SCOTTISH
QUALIFICATIONS
AUTHORITY

2005 Economics

Higher

Finalised Marking Instructions

These Marking Instructions have been prepared by Examination Teams for use by SQA Appointed Markers when marking External Course Assessments.

Economics 2005

Higher

ITEM A

Marks

(a) **(i)** The earnings/wages (½ mark) workers receive after all deductions (income tax (½ mark) , national insurance (½ mark) etc) have been made. It is their net/take home pay ie the money they have to spend (1 mark). **2**

(ii) The buyers of (½ mark) (demand for) houses and the sellers of (½ mark) (the supply of) houses plus the houses (½ mark). Must also make some mention of the exchange or price (½ mark). **2**

(b) The main benefit of low inflation is that it increases the competitiveness of UK exports (if our inflation rate is below that of our major trading rivals). Candidates can gain full marks for this one point if they go on to explain how this will result in other benefits eg increased employment, faster growth and reduced trade deficits. Other reasons include: prevents the arbitrary redistribution of income (which occurs during times of high inflation), encourages efficiency (inefficient firms cannot hide behind fast rising prices), encourages saving (no need to rush out and buy because of fast rising prices), workers do not price themselves out of jobs, leads to increases in real income, reduced 'shoe leather' costs, lower interest rates, brings stability to the economy (which could lead to increased FDI). Any 2 reasons for full marks. **3**

(c) Income elastic demand occurs when an increase in income results in a proportionately greater increase in the demand for a good. As this is the case with the demand for houses, the recent increases in UK income have led to a significant increase in the demand for houses which has contributed to the increase in their price. Mark according to overall quality. **3**

(d) Real disposable income is the purchasing power of income (1 mark, but candidates can get full marks without defining real disposable income). It rose (by 1.7%) in 2002 (1 mark) because, in 2002, disposable income rose at a faster rate (1 mark) than inflation (1 mark). **3**

(e) Diagram should show an increase in the supply of houses and a larger increase in the demand for houses with a resultant increase in the equilibrium price. 1 mark for showing the increase in demand and supply. 1 mark for showing the increase in demand is greater than the increase in supply. 1 mark for showing the increase in price (if it is logical).

Look for an understanding of how the increase in the supply of houses (which should reduce their price) has been outweighed by the fact that the demand for houses has increased by a (proportionately) greater amount. The overall result has therefore been an increase in house prices.
Can mark 1:3, 2:2 or 3:1. **4**

(f) **(i)** Look for a simple explanation of how increased interest rates put up the cost of buying a house (mortgage payments) and therefore reduce the demand for private housing. (2 marks). Also credit explanations of 'overheating' and how increased interest rates will reduce excess demand. **2**

(ii) Look for at least two descriptions of how an increase in interest rate will: encourage saving and discourage borrowing; reduce spending/demand; reduce investment; slow down the rate of inflation; reduce growth; increase unemployment; increase hot money inflows; strengthen sterling; reduce monetary growth etc. **4**

(g) Demand for houses is higher in London (1 mark) (because average wage levels are higher) and the supply of new houses is lower (1 mark) (because of the lack of land space). **2**

ITEM B

Marks

(a) **(i)** The value of the UK's imports of goods is greater than the value of the UK's export of goods. If candidate talks about amount/volume, 1 mark. **2**

(ii) After having experienced low or negative growth rates (a recession) the growth rate (in the US and Asia) is now steadily rising (and approaching the trend rate). **2**

(b) A fall in the value of Sterling against the Euro will make British exports cheaper in the Eurozone (no need to explain why) therefore the volume of British exports to the EU should increase. **2**

(c) Look for an understanding of the fact that much of the Eurozone is experiencing a low rate of economic growth/a high level of unemployment. This will result in AMD (and therefore consumer demand) rising very slowly. Credit any other plausible explanation eg a fall in income levels **2**

(d) This question can be answered in two ways. Both ways involve 4 steps – hence the 4 marks.

