

Paper 14 – Marking Scheme

1.

i. **How does freedom to enterprise and freedom of choice affect functioning of free market economy? (4 marks)**

- Freedom to enterprise is People have freedom to own property, organize them in the production process, produce and sell goods and services according to their own preference. (01 Mark)
- Freedom of choice is
 - a. Workers have freedom to choose their job according to their ability. (1/2 Mark)
 - b. Consumers have the freedom to buy goods and services according to their preference from their income. (1/2 Mark)
 - c. Firms have freedom to decide which goods to produce, in which quantity, using which technology. (1/2 Mark)
- Freedom of enterprise and freedom of choice makes all economic actors (agents) to take their decisions freely based on the market signals. (01 Mark)
- Thereby, these factors helps to allocate resources efficiently based on market mechanism/ price mechanism (1/2 marks)

ii. **Explain difference between the following terms: (02 marks each)**

a. **Traditional Economy Vs. New Traditional economies**

Traditional Economy	New Traditional Economy
Traditional economies are economies those in which basic economic problems are solved through traditions, customs and beliefs. (1/2 marks)	These are the economies those show a tendency to make economic decisions though a cultural framework based on religion or customs. (1/2 Marks) (These are also known as Islamic economies)
These are simple self- sufficient economies such as tribal economies where it uses simple technology. (1/2 marks)	These economies are connecting with new technology and modern economic world. (1/2 Marks)
Ex:- African Tribal Groups	Ex:- Iran, Pakistan, Afghanistan, Iraq

b. Social market economy Vs. socialist market economy

Social market economy	Socialist market economy
Social market economy is the market economy that highly emphasis social equity and social policy favoring social insurance. (1/2 marks)	This is the economic system, which is based on socialist principals (state-owned enterprises) but allow the functioning of market mechanism in the economy in economic decision-making. (1/2 marks)
Therefore this economic system combines merits of both free market economy and planned economy. (1/2 marks)	In this economy property ownership is largely owned by public sector but basic economic problems are solved through market mechanism. (1/2 marks)
Ex:- Norway, Germany, Switzerland	Ex:- China

