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# Economics

## Higher level

### Paper 2

10 November 2023

**Zone A** morning | **Zone B** morning | **Zone C** morning

1 hour 45 minutes

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#### Instructions to candidates

- Do not open this paper until instructed to do so.
- You are permitted access to a calculator for this paper.
- Unless otherwise stated in the question, all numerical answers must be given exactly or correct to two decimal places.
- You must show all your working.
- Answer one question.
- Use fully labelled diagrams and references to the text/data where appropriate.
- The maximum mark for this examination paper is **[40 marks]**.

Answer **one** question.

1. Read the extracts and answer the questions that follow.

### **Text A — Costa Rica: Economic growth and development strategies**

- 1** In the early 1990s, Costa Rica, a Central American country with a population of approximately 5 million people, was considered an economic development success story. This stable democracy has experienced consistent economic growth (approximately 4 % annually) for the last 20 years. Some experts say this has been due to moving from a failed **import substitution** policy to outward-oriented economic policies. The outward-oriented policies included export promotion, diversification, trade liberalization and inward foreign direct investment (FDI). During the same period, social and environmental policies were implemented. Public education and healthcare were guaranteed for all citizens, social programmes were improved to include extensive transfer payments and minimum wages were increased. This helped the reduction in absolute poverty rates and Costa Rica became known as a global leader in environmental conservation efforts.
- 2** The Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR), was a significant move towards trade liberalization. In addition to reducing trade barriers, it established a secure and predictable environment for foreign investors. This agreement also led to the breakup of the state-owned monopolies in the telecommunication and insurance industries in Costa Rica. Additionally, trade agreements with Canada, China, the European Union (EU), Mexico, Peru and Singapore were established.
- 3** Costa Rica encouraged inward FDI by lowering regulations and providing tax incentives in manufacturing industries. In 1997, Intel, a large multinational tech company from the United States (US) invested US\$300 million in building a computer parts factory. Intel's investment helped diversify Costa Rica's main exports away from coffee and bananas to electronics. Moreover, the FDI allowed Costa Rica to benefit from production externalities, as multinational companies provided training to local employees. Manufacturing and services overtook agriculture in terms of contribution to gross domestic product (GDP), and Costa Rica experienced its first trade surplus in 50 years. The increase in real GDP from the FDI was significant, as the marginal propensity to consume (MPC) was 0.8 at the time.
- 4** To promote diversification, export subsidies for companies in the manufacturing sector were granted. Agricultural diversification was also encouraged through subsidising farmers who were adopting new technology to produce higher value-added products, such as roasted coffee beans.

**(This question continues on the following page)**

**(Question 1 continued)**

**Text B — Current concerns**

- 1** Despite earlier successes, income inequality in Costa Rica has remained high and poverty levels have remained unchanged for several years. This has been blamed on insufficient transfer payments due to a tax system that is not progressive enough and tax exemptions offered to foreign firms. Unemployment has consistently risen, and despite high levels of spending in education, a significant number of young people have not completed secondary or higher education. The focus on higher value-added sectors did not create jobs for low skilled workers, which had a disproportionate impact on women and youth. Additionally, the social programmes have often failed, and still fail, to reach the very poor.
- 2** High social and environmental spending, large increases in public sector wages, and insufficient revenue have resulted in very large government (national) debt. Most of the debt is domestic, which is raising concerns about possible crowding out.
- 3** FDI has historically supported economic growth, however, domestic investment and further FDI have slowed down due to rising costs and outdated infrastructure. Additionally, the appreciating colón (Costa Rica’s currency) has lowered export competitiveness, and Costa Rica remains heavily dependent on one major trading partner, the US.

**Text C — “Green Trademark” environmental policy**

The “Green Trademark” policy has reversed deforestation and has resulted in Costa Rica becoming one of the countries with the greatest level of biodiversity in the world. However, it is difficult to maintain the environmental focus due to pressure on government resources and the high opportunity costs associated with land use. The consistent economic growth has made it difficult for Costa Rica to reduce carbon emissions from fossil fuels. Increasing urbanization and the growth in the manufacturing sector have increased air and water pollution. Moreover, the overuse of chemicals in farming has caused river pollution, and the intensive use of land for agriculture has generated concern for environmental conservation.