- An increase in UK interest rates will increase the inflow of hot money (sterling now more rewarding for speculative funds).
- This increase in hot money will increase the exchange rate of sterling (as it will increase the demand for sterling).
- UK exports will therefore increase in price/be less competitive.
- This will make exports fall even further.

OR

- An increase in UK interest rates will increase the borrowing cost of UK firms.
- UK firms will increase their prices (to maintain profit margins).
- This will make our exports less competitive.
- Therefore the demand for them will fall even further. **4**

(e) **(i)** £0.8 billion (£3.6b - £2.8b (½ mark)). **1**

(ii) The main reason is because of our large surplus in financial services. The activities of the City of London (banking, insurance, shares, bonds etc) earn a great deal of export revenue for the UK (2 marks). Another reason is the fact that the IPD section is usually in surplus because of the large inflows of profits and dividends we receive from past overseas investment (2 marks). **2**

(f) **(i)** The question asks candidates to 'discuss', so look for benefits as well as problems for full marks.

Continued deficits could lead to increased unemployment in our export and import-competing industries. Our national income, standard of living and rate of economic growth could all fall, as imports are a leakage from, and exports an injection into, the circular flow. Our creditworthiness will fall which could result in a reduction in FDI. The exchange rate of sterling will fall which (although it should reduce the deficit) will increase the price of our imports and build up cost-push inflationary pressure.

The influx of imports will result in greater choice and possibly better value for UK consumers. It will also increase the level of competition in the UK which could lead to lower prices and reduce the monopoly power of large firms in the UK. Credit any other plausible impacts but if candidate only mentions one aspect (either benefits or problems), maximum is 2 marks. **3**

(ii) For full marks, look for a straightforward description of at least three forms of import controls (tariffs, quotas, high safety/quality standards, exchange controls, subsidies to home producers etc).
Also credit descriptions of measures to reduce demand or inflation eg budget surpluses, increased interest rates as well as supply side measures, trade exhibitions, export drives etc. **4**

(g) The two other items are Interest, Profits and Dividends – from overseas investment, FDI and overseas borrowing and lending (2 marks); and Transfers, such as overseas pensions, contributions to the EU etc (2 marks). **3**

SECTION B

Marks

1 **(a)** Look for straightforward explanation of relative scarcity eg although the wants for goods and services are unlimited (credit reasons), the resources required to produce the goods and services are limited. This combination of unlimited wants and limited resources creates the universal economic problem of scarcity. This scarcity applies to all (economic) goods in all societies – no country has (or ever will have) enough resources to eliminate scarcity. A shortage, on the other hand, occurs when the demand for a good is greater than the supply of it. In a market economy, shortages usually do not last for long and will be cured by a rise in price and/or an increase in supply. Credit candidates who state that demand is not the same as wants (demand = wants backed up by the ability to pay). Demand is limited by income and, in a market economy will be nearly always fully satisfied. Wants are unlimited so can never be fully satisfied.

No need for candidates to mention all the above points – full marks should be given to any answer that highlights the basic difference between wants and demand and relates this to scarcity and shortages. **8**

(b) Explanation should centre round the concept of variable returns, although other terms, eg factor efficiency, may be used instead.

Credit definition of short run ie period of time during which at least one factor input cannot be varied (1 mark).

An average total cost curve falls, reaches a minimum (optimum output) then starts to rise. Candidates may explain this in a variety of ways eg may explain it in terms of the shapes of the AFC and the AVC curves (since ATC = AFC +AVC) or relate it to the influence of the MC curve. Either explanation should refer to variable returns to gain full marks.

Average fixed costs decline continuously since fixed costs are being spread over a larger and larger output. Average variable costs fall at first – increasing (average) returns to the variable factor cause cost per unit to decrease. Eventually the fixed factor becomes overworked and diminishing (average) returns set in. This causes average variable cost to rise.