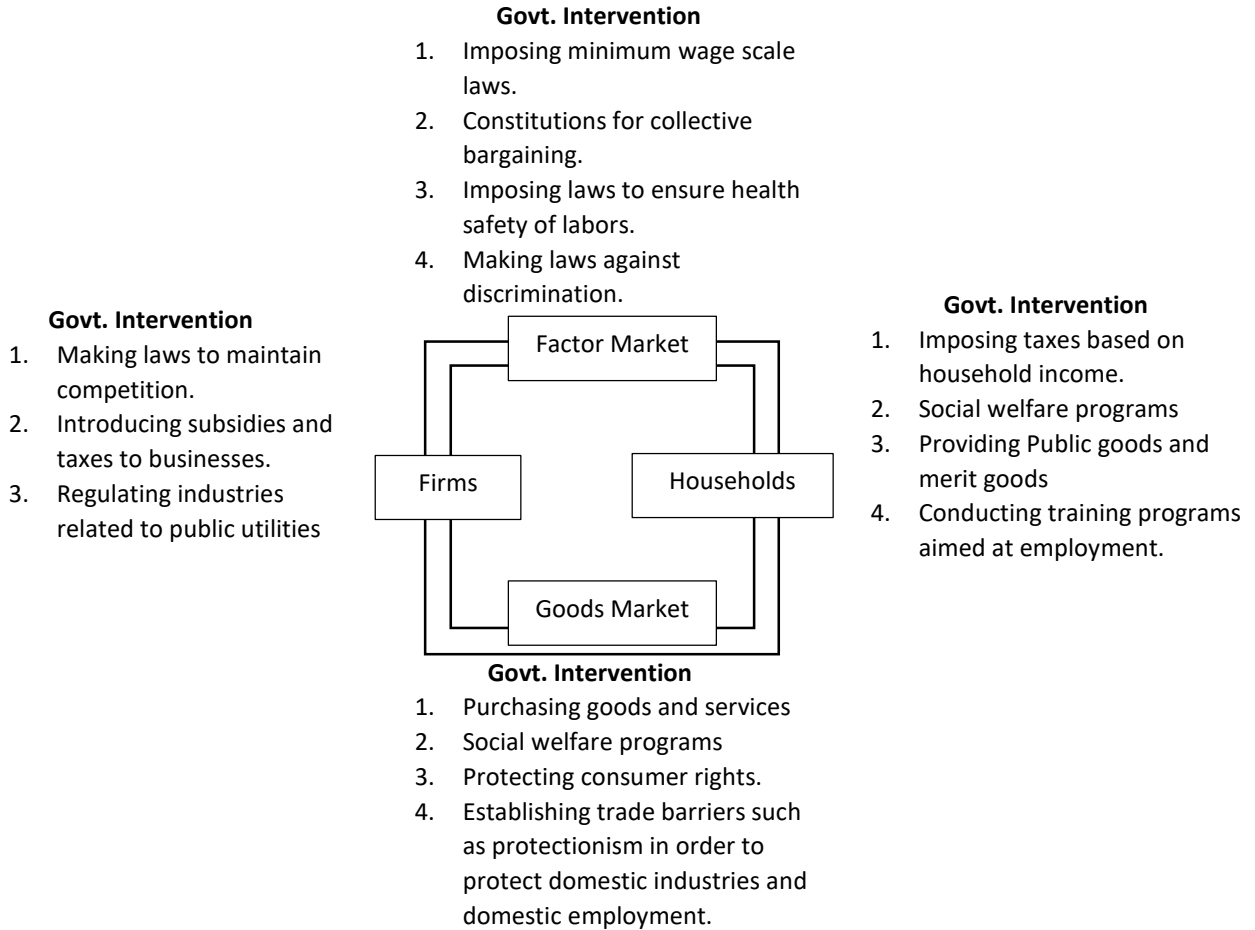
c. Social Capital Vs. Human capital

Social Capital	Human Capital
This refers to the institutions, relationships and norms established by the group of people for the common good from which shape the quality and quantity of a society's social interactions. (1/2 mark)	Human capital refers to the improved labour power through education and training. (1/2 Marks)
Ex :- Youth clubs, Maranadara samithi (1/2 mark)	Human capital is a result of an investment made in humans and it improves labour productivity (1/2 Marks)

iii. "Property ownership is essential for the functioning of a market economic system. "Do you agree? Explain (3 marks)

- Yes (1 mark)
- Private property ownership enables people living in the society to buy and sell property. (1/2 mark)
- In a society where property ownership is not established, people have been given the freedom to acquire goods and services, without any pay. Thus, in such an economy, people will have to sacrifice their time and resources in order to protect their property from stealing. (1 mark)
- Private property ownership, establishes private enterprises and the opportunity to produce and consume goods and services with much freedom since they can claim the ownership. (1/2 mark)

- iv. Using an appropriate diagram explain how government intervenes each and every section of a mixed economic system. (4 marks)



- v. What are the characteristics of Islamic economic systems? (3 marks)

- Property Ownership
 - Both private and public property can be seen.
 - Property is owned by the god. Humans are only guardians, not the actual owners.
 - When referring to public property, it is said that it has been created by god for the use of every person equally.
- It is illegal for buyers and sellers to decide the market price. Instead it should be decided based on market demand and supply conditions.
- Govt. intervention is encouraged in special situations.
- Charging interest on investments is not accepted.
- Banking, financial activities and businesses are carried out in line with Sharia law. (Any of appropriate 03 points 03 marks)

2.

I. **“When you move along the demand curve, you must hold income constant, yet one factor that can cause a change in the quantity demanded is an “income effect”. Explain. (03 marks)**

- Demand curve is drawn by assuming the fact that all other factors (including income) those affect to demand held constant. Thus, demand curve shows the negative relationship between price and quantity demand. (01 mark)
- Change in quantity demand (when a point move along the demand curve) considers when other factors held constant, the changes taking place in the quantity of the concern good due to a change in price of the concerned good. (01 mark)
- When price of the concern good is changed, quantity demand of the concern good changes due to income effect and substitution effect. (1/2 mark)
- In this context, ‘income effect’ is when nominal income (money income) remain constant if price of the concern good changes, change in ‘real income’ of consumers leading to a change in purchasing quantity. (1/2 mark)
- Thus, income effect also contributes when point is moving along the demand curve.

II. **“A Giffen good is an inferior good, but an inferior good is not necessarily a Giffen good.” Explain. (3 marks)**

- The effect of a change in price of an inferior good is different. For an inferior good, the income effect is negative. Thus for an inferior good, a lower price does not always lead to an increase in the quantity demanded. (1/2 Marks)
- The lower price has a substitution effect that always increases quantity demanded. This substitution effect is offset to some degree by the negative income effect. The final result depends on the relative strengths of the two effects. (1/2 Mark)
- Thus, for some inferior goods, the negative income effect only partially offsets the substitution effect, and therefore, quantity demanded increases as a result of the price decrease, though not as much as for a normal good. This is the typical pattern for inferior goods, and it too leads to negatively sloped demand curves. (01 Marks)
- When the negative income effect actually over weighs the substitution effect, and thus leads to a positively sloped demand curve. This is the case of Giffen goods. For this to happen, the good must be inferior. But that is not enough; the change in price must have a negative income effect strong enough to more than -offset the substitution effect. Therefore, all inferior goods are not Giffen goods. (01 Marks)

III. What types of goods have (02 marks)

a. Positive price elasticity of demand.

Giffen goods, Speculatory goods, Veblen goods (snob goods)

(Either one of the answers (1/2 Mark))

b. Negative cross elasticity of demand

Complementary goods (1/2 Mark)

c. Income elasticity of demand greater than one

Luxury goods (1/2 Mark)

d. Income elasticity of demand less than one

Essential goods (1/2 Mark)

IV. "Without a want a demand may not occur, but demand is not just a want." Do you agree?

Explain? (03 marks)

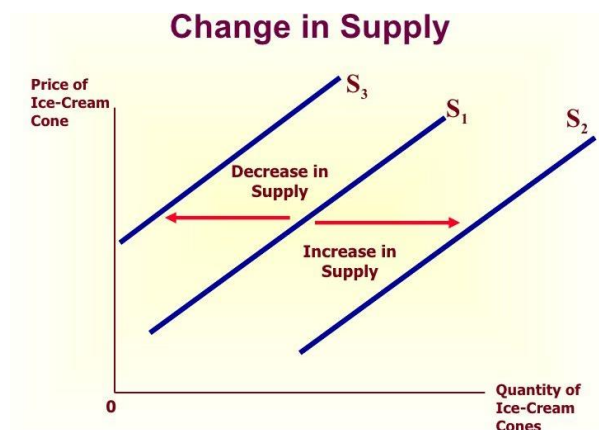
- Yes, I agree (1/2 mark)
- Want is a narrow concept but demand is a broader concept than want. (1/2 mark)
- In addition for the consumers' having a want to purchase a good, the following 2 conditions should also be satisfied in order for a want to be a demand.
 - Consumers have a purchasing power to purchase a good. (01 mark)
 - Consumers have planned to purchase a good. (01 mark)

