

Markscheme

May 2021

Economics

Higher level

Paper 1

14 pages

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Section A

Microeconomics

1. (a) Explain why governments provide subsidies.

[10]

Answers may include:

- definitions of subsidy
- diagram showing the imposition of a subsidy leading to higher producers' revenues (including the subsidy), lower prices and higher level of production/consumption
- explanation that governments provide subsidies to stimulate the production and consumption of merit goods (eg education, healthcare) and to support certain producers/consumers for political reasons
- examples of specific markets where subsidies have been provided in practice.

Assessment Criteria

Part (a) 10 marks

Level		Marks
0	<i>The work does not meet a standard described by the descriptors below.</i>	0
1	<i>There is little understanding of the specific demands of the question.</i>	1–3
	Relevant economic terms are not defined. There is very little knowledge of relevant economic theory. There are significant errors.	
2	<i>There is some understanding of the specific demands of the question.</i>	4–6
	Some relevant economic terms are defined. There is some knowledge of relevant economic theory. There are some errors.	
3	<i>There is understanding of the specific demands of the question.</i>	7–8
	Relevant economic terms are defined. Relevant economic theory is explained and applied. Where appropriate, diagrams are included and applied. Where appropriate, examples are used. There are few errors.	
4	<i>There is clear understanding of the specific demands of the question.</i>	9–10
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- (b) Evaluate the effectiveness of price floors in achieving a reduction in the consumption of demerit goods.

[15]

Answers may include:

- definitions of price floor, demerit goods
- diagram showing the imposition of a price floor, resulting in increased price and decreased quantity demanded (consumed)
- explanation that the imposition of a price floor on the market for a demerit good would increase the price and reduce the quantity demanded (and consumed) of the good, moving consumption of the good closer to the socially optimal quantity
- examples of cases where price floors have been imposed to discourage the consumption of demerit goods
- synthesis or evaluation.

Evaluation may include:

- Consideration of the limitations of the policy: unlike indirect taxes, price floors do not increase government revenues; may lead to surpluses and attempts by the producers to sell the surpluses at a price below the legally set minimum (in parallel markets); may increase the producers' revenues and profits (if the demand for the demerit good is inelastic).
- Consideration of the strengths of the policy: the threat of a price floor may cause the suppliers to modify the product to reduce the negative externalities; price floors may be used in cases where the local government is not legally allowed to impose indirect taxes or ban the use of the demerit good. A price floor allows government to set the price, a tax might be absorbed by abnormal profit-making producers.
- Consideration of the strengths and limitations of alternative policies such as indirect taxes and government regulations (restrictions).

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

Assessment Criteria

Part (b) 15 marks

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2. (a) Explain the reasons for the shape of the long-run average total cost curve. [10]

Answers may include:

- definitions of long run, average total cost
- diagram showing appropriate LRATC curve (U-shaped, L-shaped, downward-sloping)
- explanation of why costs per unit of output fall as the firm realizes economies of scale and/or why costs per unit of output may rise if the firm suffers from diseconomies of scale
- examples of firms/industries which experience economies/diseconomies of scale.

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- (b) Discuss the view that governments should always try to prevent the creation of barriers to entry in a market.

[15]

Answers may include:

- definitions of barriers to entry, market
- diagram showing a firm that faces a downward-sloping average revenue (demand) curve and realizes economic profit
- explanation of barriers to entry and how they permit a firm to achieve monopoly power and realize economic profit by restricting competition from other firms
- examples of barriers to entry in practice and/or firms that have acquired monopoly power because of economies of scale, strong brands or legal barriers to entry
- synthesis or evaluation (discuss).

Discussion may include: the possible negative effects of barriers to entry on allocative and productive efficiency; economies of scale may lead to lower prices and higher output, benefitting both producers and consumers; branding reduces problems of asymmetric information and may be beneficial to consumers; legal barriers to entry may protect consumers (eg licensing) and stimulate R&D (eg patents) or lead to inefficiencies and rent-seeking.

