UNIT 4: EVALUATING ECONOMIC MODELS AND POLICIES

MARK SCHEME

GENERAL MARKING GUIDANCE

Positive Marking

It should be remembered that learners are writing under examination conditions and credit should be given for what the learner writes, rather than adopting the approach of penalising him/her for any omission. It should be possible for a very good learner to achieve full marks and a very poor one to achieve zero marks. Marks should not be deducted for a less than perfect answer it if satisfies the criteria of the mark scheme, nor should marks be added as a consolation where they are not merited.

Below are the assessment objectives for this specification. Learners must demonstrate their ability to:

AO1

Demonstrate knowledge of terms/concepts and theories/models to show an understanding of the behaviour of economic agents and how they are affected by and respond to economic issues

AO2

Apply knowledge and understanding to various economic contexts to show how economic agents are affected by and respond to economic issues

AO3

Analyse issues within economics, showing an understanding of their impact on economic agents

AO4

Evaluate economic arguments and use qualitative and quantitative evidence to support informed judgements relating to economic issues

<table>
<tr><th>Q.1 (a)</th><th colspan="2">Explain, using a diagram, how the price and output of a profit maximising monopoly would be determined in the short run. [10]</th></tr>
<tr><th rowspan="2">Band</th><th>AO1</th><th>AO3</th></tr>
<tr><th>6 marks</th><th>4 marks</th></tr>
<tr><td>3</td><td>5-6 marks

Excellent understanding of monopoly in the short-run.

Completely accurate diagram:
MC cuts min point of AC
MR is twice the gradient of AR
Equilibrium, output is at MC=MR
Equilibrium price is on AR at the equilibrium output.</td><td></td></tr>
<tr><td>2</td><td>3-4 marks

Good understanding of monopoly in the short-run.

Diagram may contain a few minor errors, but correct in terms of its profit maximisation elements and a good understanding of monopoly in the short-run is shown.

Or diagram is completely correct, but there is no reference to monopoly in the short-run.</td><td>3-4 marks

Good clear analysis as to why profits are maximised at the output where MC=MR and why price will be determined by AR consistent with that output.</td></tr>
<tr><td>1</td><td>1-2 marks

Limited understanding of monopoly in the short-run.

Diagram is recognisable as monopoly, but gets either profit maximising output or price incorrect and also errors with respect to MC/AC or MR/AR.</td><td>1-2 marks

Limited analysis.

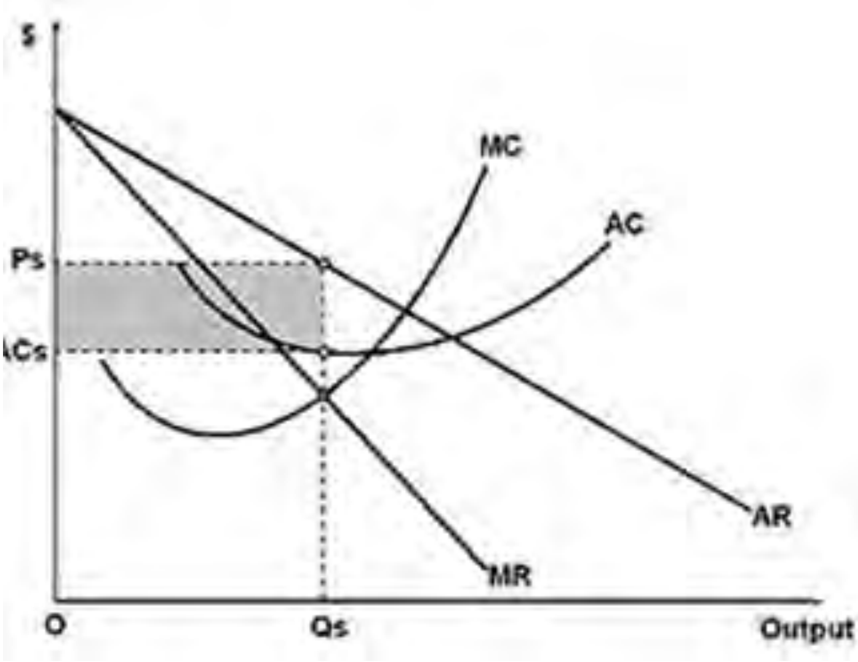
Either clear analysis as to why profits are maximised at MC=MR with no reference to price.

Or limited, but not wholly convincing explanation of both price and output.</td></tr>
<tr><td>0</td><td>0 marks

Diagram wholly incorrect.</td><td>0 marks

No valid analysis present.</td></tr>
</table>

Indicative content:



Monopoly firms have barriers to entry such as economies of scale, sunk costs, strategic advantages and so on and are hence able to set their own price. Pure monopolies have a 100% market share, meaning that the firm's demand curve is the industry demand curve.

Profits are maximised at the output at which MC=MR. Before this output, all units produced add more to revenue than cost, meaning that profits increase with each unit produced. Beyond this output, MC is above MR meaning that each unit produced adds more to cost than to revenue, hence profits will be reduced. Therefore profits are maximised at MC=MR.

Price will be set so that the profit maximising number of units are demanded by consumers. Because the AR curve is also the demand curve, price will be determined where Qs in the diagram above intersects with the AR curve.

