



MARKSCHEME

May 2006

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

1. (a) Carefully distinguish between merit goods, demerit goods and public goods. [10 marks]

- definition and explanation of all three types of goods by referring to the following features:
 - merit: $MSB > MPB$, positive externalities, underproduction/underconsumption, example
 - demerit: $MSC > MPC$, negative externalities, overprovision/overconsumption, example
 - public: non excludability, non rivalry, free riders, example
 - distinguish between merit and demerit goods on the one hand and public goods, on the other
 - indicate that all three can lead to market failure
 - reward the drawing of a MSC/MPC diagram or any other relevant one.

Good candidates will probably define externalities.

(b) Evaluate the view that governments should always intervene in markets for such goods as cigarettes and alcohol. [15 marks]

- methods of intervention

Good candidates may identify different types of intervention *i.e.* market based and non market based.

For the view answers may include:

- cigarettes and alcohol as demerit goods
- market failure arising (overprovision)
- generation of negative externalities
- use of MSC/MSB diagrams
- importance of PED and tax revenue

Against the view answers may include:

- interferes with signalling and incentive functions of price.

Good candidates may identify the importance of price in allocation decisions.

- problems of particular types of intervention; *e.g.* smuggling and black markets arising from regulation, equating the tax levied to the value of the negative externality
- higher prices to consumers (inflation)
- impact on output and employment despite low PED.

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2. (a) **Explain the difference between demand-side and supply-side economic policies.** **[10 marks]**

- explanation of demand-side policies in terms of monetary and fiscal policy
- explanation of supply-side policies in terms of particular policies, *e.g.* tax cuts, welfare cuts, privatisation, deregulation and an outward shift of the LRAS curve
- use of AD/AS diagram to illustrate the difference

Reward references to the Keynesian/Monetarist debate.

- (b) **“Higher economic growth can only be achieved through the implementation of supply-side policies.” Discuss.** **[15 marks]**

Answers may include:

- definition of economic growth
- illustration of economic growth in terms of an outward shift of the PPC/LRAS curve
- distinction between actual and potential growth
- explanation of linkages between supply side policies and growth
- importance of AD
- Reward references to the Keynesian Monetarist debate
- demand side policies and the multiplier effect
- interdependence of supply side and demand side policies

This is potentially a big question for candidates to tackle. Do not expect answers to be able to cover the greater part of the above. Good candidates should be able to show how supply side policies can increase economic growth. They also need to be able to discuss this in the context of alternative demand side policies.

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3. (a) **Explain why an improvement in a country’s terms of trade does not always lead to an improvement in its balance of payments on current account.** **[10 marks]**

- definition of terms of trade
- definition of current account
- explanation of improvement in terms of trade
- impact of higher export prices/lower import prices on the current account
- importance of PED

Some candidates may confuse this with the balance of trade. If so, do not automatically award zero, reward relevant material if it appears.

- (b) **An economy is currently experiencing a deficit on the current account of its balance of payments. The government is considering *either* allowing the exchange rate to fall *or* reducing aggregate demand.**

Evaluate the relative advantages *and* disadvantages of these two policies.

[15 marks]

Exchange rate fall answers may include:

- explanation of how the exchange rate can fall (depreciation/devaluation)
- reference to expenditure switching policies
- exports cheaper/imports more expensive – increase in demand for exports, fall in demand for imports
- importance of PED/Marshall Lerner
- importance of J curve effect
- impact on other goals of economic policy, *i.e.* inflation, unemployment and economic growth
- possibility of competitive depreciations

Reducing aggregate demand answers may include:

- reference to expenditure – reducing policies
- use of fiscal and monetary policy to reduce demand
- linkage between less AD and the current account
- impact of higher interest rates, higher taxation and less government spending on growth, employment and inflation
- problems of time lags
- problem of discriminatory nature of higher taxes and interest rates

Reward the use of AD/AS diagrams.

Candidates may consider other policies in their evaluation but they must answer the question put.

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4. (a) **Explain how an increase in the quantity and quality of a nation's factors of production can promote economic development.** [10 marks]

- definition of factors of production
- definition of economic development

Candidates may respond to this in terms of measures of development such as HDI *etc.*

- explanation of an increase in the quantity of productive factors
- the impact of an increase in the quantity of resources on productive capacity, economic growth and, possibly economic development
- explanation of an increase in the quality of productive factors
- the impact of specific examples of an increase in the quality of factor inputs, *e.g.* the use of improved health and education programmes, on economic development
- reward the use of appropriate diagrams
- reward the use of appropriate growth models

- (b) **Evaluate the impact of globalization on the economic development of developing countries.** [15 marks]

A definition of globalisation

Answers may include:

- features of developing countries
- evaluate the impact of (in terms of positives and negatives):
 - free trade
 - FDI by MNCs
 - liberalisation of capital markets
 - greater labour mobility
 - the transfer of knowledge and technology
 - income and wealth inequality
 - increased industrialisation and urbanisation
 - greater tourism
 - protection in developed countries

Crucial to this question is the need for candidate answers to have clear links to economic theory. This is a big subject and answers may vary. A good candidate is going to define globalisation and then go on to evaluate its impact in terms of how they have defined it.

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