**(This question continues on the following page)**

(Question 1 continued)

**Table 1: Economic data for Costa Rica**

	<b>2009</b>	<b>2019</b>
Real GDP (US\$ billion)	44.47	64.28
Real gross national income (US\$ billion)	43.05	60.42
Unemployment rate (%)	7.71	11.49
Exports (% of GDP)	34.63	34.01
Government (national) debt (% of GDP)	26.0	56.7
Inflation rate (%)	9.2	2.2

**Table 2: Development data for Costa Rica**

	<b>2009</b>	<b>2019</b>
Inequality adjusted Human Development Index (IHDI)	0.592*	0.661
Human Development Index (HDI)	0.744*	0.810
HDI ranking	59	62
<b>Happy Planet Index</b>	69.7	62.1
Happy Planet Index ranking	1	1
Gini coefficient	0.474	0.482
Relative poverty (% of population)	24.1	23.9

\*2011 figure

(This question continues on the following page)

**(Question 1 continued)**

- (a) (i) Define the term *import substitution* indicated in bold (**Text A**, paragraph **1**). [2]
- (a) (ii) List **two** components of the *Happy Planet Index* indicated in bold (**Table 2**). [2]
- (b) (i) Using information from **Text A**, paragraph **3**, and the Keynesian multiplier, calculate the increase in GDP due to the investment made by Intel. [3]
- (b) (ii) Sketch a monopoly diagram **and** indicate the welfare loss if the state-owned monopoly in the telecommunication industry was maximizing profit (**Text A**, paragraph **2**). [2]
- (c) Using a Lorenz curve diagram, explain how introducing extensive transfer payments may have changed the income distribution in Costa Rica (**Text A**, paragraph **1**). [4]
- (d) Using a labour market diagram, explain the possible impact on Costa Rica's unemployment rate of increasing the minimum wage (**Text A**, paragraph **1**). [4]
- (e) Using an exchange rate diagram, explain how the change in the trade balance after 1997 may have changed the value of the colón (Costa Rica's currency) (**Text A**, paragraph **3**). [4]
- (f) Using an externalities diagram, explain how the overuse of chemicals in the market for agriculture could result in market failure (**Text C**). [4]
- (g) Using information from the texts/data and your knowledge of economics, evaluate the effectiveness of the economic policies implemented by Costa Rica's government in achieving economic growth **and** economic development. [15]

2. Read the extracts and answer the questions that follow.

**Text D — Overview of Cambodia**

- 1** Between 2010 and 2019 Cambodia had one of the fastest growing economies in Southeast Asia. Most of the growth was driven by tourism, exports of garments and improved consumer confidence.
- 2** However, despite high economic growth, rural poverty has persisted, and inequality has grown within rural populations. Approximately 90 % of workers are employed in the informal sector and access to quality healthcare and education remain a challenge for Cambodia. Youth (under 25 years old) make up a large proportion of the labour force, but many do not complete secondary school. As a result, those entering work are under-skilled and **human capital** is low. Access to clean water and sanitation facilities is still lacking. Export-driven growth is being threatened as the European Union (EU), which accounts for 30 % of Cambodia’s export market, recently ended a preferential trade agreement and will now impose tariffs on Cambodian products, such as garments.
- 3** Experts state that the focus on growth through garment manufacturing is unsustainable. The garment industry, which is the largest informal employment sector, has been criticised for poor working conditions and pay. Even workers who are formally employed can barely meet basic needs, despite the recent minimum wage increase and introduction of a price ceiling on rents for housing in cities. Additionally, there are reports of pollution and water waste generated by garment factories, damaging the health of those who live nearby.
- 4** To help solve the market failure in the garment industry, economists recommend that the government should support projects that encourage garment factories to adopt a circular economy approach, either in partnership with worldwide clothing brands or by forming social enterprises (SEs) locally. The circular economy approach can help reduce environmental waste that occurs during production by encouraging the recycling and reusing of materials. Developing ecotourism has also been recommended to support sustainability and provide new job opportunities for the youth and the rural population. Furthermore, ecotourism could help Cambodia benefit from growing world income levels.
- 5** Reforms in the garment and tourism industries are needed, along with improvements in infrastructure, to maintain sustainable growth and competitiveness. Promoting entrepreneurship, developing new skills and increasing the use of technology would help solve current labour market needs.

