

2006 Economics

Advanced Higher

Finalised Marking Instructions

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Marking Instructions
Economics Advanced Higher

Detailed marking instructions/guidelines

The appended marking instructions are guidelines only; candidates will adopt different ways of tackling particular questions. Differences of interpretation will be resolved at the Markers meeting in June.

In the essay questions in particular it is not necessary for candidates to include all the points listed. Candidates are expected to demonstrate a thorough appreciation of the topic and a sound understanding of the economic issues under discussion. Marks should not be allocated on rigid point-scoring basis, but on the overall quality of the answer.

Candidates who use appropriate examples and show evidence of up to date knowledge of the question being answered should be rewarded accordingly.

Section A

- | | | | |
|----|-----|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---|
| 1. | (a) | A tax that is increased at a faster rate than the increase in the retail price index
Must mention above inflation for full mark | |
| | (b) | A payment imposed on motorists who enter a restricted area at a certain time of day because they occupy scarce road space | 2 |
| 2. | (a) | PED is inelastic, the coefficient is -0.2 . Both points necessary for full marks
$1\frac{1}{2}$ if only % changes discussed | 2 |
| | (b) | Revenue increases whenever the tax rate is increased because demand declines at a lower rate than the increase in price caused by higher taxation.
Even large increases in petrol taxation have little impact on consumption thus doing little to protect the environment. | 3 |
| 3. | (a) | Private costs are borne by individuals who use a car, for example fuel, insurance and wear and tear. Social costs are borne by other members of society, for example noise and pollution
Some credit for £18bn = 1 mark | 3 |
| | (b) | Diagram as below, explanation is not required. | |
| | | | 2 |
| 4. | (a) | The social costs of motoring are at least £44 billion per annum, but petrol taxes collect about £26 billion each year. Other costs such as accidents and stress are not included in this calculation.
Figures needed for two marks | 2 |
| | (b) | Some of the following arguments should be discussed <ul style="list-style-type: none"> • Higher fuel prices are inflationary • Those who live in remote areas cannot use public transport as an alternative • The tax is regressive • The tax may not take into account the pollution created by some cars • Consumer reaction may prove electorally disadvantageous for the government • Firms face rising costs that may make them less competitive and even force them to close down and • Other countries may be unwilling to increase their petrol taxes. | 4 |

		Marks
5.	A congestion charge is related to miles driven and access to restricted areas. Wealthier citizens are readier to bear these charges because they have lower income elasticity and drive larger and more cars than poorer people. Good candidates will discuss the fact that since only 65% of families own cars existing taxes are more discriminatory than they appear to be. Marks awarded for income related arguments, no marks for areas.	3
6.	High oil prices lead to very high abnormal profits, enterprising firms and individuals will seek to cash in on an opportunity to enter the market especially by developing a cheaper substitute for petrol. Oil companies are looking to the future and developing new products and strategies. For example, BP now stands for 'Beyond Petroleum'.	4
		(25)

Section B

Marks

1. (a) Candidates expected to show awareness of the current situation in the UK and many other countries

Reasons include

- An ageing population especially because of increased life expectancy and a falling birth rate
- Improvements in medical care and the standard of living
- The increased burden of the state pension (currently almost £50 billion each year)
- Budget deficits and other claims on government expenditure
- Significant rise in taxes likely to be necessary without reform (7% of GDP, about £70 billion at current prices is the projected increase in pension funding up to 2050)
- The poor performance of the financial markets
- Inadequate levels of private saving ('12 million people not saving enough')
- Low level of interest on savings cutting the income of the retired population
- The closure of many company pension schemes
- Impact of government taxes on share dividends

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- (b) People can work for longer (politically difficult), but logical given rises in life expectancy
Greater emphasis on making private pension provision, especially since people have higher living standards
The decline in the state pension as a proportion of average earnings over many years has made people less dependent on state pensions
Should pension provision be the main responsibility of the state or the individual?
Rising productivity

5

- (c)(i) **Main proposals were**
Gradual rise in state pension age to 68
Increase in state pension age linked to rising life expectancy
State pension should be indexed to average earnings
A national pension savings scheme by 2010 for those who do belong to a work place pension scheme to which employees would contribute 4% of their after tax salary, employers 3% and the government 1%

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- (ii) **Discuss the effectiveness of these proposals**
Government reluctant to accept financial implications of report especially since Turner included improving the state pension in his report
Unwillingness of workers and unions to accept a longer working life (refer to public sector workers)
Can people be compelled to save?
Will taxes or National Insurance Contributions be increased to pay for higher pensions?
John Hutton, Work and Pensions Secretary, has formulated five tests personal responsibility, fairness, affordability, simplicity and sustainability when considering the future of pensions.

