

MARKSCHEME

November 2006

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 as indicated. Each question is worth [10 marks].

- 1. Use a diagram to explain how the incidence (burden) of a tax is shared among producers and consumers when an *ad valorem* indirect tax is placed on a good which has relatively inelastic demand.**

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

- definition of indirect tax
- definition of *ad valorem* tax
- definition of inelastic demand
- diagram showing a relatively inelastic demand and an upward shift of the supply curve where the gap between the curves (the *ad valorem* tax) widens
- the diagram should indicate that consumers bear a greater burden of the tax than producers
- an explanation that since demand is relatively inelastic, producers will be able to pass on a higher proportion of the tax to the consumer

If the question is answered in terms of a specific tax (parallel shift in the supply curve) then up to a maximum of [6 marks].

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

- 2. A monopoly firm decides to maximize revenue rather than profit. Use a diagram to explain what will happen to price and quantity.**

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

- definition of monopoly
- distinction between revenue and profit
- diagram including an AR(D), MR and MC curve
- diagram should show profit maximizing level of output ($MC = MR$)
- diagram should show revenue maximizing level of output ($MR = 0$)
- an explanation that when there is a move from profit maximization to revenue maximization, output will increase and the price of the good will fall

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3. Explain how an increase in government spending can lead to crowding out.

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

- increase in government spending may involve an increase in the demand for loanable funds/money
- this will result in an increase in the interest rate
- higher interest rates raise the cost of borrowing to firms and therefore investment is likely to fall
- governments use of loanable funds means that there is less available for private investment (notion of crowding out)
- a diagram showing the demand and supply for loanable funds (money) may be used together with an investment diagram
- a diagram showing AD/AS, with AD shifting to the right (due to an increase in government spending) and then to the left (due to a fall in investment) may be an alternative

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4. Explain how a progressive tax system may be used to redistribute income.

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

- definition of progressive tax
- a numerical example to illustrate the concept of progressive tax may be used
- an explanation that progressive taxation is designed to reduce the burden of tax on lower income earners
- government tax revenue can be used to redistribute income to these low income earners
- the redistribution of income may take the form of transfer payments, subsidies and spending on merit goods
- a diagram may be used to show that progressive taxation results in a higher tax paid at higher levels of income

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5. Explain the link between the Marshall-Lerner condition and the J-curve effect.

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

- explanation of the Marshall-Lerner condition
- explanation of the J-curve effect
- a diagram showing the J-curve
- explanation that in the short-run, PED for exports and imports is expected to be inelastic, with the combined elasticities being less than one
- in the long-run, the PED for exports and imports are expected to increase such that the combined elasticities will be greater than one
- a current account deficit may be reduced by a depreciation/devaluation, but due to the inelastic demand for exports and imports, the current account balance is likely to worsen in the short run (J-curve)
- in the long-run, as the elasticity of demand for exports and imports increases, the current account balance will improve (Marshall-Lerner)

Candidates may define a number of concepts correctly but to reach Levels 3 and 4 candidates must attempt to explain the linkage.

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6. Explain which is likely to be higher in a Less Developed Country – Gross National Product *or* Gross Domestic Product?

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

- a definition of GNP
- a definition of GDP
- an observation that the difference between the two is net property income from abroad
- a high proportion of an LDC's economic activity may be generated by MNCs
- if MNC profits are repatriated it may result in a negative net property income from abroad
- the result is that GDP is greater than GNP
- in some cases it may happen that GNP would be greater than GDP in some LDCs receiving substantial workers' remittances. Reference to this should be rewarded

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