V. What is the difference between change in supply and change in elasticity of supply? (03 marks)

Change in supply:

- Refers to a shift in the whole supply curve that is a change in the amount that will be supplied at every price. (1/2 mark)

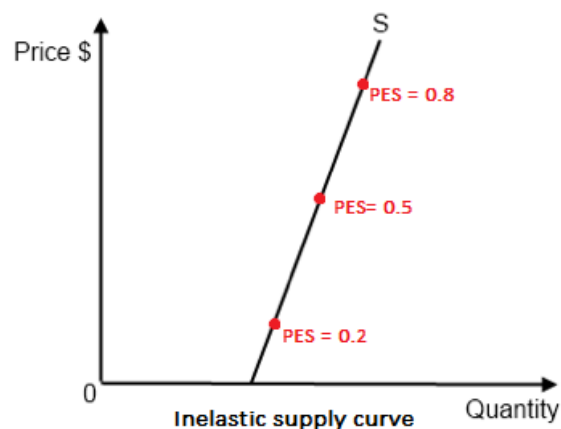
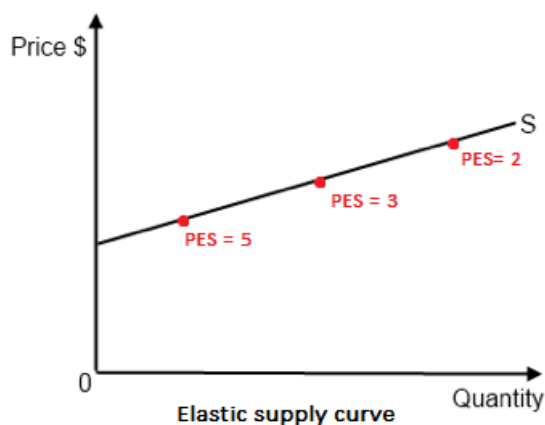
(1/2 mark for the correct diagram)



- **Change in price elasticity of supply:**

- Price elasticity of supply is the measure of the responsiveness of the quantity supplied of a good to changes in its own price.
- In an upward sloping supply curve which is inelastic, coefficient of PES will be less than 1 but increases when moving along the supply curve from left to right. (1/2 Mark)
- In an upward sloping supply curve which is elastic, coefficient of PES will be greater than 1

Item	Price support system
Consumer surplus	A
Producer surplus	B+C+D+E+G
Govt. expenditure	D+E+G+G+H+I
Net social welfare (Dead weight loss)	D+E+G



but decreases when moving along the supply curve from left to right. (1/2 Mark)

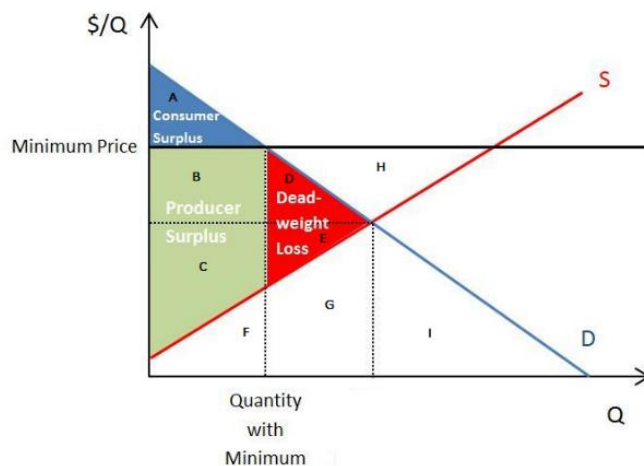
- At each point coefficient of PES will remain constant in perfectly elastic, unitary

elastic and, perfectly inelastic supply curves.

(01 mark for the 2 diagrams)

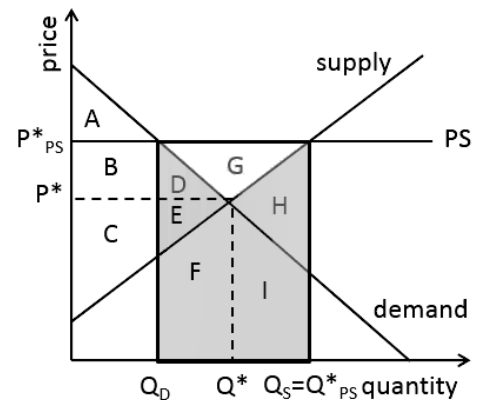
VI. Using an appropriate diagram, appropriate diagram show consumer surplus, producer surplus, government expenditure and dead weight loss in following incidences.

a) Price floor without a price support system (02 marks)

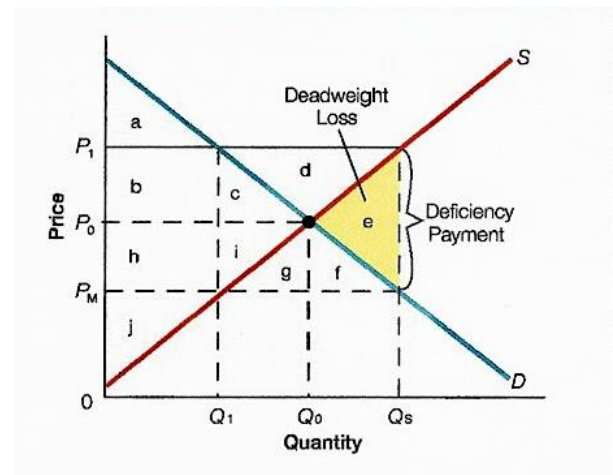


b) Price floor with a price support system that government purchases excess stocks (02 marks)