Therefore ATC falls when both AFC and AVC are falling (or when the fall in AFC outweighs the rise in AVC). Eventually the rise in AVC outweighs the fall in AFC and ATC begins to rise. 1 mark for a correctly drawn ATC diagram.

OR

A MC curve falls at first as the firm experiences increasing (marginal) returns to the variable factor but will eventually start to rise – when diminishing (marginal) returns set in. When marginal costs fall they pull down average costs. Average costs will continue to fall as long as marginal costs are less than average costs. As soon as marginal costs are greater than average costs, average costs will start to rise. The result is a U-shaped average cost curve which is cut at its lowest point by the marginal cost curve.

Mark both explanations according to overall quality.
(No credit for economies and diseconomies of scale) **10**

(c) Credit definition of the long run ie the period of time long enough for all factors of production to be varied. A long run ATC curve is made up of a series of short run ATC curves (one mark for definition, one mark for envelope diagram).

Long run average total costs fall when a firm is experiencing economies of scale (increasing returns to scale) – when the % increase in costs is less than % increase in output.

Look for a straightforward description, and examples of, three economies of scale eg technical, financial, marketing etc. For full marks candidates must, in at least some of their descriptions, show how an economy of scale results in falling ATC. **7**

2 **(a)** Economic growth refers to an increase in the productive capacity (ie the ability to produce) of an economy over time (2 marks).

It is usually measured by increases in real (per capita) GDP (2 marks). It is caused by either increases in the quantity or quality of the factors of production or advances in technology (2 marks).

Look for a clear, well drawn, fully labelled diagram showing an outward shift in the PPC curve (2 marks). Credit candidates who explain the difference between an outward shift in the PPC (economic growth) and a movement of actual production towards the PPC (an increase in economic activity). **7**

(b) Economic growth represents an increase in productive capacity – this usually involves an increase in output. There will therefore be an increase in the average standard of living and, probably, more leisure time. There will also be increased employment opportunities and job security. The government will gain increased tax revenue (credit reasons) and can therefore afford to spend more on health, education etc. It makes it easier for the government to reduce income inequalities if all incomes are rising. Inward investment is encouraged if the economy is seen to be healthy. Credit any other plausible benefit of economic growth. Three, well explained benefits for full marks. **6**

(c) Credit definitions of fiscal (changing G and T to influence AMD) and monetary policy (changing R to control inflation) – (one mark each).

Fiscal measure – budget deficit – either by increasing government spending (credit examples) and/or decreasing taxation (credit examples). The government is therefore putting more money (and demand) into the economy than it is taking out. (Credit explanations of how increases in government spending and/or reductions in taxation, increase income.) As people now have more money, they will spend more ie there will be an increase in AMD. (Maximum 8 marks)

Monetary measure – a decrease in interest rates will encourage borrowing, as it is now cheaper, and discourage saving, as it is now less rewarding. Both of these should increase spending and therefore increase AMD. Credit highly those candidates who mention that the real income of borrowers (especially variable interest mortgage holders) will increase, which will increase their demand for other goods. (Maximum 8 marks)
Some candidates may answer this question in terms of economic growth and explain how fiscal and monetary measures can increase the quantity and quality of the factors of production and encourage technological advancement. For example they may argue that economic growth (and therefore AMD) can be increased by increased government spending on education, training, R and D and cuts in interest rates (to stimulate investment). This type of answer is acceptable and can therefore gain full marks. **12**

3 **(a)** A minimum wage is the lowest amount which may be paid to a worker for a standard period of time at work (2 marks). The reasons it was introduced include the facts that it: guarantees a basic standard of living for those in work; gives greater motivation to the unemployed to find work; reduces government spending on income support to the low paid; prevents employers exploiting labour and forces the employer (rather than the government) to pay the cost (2 marks per explanation) **7**

