



MARKSCHEME

November 2008

ECONOMICS

Higher Level

Paper 1

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

1. (a) Explain the determinants of price elasticity of demand.

[10 marks]

Responses **should** include:

- definition of price elasticity of demand (PED)
- explanation of elastic and inelastic demand with, preferably, appropriate diagram(s)
- determinants of PED, which **may** include:
 - availability of substitutes
 - time period
 - degree of necessity/habit forming
 - percentage of income spent on goods/price of goods
 - any reasonable response.

In order to move beyond Level 2, a candidate must explain at least two determinants of PED.

Examples to illustrate these determinants are required to move beyond Level 3.

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

- (b) **“A deterioration in a country’s terms of trade will always be disadvantageous for the current account balance.” Evaluate this statement using the concept of price elasticity of demand.**

[15 marks]

Responses **should** include:

- definition of terms of trade
- explanation of deterioration in the terms of trade
- explanation of relationship between terms of trade and current account.

Responses **may** include:

- possible factors that can cause a deterioration in the terms of trade such as lower demand for exports, higher demand for imports, a depreciation of the exchange rate, increases in oil prices (for oil importers) and technological progress lowering costs of production for certain exports
- explanation that if the terms of trade has deteriorated due to lower demand for exports and/or increased demand for imports, then this will definitely be disadvantageous for the current account
- if, however, the deterioration of the terms of trade is due to other factors, such as a depreciation of the exchange rate, then the impact on the current account balance will depend on the price elasticity of demand for exports and imports
- explanation of Marshall Lerner condition which is relevant in the event that there is a depreciation of the currency
- discussion of the problems associated with a deterioration of a country’s terms of trade for countries whose demand for exports and imports is inelastic (*e.g.* commodity-exporting countries):
 - low PED for exports means total export revenues fall
 - low PED for imports means total import expenditure rises
 - can lead to deficit on current account
 - can lead to depreciation of exchange rate which may be advantageous or disadvantageous
 - export prices can fall further due to depreciation of currency and terms of trade deteriorates even further
- discussion of the benefits associated with a deterioration of a country’s terms of trade for countries whose demand for exports and imports is elastic:
 - high PED for exports means total export revenues rise
 - high PED for imports means total import expenditure falls
 - can lead to improvement on current account
 - can lead to appreciation of currency which may be advantageous or disadvantageous
 - living standards can improve due to ability to afford more imports
 - benefits may increase further if deterioration of terms of trade has been caused by lower inflation at home and greater efficiency of domestic producers
- in the short-run, demand for exports and imports is likely to be inelastic and thus usually a deterioration in the terms of trade will cause a worsening of the current account (link to J-curve).

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

Effective evaluation may be to:

- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

2. (a) **Explain the concepts of allocative and productive (technical) efficiency.** *[10 marks]*

Responses **should** include:

- definition of allocative efficiency
- $MSC = MSB$
- $P = MC$
- definition of productive (technical) efficiency
- production is achieved at the lowest cost per unit
- bottom of AC curve
- technical efficiency may also be described as producing the maximum output with a given number of inputs.

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

(b) **“Monopolies are inefficient and therefore always act against the public interest.” Discuss this statement.** *[15 marks]*

Responses **may** include:

- an explanation of how a profit-maximizing monopoly will be allocatively and productively inefficient
- an observation that profit-maximization may not be the goal of a monopoly and therefore may be allocatively or productively efficient
- monopolies may act against the public interest:
 - welfare loss
 - anti-competitive behaviour
 - reduction in output and higher price
 - less choice
- monopolies may act in the public interest:
 - abnormal profits allow for research and development
 - ability to achieve economies of scale may lead to lower prices than a more competitive firm
 - natural monopolies
 - if a market is contestable, a monopoly will act in a more competitive manner and will act in the public interest.

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

3. (a) **Explain the difference between progressive taxation and regressive taxation.**

[10 marks]

Responses **should** include:

- definition of progressive taxation and example
- definition of regressive taxation and example
- progressive taxes may be used to redistribute income from rich to poor
- regressive taxes result in a more inequitable distribution of income.

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

- (b) **Evaluate the possible effects of a decrease in direct taxation on a country's inflation rate, unemployment rate and balance of payments.**

[15 marks]

Responses **may** include:

- definitions of direct taxation, inflation rate, unemployment rate and balance of payments
- explanation that taxation is a tool of fiscal policy
- explanation of how a decrease in direct taxation is likely to increase aggregate demand
- if the economy is near full employment, this will cause inflationary pressure
- if the economy is below full employment, this may lead to a fall in demand-deficient unemployment
- the incentive effect of lower taxes may shift LRAS
- higher disposable incomes may result in increased demand for imports
- inflationary pressure may result in decreased competitiveness of exports
- the current account may worsen.

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

Effective evaluation may be to:

- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

4. (a) Explain *three* barriers to economic development for developing countries. [10 marks]

Responses **should** define economic development and **must** explain any **three** of the following barriers:

- ineffective taxation structure
- lack of property rights
- political instability
- corruption
- unequal distribution of income
- formal and informal markets
- lack of infrastructure
- overdependence on primary products
- adverse movements in the terms of trade/a deteriorating terms of trade
- a narrow range of exports
- protectionism in international trade
- indebtedness
- non-convertible currencies
- capital flight
- social and cultural factors.

In order to reach level 3 candidates must explain each of their three factors in terms of how each of the factors acts as a barrier to economic development, as opposed to economic growth.

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

(b) Evaluate the view that trade is more effective than aid in achieving economic development.

[15 marks]

In order to evaluate effectively, candidates are likely to contrast the positive and negative effects of aid with the positive and negative effects of trade and come to a reasoned conclusion.

Responses **may** include:

Positive effects of aid:

- fills the savings, investment, foreign exchange and technology gaps
- food aid can act as emergency relief
- multilateral aid tied to a specific project is most successful in achieving economic development.

Negative effects of aid:

- aid often is given to governments and never reaches the people
- leads to dependency on donor nations
- food aid damages local agricultural producers
- masks poor government policies which have created large debts
- aid is often directed at urban areas which further worsens uneven income distribution
- aid may be tied, leading to greater benefits to the donor nation.

Positive effects of trade:

- leads to more choice for domestic residents
- increased access to lower priced imports which will help LDCs
- increased access to necessary drugs and sanitation programmes.

Negative effects of trade:

- disadvantages local agricultural producers
- unemployment
- dumping
- LDCs become locked into production of primary goods which limits their income potential and lessens the possibility of a steady source of income.

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

Effective evaluation may be to:

- consider short-term versus long-term consequences
 - examine the impact on different stakeholders
 - discuss advantages and disadvantages
 - prioritize the arguments.
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