SCOTTISH
QUALIFICATIONS
AUTHORITY

2006 Economics

Higher

Finalised Marking Instructions

Economics 2006

Higher

Marks

ITEM A

(a) The LFS samples around 150,000 people each quarter (1 mark – be flexible over the actual number and time period), and determines who is unemployed from the information gathered (1 mark). Credit references to the fact that it uses the ILO definition of an unemployed person, although this is not necessary for full marks.

The government prefers this measure because it gives an accurate measure of unemployment (more accurate than the Claimant Count) and is directly comparable across countries. Mark 2:1 or 1:2. **3**

(b) Credit a definition of real earnings (1 mark). They rose by 2.7% (1 mark) because, during that period, although (money) earnings rose by 4.6%, prices rose by 1.9% (1 mark). Therefore the real value (ie the purchasing power) of earnings rose by 2.7% (1 mark). If candidates do not use actual figures ie if they simply state that real earnings rose because average earnings rose at a higher rate than inflation, the maximum is 2 marks, although they can gain full marks if they also give a correct definition of real earnings. **3**

(c) Look for a simple understanding of how an increase in wages can lead to an increase in prices eg if a group of workers receives a wage rise, the producers might be tempted to pass this increase in costs on to consumers in order to maintain profit margins (2 marks). Therefore wage inflation pressure refers to the fact that an increase in wages can lead to an increase in the rate of inflation because of the desire of producers to maintain profit margins (2 marks). Also credit candidates who explain how increase in wages can lead to increased demand-pull pressure (2 marks). **2**

(d) **(i)** Candidates need to make 2 clear points for full marks. Firstly, a slow down in earnings growth should lead to a lessening of inflationary pressure/a fall in inflation (no explanation required). Secondly, this situation could allow the MPC to reduce interest rates without fear of pushing inflation above the government's target. **2**

(ii) They are likely to increase the rate of economic growth (1 mark – provided correct reasons are given). Look for a straightforward explanation of how interest rate cuts are likely to lead to increases in AMD (and hence economic growth). Therefore credit explanations of increased consumer borrowing, reduced saving, increased real incomes of mortgage holders, increased investment and, because of a reduction in the ER of sterling (due to increased Hot Money outflows) increased exports and reduced imports. An explanation of any 2 of these (related to AMD) gains 3 marks. **3**

			Marks
(e)	**(i)**	Credit any logical explanation eg loss of comparative advantage (to the BRICs), increased automation, growth of the service sector, strong pound, increased off-shoring, branch economy (Peugeot/Citroen). Mark according to the quality of the explanation.	**2**
	(ii)	Look for a simple description of a possible consequence eg increased trade deficits, slower economic growth, need for increased mobility. 1 mark for the consequence, 1 mark for the description. Do not credit descriptions of the consequences of unemployment eg increased spending on JSA, fall in taxation revenue etc.	**2**
(f)	**(i)**	People of working age who are not actively seeking work or any similar definition, but do not credit definitions of the dependent population.	**1**
	(ii)	Reasons include increases in the number of (full-time) students, those on disability, people taking early retirement, people looking after elderly relatives.	**1**
(g)	**(i)**	The main reason is the sustained period (13/14 years) of economic growth (at, or about, the trend rate) which has resulted in a steady increase in the demand for labour (credit reference to derived demand). However other reasons include: the increased flexibility of the UK labour market, the growth of the service sector, government incentives (the New Deal, From Welfare to Work etc), relatively low inflation and interest rates, the minimum wage and the increase in the number of public sector jobs. Mark according to overall quality.	**2**
	(ii)	Look for a straightforward explanation of how a fall in unemployment increases government revenue or reduces government spending. Do not credit political advantages.	**2**
	(iii)	The obvious (?) problem is in the area of exports. High EU unemployment will reduce (or at least, slow down the growth in) the level of AMD in the EU (1 mark). This fall in AMD will reduce the EU demand for UK exports (1 mark). Credit reference to the fact that the EU is our biggest export market. Also credit explanations of why our tourist industry could suffer.	**2**

ITEM B

Marks

(a) **(i)** EU enlargement refers to the time (May 2004) when the EU increased in size (1 mark) from 15 member countries to 25 (1 mark). Credit candidates who mention that the new entrants consist mainly of Eastern European, former Communist countries and that the EU population increased by 75 million to 450 million. Also credit references to future enlargements eg Romania and Bulgaria in 2007. **2**

(ii) Normal profit is the level of profit an entrepreneur must earn to keep him/her in business (2 marks). It is therefore a cost of production (1 mark) as it must be paid/earned or the goods will not be produced (1 mark). It is the extra cost of getting a good produced in a market economy (1 mark). **2**

