



**ECONOMICS
HIGHER LEVEL
PAPER 3**

Tuesday 22 May 2007 (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 references to the text / data where appropriate.

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

China eager to embrace world of business

- ① Considering he was teaching in China, Professor Li Mingzhi of Tsinghua University must have been amused asking his students in an economics class for examples of a **centrally planned economy**, where the government decides how much people earn, how much people produce and how much products cost. One student quickly said, “China, several years ago”.
- ② This suggests that the China in which the government makes all these decisions, is disappearing into history.
- ③ In the 1990s the government restructured China’s planned economy and introduced free enterprise reforms. These reforms included closing many state owned enterprises that were losing money, seeking **foreign direct investment**, and speeding up market reforms. The result is that China has become an economy in transition.
- ④ Today, through efficiency improvements, entrepreneurs, joint ventures and multinational corporations are contributing to increasingly rapid economic growth and expansion in China’s cities. These businesses are developing entire suburbs for the growing middle class, manufacturing the cars for transport and mobile phones for communication.
- ⑤ The increased domestic demand, along with the push to make more goods for the international market, has increased China’s consumption of just about everything. 10 years ago China was self-sufficient in food and oil, but in the first six months of 2004, imports of these commodities have increased by 60%. The impact of this has been felt in global commodity markets where China is held responsible for the high oil prices and rising costs of copper, steel and cement. Domestically, economic growth of nearly 10% has led to fears that the economy is overheating. China is under threat from inflation.
- ⑥ There is great anger within China as a result of the growing gap between the wealthy cities on the eastern seaboard and poor rural communities in western regions. This combined with environmental concerns has led many people to question the benefits of rapid economic growth.

[Source: adapted from Gady Epstein, *The Guardian Weekly*, 26 November to 2 December 2004 and Jonathan Watts, *The Guardian Weekly*, 24 December to 6 January 2005]

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(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) centrally planned economy (*paragraph 1*) *[2 marks]*
 - (ii) foreign direct investment (*paragraph 3*). *[2 marks]*
- (b) Using an appropriate diagram, explain why China is experiencing “increasingly rapid economic growth and expansion” (*paragraph 4*). *[4 marks]*
- (c) “The increased domestic demand, along with the push to make more goods for the international market, has increased China’s consumption of just about everything” (*paragraph 5*). Using an appropriate diagram, explain how increased domestic demand in China may impact upon prices and output in China. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the economic consequences resulting from the transition of an economy from central planning to a market economy. *[8 marks]*

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

\$2 billion road system

- ❶ A new road (expressway) system that charges tolls for its use has been built. This new road system has added significantly to the overall stock of infrastructure.
- ❷ People living in the suburbs near the new road system say it is failing them as motorists try to avoid using it. These motorists are using slower alternative routes through the suburbs to avoid paying the tolls. This increased travel on the streets near the road system has caused traffic congestion, delays, pollution and general wear and tear on the roads.
- ❸ Although the road system has reduced travel times significantly for motorists that use it, those living in the suburbs want measures introduced to remove the large numbers of motorists off their streets.
- ❹ There is general agreement that the road system provides much quicker travelling times during all periods, but more needs to be done to encourage greater numbers of motorists to use the new system. The road system’s full capacity is not being used.
- ❺ In peak periods when householders use their cars to travel to work, the price charged would appear to be correct. However, recent research suggests that **price discrimination** in the form of discounted or reduced toll rates for regular private household users, should be introduced for off-peak periods to encourage greater use.
- ❻ For businesses (producers) the new road system has been a huge help, giving a high speed run between industrial areas, the shipping port and the major airport, cutting transport costs and allowing the use of larger trucks.
- ❼ The price elasticity of demand for households and producers that use the new road system has been estimated in the table below.

Price Elasticity of Demand (PED) for households and producers

Year	Households PED	Producers PED
2002	1.45	0.38
2003	1.39	0.41
2004	1.41	0.39

The **income elasticity of demand** is estimated to be a positive two.