Item	Deficiency payment system
Consumer surplus	A+B+C+F+G+H+I
Producer surplus	B+C+D+H+I+J
Govt. expenditure	B+C+D+E+F+G+H+I
Net social welfare (Dead weight loss)	E



c) Price floor with a deficiency payment system (02 marks)



Item	Without Price support system
Consumer surplus	A
Producer surplus	B+C
Govt. expenditure	0
Net social welfare (Dead weight loss)	D+E

3.

i. Why do economists regard normal profit as a cost? (04 marks)

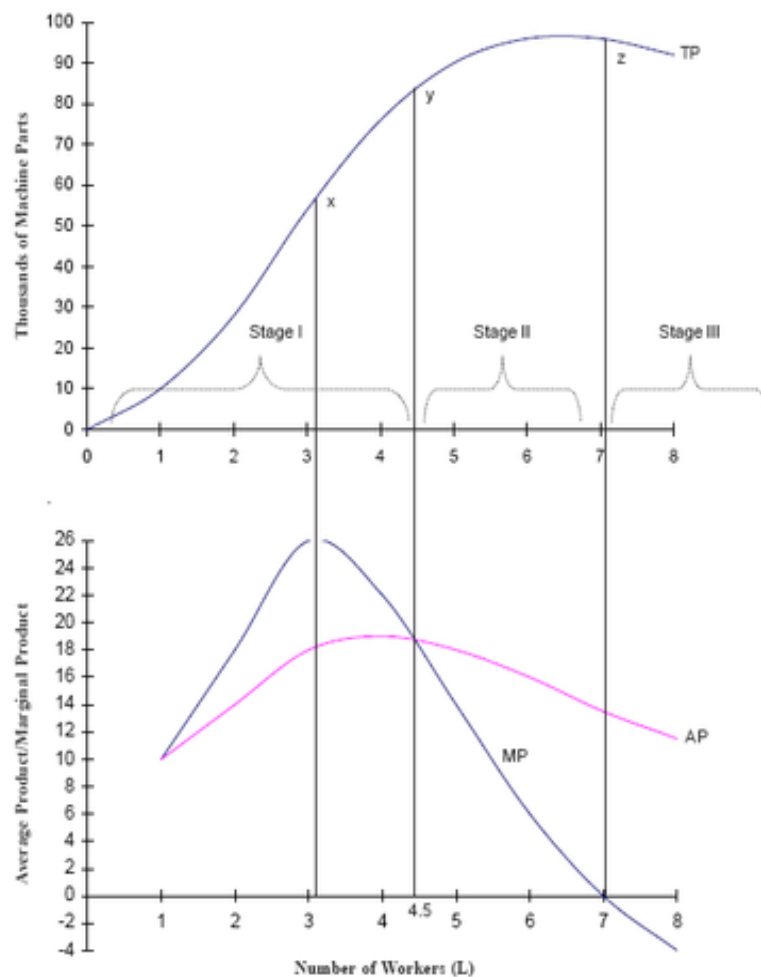
- Normal profit is the minimum expected profit (return) by an entrepreneur as the

factor return for the entrepreneurship that he has supplied for the firm (1/2 mark)

- In other words, if he does not receive at least a return equals to normal profit he will opt out from the current business and may involve with some other more profitable business opportunity. (1/2 Marks)

- Thereby, normal profit is the minimum incentive expected by an entrepreneur for the risk he has taken in starting the business and to justify staying in the current business. (1/2 Mark)
- Thereby as the same way rent, wages, interests are considered as costs since they are the cost of obtaining land, labour and capital, normal profits should also be considered a cost since it is the cost of obtaining entrepreneurship (1/2 Mark)
- However, it is an implicit cost but not an explicit cost (1/2 Marks)

ii. Using an appropriate diagram, explain the relationship between average production, marginal production and total production curves. (04 marks)



- At first, TP increases at an increasing rate where MP is also increasing. (1/2 mark)
- Then, the MP starts to decrease, but still positive, and in this stage TP increases at a decreasing rate. (1/2 mark)
- When MP is zero, TP becomes highest, and if production is further increased MP will become negative where TP will start to decrease. (1/2 mark)
- AP will increase as long as $MP > AP$. (1/2 mark)
- AP will reach its maximum when $AP = MP$. (1/2 mark)
- AP will decrease when $AP > MP$. (1/2 mark) (01 mark for the correct diagram)

iii. What is the reason for the fixed cost curve to become a horizontal straight line whereas total variable cost curve to become a curve with an upward sloping curve?(04 marks)

- In the short run, total fixed cost will not change with the level of output. It will remain constant, irrespective of the level of output. Thereby it becomes a straight line parallel to the horizontal axis. (1 Mark)
- In the short run, total variable cost will change with the level of output. When the level of output increases TVC will increase. Initially, TVC will increase at a decreasing rate due to increasing marginal returns, whereas TVC will increase at a higher rate after a particular point due to diminishing marginal returns. (1 Mark)
- When the slope of TVC curve at each quantity is plotted in to graph, it is equal to the marginal cost curve. TVC will have a positive slope (upward slope), as marginal cost is always positive. (1 Mark)

iv. 'Economies of scale can mostly be able to obtain by the large scale businesses'. Briefly explain main factors contribute to create economies of scale and how large scale businesses receive advantage of economies of scale rather than small businesses. (04 Marks)

a. Indivisibility nature of inputs (Inputs are indivisible with output) (1/2 Mark)

