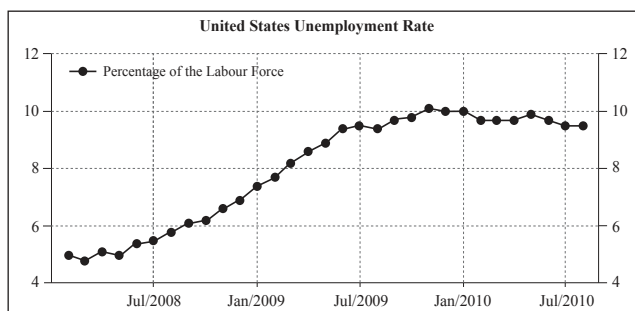


Figure 2

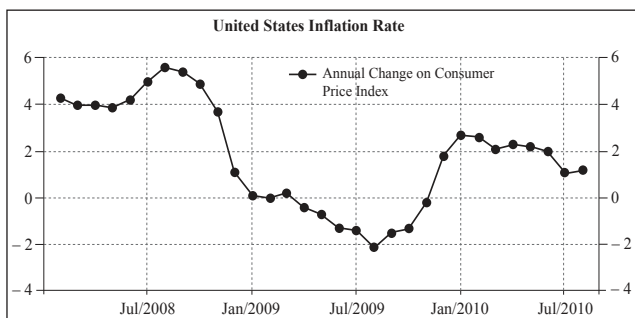
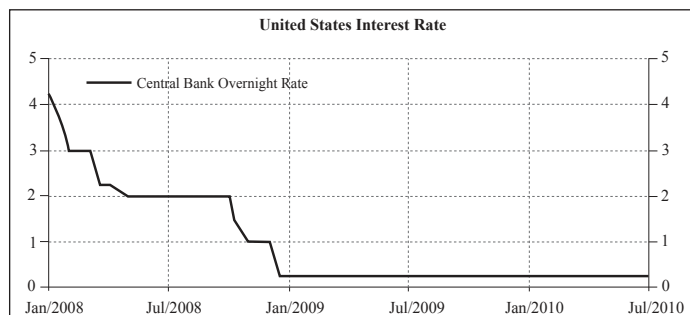


Figure 3



[Source: adapted from www.tradingeconomics.com]

- (a) Define the following terms indicated in bold in the text:
 - (i) multiplier (*paragraph 4*) [2 marks]
 - (ii) crowding out (*paragraph 4*). [2 marks]
- (b) Using an appropriate diagram, explain whether the data in Figures 1 and 2 support the theory of the short-run Phillips curve. [4 marks]
- (c) Using an appropriate diagram, explain how the supply-side policies described in *paragraph 5* can contribute to long term economic growth. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the use of fiscal policy as a method to reduce unemployment in the US. [8 marks]

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

Should Latvia's currency be devalued?

- ❶ Badly hit by the financial crisis, Latvia is going through severe recession, losing 25 %–30 % of its Gross Domestic Product (GDP) in two years. It has very large budget and trade deficits, a large and growing public debt, and the deep recession has resulted in **deflation**.
- ❷ In view of these developments, the lat (Latvia's currency) would face **depreciation** in a freely floating exchange rate system. However, the lat has been pegged (fixed) to the euro since 2005 (0.7 lat : 1 euro). The Latvian government has shown its determination not to allow the lat to devalue. A stable currency relative to the euro is a condition for future adoption of the euro.
- ❸ Yet with very large trade and budget deficits, it has had to turn to the International Monetary Fund (IMF) and the European Union (EU) for loans. To qualify for the loans it has been forced to implement a highly restrictive fiscal policy, involving deep cuts in government spending on education and health care. Another government policy involves cutting wages in an effort to increase firms' export competitiveness.
- ❹ To maintain the pegged value of the lat, the Latvian central bank must keep interest rates at a relatively high level, in order to attract financial capital and prevent currency outflows. If the government devalued the lat, this could work to solve some of the problems. It would help correct the trade deficit and could also encourage economic growth. Economic growth might help reduce the public debt. A devaluation of the lat would also allow the government to pursue expansionary fiscal and monetary policies to deal with its deep recession.
- ❺ However, devaluation comes with risks. The government argues that it may create inflationary pressures due to higher import prices and a loss of export competitiveness. Widespread bankruptcies could arise because 85 % of consumer borrowing is in euros, meaning that the real value of consumer debt would increase.
- ❻ Estonia, Lithuania and Bulgaria (also with currencies pegged to the euro) may also devalue their currencies, reducing Latvia's competitive advantage from a devaluation of the lat.

[Source: adapted from "Latvia shows the damage that far right economic policy can do – with support from the European Union and IMF", *The Guardian Unlimited*, 15 January 2010; "Devaluation "will not be considered" says Latvian Finance Minister", *Deutsche Presse Agentur*, 15 January 2010 and "Latvia remains on deflation slope: data", *Agence France-Presse*, 11 January 2010
http://news.monstersandcritics.com/business/news/article_1525729.php/Devaluation-will-not-be-considered-says-Latvia-Finance-Minister]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) deflation (*paragraph 1*) *[2 marks]*
 - (ii) depreciation (*paragraph 2*). *[2 marks]*
- (b) Using an appropriate diagram, explain how cuts in wages can improve Latvia's export competitiveness (*paragraph 3*). *[4 marks]*
- (c) Using an AD/AS diagram, explain how a devaluation of the lat could help encourage economic growth in Latvia (*paragraph 4*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the decision of the Latvian government to maintain the pegged (fixed) value of the lat. *[8 marks]*

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

Malawi-EU trade and development

- ① Malawi and the European Union (EU) have been negotiating an agreement involving trade and development. The objectives are to gradually liberalize trade between the two parties and provide support for economic development in Malawi.
- ② However, the talks have stopped as Malawi refuses to sign the agreement in spite of strong pressure by the EU to do so. Malawi's trade minister wants to break the poverty cycle and has said that Malawi is at a disadvantage with trade liberalization because it is a country with poor **infrastructure**, low labour productivity, poor technological capacity and unreliable public utilities. The trade minister needs assurance that issues like rural roads, health and education facilities, and more investment in research and technology development will be addressed in the agreement.
- ③ The director of a group of non-governmental organizations (NGOs), added that the agreement would lead to losses in tariff revenues. Tariffs are also needed to protect the growth of the manufacturing sector. Also, he fears that trade liberalization with the EU will encourage Malawi's position as an exporter of low-value agricultural commodities, preventing diversification of production and exports. It may also prevent regional trade from developing.
- ④ Representatives of the EU argue that gradual trade liberalization will contribute to development, growth and job creation. Malawi will benefit from the European Development Fund, which provides private sector grants, loans and technical assistance. Also it will benefit from facilities to be developed as a result of "aid for trade", which is **multilateral aid** intended to assist countries to build institutions and infrastructure needed to take advantage of international trade opportunities.

[Source: <http://www.ipsnews.net/2010/07/trade-malawi-stands-firm-on-conditions-for-signing-epa/>]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) infrastructure (*paragraph 2*) *[2 marks]*
 - (ii) multilateral aid (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain how investment in health and education facilities can contribute to economic growth (*paragraph 2*). *[4 marks]*
- (c) Explain how low incomes contribute to the poverty cycle in Malawi (*paragraph 2*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the likely effects of Malawi's trade and development agreement with the EU. *[8 marks]*
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