(b) Reasons include: it is now easier to enter the airline market as it has been deregulated (candidates simply have to repeat the statement in the first sentence of the passage); the large profits being made have attracted new firms; it is relatively easy to set up a new airline (planes can be leased, pilots can be lured out of early retirement etc); the increased demand for air travel (because of eg rising real incomes). Two reasons with some development for full marks. **3**

(c) The increased competition has led to lower fares, more destinations, more flights per day etc – all of which make air travel more attractive. Two points, with explanations, for full marks. **3**

(d) Advantages include: the extra people and land (ie resources) should boost economic growth and create new jobs; the bigger market will create greater opportunities for economies of scale. Also credit candidates who state that the CAP will have to be reformed (to accommodate the new members) – provided they mention that it is in drastic need of reform anyway (otherwise it can be regarded as a disadvantage for existing members).

Disadvantages include: re-location can lead to job cuts in existing member countries; EU regional funds will have to be altered in favour of the new entrants (as they all have living standards below the EU average); the CAP will have to be reformed (or the enlarged EU will bankrupt the EU) and the influx of cheap labour. **4**

Marks

(e) **(i)** External costs are the costs of production (or consumption) which are not borne by the producer (1 mark) but by the rest of society (1 mark). They are the spill-over effects of production (1 mark) which the producer imposes on other people (1 mark). Credit examples (1 mark). **2**

(ii) Look for a simple explanation of how fines, pollution taxes, greenhouse/environmental taxes, tradeable pollution rights etc can lead to a reduction in external costs (1 mark for the measure, 2 for the explanation). **3**

(iii) All that is required is a simple description of fuel emissions (mainly carbon dioxide), engine noise, airport congestion, flight delays, accident costs etc. **2**

(f) **(i)** Look for any logical explanation of why the demand for business flights is less responsive to price changes than the demand for holiday flights eg business flights often have to be taken at a certain time (meetings have been pre-arranged etc) while holiday journeys are more flexible; business flights are paid for out of company expenses, holiday flights are paid for out of people's pockets; off-peak, lower priced flights are more likely to attract holidaymakers than business people. **2**

(ii) All that is required for full marks is a simple explanation of how, when demand is price inelastic, an increase in price leads to an increase in total revenue. As the demand for business flights is price inelastic, airline companies can increase the price of these flights and demand for them will not fall very much (specifically, a given % increase in price will result in a smaller % fall in demand). As a result, the companies will experience an increase in total revenue and therefore an increase in profit (if they were earning normal profit only, they will now be making above normal profit). **2**

SECTION B

Marks

1. **(a)** Look for a clear explanation of relative scarcity. Resources/inputs/factors of production are used to produce goods and services to satisfy consumer desire for them. However, although the wants for goods and services are unlimited (credit reasons), the resources (land etc) required to produce the goods and services are limited. This combination of unlimited wants and limited resources creates the universal economic problem of scarcity. No country will ever have the resources to eliminate scarcity because no country has enough resources to produce enough goods to satisfy completely all the wants of its people. **5**

(b) Look for a straightforward explanation of how (in a market economy) changes in demand eventually bring about changes in supply. Credit candidates who mention that, in a market economy, consumers aim to maximise satisfaction and producers aim to maximise profit. Consumer demand therefore provides a signal to producers, telling them what to produce, and changes in demand send price signals to producers, encouraging them to produce more, or less, of a particular product.
If consumer demand for a product increases, the resultant shortage will cause the price to increase. As producers of the product can now make more profit on this good (relative to the profit they are making on other goods) they will switch more resources into the production of the good (as they are profit maximisers), therefore the increase in demand leads to increases in supply – and vice versa.
(If consumer demand for a product falls, the resultant glut will cause its price to fall resulting in a fall in the profit made on the good. Resources are then moved out of the production of that particular product and used to produce those products that are now relatively more profitable.) Maximum 7 marks.

Advantages:
Efficient: resources allocated on the basis of consumer demand; greater incentive for firms to cut costs, increase productivity and develop new products because of the chance of extra profit; competition keeps prices low and quality high; encourages the use of better methods/machinery for production.
Flexible: changes in demand quickly bring about changes in supply so surpluses/shortages do not last (the market responds quickly to demand changes); there is freedom to buy and sell, work in any job and enjoy a wider choice of goods and services.