Q.1 (b)	**Evaluate the assumption that firms will always aim to maximise profits.**		**[20]**
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5-6 marks** Excellent understanding of the factors that determine whether firms aim to maximise profits. There is broad and deep coverage of the factors that are relevant with no significant omissions. Points are well-developed and linked back to the assumption of profit maximisation.	**5-6 marks** An excellent analysis of the assumption that firms will always want to maximise profits. A well-developed argument has been made with a focus on the assumption, not just profit maximisation. Arguments in this band do not simply talk about whether firms do/don't or can/cannot maximise profits, they link these points back to whether the assumption is sensible.	**6-8 marks** An excellent critical evaluation. Learner fully evaluates the assumption of profit maximisation pointing out that under certain circumstances that assumption is warranted, in other cases not. Very top band response will tend to separate out the assumption from the actual behaviour of the firms – i.e. even if firms do not in fact maximise profits, the assumption may still be useful. Clear judgements are made with supporting statements to build an argument.
2	**3-4 marks** Good understanding of the factors that determine whether firms aim to maximise profits. Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band.	**3-4 marks** A good analysis of the assumption that firms will always want to maximise profits. Answers in this band show developed chains of argument with a sensible grasp of whether firms do, can or should maximise profits. Answers in this level may lack depth, diagrams may not always be well-integrated or completely correct, or key points are missing.	**3-5 marks** A good evaluation that includes most of the key issues. At least 2 points are evaluated with a clear discussion of why the assumption of profit maximisation might not be reasonable. Answers in this level will qualify arguments (profits are vital for reinvestment, but…) without really focusing back on whether this makes the assumption useful/sensible.
1	**1-2 marks** Limited understanding of the factors that determine whether firms aim to maximise profits. Several advantages and disadvantage of monopoly are identified, but struggles to show understanding.	**1-2 marks** Limited analysis as to whether firms do/can/should maximise profits. Answer lacks key economic concepts and tends to avoid technical analysis.	**1-2 marks** Limited evaluation. The learner shows an awareness that profit maximisation may not always be a sensible assumption. There is some attempt to evaluate points, but evaluation tends to be asserted rather than explained.
0	**0 marks** No knowledge or understanding present.	**0 marks** No relevant analysis.	**0 marks** No relevant evaluation.

Indicative content:

Firms will wish to maximise profits

They need funds for reinvestment.

High profits make it easier to sell shares in the longer term.

Profits are the reward for the entrepreneur who may well own the firm. **But** in the city, most large companies face the divorce of ownership from control, so this may not really be justified.

Profits are needed to keep shareholders happy – failure to maximise profits may lead to shareholder revolts at AGMs, shareholders may sell shares resulting in a fall in share price, making it harder to sell shares in the longer term and making the firm more vulnerable to takeover. But shareholders face difficulties in exerting control over decision takers due to information asymmetry, collective action and day-to-day control issues, meaning that managers may be free to pursue their own objective (hence managerial theories of the firm).

Firms may not wish to maximise profits

Risk of short-termism destroying the firm in the long-term – excess focus on short term profits may alienate consumers, workers etc.

Not all businesses operate with profit in mind – network rail, charities or alternatively, some firms see profit as a by-product of success rather than a goal to be pursued in and of its own right.

At times other objectives such as survival (hence prioritising cash flow) will make more sense.

Firms may have longer term goals – Amazon made no profits for its first 8 years of operation in an attempt to maximise its long-term profit.

Risk of excessive profit - leading to risk of tougher regulation in the longer term.

Firms may not be able to maximise profits

Divorce of ownership from control (see above).
Behavioural theories.
Lack of information on MC and MR.

Overall

May be a more sensible assumption for some firms than others, depending on circumstances.

Whether firms do or don’t maximise profits may not be the key - the point is a useful assumption about firms’ behaviour that provides a template for comparing the real world with – the whole point about assumptions is that they don’t have to be realistic – their goal is by their very nature to simplify reality.

Without some level of profits, firms are not going to be able to survive in the long run, but whether it is necessary to maximise profit is probably open to debate.

Q.2 (a)	**With the aid of appropriate examples, explain the main features of oligopoly. [10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5-6 marks** Excellent understanding of the key features of oligopoly. Clear use of actual characteristics of oligopoly from different sectors. Examples may be broad based, to do with types of industry and precise specific case-studies are not required**.** For example, when talking about barriers to entry, learners might talk about the high cost of mobile phone licences, but in-depth knowledge is not required.	
2	**3-4 marks** Good understanding of the key characteristics of oligopoly. But these lack convincing examples; answer may talk about interdependence, but may be unable to give examples of circumstances in which this might occur. **Or** the answer may demonstrate good examples, but lack depth of explanation as to what the characteristics really mean in economic terms.	**3-4 marks** Good clear analysis why the features are inherent to oligopoly. Clear chain of argument that analyses the features and shows a clear connection between the features and why they are present in oligopoly. Where characteristics are unique to oligopoly, answers may contrast with other market structures explaining why the feature is key to oligopoly but does not occur elsewhere (interdependence, for example), but this is not required.
1	**1-2 marks** Limited understanding of the key characteristics of oligopoly. Learner lists a number of characteristics, but does not show understanding of what the characteristic really means. Low band answers will not have examples. If examples are being given, they may be anecdotal rather than clearly exemplifying the characteristic being described.	**1-2 marks** Limited analysis why the features are inherent to oligopoly. **Either** the link to oligopoly is superficial for all characteristics – it is not clear what it is about the nature of oligopoly that makes this characteristic central or important. **Or** only 1 or 2 of the characteristics are linked back effectively and the others are largely asserted.
0	**0 marks** Relevant features not identified.	**0 marks** No valid analysis present.

