

# **MARKSCHEME**

**November 2002**

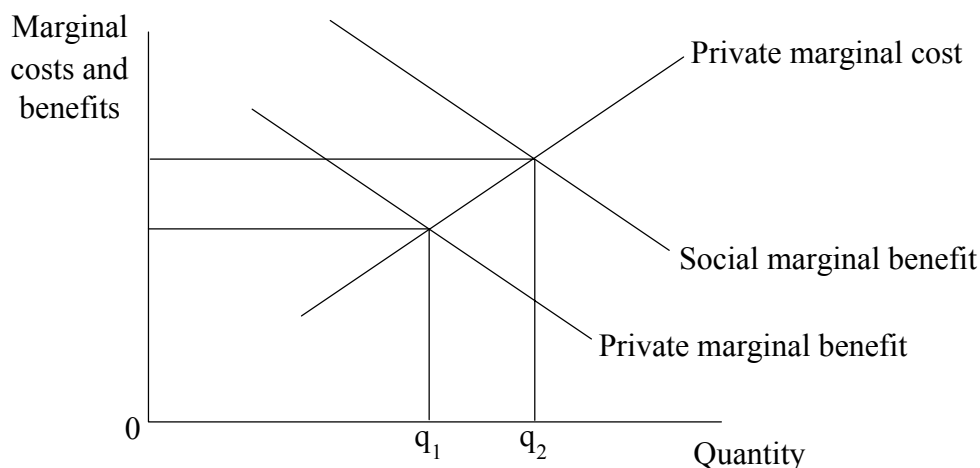
**ECONOMICS**

**Higher Level**

**Paper 2**

**1. What is a positive externality? Give an example and illustrate your answer with a diagram.**

Candidates should produce an initial definition. This should include evidence that the candidate understands that social benefit exceeds private benefit, *i.e.* that a producer or consumer can benefit from the actions of others. A good example is vaccination. A correctly labelled diagram should follow, and while there are several variants to be found, this one would suffice.



While the free market would produce  $0q_1$ , the socially ideal output would be  $0q_2$ . Thus the presence of positive externalities leads to under-consumption. If no diagram the mark should not exceed [5 marks] (depending on the quality of the explanation). An accurate / technical definition plus explained example could go to Band 5.

**2. Why do some oligopolistic firms engage in non-price rather than price competition?**

Candidates should explain that non-price competition is a feature of oligopoly rather than other market structures, and should demonstrate an understanding of what oligopoly means (small number of large firms whose behaviour within the market is rendered interdependent by large market share). A diagram showing the kinked demand curve may be drawn in order to show that competition on price is unhelpful in either direction and the consequences of both price increases and decreases should be explained. As always, candidates who draw clear and properly labelled diagrams should be rewarded. Candidates who give real world examples of non-price competition should also be rewarded. Full marks can be earned without a diagram if the explanation is well done. If no discussion of non-price competition the mark should not exceed [7 marks].

**3. Explain the effects of inflation on a country's international competitiveness.**

Inflation reduces competitiveness. Candidates should produce a structure of reasoning which points to higher priced exports and relatively lower priced imports, if the inflation rate is higher than that of trade partners. This might lead to trade deficits and consequent depreciation of the currency, leading to the vicious circle of further imported inflation and lost competitiveness. Candidates should be rewarded for clear expression of these relationships and for understanding their interrelatedness. Answers which focus on domestic effects of inflation should be awarded few marks.

**4. Use an aggregate demand / aggregate supply diagram to analyse the likely effects of an increase in income tax.**

An increase in income tax may impact on AD and AS, although candidates are most likely to focus on the demand side.

As income tax increases, disposable income will fall and household consumption is likely to decline. Investment may also fall due to a worsening of business expectations and a lower level of sales. Both C and I are important components of AD. Therefore, AD will fall, the AD curve will shift to the left, causing the level of real output to fall.

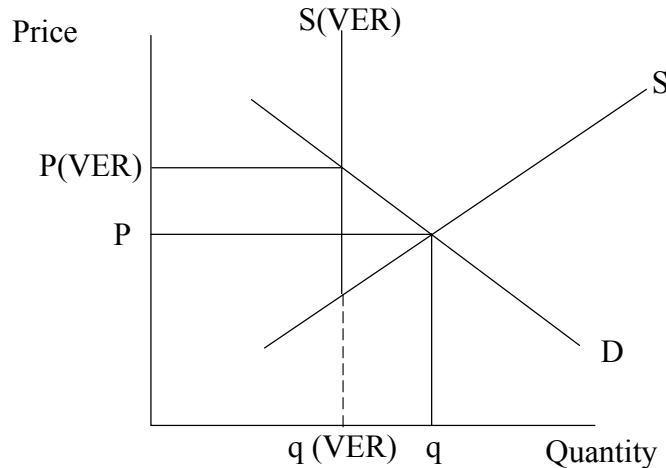
An increase in income tax may also cause real output to fall via a leftward shift of the AS curve. Here the tax increase may alter preferences between work and leisure, reducing the opportunity cost of leisure and making work less attractive. People's willingness to supply their labour will decrease, and aggregate supply will fall. Alternatively, it could be argued that an increase in income tax would increase the supply of labour, as people would have to work longer to achieve a given target level of income.

It should be possible for candidates to earn full marks for analysing either the demand or supply side effects, providing an accurate AD/AS diagram is drawn. The explanation of the diagram is incorporated into the text and the links between the increase in income tax and the shift of AD/AS are fully developed.

If no diagram is used, a maximum of *[5 marks]* should be awarded. If AD alone is considered then to earn a maximum of *[10 marks]* candidates should look at the impact of the tax increase on both consumption and investment. If only one of these is considered (together with a correct diagram) a maximum of *[7 marks]* should be awarded. For the diagram to be accurate it must be labelled correctly i.e. Price Level on the y-axis and GDP on the x-axis, and not price and quantity.

**5. What is a voluntary export restraint and who is likely to benefit from it?**

Candidates may or may not be able to produce a diagram, but should be rewarded if they can show a vertical supply curve at the point of the VER, with output less than equilibrium and consequently higher price and benefit to the domestic producer.



However, they may be able to answer the question without a diagram, referring to the externally applied quota and its resultant higher price / lower quantity. It is most effective when demand is price inelastic and products are differentiated. Candidates may give real world examples, and should be rewarded for this *e.g.* Japanese car manufacturers imposing VERs on themselves to avoid quotas applied by importing countries. The point is that the **self** imposed quota (VER), while appearing an act of self-denial, can be very advantageous to the producer. The issue of who is likely to benefit is quite open-ended so be prepared to reward any plausible answer.

**6. Why might a less developed country find difficulty in maintaining stable export revenues?**

Candidates might be expected to make some or all of the following points.

- LDC exports often have low income elasticities in MDCs. A good example would be exports of foodstuffs. Thus it is difficult to grow export revenues.
- LDCs often produce primary products for which supply is short run inelastic and demand in MDCs is price inelastic. Thus small changes in supply or demand will induce large price fluctuations, making the LDCs' export revenues unstable.
- Technical changes in MDCs have undermined markets for some LDC exports in recent years (*e.g.* ropes were made of natural fibres from the Indian subcontinent, but now nearly all rope is synthetic fibre from MDCs).
- Technical changes in LDCs have raised productivity, increasing supply and leading to lower commodity prices, particularly in agriculture.

*Reward should be given for examples which show some real world awareness.*

Two reasons fully explained or three or more in less detail can earn up to [10 marks].