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Section B

Macroeconomics

3. (a) Explain the causes of cost-push inflation. [10]

Answers may include:

- definitions of inflation, cost-push inflation
- diagram showing cost-push inflation (increase in the price level due to decrease in SRAS)
- explanation that cost-push inflation is caused by an increase in the costs of factors of production
- example(s) of specific policies/events that may cause cost-push inflation, examples of economies that have experienced cost-push inflation (eg USA in the 1970s).

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(b) Discuss the view that deflation is more harmful than inflation.

[15]

Answers may include:

- definitions of inflation, deflation
- diagrams showing deflation and inflation
- explanation of the possible consequences of high inflation rates (increased uncertainty and more difficult planning, wealth/income redistribution and social tensions, lower savings rate/higher consumption, lower export competitiveness) and the possible consequences of deflation (increased debt burden, bankruptcies and cyclical unemployment, wealth/income redistribution and social tensions, higher savings rate/lower consumption)
- examples of economies that have experienced high inflation rates (eg Weimar Republic, Zimbabwe, Venezuela), examples of economies that have experienced deflation (eg USA during the Great Depression, Japan), examples of specific cases of negative and/or positive consequences
- synthesis or evaluation (discuss).

Discussion may include: in a progressive taxation system the inflation pushes individuals and businesses into higher income brackets, leading to higher tax revenue for the government and higher tax burden for individuals and businesses; the effect of inflation/deflation on groups with fixed incomes versus the effect on groups with incomes that change with the price level; the importance of the magnitude of price changes (low inflation rates of about 2 % or less may be beneficial for the economy); the importance of how prolonged the inflation/deflation is, whether the inflation/deflation is anticipated or not anticipated, whether the deflation is caused by supply-side or demand-side factors, whether the inflation is demand-pull or cost-push (mild demand-pull inflation may stimulate employment and economic growth, increase profits); the possibility that inflation may get out of control and inflation rates may reach astronomical levels.

NB It should be noted that definitions, diagrams, theory and examples that have already been given in part (a), and then referred to in part (b) should be rewarded.

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4. (a) Explain how the Lorenz curve and the Gini coefficient are used to measure differences in income inequality between countries.

[10]

Answers **may** include:

- definitions of income inequality, Lorenz curve, Gini coefficient
- Lorenz curve diagram(s) with one Lorenz curve that is closer to the line of perfect income equality and another Lorenz curve that is further away from the line of perfect income equality
- explanation of why a Lorenz curve closer to the line of perfect income equality (Gini coefficient closer to zero) indicates higher income equality and/or explanation of why a Lorenz curve further away from the line of perfect income equality (Gini coefficient closer to 1) indicates lower income equality
- examples of countries with a relatively equal (eg Sweden, Denmark) and relatively unequal (eg Brazil) distribution of income.

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- (b) Discuss the view that taxation is the most effective means of achieving equity in the distribution of income.

[15]

Answers may include:

- definitions of taxation, equity, distribution of income
- diagram(s) showing the Lorenz curve shifting closer to the line of perfect income equality and/or the effect of imposing taxes on a market
- explanation of why progressive taxation may increase the income equality in a country; explanation of why other government policies may also increase the income equality in a country
- examples of progressive taxes in practice, examples of alternative policies that will make the distribution of income in a country more equal (eg subsidized health care services, subsidized education, subsidized utilities, old age pensions, unemployment benefits, child allowances)
- synthesis or evaluation (discuss).

Discussion may include: consideration of the meaning of the word “equity”; the difference between equity in the distribution of income and equality in the distribution of income; a consideration of whether it is the most effective means of achieving equity; the effect on equity/equality depends on the type of taxation – progressive (direct) taxation tends to decrease equality/equity while regressive (indirect) taxation may decrease equality/equity; taxation is a major source of government revenue; taxation may be used to discourage the consumption and production of goods with negative externalities; too much taxation may discourage hard work and entrepreneurship; government expenditures on human and physical capital formation may have positive effects on economic growth in the long run; transfer payments may improve the quantity and quality of human capital but may also decrease the incentives to look for employment and to work hard or study; government expenditures and transfer payments may lead to budget deficits and high levels of indebtedness.

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