Indicative content:

Features are likely to include

Interdependence – there are a small enough number of players that each will have to think about the probable response of others before embarking on strategic changes.

Uncertainty – the response of other firms cannot be predicted in advance, making it difficult to know what the optimum strategy will be.

Price stability under certain circumstances (may be illustrated with game theory/kinked demand curve), punctuated by occasional price wars.

Hence non-price competition may well dominate competitive strategies.

Possibility of collusion because there are a small enough number of firms for agreements (tacit or otherwise) to hold.

Barriers to entry allowing abnormal profits to be earned in the long-run.

A distinction may be made between structural and behavioural barriers to entry

Q.2 (b)	Discuss the need for government intervention in UK energy markets. [20]		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5-6 marks** Excellent understanding of the need for regulation in energy markets. At least 4 points are identified which show a good understanding of both the problems of unregulated markets and the disadvantages of regulation. Answers in this band will contextualise their answers, referring to the UK energy sector.	**5-6 marks** An excellent analysis of the impact of government intervention on UK energy markets. At least 4 points are analysed with a clear line of argument linking them to the desirability or undesirability of government intervention in oligopoly markets. Answers in this level will use appropriate diagrams to support their analysis.	**6-8 marks** An excellent critical evaluation. At least 3 evaluation points are well-explained. There is a very well-developed argument. A well-reasoned conclusion may be included which looks at the circumstances in which intervention might be more or less desirable in energy markets.
2	**3-4 marks** Good understanding of the need for regulation in energy markets. 3 or 4 points are identified which show a good understanding of both the problems with unregulated markets and the disadvantages of regulation. Answers in this band will contextualise their answers, referring to the UK energy sector.	**3-4 marks** A good analysis of the impact of government intervention on UK energy markets. At least 2 or 3 points are analysed linking them to the desirability or undesirability of government intervention in oligopoly markets. Analysis may lack depth, diagrams may not always be well integrated or completely correct, or key points are missing.	**3-5 marks** A good evaluation. At least 2 points are evaluated with a clear understanding of why intervention may not always be desirable or undesirable. Answers in this level will tend to qualify arguments without giving an overview of what will make intervention more or less likely to produce beneficial or undesirable outcomes. Reference to energy markets is likely to be limited.
1	**1-2 marks** Limited understanding of the need for regulation in energy markets. Several reasons for and against intervention are identified, but struggles to show understanding and examples are not present.	**1-2 marks** Limited analysis of how intervention is or is not undesirable. Answer lacks key economic concepts and tends to avoid technical analysis.	**1-2 marks** A limited evaluation. A brief attempt to show that intervention may not always produce desirable outcomes. There is some attempt to evaluate points, but evaluation tends to be asserted rather than explained.
0	**0 marks** No knowledge or understanding present.	**0 marks** No relevant analysis.	**0 marks** No relevant evaluation.

Indicative content:

The case against

Free market economies will allocate resources optimally and although the energy market is not perfectly competitive, there are claims by some that the market delivers low prices relative to those in the rest of Europe.

Excessive intervention will impose costs on firms which will either erode profits, damaging investment into the long-term energy security of the country or will be passed on to consumers in the form of higher prices.

The UK may become unattractive to the sorts of multi-national entities that will be needed if the UK is to develop a privately funded nuclear power industry (for example).

Government intervention may result in government failure, where government initiatives to force firms to act will result in distortions which reduce economic welfare (subsidies for green energy, regulation over light bulbs etc.).

The case for

The big 6 energy firms appear to be acting as a cartel, with prices rising and falling simultaneously **but** the energy companies themselves argue that this is an inevitable by-product of the fluctuating wholesale price of gas and electricity **but** they themselves set these prices too due to vertical integration and evidence suggests that prices rise much more easily than they fall in response to changing wholesale prices.

Theoretical arguments about the need for intervention to deal with disadvantages of oligopoly markets:

- Protect consumer welfare
- Promote efficiency
- Support the wider needs of the economy as a whole.

Strong answers will relate these effectively back to the markets for energy- vulnerable consumers, fuel poverty and so on.

All markets need some degree of intervention even if simply in terms of background rules and regulations.

Judgement

Intervention comes in many forms and does not necessarily imply restrictions on firms – government sponsored initiatives to promote energy efficiency, for example would be classed as intervention.

Any intervention needs to balance the needs of current consumers with the needs of future consumers – if the impact of reducing bills to today is to create power shortages in the future then we will have failed the test of inter-generational efficiency.

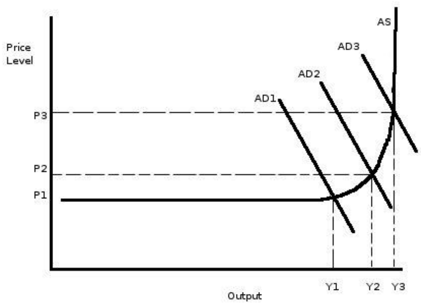
However, most commentators seems to feel that the market isn't working well for consumers, with smaller entrants struggling to access wholesale supplies, therefore some sort of intervention of some form might be seen to be desirable, but much will depend on that form.