**(This question continues on the following page)**

(Question 2 continued)

**Text E — Social Enterprise (SE) in Cambodia**

- 1** When Cambodia’s status changed from low income to lower middle-income in 2015, the inflow of foreign aid decreased dramatically. As a result, SEs became increasingly more important in promoting Cambodia’s economic development. Furthermore, SEs were seen as a key factor in breaking the poverty cycle and providing opportunities for its young labour force. SEs may also encourage local investment, which has experienced very slow growth compared to foreign direct investment (FDI).
- 2** Many SEs focus on addressing issues of poverty, child rights, education, disability, health and environmental concerns. The main beneficiaries are children, youth, women and people with disabilities. Successful Cambodian examples include Phare Performing Social Enterprise (PPSE), which is a performing arts school targeting underprivileged children. Most graduates become full time workers at PPSE. Another example is Hydrologic, which provides affordable safe water options to rural households. New SEs are currently being established to ensure sustainability within the growing ecotourism industry.
- 3** However, challenges exist within the SE sector. Less than 8% of SEs are formally registered due to bureaucracy and high taxes. This limits access to potential investors and markets and encourages businesses to stay in the informal sector. New SE start-ups often fail due to lack of sufficient funding and the inability to attract skilled labour.

**Text F — Microfinance in Cambodia**

Since 1991, Cambodia has had one of the fastest growing microfinance sectors in the world. Microfinance has helped decrease poverty in rural areas and solve **asymmetric information** in the market for loans. However, key issues have persisted, including low success rates of some businesses due to inadequate financial literacy and expertise. Additionally, microfinance has become increasingly dependent on funding from international banks and investors, resulting in higher interest rates. Some borrowers have been forced to sell their land as they could not meet their debt repayment obligations. Recently the government implemented a price ceiling on the interest rate for loans in rural areas to help prevent increasing household indebtedness.

(This question continues on the following page)

(Question 2 continued)

**Table 3: Economic data for Cambodia**

	<b>2010</b>	<b>2019</b>
Real gross domestic product (GDP) (annual growth rate, %)	6	7
Real GDP per capita (US\$ PPP)	2603.58	4388.80
Population (million)	14.09	16.49
Tourism sector (% of exports)	28	25
Garment sector (% of exports)	62	78
FDI (% of GDP)	8	14
FDI (% of total investment spending)	Not available	58
Ease of doing business (ranking out of 190 countries)	145	144
Number of microfinance loans (thousand)	978	1921*

\* 2016 figure

**Table 4: Development data for Cambodia**

	<b>2010</b>	<b>2019</b>
Human Development Index (HDI)	0.551	0.594
Inequality adjusted Human Development Index (IHDI)	0.384	0.475
Gini coefficient	0.331	0.372*
Rural population (% of total population)	79.7	76
Secondary school completion rate (%)	49	58
Life expectancy at birth (years)	66.6	69.8

\* estimate

(This question continues on the following page)

**(Question 2 continued)**

- (a) (i) Define the term *human capital* indicated in bold (**Text D**, paragraph **2**). [2]
  - (a) (ii) Define the term *asymmetric information* indicated in bold (**Text F**). [2]
  - (b) (i) Using information from **Table 3**, calculate Cambodia’s real GDP for 2019 (in US\$ PPP). [3]
  - (b) (ii) Sketch an AD/AS diagram to show the possible impact on Cambodia’s economy of the change in consumer confidence (**Text D**, paragraph **1**). [2]
  - (c) Using an international trade diagram for the EU, explain how the EU ending the preferential trade agreement with Cambodia might impact the export revenue of Cambodia’s garment producers (**Text D**, paragraph **2**). [4]
  - (d) Using a demand and supply diagram, explain the possible impact of price controls on rents for housing in cities on social/community surplus (**Text D**, paragraph **3**). [4]
  - (e) Using an externalities diagram, explain how the market failure in the garment industry could be reduced with adoption of the circular economy (**Text D**, paragraph **4**). [4]
  - (f) Using a circular flow of income diagram, explain the impact increased microfinance could have on the Cambodian economy (**Text F**). [4]
  - (g) Using information from the texts/data and your knowledge of economics, evaluate the impact of social enterprise and microfinance on Cambodia’s economic growth **and** economic development. [15]
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