(b) The diagram should show the demand for and supply of labour and the equilibrium wage level (1 mark), in a particular industry. It should also show the NMW at a level above the equilibrium level (1 mark) and the resultant fall in the number of workers employed (2 marks). The explanation should mention that if the NMW is (well) above the equilibrium wage for an industry, although the number of people willing to do that particular job is likely to increase, the demand by producers for that type of labour will fall. The result will be a fall in the numbers employed in that industry. Credit candidates who explain that the increased cost of labour (because of the NMW) may persuade some producers to replace labour with machines. Also credit candidates who mention that there is little evidence of this happening at the moment, but it could in the future, if the NMW is set at a very high level. **8**

(c) Reasons include:

- Government incentives (credit examples)
- skilled labour force, therefore no need for incoming firms to spend huge amounts on training
- quality universities and science parks (credit examples)
- relatively cheap land therefore rents/leases relatively cheap
- to get inside 'fortress Europe' – can export to the rest of the EU 'freely'
- efficient infrastructure – transport, financial facilities etc
- stable economy (steady growth and low inflation)
- common language (if American)
- quality of life (scenery and golf courses)
- relatively low wage costs (NMW is at a relatively low level)

Four well developed reasons for full marks. **10**

4 **(a)** **(i)** Look for an explanation of the fact that public goods are non-excludable (once they are produced, the producer cannot stop people from benefiting from them, even though they refuse to pay for them) and non-rival (no matter how many one person consumes of them, it does not affect the amount left for everyone else). Examples include: lighthouses, defence, police force.

Private goods are both excludable and rival. Most goods are therefore private goods eg cars, TVs, Mars Bars etc. (Maximum 4 marks)

(ii) In a mixed economy, the private sector would produce very few (if any) public goods as no profit maximising producer would produce a good or service that he/she could not withhold from a non-paying consumer. Public goods are therefore usually provided by the government out of taxation revenue. (Maximum 4 marks) **8**

(b) Credit definition of negative externalities eg the third party or spill-over costs (imposed on the rest of society) which arise from the production and/or consumption of goods and services. (2 marks). Road congestion imposes extra costs in the form of pollution from exhaust fumes, traffic jams, longer travelling times, road rage etc (2 marks). Road congestion occurs when the demand for road travel is greater than the supply of roads. Charging motorists for using busy roads will increase the cost of travelling on these roads which should persuade some motorists to take alternative routes. This should reduce the traffic on these roads, reduce the level of road congestion and therefore reduce the negative externalities associated with road congestion (6 marks). **8**

(c) Other methods include:

- environmental taxes (making the polluter pay) – this will increase the producer's costs and force him/her to cut back production eg landfill tax, carbon tax etc. Credit references to bringing PMC in line with SMC;
- government regulation – imposing legal limits or complete bans on certain polluting activities eg limits on car exhaust fumes, banning dumping waste in rivers etc;

- allowing workers to claim compensation from polluters (by extending property rights) eg workers suffering from asbestosis can now sue their employers;
- tradeable pollution rights (allowing pollution up to a certain level) – will reduce costs for low polluters and increase costs for high polluters.

Three methods with some explanation for full marks. **9**

5 **(a)** Reasons include:

- the UK is a member of the EU, therefore our trade with other EU members is free from any form of restriction – this makes trade simpler and cheaper
- proximity – we are geographically close to Europe, therefore trade with Europe is easier, quicker and cheaper
- Europe consists of relatively rich countries who consume the sort of goods and services we provide
- the UK is a rich country and we therefore consume the sort of goods the EU provides
- EU enlargement has increased the scope for increased trade with the EU.

Any 3 reasons for full marks. **5**

(b) Advantages include:

- it will bring to an end the post war division of Europe and begin a new era of political and economic stability
- the addition of 105 million people and an increase in land should boost economic growth and create new jobs
- the bigger market will create greater opportunities for firms to benefit from economies of scale
- the lower wage costs in the new member states will provide opportunities for firms to cut costs by re-locating their operations
- UK skill shortages could be reduced by an inflow of labour from Eastern Europe.