[Source: adapted from Christian Catalano, Stephen Moynihan and Melissa Marino, *The Sunday Age*, 5 May 2002]

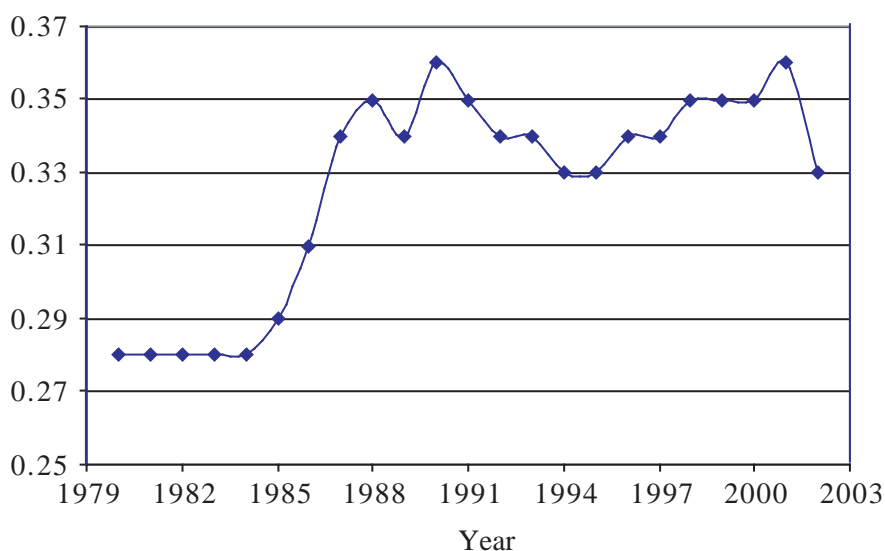
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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) price discrimination (*paragraph 5*) *[2 marks]*
 - (ii) income elasticity of demand (*paragraph 7*). *[2 marks]*
- (b) With reference to paragraph **2**, use an appropriate diagram to explain why the new road system does not reflect the true cost to society. *[4 marks]*
- (c) Using at least **one** appropriate diagram, explain why the price elasticity of demand (PED) is different for the two main users of the road system. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the arguments for and against charging for the use of roads. *[8 marks]*

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

Gini Coefficient for the UK



[Source: adapted from *National Statistics*, 13 April 2005]

Text 1:

The central issue appears to be whether we want the tax system to alter the distribution of income in favour of the less well-off, thereby reducing absolute and relative poverty. Another way of putting the same question is whether those who can most afford to pay should take a higher share of the burden of financing public spending. For most of the past 100 years, in most Western societies the answer has been yes and **progressive tax** systems have been used for personal income. For example, in the United Kingdom there are three income tax rates, 10 per cent, 22 per cent and 40 per cent. Economists however, worry about the impact of progressive taxes on efficiency and output.

[Source: adapted from *Telegraph*, 10 April 2005]

Text 2:

Indirect taxes on goods and services, such as a Value Added Tax (VAT) or a Goods and Services Tax (GST), continue to grow as a source of revenue for governments throughout the world, despite being considered regressive and inflationary. 29 of 30 OECD* member countries now have a VAT/GST.

* OECD is the Organization for Economic Cooperation and Development (formed in 1961). The members in 2006 were: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

[Source: adapted from http://www.oecd.org/topic/0,2686,en_2649_33739_1_1_1_1_37427,00.html, 13 April 2005]

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(Question 3 continued)

- (a) Define the following terms indicated in bold in the text and data:
 - (i) Gini Coefficient (*graph heading*) [2 marks]
 - (ii) progressive tax (*text 1*). [2 marks]
- (b) Using a Lorenz Curve diagram, explain what happened to the distribution of income in the UK between 1984 and 1988. [4 marks]
- (c) Using an appropriate diagram, explain how the introduction of an indirect tax on a good or service will affect its price. [4 marks]
- (d) Using information provided and your knowledge of economics, evaluate the use of progressive tax systems to provide a more equitable distribution of income. [8 marks]

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

USA and Australia enter trade agreement

Text 1

With the Australia-United States Free Trade Agreement coming into force on 1 January 2005, the Australian Government has officially joined much of the rest of the world in promoting the opportunities and benefits of bilateral and regional free trade agreements.