Q.3 (a)	**Explain, using diagrams, the difference between demand-pull and cost-push inflation.** **[10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5-6 marks** Excellent understanding of the 2 types of inflation. Diagrams are accurate and examples are appropriate. Answer demonstrates a clear awareness of what each type of inflation is.	
2	**3-4 marks** Good understanding of the 2 types of inflation. Answers in this band are likely to show a well-developed understanding of only 1 of the 2 causes of inflation.	**3-4 marks** Good clear analysis. Each type of inflation is explained in detail - there is direct use made of the diagrams and examples and the reason that prices rise in each case is made completely clear.
1	**1-2 marks** Limited understanding of the 2 types of inflation. Learner may focus on only 1 type. The diagrams have several major flaws.	**1-2 marks** Limited analysis. Only 1 of the 2 types of inflation is well-explained in terms of why prices are rising. Superficial explanation as to why prices are actually rising.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.

Indicative content:

Demand-pull

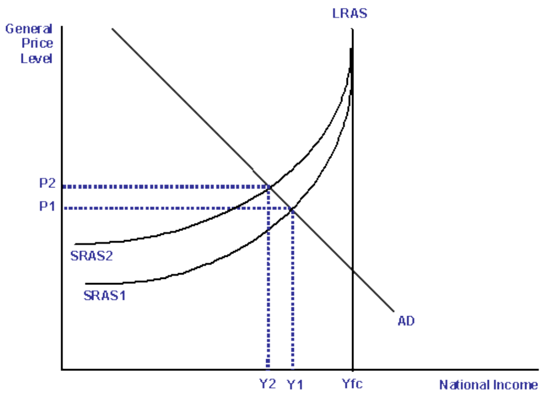
Demand-pull inflation occurs where AD rises faster than the capacity of the economy to cope – hence AD may be rising faster than potential growth without there being slack in the system to be able to accommodate it. As a result there is reduced competition in product markets, making it easier for firms to have more customers than they need. On top of this there is pressure in factor markets as a result of increased competition for resources, meaning that firms may be forced to increase their prices. Examples may be real (mid 00s as interest rates rise to control it) or theoretical with a clear explanation of why AD might be rising.



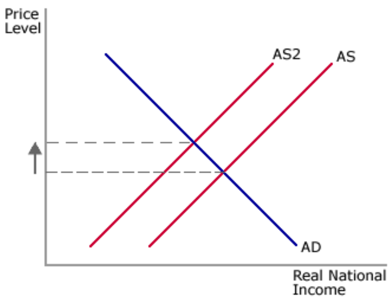
Cost-push

Cost-push inflation occurs where there is some sort of supply shock such as commodity prices or pay claims that drives up the cost base of domestic firms. Consequently firms are forced to pass on price increases to consumers to protect their profit margins.

Some answers may refer to the linkages between cost-push and demand-pull inflation, using the wage spiral to their advantage.



Or alternatively this diagram



Q.3 (b)	**Discuss the view that policies to reduce inflation will always lead to increasing levels of unemployment. [20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5-6 marks** Excellent understanding of policies used to reduce inflation. At least 3 broad key strategies to reduce inflation are explained. The strategies have depth to them and there is clear understanding as to how they would be intended to operate (not just 'AD goes down so inflation falls').	**5-6 marks** An excellent analysis of why the policies to reduce inflation may impact on unemployment. Learner has a clear line of argument to explain how strategies will or will not increase unemployment. It is likely that at least 3 different strategies will be analysed, but the key here is the depth of explanation and analysis- a band 3 answer will be very clear exactly why the policy does or does not increase unemployment.	**6-8 marks** An excellent critical evaluation. Learner comes to a clear view as to the circumstances under which inflation reduction strategies will be likely to cause unemployment. The answer is likely to deal with the underlying cause of inflation and consider the idea that different types of strategy may be more or less appropriate depending on the circumstances being faced.
2	**3-4 marks** Good understanding of policies used to reduce inflation. At least 2 or 3 appropriate strategies are identified and attempt to explain in some detail how they would be intended to work. The explanation as to how the policy is intended to operate is not well developed, meaning that full understanding is not really demonstrated.	**3-4 marks** A good analysis of why the policies to reduce inflation may impact on unemployment. Answer may be strong only on 1 policy, with limited development of others. Alternatively, the answer may attempt to explain the links between the policy and unemployment, but may not be fully detailed in terms of its approach.	**3-5 marks** A good evaluation. Answers in this level will have qualified arguments but the answer lacks a fully rounded approach to the question – the evaluation feels fragmented probably arguing that 1 policy will be likely to increase unemployment but a different one won't – each policy is treated on its own merits rather than looking at the question as a coherent whole.
1	**1-2 marks** Limited understanding of policies used to reduce inflation. 1 or 2 approaches are identified, but they are stated without explanation, meaning that an understanding of what the policies really are or how they might operate is not effectively conveyed.	**1-2 marks** A limited analysis of why the policies to reduce inflation may impact on unemployment. Analysis is limited primarily to diagram based assertion in which the impact of a policy is shown through AD/AS diagrams, but the forces which are driving the links between unemployment and inflation are not developed.	**1-2 marks** A limited evaluation. A basic attempt to show that policies to reduce inflation may not always increase unemployment. Points are qualified to a limited extent, but there is little depth of explanation.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.	**0 marks** No valid evaluation present.

Indicative content:

Much will depend on the state of the economy - it will be difficult to reduce cost-push inflation without increasing unemployment (although it may be possible, depending on which type of inflation reduction strategy is introduced). Demand-pull inflation is easier to control without significant job losses, although even here, it may well be the case that some job losses are unavoidable in industries that are most directly affected by the inflation reduction policies.