Some of the input (such as machines) cannot be adjusted based on the level of output. For example production capacities of the machines are fixed and it cannot be adjusted based on level of output. Thus, economies of scale takes place when machines have large capacities are used in to production. However, if such machine is used in to small production there will be huge resources wastage since large part of machine capacity remain unutilized. (1/2 Mark)

b. Ability to create specialization through division of labour (1/2 Mark)

Division of labour makes production efficient by increasing labour productivity. This helps to use more capital goods at each production process and reduce time consumed for production significantly. However, this benefit of division of labour can mostly be obtained by the large businesses only. For small businesses division of labour is not appropriate and probably through division of labour there can have resource wastage in small businesses. (1/2 Marks)

c. Ability to use machinery (1/2 Marks)

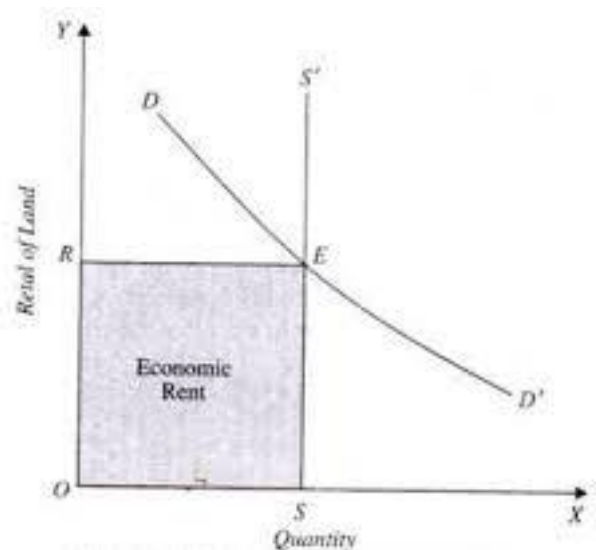
Due to division of labour large businesses will be able to introduce specific machinery (capital equipment) to each stage of production in order to improve productivity in production. However, this advantage will mostly be with the large businesses but not with the small businesses. (1/2 Marks)

d. Existence of one-time costs (1/2 Marks)

Expenditure such as research and development cost, advertising and promotional cost are one-time costs. These costs become productive if these costs help to increase sales and production of the business. Thereby, mostly large organizations will be able to spend large sums on their research and development cost, advertising and promotion etc. to improve their sales significantly and reduce unit cost greatly. Thereby, through these kinds of costs most of the time benefit is delivered to large organizations only.

v. For a particular factor of production, in which situation the total factor earnings will consist of only with economic rent? Explain your answer with use of a diagram (4 marks)

- Economic rent is the return that the factor owner receives over and above the minimum expected return required to provide a factor of production for a particular economic activity. (1/2 Mark)
- In other words, extra return received on top of expected return by the factor owner to continue the supply of a particular factor of production into a particular economic activity. (1/2 Mark)
- It is the difference between the actual earning and the transfer earning.
- For a particular factor of production the total factor earnings will consist of only with economic rent when the supply of factor is perfectly inelastic. (01 Mark)
- correct Graph: (01 Mark)



i. “All production activities should be included in GDP calculations” Do you agree? Explain your answer with examples. (4 marks)

- Disagree with the statement.
- Even though conceptually, all productive economic production should be included in national accounts due to various practical reasons some of the productive activities are excluded from national accounts.
- Any new good created by a purely natural process without human involvement or direction is not considered as production in national accounts even though it can be considered as a productive economic activity since it involves generating a new product.

Ex: the unmanaged growth of fish stocks in international waters is not production, whereas the activity of farming is production.

Growth of trees in maiden forests is not production, whereas, the activity of agriculture is production.

Free flow of water in a river or a stream is not production, whereas water collected and used for agriculture is production.

- For a productive economic activity to be included in GDP calculation it should be within the production boundary.
- The productive economic activities excluded from national accounts are:
Some self-services
Non-observed economic activities
Production of natural resources purely by a natural process without any human involvement or direction
Leisure

ii. What is the impact of the following economic activities on GDP of a particular year? (4 marks)

i. Service given by the hired family driver

Included in SNA under income method

ii. Increase in forest area

Excluded in SNA as it is considered unproductive

iii. Dividend income earned by selling shares

Included in SNA under income method

iv. Purchasing of a bond

Excluded in SNA as it is a pure financial transaction

iii. How does the problem of double counting arise in calculating GDP, and how is it corrected? (4 marks)

- The double counting error is the error of including the same value more than once in the calculation of national accounts.
- National income value would be overstated by adding intermediary goods values since even final products include the same value.
- There are 2 alternative methods to solve the error of double counting;
 1. Final method value – Considering only the final value without intermediary value.
 2. Value added method – Considering only the value added in all productive economical stages.

iv. You have been given the following data for a hypothetical economy

Item	Value (Rs. Billion)
Value added in agricultural sector	2 400
Value added in industrial sector	3 200
Receipts of primary income	6 000
Taxes on goods and services	12 000
Fixed capital consumption	7 400
Payments of primary income	9 000
Subsidies on goods and services	5 000