Disadvantages:
although the question asks for the disadvantages of the price mechanism as a method of allocating resources, credit candidates who base their answers on market failure (ie the disadvantages of a market economy) and write about monopolies, externalities, luxury goods produced rather than public goods, lack of merit goods, unprofitable services, inequalities in income and wealth, access to goods and services dependent on income etc.
Credit highly candidates who concentrate on the disadvantages of the price mechanism eg fluctuating prices, creating periods when factors of production lie idle, and the fact that the price mechanism does not always work smoothly (credit reasons). Maximum of 2 for each advantage or disadvantage.
Maximum 7 marks. **12**

Marks

(c) The main way is through taxation, which gives the government the revenue it needs eg to provide merit goods, public goods etc. Other ways include: government watchdogs (to prevent exploitation by privatised companies), the Competition Commission (to prevent exploitation by monopolies), fines, permits, taxes (to reduce pollution levels), progressive taxation and increased welfare benefits (to reduce income inequalities), and fiscal and monetary policy (to prevent booms and slumps). Also credit candidates who relate their answers to the price mechanism (and not resource allocation) eg minimum and maximum prices, taxes and subsidies etc. **8**

Marks

2. **(a)** **(i)** Trade in goods deficit – when the value of exports of goods is less than value of imports of goods. Budget deficit – when government income (eg from taxes) is less than government expenditure (eg on NHS). Mark 2:2. **4**

(ii) Look for an understanding of how Budget deficits increase aggregate monetary demand (government spending increases AMD, taxation reduces AMD). As Budget deficits are created by increases in G and/or reductions in T, they inject more money (and therefore demand) into the economy than they withdraw. Candidates should then explain how increases in AMD lead to increased imports and increased employment (demand for labour being derived from the demand for goods and services).

Specifically, if taxes decrease consumers have more disposable income. The UK's high propensity to import could lead to increased trade deficits. Also, the resultant increase in aggregate demand will encourage firms to expand production and hire more workers, leading to falls in unemployment.

If government spending increases, aggregate demand will increase – credit explanation (eg public sector workers incomes increase), firms expand production, so hire more workers and unemployment falls. The increase in aggregate demand will increase the demand for imports, leading to increased trade deficits.

Also credit explanations of how increased government spending on capital projects can lead to increased trade deficits and decreased unemployment.

8

(iii) Reasons include: increased foreign competition (especially from China) and the resultant loss of comparative advantage; lack of price and non-price competitiveness; the strong £; booming UK consumer demand; rising real incomes plus our high UK propensity to import; the economic downturn in the EU and the US – our main trading partners. Any 2 well-explained reasons for full marks. **6**

(b) The main Budget policies to reduce income inequality are a more progressive taxation system (credit examples and explanations) and real increases in welfare benefits (credit examples and explanations). Also credit references to government training programmes and government assistance for businesses setting up in areas of high unemployment. **7**

Marks

3. **(a)** Economic growth is an increase in the productive capacity (increase in potential output/the ability to produce) of an economy over a period of time. Shown by an outward shift in the production possibility curve (caused by increases in the quality or quantity of factors of production or advances in technology). Usually measured by increases in real GDP per capita. **5**

(b) Look for a description of some of the following: surplus food, capital loans, technical aid, educational support, tied aid, charitable aid, military aid, capital equipment, education and training, cheap medicines, soft loans, debt relief and free and fair trade. The next part is quite difficult but look for some understanding of the difference between short-term emergency aid and long-term effective aid. The key point is that aid will only be effective if it results in increasing long-term growth in the developing countries ie if it helps them to increase their productive capacity.

Specifically:

- Free food can only ever be an emergency measure aimed at reducing an immediate danger of famine. In the long run it will destroy farming incentives and perpetuate and aggravate future food shortages
- Lending by the large banks (some of which helped, but much of which was 'wasted') has created a massive debt problem and many developing countries have to use their hard earned foreign exchange to pay debt interest. Debt relief can therefore allow them to spend more on their infrastructure, health care etc.
- Provided the technical aid is appropriate to the specific need (usually some form of intermediate technology is what is required) this can be a very effective method (especially if accompanied by technical assistance) of increasing their production and enabling them to reach their take-off point.
- Literacy programmes and basic education for the majority are essential if the productivity of the work force is to increase.
- Tied aid forces the developing country to buy goods from the donor country when there may be cheaper alternatives elsewhere
- Charitable aid is often used in emergencies to prevent widespread famine but increasingly used to finance long term development schemes and some charitable organisations are leading the campaign for a reduction in third world debt.
- Military aid can stabilise government and therefore encourage growth, however it can divert resources from goods into armaments (and can help keep dictators in power).