Policies are likely to come in 4 broad categories:

(1) Demand side

Good answers here will answer that the goal isn't necessarily to reduce AD, but to reduce that rate of growth of AD. Hence if these policies are being used to tackle demand-pull inflation, a major rise in unemployment is probably avoidable, although this will depend on how the policy is implemented.
Likely approaches include:

(i) Monetary – answers might go down a standard interest rate control path or might attempt to use the quantity theory and look at control of the money supply (or might compromise and talk more generally about QE).

(ii) Fiscal – answer might talk about cuts in G and increases in T and then assess the extent to which these are likely to create job losses.

It's likely that good answers will contain a couple of approaches from here.

(2) Supply-side

Stronger answers here will probably look at how SSPs in this context are designed to break the wage-price spiral by increasing competition in product markets and greater flexibility in labour markets. Hence, even though on an AD/AS diagram these policies appear to square the circle, the reality is that there may be significant job losses in the short-run, again depending on the type of inflation that they are introduced to combat. Good analysis requires that there is a clear understanding of the way in which the policy identified actually impacts on inflation and hence whether or not jobs are likely to be lost.

(3) Direct controls

This might be a reference to old-fashioned prices and incomes policies, could be control of public sector wages or could be direct control of process in state-run sectors in economies other than the UK. Might refer to regulation of the housing market to prevent the emergence of asset bubbles which can feed through into price inflation.

(4) Policies to influence inflationary expectations

Might be inflation targeting, forward guidance, central bank independence and so on.

Q.4 (a)	**Explain, using an appropriate diagram, why an increase in income tax might be associated with either a rise or fall in the budget deficit. [10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5-6 marks** Excellent understanding of the budget deficit. A clear diagram is used which shows that the learner is aware that changes in income tax might impact either positively or negatively on tax revenue and correctly identify the factors for this. A clear understanding of what is meant by a budget deficit is shown.	
2	**3-4 marks** Good understanding of the budget deficit. Answers in this band are likely to show a well-drawn diagram which illustrates the impact of income tax changes on tax revenue, but a clear understanding of what is meant by the budget deficit is not demonstrated, and the diagram may not be well-integrated into the answer. The answer may identify factors for either an increase or a decrease in the budget deficit not both, using an accurate diagram, but answering only part of the question.	**3-4 marks** Good clear analysis on the impact of tax on the budget deficit. There is a clear analysis as to how a rise in income tax might either increase or reduce tax revenue hence either reducing or increasing the budget deficit. The diagram is well-used to support the analysis.
1	**1-2 marks** Limited understanding of the budget deficit. The diagram has errors and the response tends to be centred around assertions about incentives to work and tax avoidance without explaining how these occur.	**1-2 marks** Limited analysis on the impact of tax on the budget deficit.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.

Indicative content:

The Laffer curve is likely to be the central part of the answer. Answers which go through AD/AS are unlikely to hit the top bands because they will struggle to produce alternate analysis for an increase or decrease in the budget deficit.

Improved budget deficit

Higher income tax rates will be likely to generate higher tax revenue because in reality most people face very little choice over whether or not they work. Therefore an increase in income tax rates, especially a modest one, is unlikely to have much impact on the willingness to work, except perhaps at the margin, and any such marginal effects will be dwarfed by the fact that the majority of income tax payers are effectively unable to avoid it by virtue of both having to work and having income tax deducted at source.

Worse budget deficit

Higher income tax rates, beyond a certain point, may begin to decrease tax revenue because of the possibility, especially for high income earners or the self-employed to engage in tax avoidance and evasion. Very high income earners who are internationally mobile may seek to rebase themselves in other domiciles to avoid high rates of tax. Low income groups may now find that it is more worth their while not to work if the benefits system is badly constructed, hence again reducing the government's tax revenue and also increasing spending on benefits.

Q.4 (b)	**"Cutting the national debt is more important than increasing government spending to promote economic growth". Discuss. [20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5-6 marks** Excellent understanding of the reasons why high national debt is undesirable. There are no major omissions in terms of main factors and there is good depth of explanation of why debt might be problematic.	**5-6 marks** An excellent analysis of the impact of high levels of national debt on economic growth. Learner has a clear line of argument explaining how each policy might be likely to promote growth. There are clear theoretical links to long-term growth here – the emphasis is not solely on AD.	**6-8 marks** An excellent critical evaluation of which policy will be most likely to promote growth. Learner comes to a clear view as to the circumstances under each policy will be more or less likely to create growth – each policy is well-discussed with the problems and limitations clearly identified. Top of the band responses will be well-anchored into the current situation in the UK.
2	**3-4 marks** Good understanding of the reasons why high national debt is undesirable. At least 2 or 3 key problems are identified but there is limited depth of explanation suggesting that not all of the points are fully understood.	**3-4 marks** A good analysis of the impact of high levels of national debt on economic growth. Answer may be strong only on 1 policy, with limited development of others. Alternatively, the answer may attempt to explain the links between the policy and growth, but may lack detail. Answer may tend to focus on problems with actual growth rather than looking beyond this.	**3-5 marks** A good evaluation of which policy will be most likely to promote growth. Answers in this level may evaluate one half of the title more effectively than the other, most likely discussing the impact of rising government spending well but being more one-sided with respect to debt. Alternatively, evaluation may not really centre on growth, being more the advantages and disadvantages of reducing debt/boosting spending.
1	**1-2 marks** Limited understanding of the reasons why high national debt is undesirable. 1 or 2 problems are identified, but they are stated without explanation, meaning that an understanding of what the problems really are is not effectively conveyed.	**1-2 marks** A limited analysis of the impact of high levels of national debt on economic growth. Analysis is limited with simple AD/AS diagrams being linked to rising government spending and cuts in debt being linked to falling AD.	**1-2 marks** A limited evaluation of which policy will be most likely to promote growth. A basic attempt to show that policies may not always be beneficial.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.	**0 marks** No valid evaluation present.