Value added in service sector	4 200
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Calculate the following based on the following data

a. Gross domestic product at market price (02 marks)

$$\begin{aligned}
 \text{Gross domestic production} &= \text{GVA of agricultural sec} + \text{GVA of industrial sec} + \text{GVA of service sec} - \text{net taxes} \\
 &= 2400 + 3200 + 4200 + 12000 - 5000 \\
 &= \underline{\text{Rs. 16 800 billion}}
 \end{aligned}$$

b. Net domestic product at market price (02 marks)

$$\begin{aligned}
 \text{Net domestic product} &= \text{GDP at market price} - \text{CFC} \\
 &= 16\,800 - 7\,400 \\
 &= \underline{\text{Rs. 9 400 billion}}
 \end{aligned}$$

c. Gross National Income (2 marks)

$$\begin{aligned}
 \text{Gross national income} &= \text{GDP at market price} + \text{NPI from rest of the world} \\
 &= 16\,800 + (6\,000 - 9\,000) \\
 &= \underline{\text{Rs. 13 800 billion}}
 \end{aligned}$$

d. Net national income (2 marks)

$$\begin{aligned}
 \text{Net national income} &= \text{GNI} - \text{CFC} \\
 &= 13\,800 - 7\,400 \\
 &= \underline{\text{Rs. 6 400 billion}}
 \end{aligned}$$

4.

i. Examine the economic costs of large budget deficits. (05 marks) (Any correct 05 points -05 marks)

- If overall fiscal deficit is financed through inflationary sources economy will face inflationary pressure
- If overall fiscal deficit is financed domestic non-inflationary effect it can lead to crowding out effect and domestic interest rates can rise.
- If overall fiscal deficit is continuously financed through foreign sources economy can lose its international credit worthiness
- Overall fiscal deficit can hinder economic growth and it can lead to economic instability.
- By financing overall fiscal deficit continuously through foreign sources local currency can get depreciated and it can lead to lose external value of local currency
- Domestic saving gets weaken

ii. For what economic reasons might there be public hostility to the transfer of publicly-owned assets to the private sector. (04 marks)

(One mark each for correct point and altogether 04 marks)

- Risk of creating a private sector monopoly instead of public sector monopoly.
- Negative impact of social welfare since private sector is motivated by profits.
- If privatization happens with multinational/foreign companies, profits will be flown out of the country
- When profitable enterprises of the public sector are privatized government will have less income to support important welfare expenditure such as education, health care etc.
- Government loses economic control.
- With the privatization if labour is laid-off unemployment can get increased
- Negative externalities that could cause when private sector narrowly focused on profits.

iii. There are progressivity, proportionality and regressively characteristics of the major taxes of the central government of Sri Lank. Give three examples of taxes to represent each of these characteristics. (3 marks)

Progressive Taxes (Any Correct answer 01 mark)

- Private Income tax
- Corporate income Tax

Proportionate Taxes (Any Correct answer 01 mark)

- VAT
- Import Tax
- Economic Service Charge (ESC)

Regressive Taxes (Any Correct answer 01 mark)

- Production Taxes (on Liquor, Tobacco, Petrol, Diesel, Kerosene)

iv. Explain following terms:

a. Externalities (01 marks)

An externality is a consequence (a cost or a benefit) of an economic activity (consumption or production) that is experienced by unrelated third parties.

b. Interim budget (01 marks)

Budget prepared during emergency is interim. Interim means in the mid or before the actual date when the budget is supposed to be made. If there are elections during budget then an interim budget is prepared and later after new government is formed the normal budget is prepared. The difference between Vote on Account and Interim Budget is Vote-on-account deals only with the expenditure side of the government's budget, an interim Budget is a complete set of accounts, including both expenditure and receipts.

c. Neutrality of taxation (01 marks)

Neutrality in taxation is the principle that ensures the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

d. Common resources (01 marks)

- there is ***no ability to exclude*** a person or persons from the consumption of a good (***non-excludable***) and
- but one additional person's consumption ***deplete*** the benefit or utility of existing consumers (***rivalrous***)
- Ex:- Fish stock, common grass lands, atmosphere, rivers, reservoirs

e. SOE (State Own Enterprises) (01 marks)

State Owned Enterprises are,

- government institutes and corporations
- those either produce or distribute goods and services
- those can be supplied through market mechanism

v. Distinguish between statutory tax incidence and economic tax incidence (03 marks)

a. Statutory or legal incidence of tax

This is legally who is liable to pay the tax to the government and the total amount that s due to pay to the government. (01 mark)

Ex;-In Income tax – Income earner (total income tax)

In goods and services tax – Producer (Unit tax on the product)

b. Economic or real incidence of tax

This is the change in real income of the parties who involved in tax. For example the division of a tax burden between buyers and sellers (01 mark)

- c. Difference between statutory incidence and economic tax incidence is related to the price elasticity of supply and demand. Party who has higher inelasticity has to bear higher tax burden. If a higher tax burden is passed on to supplier it is known as backward shift & if a higher tax burden is passed on to consumer it is known as forward shift of tax incidence. (01 mark)

5.

i. **What are the key expectations of taxation? (3marks)**

- Reduce disparities in income and wealth distribution
- Efficient management of resources
- Discourage consumption of demerit goods which have a high social cost.
- To make an impact on aggregate demand and aggregate supply to achieve macroeconomic objectives.

ii. **In order to create an equitable tax system there are 2 principles that need to be adhered. What are they? Explain. (2 marks)**

- Horizontal equity – means that individuals with comparable incomes pay comparable levels of taxes (*comparable equally*) (01 mark)
- Vertical equity - means that individuals with higher levels of income pay a higher level of taxes than those with lower levels of income. (*incomparable unequally*) (01 mark)

iii. **What are the 2 policies used to explain how public finance helps in achieving macro-economic objectives? Explain. (4 marks)**

- **Automatic stabilization policy (01 mark)**

According to automatic stabilization policy, the fiscal policy acts as an automatic stabilizer in stabilizing the economy from fluctuations of the business cycle. (01 mark)

Eg: In the expansionary phase of the business cycle, with the increase in income, the amount of tax paid by households and business firms increase. The expansionary effect created by the increase in income is automatically controlled by the increase in taxes. Thereby the economy will achieve macroeconomic stability.