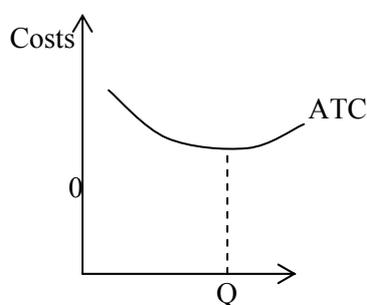
7

		Marks
2.	<p>(a) Candidates expected to give a full account of UK monetary policy The use of the inflation target since 1997, initially 2.5% RPIX and since 2003 2% CPI Government sets the target MPC to choose the appropriate rate of interest to achieve that target Membership and operation of the MPC Explanation of the monetary transmission mechanism tracing the relationship between a change in interest rates and the rate of inflation Appreciation of the effectiveness of the policy for high marks</p>	10
	<p>(b) CPI running above target for several months at the end of 2005, but no increase in rate of interest Main factor the distorting effect of high oil prices which would have a deflationary effect over the longer term. Higher oil prices (and gas prices) reduce disposable income and cut AMD Housing market had slowed down Evidence that private consumption would level off leading to an economic slowdown or even a recession (Refer to evidence – slower rise in GDP growth and rising unemployment) Companies struggling especially in the manufacturing sector MPC expected to take longer term view (2 years) when making interest rate decisions A higher interest rate might undermine confidence in a wide range of markets</p>	7
	<p>(c) A significant rise would need to be sustained and caused by factors within the UK economy A renewed housing boom Sharp rise in wage inflation A rise in GDP above the economy's long term growth rate Excessive consumer spending leading to tight product and labour markets Government borrowing moving well outside the Chancellor's rules An unsustainable credit boom (Are we getting near to this with current levels of indebtedness?)</p>	8

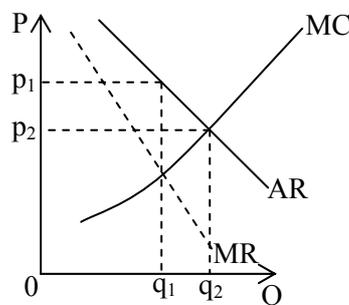
3. (a) Brief explanation of meaning of an oligopoly to include a number of firms, entry barriers, price levels and product differentiation
 UK rules flexible compared with USA, but growing similarity after the Competition Act of 1998 and the Enterprise Act of 2002
 Independent role of Office of Fair Trading (OFT) when investigating any proposed merger that will curtail competition. Government role reduced sharply since 2002.
 Main guideline now ‘substantial lessening of competition’ not the public interest
 Effective yardsticks for investigation include over 25% of market share, a £70 million turnover test, but emphasis is on monopoly abuse rather than rigid trigger numbers
 Cartels now against the criminal law and firms who break competition laws may be subject to heavy fines and company directors liable to imprisonment

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(b) **Diagrams should demonstrate both economic and allocative inefficiency**
 Average costs may be above most technically efficient output level (the optimum) because of the absence of competition
 Allocative inefficiency occurs when price exceeds marginal cost in the long run, implying that price is too high and output too low to achieve economic efficiency
 Credit reference to lack of innovation, poor service and a general indifference to consumer wants
At least half of the marks should be awarded for the two diagrams below.



Technical Efficiency



Allocative efficiency p_2, q_2
 Profit maximisation p_1, q_1

10

- (c) Discussion of the theory of contestable markets is expected, it is not the size of market share that matters but the existence of realistic alternatives.
- Even if Tesco has over 30% of the retail markets other competing firms exist and Tesco draws attention to the fact that Walmart (Asda) is one of the world's largest firms
- Tesco claims that customers choose their stores because they offer good value for money and satisfy other consumer demands ('everything, everywhere and everyone')
- When Tesco acquired T and S in 2004 this was considered by the competition authorities to be a different type of business (small independents)
- Strong candidates will note that in some towns Tesco has around 50% of the retail market (Inverness and Milton Keynes) and one pound in every eight spent in retail stores in the UK is spent in Tesco stores

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4. (a) Some background to the UK rebate should be given. The UK had a small agricultural sector that was relatively efficient and was one of the poorer countries per capita in the EU.
The CAP has been reformed significantly and no longer concentrates on subsidies leading to overproduction and has limited the amount given to the CAP particularly to large farms. The main drift of policy is social and environmental. Good candidates will discuss the reality of these changes since 2000.
The UK has become one of the wealthiest members of the EU especially with the admission of ten new members in 2004.

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- (b) EU funds are surprisingly low (100 billion euros) – only 1% of EU GDP.
Agriculture receives about 45% of the EU Budget, the Structural Budget is about 34%
Shift from agriculture to structural funds (regional)
Agricultural expenditure frozen and under reform
Limited attempts to widen the tax base by basing it on GDP, resisted by several countries
Political opposition from members especially UK to current expenditure and any increases
Some discussion of tax harmonisation especially on profit taxation.

Reasons for reform include

Evidence of waste, inefficiency and corruption especially in agriculture
Attempts to help poorer areas (Objective One status)
The admission of the ten new members in 2004 with lower living standards and large agricultural sectors was the main catalyst for change. Desire to help them, but also to prevent them seizing all the funds at the expense of existing members or through a large increase in expenditure
Reference to the voting system and the unsuccessful attempts to introduce a European Constitution should be credited
Most countries do not wish to pay more into the EU.