Indicative content:

Cutting the debt is more important if growth is to be created

High levels of national debt can have a number of negative impacts on the economy:

The opportunity cost of debt interest and repayments. In the current year, debt interest is £50bn, over 50% of the education budget, which implies less funding to contribute towards long-term economic growth. **On the other hand**, interest rates are historically low and a significant proportion of the debt is held by the Bank of England at the present time lessening the true impact. Also high rates of actual growth are likely to start to repay the debt in a few years' time without any need for further government action, although some argue that the deficit is still structural, implying that this argument itself may not hold.

The UK may become like Greece and be unable to access international capital markets, resulting in much more serious and sudden budget corrections which will plunge the economy into recession damaging actual and potential growth (as the government has to cut back on key areas of expenditure). **However**, UK bond yields remain at historic lows in spite of the size of the current budget deficit, suggesting that there is no imminent danger of a funding crisis.

High levels of borrowing may crowd out the private sector by driving up the cost of private capital and restricting the supply of funds to businesses (lenders preferring the security of gilts). Hence investment may be damaged, meaning that long-term growth may be negatively affected. Hence Reinhart-Rogoff. **However,** rates remain at historic lows and most analysis suggests that business borrowing is demand constrained rather than supply constrained and that what constraints there are on the supply-side are more to do with banks' capital requirements.

High levels of government debt may damage consumer and business confidence, again restricting investment.

Fears of instability in the UK system as a result of high public sector debt and a subsequent run on the pound may deter FDI, again restricting growth. **But** debt is relatively low by historic standards, bond yields are low and the UK has a good track record on meeting its obligations.

Increasing government spending is more important if growth is to be stimulated

Cutting debt via fiscal tightening may create the risk of debt deflation in which neither objective is achieved – growth is stunted and the debt remains high. Therefore increasing government spending may be a route to both lowering debt in the long-term and stimulating growth.

Government spending on infrastructure may stimulate I and FDI, contributing to an improved industrial base and growth.

Government support for science, enterprise and innovation may well stimulate growth and is important because most growth theory stresses the importance of technological advancement if diminishing returns to capital are to be avoided.

Government investment in skills and education is also likely to be important at a time when the population is relatively static and ageing.

However

In the short-term, such measures may increase the national debt exacerbating the issues identified above. Furthermore there is a risk of mal-investment and white elephants that create bubble risks and long term maintenance expenditure respectively.

Overall

Much depends on where the government spending is directed if G is increased. For this to work, it needs to be in areas that will underpin the long-term success of the economy (although Keynesians might well argue that any sort of government spending is valuable to promote short-term growth, but this argument is less applicable now that the economy is recovering strongly).

If the focus is on reducing debt, much may depend on the way in which debt is reduced and the speed at which it is reduced. Clearly in the long-term, debt of up towards 100% of GDP is undesirable, but growth itself may help to repay this. If short-term cuts in infrastructure spending damage potential growth then the policy may be self-defeating. On the other hand, well-directed cuts may allow the debt to be reduced more rapidly than it might otherwise have been without significant damage to economic growth.

Much may also depend on the underlying flexibility of product and labour markets. If these are fully flexible then the budget deficit can be reduced rapidly via a period of austerity with no real long-term consequences, but the evidence suggests that even in the UK this flexibility is not as great as it might be.

Q.5 (a)	**Explain the strengths of possible measures of economic development. [10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5-6 marks** Excellent understanding of the measures of economic development. There is a good range of indicators used and the answer shows that these measures have been well-understood. Answer will have at least 1 major indicator out of national income per capita or the HDI.	
2	**3-4 marks** Good understanding of the measures of economic development. The answer lacks either range or depth, perhaps mainly focussing on 1 major indicator in-depth with others dealt with in passing. Alternatively there may be a wide range of indicators but a lack of depth of explanation.	**3-4 marks** Good clear analysis of the advantages/strengths of the measures identified. There is a clear link to why they will show development.
1	**1-2 marks** Limited understanding of the measures of economic development. The answer may amount to little more than a thinly developed list of different factors.	**1-2 marks** Limited analysis of the advantages/strengths of the measures identified. The link between the measure and economic development is not made fully clear.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.

Indicative content:

The HDI

The Human Development Index measures three key components of development – education, health and living standards. Each of these areas has a sub-index and the final index is the geometric mean of the three sub-indices.

Each of the individual sub-indices is measured on a scale of 0-1, with 1 being the highest point on the scale, and is determined by the current best performing country in that area. Hence performance is relative- a country's HDI will fall if it fails to improve as quickly as the best performer. Another way in which the index is relative is the classification of development. There are four categories- very high, high, medium and low, but these are simply determined by quartiles- only the highest scoring 25% of the countries can have 'very high' human development.