One mark for the type of aid, 2 for its effectiveness. If candidates only describe the various forms of aid, the maximum is 6 marks.

12

Marks

(c) Look for an appreciation of the fact that to continue to give aid to a developing country with the aim of helping it to increase its output and then impose trade restrictions on any good it might be able to export is largely pointless and defeats the purpose of giving aid in the first place. Many economists believe that fairer trade is the most effective way of increasing growth rates in the third world.

- Aid is very important in the early stages of economic development when there is nothing to export. The point of giving aid is to help developing countries increase their rate of economic growth and enable them to produce a surplus for export.
- However, these exports (eg cheap textiles) often compete with goods produced in the developed countries and therefore attract some form of import restriction, or domestic subsidy, to protect industry in the developed country.
- Any such restrictions would harm growth in the developing country and therefore negate the basic aim of giving aid. Credit examples such as EU sugar subsidies and US cotton subsidies.

However:

- The developed world might have to be prepared to allow some of its industry to be run down in order for aid to be effective.
- Free trade can lead to some firms in developed countries going out of business.
- Developing countries also impose trade restrictions. There is disagreement over whether they should drop these or be regarded as a special case and allowed to maintain them.
- Credit candidates who mention that trade and aid do not have to be alternatives but can (and should??) complement each other.

Mark according to overall quality, but the question asks for a discussion, therefore if candidates only mention the arguments for OR against the view, the maximum is 6 marks. **8**

Marks

4. **(a)** The factors include:

- Number of firms – the larger the number of firms, the greater the degree of competition. Each firm will have less influence on consumers and other firms.
- Size of firms – where firms in a market are large, the amount of competition may be reduced because firms have a greater degree of monopoly power due to their size.
- Number of consumers – in some markets where there are a few buyers but a large number of sellers, the buyers may be able to dictate terms to sellers.
- Product differentiation – this gives suppliers a degree of monopoly power and could decrease the amount of competition. However, product differentiation may increase the level of competition in a market if producers try to outdo each other.
- Barriers to entry – where firms can prevent others entering a market, the level of competition will be lower because consumers will have less choice. Credit references to contestability.

In practice, the above do not occur in isolation and often overlap. This is why it is difficult to assess the level of competition in markets.

Candidates must explain 4 factors for full marks. Three factors can gain 7 marks. **9**

(b) **(i)** Three possible reasons: income effect, substitution effect and diminishing marginal utility – any 2 (well explained) can gain full marks.

Income effect – when the price of a good falls, existing consumers will experience a rise in their real income ie when they buy their usual amount of the good, they will now have some money left over. With this 'extra' money they can now buy more goods – possibly even the good in question. Reducing the price of the good also widens the market for it and means that more consumers can now afford it.

Substitution effect – when the price of a good falls, it might become cheaper than its substitutes. Some consumers might now switch and start buying the cheaper substitute. Credit examples.

Diminishing marginal utility – the more we consume of a good, the less satisfaction we get from consuming one more. In money terms this means that when we equate marginal utility with price, the more we consume the less willing we are willing to pay for one more. When the price of a good falls it gives the consumer greater satisfaction for the money spent ie it gives better value for money (the good becomes a 'better buy'). Consumers can now increase their total satisfaction by buying more of this good and less of another (equi-marginal utility). **10**

Marks

(ii) Look for a straightforward explanation of at least 2 of the following:

- Speculation – consumers buy more of a good when its price rises because they expect the price to rise even further. Credit examples.
- Ostentatious buying (Veblen goods) – when the (high) price of a good is well known, some people may buy it to show off. Therefore if the price of the good rises, it might, for these consumers, become even more desirable. Credit examples
- When the quality of a good cannot easily be assessed, its price may be taken as an indication of its quality. If the good falls in price, fewer may be bought because of doubts over its quality. Credit examples.
- Giffen goods – when the price of some basic foods increases, some poorer consumers (whose diet might consist largely of these goods) may be forced to buy more because they cannot now afford anything else. Credit examples. **6**

Marks

5. **(a)** Look for a diagram showing the flow of factor rewards from firms to households and the subsequent flow of expenditure from households to firms – 2 marks. The diagram should also show the 3 injections of income and the 3 withdrawals of income – 3 marks.

Credit definitions of National Income (although not necessary for full marks) eg the total (money) value of goods and services produced in an economy over a period of time ie the income generated from the production of goods and services.