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- (c) Some indication of growth rates expected with particular emphasis on the UK and USA excellent records since 1992

Reasons for UK and USA success might include

The successful monetary policies followed in the UK and the USA
Their open economies and trade with Asia
The absence of regulation, for example on hours and employment contracts
Some may refer to the caution and inertia of the EU authorities, especially the ECB
The EU had performed better before 1992, were the others catching up?
The slow adjustment of many EU members to changes in the world economy, in particular globalisation
Problems associated with the break up of the communist bloc and the development of Eastern Europe, particularly for Germany
The poor performance of the German and French economies
Flag waving is not appropriate, but candidates may refer to the merits of the Anglo-Saxon laissez-faire model of economic theory and development!

10

5. (a) Brief discussion of the merits of free trade
 Are free trade and fair trade the same thing?
 Candidates may stress that some nations are keener to encourage freer trade than other countries

Reasons include

Consequences for own economy of collapse of firms and industries, lost jobs, and the impact on the balance of payments
 Own citizens may vote against governments that undermine their jobs and livelihood
 Genuine fear that some poorer countries exploit their workers in pay and conditions
 Fear of dumping
 USA and others hold out assistance to encourage growth of democratic regimes
 Fear that some countries will undermine commitment to free trade by dubious devices to assist own firms, for example subsidies and petty restrictions.

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- (b) Helpful to distinguish between roles of different organisations

Attempts include

Reductions in tariffs on industrial goods through various 'rounds'
 Removal of quotas
 Widening measures to include agricultural and services
 Cancellation of debt owed by some of the poorest countries
 Foreign aid commitment of 0.7% of GDP, but not met by many developed nations
 Inward investment
 Growth in membership of WTO and IMF (32 developing nations are members of WTO)
 Technical and educational assistance
 Provision of development loans for poorer nations – sometimes with tightly knotted strings!
 G8 debt cancellation and more aid but limited progress on trade
 IMF approach usually commercial and difficult for poorer nations

9

- (c) **Effectiveness debatable**
Reduction in levels of world poverty, but it is still widespread
Debts reduced, but poverty is not history yet
Increases in aid to nearer UN target
Little progress on free trade
Growing role of G20 group of poorer nations especially BRIC (Brazil, Russia, India, China)
Cynics will say that the urgency is driven by the fear of terrorism
Failure to achieve breakthrough at Hong Kong in December 2005
Reluctance to cut agricultural export subsidies by Japan, EU and USA – not due to be abolished until 2013! Agreed at Hong Kong
Limited market access to EU and USA markets. Continuation of tariffs on agricultural products from developing nations. No agreement at Hong Kong
Developing nations reluctant to cut tariffs on industrial goods (as part of a deal with the developed countries). No agreement at Hong Kong
Up to date knowledge of progress expected (Geneva April 2006)

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6.	<p>(a) What is a budget deficit? Circumstances include The pattern over a few years is more important than the figures for a single year Capital investment (long term growth) to benefit future generations through reproductive debt To avoid a recession by increasing AMD and linked to a discussion about the economic cycle In war time or similar crisis Good candidates may argue along these lines, if the cost of servicing existing debt is £25 billion a year a budget deficit of £25 billion has not increased the extent of long term indebtedness</p>	7
	<p>(b) (i) UK rules are The Golden Rule – borrowing to fund capital investment only The Sustainable Investment Rule – keep public sector debt at a ‘stable and prudent level’ of no more than 40% of national income EU rules are Budget deficit each year should not exceed 3% of GDP Overall debt (national debt) should not exceed 60% of national income</p>	4
	<p>(b) (ii) Reasons for the rules To prevent inflation caused by excessive borrowing and ‘crowding out’ of the private sector To maintain a prudent macroeconomic policy To encourage responsible policy making To stabilise the exchange rate To limit the burden of debt repayment and interest for future generations on spending incurred by the current generation (‘intra-generational fairness’) In the EU to assist monetary co-operation and policy that could be undermined by member nations who run substantial deficits</p>	10
	<p>(c) (i) The rapid rise in public expenditure on health, education and social security Increase in health spending – 70% in four years – should be stressed Despite increases in some taxes, income tax and VAT the main sources of revenue have changed little Some candidates may draw attention to waste and inefficiency Sharp rise in public sector employment Slower growth in past year has cut tax revenue</p>	6 4
	<p>(c) (ii) Possible responses Relax the rules, by ‘retiming’ the economic cycle (already happening) The rules are not mandatory – they do not have any specific meaning, but breaking them would suggest a failure by the government to meet its own self-imposed guidelines Higher levels of taxation Attempts to rein in spending for example on benefits, especially incapacity benefit and pensions Cutting employment in the public sector in the pursuit of greater efficiency Wider use of various public/private sector agreements such as the PFI</p>	8 4

[END OF MARKING INSTRUCTIONS]