ECONOMICS
HIGHER LEVEL
PAPER 3

Thursday 19 May 2005 (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 real-world examples where appropriate.

*Answer **three** questions. Each question is worth [20 marks].*

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

European Union (EU) to investigate high prices for compact disks (CDs)

❶ Fears that the world's big five music companies operate a **collusive oligopoly** to keep CD prices artificially high have prompted the European Commission to investigate big industry mergers.

❷ Although no strong evidence has been found to date that Europeans are paying far too much for their CDs, there is a strong belief that there is more than enough evidence to warrant a full enquiry. The European companies under investigation are the EMI Group, Bertelsmann, Warner Music, Sony Corp and Universal ("the big five") together with five online retailers and 13 traditional retailers.

❸ The Commission is particularly interested to find out why there are such wide differences in CD prices within Europe and why music costs are higher in Europe than in the USA. It also wants to know why a CD costs 30 % more than a cassette for exactly the same content. The issues emerged when a massive merger between EMI and Warner Music was reviewed and rejected on the grounds that it would harm competition due to the economies of scale it would create (barriers to entry).

❹ A consumer association survey looked at a best selling album of the female singer Britney Spears which cost an average of US dollars (US $) 10.77 in US music stores compared to US ($) 12.08 in the European Union. In Italy, the album costs US ($) 14.16, while in London it costs US ($) 12.26.

❺ The Commission is investigating the big five companies and a similar investigation in the USA concluded that American consumers paid US ($) 320 million more for their CDs than they should have. The US authorities discovered that the big five music companies had been setting **minimum prices** for CDs for at least five years.

[Source: adapted from Andrew Osborn, *The Guardian,* 27 January 2001]

(This question continues on the following page)

(Question 1 continued)

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

(i) collusive oligopoly *(paragraph ❶)* *[2 marks]*

(ii) minimum prices *(paragraph ❺)*. *[2 marks]*

(b) Using an appropriate diagram, explain why prices in a collusive oligopoly are not likely to fall. *[4 marks]*

(c) Explain how it is possible for a music company to charge different prices in different countries. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the benefits and costs of collusive practices by large companies. *[8 marks]*

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

Extract 1

The Federal Reserve (US Central Bank) cuts US interest rates to lowest level since 1958

The Federal Reserve (US Central Bank) last night cut US interest rates by another quarter percent to their lowest level in 45 years in an effort to stimulate an American economic revival.

In an unpromising assessment of the American economy, a representative of the Federal Reserve said that the USA "has yet to exhibit sustainable economic growth". The USA is moving towards a recession due to falling consumer and business confidence, and the collapse of high profile corporations in this time period.

The Federal Reserve repeated its view on the US growth and inflation outlook. In a signal that it remains ready to take more action to stimulate economic activity, it said the risks of deflation outweigh any threat posed by an increase in inflation. Falling housing costs associated with a low level of mortgage (housing) interest rates and lower import prices due to the US dollar ($) appreciation, had contained the inflation rate.

It will be some time before it will be known whether the cut in the US interest rates will prove an encouragement for an American economic recovery. The Federal Reserve cut the official interest rates to increase **aggregate demand**, raise investor confidence, and reduce business debt servicing costs.

Lower interest rates will also help export sector growth as the US economy looks to improve its trade with Europe and Japan.

Extract 2

US GDP, Inflation Rates, Interest Rates 2000-2002

Year	**GDP** (Real % change)	Inflation Rate	US Official Interest Rates
2000	4.4 %	2.9 %	5.69 %
2001	1.8 %	3.4 %	3.49 %
2002	0.8 %	1.8 %	1.25 %

[Source: adapted from Gary Duncan, *The Times,* 26 June 2003]

(This question continues on the following page)

(Question 2 continued)

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

(i) GDP (Gross Domestic Product) *(Extract 2)* *[2 marks]*

(ii) aggregate demand *(Extract 1)*. *[2 marks]*

(b) Using an appropriate diagram, explain how a fall in interest rates might stimulate aggregate demand in the USA. *[4 marks]*

(c) Using the data, explain what phase of the trade/business cycle the US economy is in. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the view that a cut in interest rates is all that would be necessary to stimulate an economic recovery in the USA. *[8 marks]*

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

Tax cuts

❶ Given that governments must raise money through taxation, how can they do so at the least cost to the economy? Usually, economists prefer taxes that change the relative prices of goods and services as little as possible, and so cause the minimum distortion to people's spending and investment decisions.

❷ Indirect taxes, such as an excise duty or VAT, which are **regressive taxes**, are a popular choice by governments because they can target particular sectors of the economy, often minimizing the political consequences. However, economists are reluctant to move away from the allocation of resources achieved in the free market.

❸ Income taxes can cause an especially serious distortion, because they affect the choice between leisure and work (and as a result, between leisure and all the things that wages can buy). Low marginal income-tax rates are therefore a special favourite among economists.

❹ Yet the precise relationship between income-tax rates, **economic growth** and tax revenues depends on how changes in tax rates affect people's behaviour. Economists argue that lower marginal tax rates give people an incentive to work more, because they can keep a larger share of every dollar they earn. This "substitution" effect means that people may work harder – so much harder, indeed, that they might end up paying more tax. This was the answer that was once offered by Arthur Laffer.