Look for a simple explanation of how and why money flows from firms to households and back again, plus definitions and explanations of injections and withdrawals. Credit explanations of National Income equilibrium. Candidates should then explain how an increase in the level of investment (or any injection) eventually increases national income by a greater amount than the initial increase in investment because of the multiplier process. Look for an appreciation of how the multiplier process rests on the fact that income and expenditure are interdependent ie when those who receive an increase in income spend it, it becomes income for others who in turn spend and so on. The initial investment injects extra income into the economy (credit examples) and when those who receive this income spend part of it (credit references to MPC/MPS), this creates extra income for others who in turn spend part of it thus creating a multiplier effect. The extra income being generated will create increases in demand, encourage producers to increase output and increase employment. Credit definitions of the multiplier, the formula for the multiplier and numerical examples of the multiplier. **15**

Marks

(b) **(i)** Advantages include:

- Increased employment
- Increased competition – leading to lower costs and prices
- Exchange of new technology and management techniques
- Increased capital inflows and exports – positive effect on Balance of Payments
- Reduced prices and wider choice for Scottish consumers.

Credit examples throughout.

Disadvantages

- Can be costly for the government to entice these firms into Scotland
- The money could have been used to help domestic firms (opportunity cost)
- No guarantee that the firms will stay in Scotland
- Creates unfair competition for Scottish firms
- Jobs created may be mainly 'screwdriver' jobs – the highly skilled jobs tend to stay in the home country
- The danger of becoming a 'branch' economy – branches are first to close in a recession
- Adverse effects on local industry
- The heightened conflict between consumers and shareholders when they are of different nationalities
- Repatriated profits worsening the Balance of Payments.

Credit examples throughout.

Three advantages and 3 disadvantages for full marks but can mark 6:4, 5:5 or 4:6. **10**

Marks

6. (a) Although the main reason is that the demand for oil is at an all-time high, the question asks for factors, therefore answers which only give reasons for the present growth in the demand for oil can score a maximum of 4 marks. These reasons include: the high growth rates in China and India which have resulted in huge increases in their demand for oil; the rapid industrialisation in many Eastern European countries which has increased their demand for oil; the increase in the demand for oil in the USA following a comparative economic recovery in some industries; the relatively cold winter. Two marks per reason. Candidates can also score 4 marks for describing supply factors such as: the (20%) fall in oil production in Nigeria; the failure of Iraq to increase its oil production; Bolivia's move to control the oil produced by foreign companies; the fall in oil refining caused by hurricanes; the lack of any significant new oil finds; the possibility that the world has reached the limits of oil exploitation; the effects of terrorism ie the damaging of oil facilities and transportation routes, and the creation of instability in the countries concerned; the failure of the expected new quantities of oil to enter the international market (eg from Russia). Credit highly those who explain the effects of speculation in the futures oil market. **6**

(b) Answers should involve an explanation of the difference between fixed and variable costs (credit definition of the short run – 1 mark). As fixed costs have to be paid even when there is no production, only variable costs are saved by temporarily ceasing to produce. Therefore firms will continue to produce (in the short run) as long as they are able to cover their variable costs. Although they will make a loss by continuing to produce, if they are earning enough revenue to cover their variable costs, there are no cost advantages of temporarily shutting down. If their revenue more than covers their variable costs (but is less than their total costs) they will make less of a loss if they remain in production (credit numerical examples). Continuing to produce will enable firms to maintain the goodwill of their workforces, maintain the loyalty of their customers, keep their machinery ticking over, maintain the profile of their products in the market and avoid the possible difficulty of restarting their production processes. Credit candidates who mention that the decision to close down when variable costs are not being covered will be influenced by the level of the firm's reserves, the expected length of the downturn in demand, the possibility of securing a bank loan etc. Also credit candidates who realise that all costs must be covered in the long run or else the firms will go out of business. **9**

Marks

(c) **(i)** Candidates should explain how an increase in the exchange rate of sterling makes our exports less price competitive (foreigners have to give up more of their currency to buy a given amount of sterling) and our imports more price competitive (each pound is buying more foreign currency). This will cause falls in the demand for the goods made by our exporting industries and our import-competing industries. These falls in demand will reduce the firms' total revenue, which could result in losses.

(ii) The main benefit is that it reduces inflationary pressure in the economy. As imports are cheaper, those industries which import their raw materials, components etc will experience a fall in costs which will help to reduce cost-push inflationary pressure in the economy. The prices of imported finished goods will also be falling. The fall in exports and increase in imports will cause a fall in AMD and therefore reduce demand-pull inflationary pressure in the economy. Also credit references to the increase in the real income of consumers who buy imports. Mark 6:4, 5:5 or 4:6. **10**

[END OF MARKING INSTRUCTIONS]