Disadvantages include:

- jobs may be lost if firms relocate to take advantage of the lower wage costs in the new entrant countries (eg Slovakia is now the world's largest car manufacturer per capita)
- a sudden influx of labour from Eastern Europe could dampen wage growth
- the CAP will have to be drastically reformed. To maintain the current levels of EU spending in the enlarged EU would bankrupt the EU
- as all the new entrants have living standards below the EU average, the distribution of EU regional funds will have to be altered in favour of the new entrants
- the UK (and particularly Scotland) will not only receive less regional aid, it may also lose its £3 billion a year rebate.

Three well described advantages and two disadvantages (or vice versa) for full marks. **10**

(c) Costs include:

- loss of monetary independence ie the MPC will not longer be able to set interest rates
- one European interest rate will not suit all member countries (especially true for the UK which is at a different stage of the economic cycle to that of the rest of the EU)
- devaluation of sterling to correct trade deficits is no longer an option (will have to deflate instead)
- the UK is more sensitive to interest rate changes because of our high % of variable rate mortgage holders
- the menu costs of changing over to the Euro will be very high
- exogenous shocks eg oil price changes, will impact the UK economy differently from the rest of the EU economies.

Benefits include:

- stable exchange rates. This will reduce the risks of trade and therefore the volume of trade should increase
- no transaction costs should lead to increased investment
- price transparency ie it will make it easier to compare prices throughout the EU, which could lead to falling prices
- membership will help maintain the UK's high level of FDI
- London's position as a leading financial centre will be maintained
- a fully independent ECB should lead to low inflation and increased economic growth and competitiveness.

Three well explained costs and two benefits (or vice versa) for full marks. **10**

6 (a) Price elasticity of demand measures the extent to which the quantity demanded of a good changes (responds) when its price changes (1 mark). Credit the formula (1 mark) and explanations of when demand is price elastic (>1) etc (1 mark). Correctly drawn diagrams should also be credited (1 mark).

Look for an understanding of the importance of the relationship between PED and total revenue. If demand is price inelastic, P and TR move in the same direction. If demand is price elastic, P and TR move in opposite directions. Credit references to the importance of PED for producers (when considering price changes) and Chancellors (when deciding tax changes).

Although not necessary for full marks, credit highly candidates who mention that PED determines the extent to which the price of a good will change when its supply changes (this is why the price inelastic demand for their exports causes LDCs problems). **10**

(b) Although not necessary for full marks, credit the definition eg income elasticity of demand (YED) measures the extent to which the demand for a good changes when there is a change in the (real) income of consumers (1 mark). Also credit the formula (1 mark), although again this is not necessary for full marks.

YED is determined by the type of product and average income levels. For most goods YED is positive ie an increase in income leads to an increase in demand. The demand for luxury and leisure goods (credit examples) in rich countries, is highly income elastic ie an increase in income results in a proportionately higher increase in the demand for these goods. The demand for essential goods (credit examples) tends to be income inelastic ie an increase in income results in a proportionately smaller increase in the demand for them. However, the demand for inferior goods (credit examples) has a negative income elasticity ie a rise in income leads to a fall in demand for these goods. For goods that consumers have enough of eg salt, YED is zero ie an increase in income has no effect on the demand for them.

Look for a description of three types of good for full marks. **6**

(c) Other economic problems include:

- a lack of capital investment. This has contributed to their low rates of economic growth
- a lack of education and training has resulted in low levels of productivity and high unemployment
- poor infrastructure has also inhibited their growth prospects
- the huge debt repayments they are required to make has reduced their funds for investment
- corrupt governments have squandered much of their development aid
- their narrow export base has made them vulnerable to demand and price changes
- their weak international bargaining power has led to lower prices for their exports
- they suffer from unfair trading practices eg dumping by developed countries, EU sugar subsidies and US cotton subsidies.

Also give some credit for socio-economic problems such as over-population, droughts, floods, famines, poor health and sanitation provision etc.

Five problems, plus some description, for full marks. **9**

[END OF MARKING INSTRUCTIONS]