❺ On the other hand, a cut in the marginal income-tax rate usually means a lower average tax rate too. So people will not have to work so hard to reach the same level of income after a tax cut as they did before. If this "income" effect outweighs the substitution effect, people will work less hard and pay less tax. They may be happier, but the treasury will be emptier.

[Source: adapted from The Economist, 28 June 2003, Vol 367, Issue 8330, p74, 1p, 1c]

(This question continues on the following page)

(Question 3 continued)

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

(i) economic growth *(paragraph ❹)* *[2 marks]*

(ii) regressive taxes *(paragraph ❷)*. *[2 marks]*

(b) Using an appropriate diagram, explain how an indirect tax can change the free market price level and the allocation of resources. *[4 marks]*

(c) Explain using an appropriate diagram, the relationship between tax revenue and income tax rates suggested by Arthur Laffer *(paragraph ❹)*. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the likely impact of income tax cuts on economic growth in an economy. *[8 marks]*

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

The benefits of a lower dollar

❶ The current decline in the US dollar ($) will provide a much-needed stimulus to the US economy. The depreciation of the dollar will bring especially welcome relief to the US manufacturing sector, which has suffered the disastrous consequences of lost jobs, reduced profits, and decreased investment as a result of the dollar's overvaluation for the past several years. However, although the dollar has come down significantly from its peak in February 2002, it has not yet fallen nearly enough to reverse the damage caused by its high value since the late 1990s.

❷ The high value of the dollar since the late 1990s has acted like a massive tax on US exports and a huge **subsidy** to US imports. As a result, although US manufacturing firms have made substantial investments in new technologies and US manufacturing workers have vastly increased their productivity, these achievements have not been successful because foreign products have been selling at artificially low prices due to the overvalued dollar. Specifically, the overvalued dollar has resulted in:

- About 740 000 lost jobs in the manufacturing sector by 2002 – more than one quarter of the 2.6 million jobs lost in manufacturing since 1998.
- A decrease of nearly US ($) 100 billion in the annual profits of US manufacturing companies by 2002.
- A fall in investment in the domestic manufacturing sector by over US ($) 40 billion annually as of 2002, representing a loss of 25 % of US manufacturing investment.

❸ There is a situation where the United States of America is running up foreign debt at a rate unseen in history. In the fourth quarter of 2002, the **current account deficit** of the world's largest economy hit an annualised rate of 5.2 % of GDP, well above the 3.4 % deficit reached in 1987, the last time the USA faced an international financial crisis.

[Source: adapted from Blecker, RA. *The benefits of a lower dollar* 30 May 2003, *EPI Briefing Paper* and *Bulletin with Newsweek*, 13 May 2003, Vol. 121 Issue 6372, p20, 1p]

(This question continues on the following page)

(Question 4 continued)

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

(i) current account deficit *(paragraph ❸)* *[2 marks]*

(ii) subsidy *(paragraph ❷)*. *[2 marks]*

(b) The text refers to the "current decline in the US dollar". Using a supply and demand diagram, explain **one** possible reason for this *(paragraph ❶)*. *[4 marks]*

(c) Using an AD/AS diagram explain the relationship between the "high value" of the dollar and the "lost jobs" referred to in the text *(paragraph ❶ and ❷)*. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the likely impact of the depreciation of the dollar on the domestic US economy. *[8 marks]*

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

Africa's economic problems have a medical solution

❶ Malaria kills three children per minute and this hidden global catastrophe affects Africa most. Currently, 300 million to 500 million cases occur each year, with severe cases resulting in death. Of the estimated 27 million people killed by malaria every year, 75 % are African children under the age of five.

❷ As the G8 countries (the world's eight leading industrialized countries) deliberate on a new approach for lifting African nations out of poverty, the leaders must look beyond increased aid and trade. Fighting disease must be a central part of economic strategy for Africa if countries are to achieve a significant boost in economic growth to reduce poverty and generate positive externalities.

❸ Infectious diseases have crippled African efforts to achieve economic self-sufficiency and economic development for the last half century, well before the **indebtedness** crisis and the trade issues that have dominated G8 discussion on Africa.

❹ If G8 leaders and others want to increase GDP in developing countries, they should consider that diseases such as malaria result in an enormous price for developing countries, not only in lives, but also in medical costs and lost labour, harming the economic well being of entire families, communities and nations. Malaria keeps the poor in a continuous poverty cycle. According to a Harvard University study published in 2000, Africa's annual GDP would be US dollars 100 billion more than it is today if malaria had been eliminated 35 years ago – many times more than all the development aid programmes to Africa in a year.

❺ Meaningful **economic development** in Africa cannot occur if addressing infectious disease is seen as a secondary goal rather than a critical part of the new vision of economic stability. This will require that the people who implement a new economic plan for Africa must broaden their notion of what constitutes a successful macroeconomic strategy.

[Source: adapted from Dr Regina Rabinovich, *The Guardian Weekly*, 11-17 July 2002]

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(Question 5 continued)

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

(i) economic development *(paragraph ❺)* *[2 marks]*

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

(b) Using an appropriate diagram, explain how the provision of a malaria vaccine by the G8 countries would generate positive externalities for African nations. *[4 marks]*

(c) Explain the link between the poverty cycle and disease. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the role of indebtedness in constraining economic development for African countries. *[8 marks]*