- **Discretionary policy**(01 mark)

According to discretionary policy, they believe that macroeconomic stability doesn't take place automatically. Policy makers intervene and change govt. expenditure and revenue accordingly to correct fluctuations in the business cycle.

iv. What is meant by crowding out effect of financing budget deficit? What are the 2 main reasons for creating crowding out effect? (3 marks)

- Crowding out effect is private investors losing the opportunity to obtain funds for their investments since government is absorbing funds available in commercial banks and non-banking financial institutions to finance fiscal deficit. (01 mark)
- Crowding out effect is created due to,
 1. Limitation of funds in the market when government absorbs funds available in the financial market.
 2. With the increase of demand for funds (demand of both private and govt. sector) interest rates get increased. Thus, private sector gets discouraged to invest.

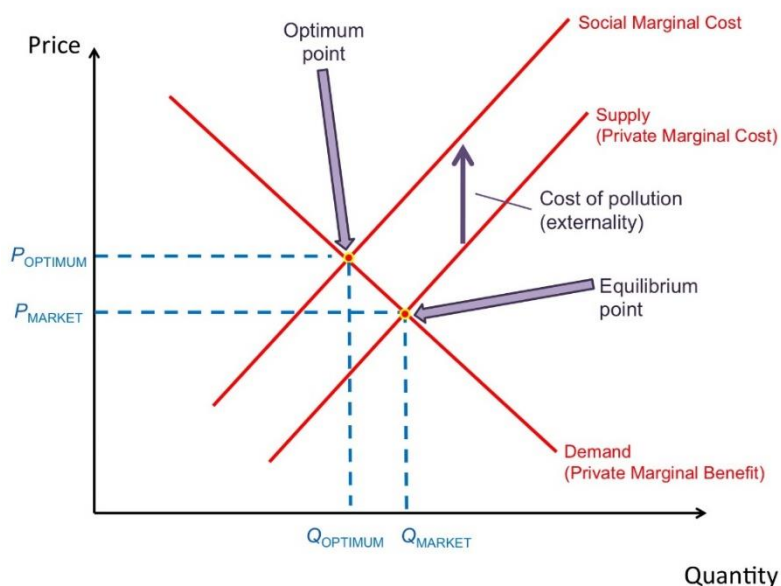
v. Use a diagram to explain how, negative externalities of production results to market failure? (4 marks)

A production related negative externality is an unrelated third party experiencing a cost due to production of a good or service. (1/2 Mark)

Eg: Due to air pollution by a factory nearby villages are experiencing respiratory problems.(1/2 mark)

When there are negative externalities social cost is higher than the private cost thereby market mechanism allocates higher amount of resources for these products than the optimum level of resource allocation. (Current market quantity will be higher than optimum market quantity.)(1 mark)

Correct graph: 2 marks



vi. Give recent statistics regarding government expenditure?

(4 marks)

- Govt. expenditure as a percentage of GDP has increased over time but reduced in 2018 particularly due to lower public investment (which was affected by political tensions that prevailed towards the end of the year resulting in delays in the implementation of budgetary operations) . (01 mark)

	2015	2016	2017	2018	2019
Govt. expenditure as a percentage of GDP	20.9%	19.6%	19.2%	18.6%	19.4%

- Recurrent expenditure consisted of a higher percentage in govt. expenditure. (01 mark)

	2017	2018	2019
Govt. expenditure as a percentage of GDP	19.2%	18.6%	19.4%
Govt. recurrent expenditure as a percentage of GDP	14.4%	14.5%	15.3%
Govt. capital expenditure as a percentage of GDP	4.8%	4.2%	4.1%

- Composition of the government current expenditure (economic classification) where the highest component was interest payments. (2019) (01 mark)

Interest Payments	31%
Salaries and wages	24%
Transfers to households	14%

- Composition of the government current expenditure (functional classification) where the highest component was interest payments.(2019) (01 mark)

General Public services	16%
Economic services	21%

Social services	31%
Other(Interest payments)	31%

6.

i. Define & give reasons causing 'market failure' & 'government failure' (05 marks)

Government Failure	Market Failure
<p>Government failure arises when <u>government intervention</u> in the market system (to improve market failure) <u>worsens the situation</u>. In other words, government intervention in the market system increases market distortions and reduces welfare and economic efficiency. (1 marks)</p> <p>Reasons for government failure (any of the three correct answers 1 1/2 marks)</p> <ul style="list-style-type: none"> · Poetical self interest · Policy myopia (shortsightedness of policy making) · Politicalizing · Bureaucracy · Corruption · Incentive problem · Very rigid regulations · Delay in decision making <p>Problems of information (lack of information)</p>	<p>Market failure is a situation that price mechanism/market mechanism fails to allocate resources efficiently (1 marks)</p> <p>Reasons for market failure (any of the three correct answers 1 1/2 marks)</p> <p>a. Situations where market economy fails to allocate resources efficiently.</p> <p>I. Imperfect competition</p> <p>II. Externalities</p> <p>III. Non-provision of public goods</p> <p>IV. Inadequate provision of merit goods</p> <p>V. Provision of demerit goods</p> <p>b. Market economy does not make sure equal income distribution. Therefore there is a significant disparity between different income classes.</p>

ii. **Explain how following events creates externalities in a market economy:**

a. Many schooling age students gets education (01 Mark)

