

MARKSCHEME

May 2005

ECONOMICS

Higher Level

Paper 3

18 pages

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Paper Specific Markscheme

In addition to the assessment criteria use the paper-specific markscheme below. Award up to the maximum marks as indicated.

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

(i) **collusive oligopoly (paragraph ①)** [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that firms in an oligopoly market structure join together to act like a monopoly

2 *Precise definition* 2

An explanation that collusive oligopoly is where a few firms act together to avoid competition by resorting to agreements to fix prices or output.

(ii) **minimum prices (paragraph ⑤).** [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is a minimum price/floor below which the price cannot fall.

2 *Precise definition* 2

An explanation that it is the lower limit/floor below which the price charged to consumer may not fall. A minimum price is usually set above the equilibrium. A correct diagram with a brief explanation should certainly gain full marks.

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

[4 marks]

There are two possible approaches to this question. The candidates may either explain that a collusive oligopoly would be acting as a monopoly and would thus face a downward sloping demand curve or they may apply the kinked demand curve theory.

First approach

level

- 0 *Inappropriate answer* 0
- 1 *Identification of appropriate theory* 1-2
 To draw an appropriate monopoly demand curve illustrating that the firm will produce where $MR=MC$ **or** an explanation that the collusive agreement may lead to the formation of a profit maximizing monopoly structure and so the price will be stable at the level where $MR=MC$.
- 2 *Correct application of appropriate theory* 3-4
 To draw an appropriate monopoly demand curve illustrating that the firm will produce where $MR=MC$ **and** an explanation that the collusive agreement may lead to the formation of a profit maximizing monopoly structure and so the price will be stable at the level where $MR=MC$.

OR

level

- 0 *Inappropriate answer*
- 1 *Identification of appropriate theory*
 To draw an appropriate kinked demand curve illustrating inelastic pricing below the kink **or** an explanation of why inelastic demand below the kink means that a fall in price would result in a fall in total revenue so that prices are relatively stable at the kink.
- 2 *Correct application of appropriate theory*
 To draw an appropriate kinked demand curve illustrating inelastic pricing below the kink **and** an explanation of why prices are relatively stable and unlikely to fall below the point at the kink.

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

level

0 *Inappropriate answer* **0**

1 *Identification of appropriate theory* **1-2**
An explanation of how profit can be maximised through price discrimination in the different countries **or** the use of a diagram illustrating price discrimination.

2 *Correct application of appropriate theory* **3-4**
An explanation of how profit can be maximised through price discrimination due to different price elasticities of demand, with producers charging a higher price in markets where demand is less price-elastic. A diagram is not necessary.

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

[8 marks]

Responses may include:

An explanation of collusive practices

- that companies collude and work together like a profit maximising monopolist, fixing either prices or output and giving each other quotas

Benefits to firms

- increases industry prices and profit
- supernormal profits will encourage the development of new technologies/reinvestment of profits
- economies of scale could be created

Costs to firms

- risk of penalty

Benefits to consumers

- New technologies as a result of the investment of supernormal profits

Costs to consumers

- consumers will not be paying the lowest price possible (*“American consumers paid US\$320 more than they should have”*)
- large companies can control supplies
- can result in allocative and productive inefficiency.

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

If there is no direct reference to the data, then candidates may not be rewarded beyond Level 2. Effective evaluation may be to:

- consider short run vs. long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritise the arguments

Level

0	No valid discussion.	0
1	Few relevant concepts recognized. Little discussion or only basic understanding.	1-2
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	3-5
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	6-8

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

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

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is the value of output in an economy

2 *Precise definition* 2

An explanation that it is the total value of goods and services produced in an economy in a given time period

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

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea of aggregate demand as the total of all spending in an economy.

2 *Precise definition* 2

An explanation that aggregate demand is the total spending in an economy consisting of consumption, investment, government expenditure and net exports. (If a response simply writes the equation $AD=C+I+G+(X-M)$ then one mark may be awarded)

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

level

0 *Inappropriate answer* 0

1 *Identification of appropriate theory* 1-2

For drawing an AD/AS diagram with a rightward shift of the AD curve due to a fall in interest rates **or** an explanation of how a fall in interest rates may lead to an increase in consumption and/or investment.