The education sub index is centred around years of schooling - both the average in the country and the current expected number of years.

The health index is based on life expectancy at birth.

The income index is based on the logarithm of GNI/capita and PPP.

Strengths

The three sub-components reflect key elements of the Millennium Development Goals.
Measuring years of health gives a good indicator as to the overall strength of the health system; if many children die young due to inadequate healthcare, the average life expectancy will be pulled down.

Education is important in development, encouraging people to invest in education and just as a measure of living standards in their own right.

GNI adjusted for purchasing power is important because rising income will allow greater access to diet, health and education for individuals as well as providing income for the state.

National income per capita (GDP/GNP/GNI)

Credit should be given to answers which distinguish between GDP and GNI/P as being more appropriate in different circumstances (generally focussed on the presence or otherwise of MNCs)

National income is useful because it shows both individual and state access to resources. Hence individuals will have better access to housing, health, education and diet whilst the state will have more resources for providing public and merit goods.

Other indexes

Might include the MDPI, Gross National Happiness, Green GDP and so on. As long as these are accurately explained then credit should be given.

Individual measures

Such as doctors/1000, internet access, child mortality rates and so on. Provided these are accurately explained and their relevance to development is explained, these are fully credit-worthy.

Q.5 (b)	**To what extent do increasing levels of GDP in an LEDC guarantee increasing standards of living? [20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5-6 marks** Excellent understanding of the advantages and disadvantages of rising GDP. Answer shows a detailed understanding of at least 4 key issues on either side of the debate.	**5-6 marks** An excellent analysis of how increasing levels of GDP impact on living standards. Learner has a clear line of argument to explain how the factors that they identify actually impact positively or negatively on living standards.	**6-8 marks** An excellent critical evaluation. Learner comes to a clear view as to the circumstances under which rising GDP will be likely to improve living standards. There is more than just a two-sided answer here - each point is well-discussed with the problems and limitations clearly identified. Top of band responses will be likely to have a well-rounded conclusion.
2	**3-4 marks** Good understanding of the advantages and disadvantages of rising GDP. At least 2 key issues are identified with understanding shown.	**3-4 marks** A good analysis of how increasing levels of GDP impact on living standards. Answer may be strong only on some of the factors identified, with a limited development of others in terms of the impact on living standards.	**3-5 marks** A good evaluation. Answers in this level may evaluate one half of the title more effectively than the other.
1	**1-2 marks** Limited understanding of the advantages and disadvantages of rising GDP. 1 or 2 issues are identified, but they are stated without explanation.	**1-2 marks** A limited analysis of how increasing levels of GDP impact on living standards.	**1-2 marks** A limited evaluation. A basic attempt to show that rising GDP may not always be beneficial.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.	**0 marks** No valid evaluation present.

Indicative content:

Rising GDP may increase living standards.

Rising GDP will increase the government’s tax base, hence allowing the government to increase spending on healthcare, education and infrastructure, all of which should feed into higher living standards. **However**, this assumes that GDP is growing faster than the population, because otherwise the increased demand for government provided services will mean that there may not be any real improvement. Also it assumes that the government is able to collect tax from the additional GDP, which may not always be straightforward.

Increasing levels of GDP should mean an increase in GDP/capita, provided that GDP is growing faster than the population as a whole. This will mean that individual households can access better housing, diet, education and healthcare (where these are not provided by the state). These should lead directly to an improved quality of life. **However**, this presupposes that the increase in GDP is evenly distributed- if there are significant income inequalities present, then rising GDP may not increase the living standards of the majority, and indeed, if higher incomes in some groups results in inflation, living standards may actually fall for low income rural groups.

In the long run, rising GDP may begin to allow a trade-off of income for leisure – working hours may fall and access to labour saving devices may allow greater free time as well. The relevance of this point will depend on exactly what stage of development the LEDC is at.

Further evaluation

Much will depend upon the role of the state in (i) ensuring even income distribution and (ii) making effective use of the increased tax income – different countries’ governments have different priorities with respect to (say) defence v’s health – where government finances are allocated will clearly have an impact on living standards.

Rising GDP implies increasing industrialisation. This may lead to rising external costs in the form of pollution, especially in urban areas, which may mean that improvements in living standards may be lower than it at first appears. Likewise it is difficult to place a value on the threat to community/family life that industrialisation may entail.

Some research suggest that in areas with a high prevalence of HIV, increased growth implied increased economic activity which seems to lead to a more rapid spread of the disease because of greater internal trade.

GDP is not GNI – if substantial amounts of the increased output comes from MNCs, which then repatriate significant amounts of profit, the impact on living standards may be lower than might at first be thought.

The rise in GDP will obviously need to be in real terms – hence inflation adjusted GDP is the key.

Overall

Most developed countries have a high GDP/capita. Most LEDCs have low GDP/capita. Whilst this is a correlation not a causation (and the correlation between log GDP/capita and PPP and the HDI is striking) it is obviously the case that rising GDP can make a major contribution to rising living standards if managed in the right way.

