



MARKSCHEME

May 2009

ECONOMICS

Higher Level

Paper 2

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In addition to the assessment criteria, use the paper-specific markscheme below. Award up to the maximum marks indicated. Each question is worth [10 marks].

1. Using a production possibility curve (PPC) diagram, explain the relationship between the economic concepts of economic goods, factors of production and opportunity cost.

Candidates **may** include any of the following:

- an explanation of the concept of economic goods: goods that are subject to scarcity, because they are produced by scarce factors of production
- economic goods have an opportunity cost greater than zero, or have a price greater than zero
- a differentiation between economic goods and free goods
- an explanation of the factors of production land, labour, capital and enterprise
- an explanation of the relationship between economic goods and factors of production leading to choice
- to make choice we balance the benefits of having more of some things against the cost of having less of something else – optimizing or economizing
- economists use the term opportunity cost to emphasize that making choices in the face of scarcity implies a cost
- opportunity cost is the next best alternative foregone
- the use of a PPC diagram: the frontier indicates the maximum production possible of economic goods given the available factors of production
- opportunity costs vary along a curved PPC (unlike a straight-line PPC) because factors of production are not perfect substitutes for each other.

N.B. Some candidates will include enterprise within the category labour. If explained correctly this is acceptable.

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

2. Explain why the marginal revenue curve is identical to the average revenue curve for a firm in perfect competition but not identical for a monopoly.

Candidates **may** include any of the following:

- a firm in perfect competition is a price taker (infinitely elastic demand curve where $AR=MR$)
- a monopoly can set its own price (demand curve is downward sloping and $MR<AR$)
- average revenue is total revenue divided by the quantity sold
- average revenue also equals price
- marginal revenue is the change in total revenue resulting from a one-unit change in the quantity sold
- graphical demonstration that marginal revenue equals average revenue in perfect competition
- explanation of the graph with an example
- graphical demonstration that marginal revenue for a monopolist lies below average revenue
- explanation of the graph with an example.

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3. Explain how direct provision of a public good by the state (government) can correct the problem of market failure.

Candidates **may** include any of the following:

- definition of a public good: a good whose consumption by one person does not reduce the amount available to be consumed by another person (non-rivalry) and once provided nobody can be excluded from its consumption (non-excludability)
- explanation of market failure: the inability of an unregulated market to achieve allocative efficiency in all circumstances (marginal benefit does not equal marginal cost)
- example of a public good *e.g.* national defence with explanation of why it is a public good
- the under-provision of public goods by private markets due to the free-rider problem
- explanation of the free-rider problem
- recognition that the size of free-rider problems is such that private markets will provide such goods on a scale smaller than required to achieve allocative efficiency
- government is likely to provide public goods on a much larger scale and get closer to allocative efficiency.

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4. With reference to *one* factor, explain why some factors might shift the SRAS (Short-Run Aggregate Supply) curve, but leave the LRAS (Long-Run Aggregate Supply) curve unchanged.

Candidates **may** include any of the following:

- definition of SRAS: it is the relationship between the aggregate quantity of final goods and services (real GDP) supplied and the price level holding everything else constant
- diagram of SRAS showing that the higher the price level the larger is the aggregate quantity of goods and services supplied up to some maximum
- definition of LRAS: it is the relationship between the aggregate quantity of final goods and services (real GDP) supplied and the price level when there is full employment – that is when employment is at its natural rate
- the LRAS shows the relationship between the quantity of real GDP supplied and the price level when wage rates change along with the price level to achieve full employment – it is vertical
- diagram and explanation of LRAS
- explanation of how one factor (*e.g.* weather conditions, oil prices, wages) might shift the SRAS curve but have no affect on a country's long-term productive capacity (LRAS curve).

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5. Explain *two* economic consequences of a favourable movement in the terms of trade resulting from an increase in demand for a country's exports.

Candidates **may** include any of the following:

- definition of terms of trade
- description of a “favourable movement in the terms of trade”.

Consequences of improved terms of trade:

- a country does not have to sell as many exports to buy the same quantity of imports
- a country has greater possibilities to gain from trade
- a country has greater possibilities to achieve economic growth because it can increase its imports of capital goods
- a country has greater possibilities to achieve economic development through increased resources made available by greater economic growth
- international income redistribution, as the country enjoying improved terms of trade gains real income at the expense of countries with deteriorating terms of trade.

Consequences of increased demand for exports:

- currency appreciation (assuming that imports do not increase)
- increased employment opportunities (assuming increased production of exports is not achieved through increased productivity or capital intensive techniques, and that elasticity of supply of exports is low)
- improved current account balance (assuming imports do not increase)
- increased demand for exports may increase inflation.

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6. Explain, using the Harrod-Domar model, how increased domestic savings could contribute to economic development.

Candidates **may** include any of the following:

- explanation of the Harrod-Domar model
- explanation of economic development
- growth rate in the Harrod-Domar model is given by the ratio between the savings (S) ratio and the capital-output (K) ratio $g = \frac{S}{k}$
- on the very basic assumptions of no foreign sector and no government sector the Harrod-Domar model states that the rate of economic growth “G” is positively dependent on the savings ratio “S” and negatively dependent on the capital output ratio “K” where k is the productivity of capital in the economy
- higher economic growth can contribute to economic development, but not always
- economic development may not occur because economic growth may be associated with increased income inequalities, lack of attention to provision of infrastructure, reduced employment possibilities in the event of capital intensive technology *etc.*
- criticism of the Harrod-Domar model.

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