Text 2

Until recently, Australia had focused its attention on multilateral trade negotiations. In fact, prior to 2003, Australia had signed only one free trade agreement with New Zealand. Since then, Australia has signed agreements with Singapore, the US and Thailand.

As a result of this relative inactivity on the bilateral front, Australia is now facing discrimination in many key markets. For this reason, the Government is looking to Asia and investigating the possibility of forming a **free trade area** with ASEAN, China, South Korea and Japan.

Text 3

The Australian Government has signalled its on-going commitment to multilateral trade agreements. It recently played an important role in negotiating the World Trade Organization (WTO) “Doha” agreement of July 2004 that provides for a reduction in protectionism, like tariffs and **subsidies**, in controversial areas such as agriculture. The removal of barriers will, hopefully, improve the access of developing nations into the markets of developed nations.

Text 4

Australia has greatly benefited from the freer market access resulting from WTO membership, with Australian exports rising from \$93 billion to more than \$154 billion since 1995 and a strengthening of the Australian dollar. The sharp increase in trade has also significantly contributed to more than 250 000 jobs created in Australia during that time. It would be unwise for Australia to turn its back on the multilateral trading regime despite nationalistic fears of job losses, dumping and the need to raise taxes.

[Source: adapted from *The Australian*, 6 January 2005]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) free trade area (*text 2*) *[2 marks]*
 - (ii) subsidies (*text 3*). *[2 marks]*
- (b) Using an appropriate tariff diagram, explain how the USA-Australian trade agreement, and the removal of US tariffs on Australian goods, could boost Australian exports to the USA. *[4 marks]*
- (c) Using an appropriate diagram, explain how “freer market access” (*text 4*) could lead to a strengthening of the Australian dollar. *[4 marks]*
- (d) Using information provided and your knowledge of economics, evaluate the consequences of WTO trade negotiations aimed at reducing protectionism. *[8 marks]*

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

Measure first, then cut

- ❶ Pointless regulations encourage corruption. The more annoying the regulatory problems, the greater the incentive there is to bribe officials not to enforce these rules. An excellent new study by the World Bank, “Doing business in 2005”, shows that red tape is one of the chief obstacles to growth and development in almost all developing countries.
- ❷ Overall, businesses in developing countries carry three times the administrative costs and have twice as many bureaucratic procedures as their counterparts in rich countries.
- ❸ Businesses in developing countries tend to remain in **informal markets**, staying outside the law and paying no taxes. They stay small to avoid detection, do not use the formal banking system and pay no taxes. This results in many unintended consequences, including an ineffective taxation structure.

**Costs and regulatory problems encountered
by developing economies compared to developed economies**

Activity	Factor by which an activity is on average more difficult in developing countries
Firing a worker	1.6 times more costly
Enforcing contracts	3.0 times more costly
Starting up a business	4.2 times more costly
Going through insolvency	1.9 times as long (in years)
Registering property	1.8 times as long (in years)
Starting up a business	2.2 times as long (in years)

- ❹ Developing countries have tended not to have credible systems for protecting **property rights**, excluding the poor from doing business.
- ❺ The benefits of reforming inefficient government regulations appear large, where the additional economic growth resulting from increasing the ease of doing business could be as high as 2.2 percentage points. In other words, there is much more to be gained from abolishing excessive rules and regulations than asking for more aid.

[Source: adapted from *Measure first, then cut*, *The Economist*, 8 September 2004; and *Doing Business in 2005: removing obstacles to growth*. World Bank, International Corporation and Oxford University Press 2005]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) informal markets (*paragraph 3*) [2 marks]
 - (ii) property rights (*paragraph 4*). [2 marks]
- (b) Using an appropriate diagram explain how removing the “regulatory problems” (*table heading*) would impact on an economy. [4 marks]
- (c) Identify and explain **two** possible consequences of an “ineffective taxation structure” (*paragraph 3*). [4 marks]
- (d) Using information from the text and your knowledge of economics, evaluate how institutional and political factors can impact upon economic development. [8 marks]
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