Q.6 (a)	**Explain some of the ways in which a country can make its labour markets more flexible. [10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5-6 marks** Excellent understanding of a flexible labour market. There is a well-articulated explanation that flexibility refers to adapting/responding quickly to changes in the macro economy. The student identifies a number of labour market policies or changes that would make it more flexible.	
2	**3-4 marks** Good understanding of a flexible labour market. The answer understands clearly what a labour market (or even labour force) is. Some development linking the labour market and flexibility.	**3-4 marks** Good clear analysis of how the methods identified will make the labour market more flexible. Each method is linked clearly to the impact on labour market flexibility. The best answers will use correct economic terminology throughout.
1	**1-2 marks** Limited understanding of a flexible labour market. The answer understands what the labour market (or even labour force is) but cannot link to the concept of adapting quickly nor identify any particular issues.	**1-2 marks** Limited analysis of how the methods identified will make labour markets more flexible. The method itself may be clearly explained, but the link back to labour market flexibility may be unclear.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.

Indicative content:

The labour force is the actual number of people available for work and labour market flexibility refers to the ability of the labour force, as a whole, to respond to changes in the macro-economy quickly. These changes might include the impact of innovation and changing technology, shifts in consumer preferences and external shocks. Economists who believe in the power of freely functioning markets for goods, services, capital and people are supporters of flexible labour markets.

The table below summaries different aspects of labour market flexibility with examples for each:

Price (wage) flexibility	**Numerical flexibility**	**Temporal flexibility**	**Occupational flexibility**	**Location flexibility**
Regional and local pay agreement rather than national wage settlements	Expansion of short term employment contracts	Flexibility of working time i.e. overtime and weekend working	Ability of labour force to use varied technology	Geographical flexibility
Pay packets reflecting skill differentials	Growth of home working	Increased use of part-time staff to meet changes in demand	Transferable skills within the workplace	Willingness to relocate
Use of performance-related-pay to boost productivity		Core of full-time employees on contracts		

Taking one (occupation flexibility); in order for a labour force to remain flexible it is essential that workers have a number of transferable skills. This means that when consumer preferences change from one product to another and industry reallocates its resources into the production of that particular good, workers can complement that change by being able to make the new product without the need for extra re-training or education (which is expensive and time consuming). It is unrealistic to think that everyone could be trained for every possible job but it is possible to educate people with transferable skills such as Maths, English, and IT that makes transition from one job to the next quicker and smoother.

Q.6 (b)	**To what extent is structural reform (free market policies) the best way of encouraging economic growth in LEDCs? [20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5-6 marks** Excellent understanding of structural reform. Answer shows an understanding of structural reform and gives at least 2 examples of possible structural reform policies.	**5-6 marks** An excellent analysis on the impact of structural reform on economic growth in LEDCs. Learner has a clear line of argument explaining how the factors that they identify actually impact positively or negatively on economic growth in LEDCs. Greater credit will be given to answers that include real-life examples as support for arguments.	**6-8 marks** An excellent critical evaluation. Learner comes to a clear view as to the extent to which structural reform is the best way of encouraging growth in LEDCs. There is more than just a two-sided answer here – each point is well-discussed with the problems and limitations clearly identified. There is also either a direct or implied comparison to other ways in which economic growth can be achieved in LEDCs. Top of band responses will be likely to have a well-rounded conclusion.
2	**3-4 marks** Good understanding of structural reform. Answer shows an understanding of structural reform, but only offers 1 example of possible structural reform policies.	**3-4 marks** A good analysis on the impact of structural reform on economic growth in LEDCs. Answer may be strong only on some of the factors identified, with limited development of others in terms of the impact on economic growth.	**3-5 marks** A good evaluation. Answers in this level may evaluate one half of the title more effectively than the other most likely over emphasising the advantages of structural reform without really balancing them against the real context of a developing country and why they may be harmful. Alternatively, evaluation may not really centre on structural reform but focus on a comparison with other growth strategies.
1	**1-2 marks** Limited understanding of structural reform. Answer shows limited understanding of structural reform policies.	**1-2 marks** Limited analysis on the impact of structural reform on economic growth in LEDCs. Analysis is limited and the link between structural reform and economic growth is not made.	**1-2 marks** A limited evaluation. Answer may well simply identify strengths and weaknesses of structural reform without any attempt to balance these or compare with alternate approaches.
0	**0 marks** No knowledge or understanding present.	**0 marks** No valid analysis present.	**0 marks** No valid evaluation present.

Indicative content:

Free market policies are policies that are concerned with the expansion of markets within the domestic economy. They include fiscal discipline and the avoidance of fiscal deficits, privatisation of state enterprises, liberalisation of inward foreign investment, deregulation etc.
The advantages of encouraging free market policies lies in the belief that privately owned firms that are producing for profit with lead to greater economic growth in the economy. For example, the learner could focus on areas such as:

Private firms minimising cost (thus becoming more competitive).

Greater incentive for firms to innovate and for more entrepreneurs to get started.

Consumer sovereignty is maximised (leading to more efficient allocation of resources and less wastage in the economy) – could be linked to PPF diagram.

Tax base is increased, government borrowing can be reduced.

Will attract inward investment.

Each line of analysis should a show a linkage to economic growth by way of an explanation of how the above causes GDP to increase. In several cases an AD/AS diagram is appropriate (though not strictly necessary).

However

Domestic firms will only produce what is profitable.

May ignore public goods/under-produce merit goods.

May ignore negative externalities.

May lead to monopoly power.

Domestic firms may be unable to compete with foreign importers.

May widen income distribution/have a regressive effect.

Normally the learner will develop a line of argument with an acknowledgement that growth is likely to occur but at some cost. In some cases (domestic firms can't compete), it may be that the learner questions altogether whether or not economic growth is a net result from the introduction of free market policies.