- This creates positive externalities. (1/2 Marks)
- When the person gets his education, he can contribute to the growth of the economy and it will help to uplift many other lives. (1/2 Mark)

b. Too many vehicles on the road and creates severe traffic congestion(01 Mark)

- This creates negative externalities. (1/2 Marks)
- When there are too many vehicles on the road it leads in to environmental pollution, road accidents, time wastage etc. Thereby, not only the persons who use vehicles but also the pedestrians and the overall economy may suffer. (1/2 Mark)

c. Provide vocational training to unemployed workers. (01 Mark)

- This creates positive externalities of consumption.(1/2 Marks)
- When an unemployed person gets vocational training his or her employability rises. As a result he/she can contribute to the economic development and the burden on public finance to provide unemployment benefits to these persons may go down. Thus, not only the unemployed worker but also the overall economy may benefit through this vocational training (1/2 Mark)

d. Not having proper waste disposal mechanism (01 Mark)

- This creates negative externalities. (1/2 Marks)
- When there is no proper waste disposal mechanism it will create many social and health problems such as dengue, malaria etc. Thereby, it may create a problem to overall society not only to the persons who do not have a proper place to dispose waste. (1/2 Mark)

e. Broadcast loud music though loud speakers and create public nuisance (01 Mark)

- This creates negative externalities. (1/2 Marks)
- When loud music is broadcasted, it creates nuisance to many persons who are not involved. Ex:- Awurudu Uthsawaya. Thereby, it creases uneasiness among many persons (1/2 Mark)

f. Spray words and make public palaces unpleasant (01 Mark)

- This creates negative externalities. (1/2 Marks)
- When public places become unpleasant it affects many persons who use these public places and it damages image of the country when foreigners visit the country. Further, in order to clean up those places public funds needed to be used. Thus, it negatively impacts overall economy (1/2 Mark)

g. Provide vaccinations to avoid communicable diseases. (01 Mark)

- This creates positive externalities.(1/2 Marks)
- Communicable diseases are the diseases those get infected from one person to another. Thereby when one person gets infected there is a chance that unrelated persons also getting infected. Thus preventing such communicable disease provide benefits to the entire society. (1/2 Mark)

h. Expenditure on research and development (01 Mark)

- This creates positive externalities. (1/2 Marks)
- Research and development expenditure helps to develop new technologies and innovations. Thus, it helps for the development of the economy which contribute to the betterment of many persons (1/2 Mark)

**iii. “Sri Lanka’s public finances are at a terrifying state”(Institute of policy Studies).
Identify the major weaknesses in public finances in Sri Lanka at present. (4 marks)
(any correct 4 points 4 marks)**

- Due to the widening budget deficit and outstanding government debt, debt service payment is at a rise.

	Budget Deficit		Outstanding Debt		Debt Service Payment	
	2018	2019	2018	2019	2018	2019
As % of GDP	-5.3	-6.8	83.7	86.8	14.5	13.5

- Large part of government revenue is spent to pay interest and repayment of loans.

	% of Government Revenue spent		
	2017	2018	2019
Repayment of loans	47%	64%	59%

Payment of interest	40%	44%	48%
Total debt service	87.5%	108.8%	107.0%

- To government tax revenue large contributor is still indirect Tax. Direct tax is relatively very low contributor to government tax revenue.

	Direct Tax		Indirect Tax	
	2018	2019	2018	2019
As % of GDP	2.2%	2.8%	9.7%	8.8%
As % of Tax revenue	18%	24%	82%	76%

- Total government revenue as a percentage of GDP was 17% in 2000 and it has come down to 12.6 in 2019 .
- The non-tax revenue to GDP ratio declined mainly due to the lower revenue collection stemming from the lack of dividend transfers by State Owned Business Enterprises (SOBEs) owing to their weak financial performance. (Refer earlier question for further study purpose)
- In government current expenditure large part of current expenditure comprises of inflexible expenditure items such as interest payment, Salaries and wages and household transfers.

	As a % of Current Expenditure		
	2017	2018	2019
Salaries and Wages	31%	30%	30%
Interest Payments	38%	41%	39%
Current Transfers to Households and Other Sectors	18%	16%	18%
Inflexible Recurrent Expenditure	87%	87%	87%

- iv. **Define what is 'imperfect information 'and 'asymmetric information' and explain how would both of them lead to market failure? (03 marks)**

- **Imperfect information** is a situation where the buyer, the seller, or both, are having less than 100% (imperfect) market information on what is being bought and sold. (01 Mark)
- As a result of imperfect information it creates inefficiencies in resource allocations in a market since consumers and sellers may either overestimate or underestimate the value of the product. This will lead in to market failure. (1/2 Marks)
- **Asymmetric information** is a situation where the both parties involved in an economic transaction have an unequal amount of information (one party knows much more than the other). Ex: - when a used vehicle is sold seller will know the condition of the vehicle better than the buyer of the vehicle. (01 Mark)
- When there an asymmetric information resource allocation will not be efficient since one party may enjoy a better advantage than the other party in terms of information. This will again lead in to market failure. (1/2 Marks)