2 *Correct application of appropriate theory* 3-4

For drawing an AD/AS diagram with a rightward shift of the AD curve due to a fall in interest rates **and** an explanation of how a fall in interest rates may lead to an increase in consumption and/or investment due to lower costs of borrowing.

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

level

0 *Inappropriate answer* 0

1 *Identification of appropriate theory* 1-2

For using the data to explain that the growth rate in the US economy is slowing down **or** an explanation that the economy is heading towards a recession, but is still experiencing positive growth.

2 *Correct application of appropriate theory* 3-4

For using the data to explain that the growth rate in the US economy is slowing down **and** an explanation that the economy is heading towards a recession, but is still experiencing positive growth.

Responses which state that the economy is in a contraction/slump/recession are technically incorrect and so cannot receive full 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]

Responses may include:

An explanation of how a cut in interest rates **may** stimulate an economic recovery. Responses should discuss:

- impact of a fall in interest rates on savings, consumption and investment, explaining the linkages
- use of AD/AS analysis.

To evaluate, the response could challenge the view by discussing:

- lack of business/consumer confidence
- collapse of corporations
- difficulty of reversing the deflationary process
- consumption and investment might be interest inelastic.

Alternatively, as a way of evaluating, responses could explain other policies that could be used to stimulate a recovery.

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

(i) **economic growth** (*paragraph 4*) [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is an increase in production in an economy

2 *Precise definition* 2

An explanation mentioning increased real output for an economy over time and/or measured as an increase in real GDP. Alternatively, it may be explained as an increase in the potential output of the economy.

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

level

0 *Wrong definition* 0

1 *Vague definition* 1

An idea that the impact of the tax is heavier on low income earners

2 *Precise definition* 2

An explanation where the proportion of income paid in tax falls as the income of the taxpayer rises.

An explanation that regressive taxation is where the average rate of tax falls as income rises.

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

level

0 *Inappropriate answer* 0

1 *Identification of appropriate theory* 1-2

Description of an indirect tax causing the equilibrium price rise and equilibrium output to fall **or** a diagram showing an upward shift in supply causing a higher price and lower output.

2 *Correct application of appropriate theory* 3-4

Description of an indirect tax causing the equilibrium price rise and equilibrium output to fall **and** a diagram showing an upward shift in supply causing a higher price and lower output.

Reference to PED and the incidence of indirect tax would give candidates access to full marks.

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

level

0 *Inappropriate answer* 0

1 *Identification of appropriate theory* 1-2

For a vague paraphrasing of the passage **or** an explanation in terms of how increased taxes act as a disincentive to work and may result in less government revenue **or** drawing a Laffer curve showing the relationship between tax revenue and income tax rates.

2 *Correct application of appropriate theory* 3-4

For a vague paraphrasing of the passage **or** an explanation in terms of how increased taxes act as a disincentive to work and may result in less government revenue **and** drawing a Laffer curve showing the relationship between tax revenue and income tax rates.

- (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]

A variety of approaches may be taken in answering this question. Responses may include:

- AS/AD analysis showing the impact of income tax cuts on consumption and the resultant changes to equilibrium income
- Lower income taxes result in an increased willingness to work so that the aggregate supply of labour may increase. This leads to an increase in the long run aggregate supply
- Keynesian analysis showing the effect on expenditure and equilibrium income. Reference may be made to the effect on the multiplier
- a descriptive approach may be taken referring to the impact on disposable income, consumption and production. Reference may also be made to taxation receipts and government's expenditure and the consequential impact on economic activity.

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

(i) current account deficit (paragraph ③). **[2 marks]**

level

0 *Wrong definition* **0**

1 *Vague definition* **1**

A very general definition such as when imports are greater than exports

2 *Precise definition* **2**

A fuller and more precise definition such as where total imports of goods and services are greater than total exports of goods and services **or** a more precise definition that import expenditure is greater than export revenues.

(ii) Subsidy (paragraph ②). **[2 marks]**

level

0 *Wrong definition* **0**

1 *Vague definition* **1**

Government support to producers

2 *Precise definition* **2**

An explanation referring to government support to producers to reduce the costs of production or an explanation that it is a payment, usually made by a government, to a firm that has the effect of reducing its costs of production. A correct diagram with a brief explanation should certainly gain full 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 ①).** **[4 marks]**

level

0 *Inappropriate answer* **0**

1 *Identification of appropriate theory* **1-2**

For drawing a demand and supply diagram for the US\$ showing either an increase in supply or a decrease in demand **or** an appropriate explanation of a reason for either an increase in supply or a decrease in demand for the dollar.

2 *Correct application of appropriate theory* **3-4**

For drawing a demand and supply diagram showing either an increase in supply or a decrease in demand **and** an appropriate explanation of a reason (*e.g.* current account deficit means increased supply of \$) for either an increase in supply or a decrease in demand for the dollar. For full marks, the y-axis must be accurately labelled – *e.g.* price of \$US, or price of \$US measured in other currencies

(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 (paragraphs ① and ②).** **[4 marks]**

level

0 *Inappropriate answer* **0**

1 *Identification of appropriate theory* **1-2**

For drawing an AS/AD diagram where a fall in exports (due to the high exchange rate) leads to a fall in AD and a lower level of output and a higher level of unemployment **or** an explanation that exports are a component of AD, so a fall in exports due to the high value of the dollar will lead to a fall in AD, a decrease in output and a rise in unemployment.

2 *Correct application of appropriate theory* **3-4**

For drawing an AS/AD diagram where a fall in exports (due to the high exchange rate) leads to a fall in AD and a lower level of output and a higher level of unemployment **or** an explanation that exports are a component of AD, so a fall in exports due to the high value of the dollar will lead to a fall in AD, a decrease in output and a rise in unemployment.

Alternatively, responses could show a labour market diagram, where the fall in demand for exports leads to a fall in demand for labour resulting in unemployment if wages are sticky downwards.

(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]

Responses **may** take a variety of approaches in answering this question and may include:

- employment creation through growth in export markets and in domestic industries which compete with imports. (positive consequence)
- investment growth stimulated by growing demand for US goods
- increased tax receipts for government through higher profits and income tax receipts through higher employment levels
- decreased government spending on welfare payments for unemployed
- inflationary pressure from higher import prices (negative consequence)
- the effect on foreign indebtedness
- disincentive for improved efficiency and productivity
- a deterioration in the terms of trade.

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- consider short run vs. long run consequences
- examine the impact on different stakeholders
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5. (a) Define the following terms indicated in bold in the text:

(i) **economic development** (*paragraph 5*) [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that economic development is a concept involving welfare improvements in an economy.

2 *Precise definition* 2

An explanation that economic development is a broader concept than economic growth involving welfare improvements to the standard of living including health, education and shelter.

(ii) **indebtedness** (*paragraph 3*). [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

An idea that a country owes money to another country.

2 *Precise definition* 2

An explanation that the government and private sector of a country owe money to overseas banks and/or governments and/or multilateral institutions.

(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]

level

0 *Inappropriate answer* 0

1 *Identification of appropriate theory* 1-2

For drawing a marginal social cost/marginal social benefit diagram or other appropriate diagram, **or** providing an explanation of how a malaria vaccine would provide external benefits thus creating a positive externality.

2 *Correct application of appropriate theory* 3-4

For drawing a marginal social cost/marginal social benefit diagram or other appropriate diagram, **and** providing an explanation of how a malaria vaccine would provide external benefits, thus creating a positive externality.

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

level

0 *Inappropriate answer* **0**

1 *Identification of appropriate theory* **1-2**

For an explanation of the poverty cycle, in terms of the idea that once you are in a state of poverty it is very difficult to escape from it.

2 *Correct application of appropriate theory* **3-4**

For an explanation that low incomes result in low savings which lead to low investment and further low incomes. Low incomes result in less savings which results in less investment in infrastructure such as clean water systems which leads to disease which in turn keeps people from gaining employment and income.

Responses may refer to a different type of poverty cycle (e.g. low income leads to poor health and inadequate education which leads to low labour productivity which leads to low income). If suitably explained, this may also receive full 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]

Problems that could be covered include:

- indebtedness does not allow savings and consequently investment in human capital and infrastructure
- borrowing from overseas, requires interest payments, restricting investment in human capital and infrastructure
- interest repayments divert funds from the health care system resulting in the inability to “address infectious disease” as a primary concern
- high levels of debt discourage future loans as countries are less willing to lend to heavily-indebted LDCs
- tied aid
- corruption
- the IMF and conditionality
- microfinance
- capital flight

A response might argue that debt may be useful and necessary in the short run to invest in human capital and infrastructure which will increase the ability to repay debt in the long run.

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