

<b>Q3.</b>	<b>As a consequence of trade liberalization, the economy specialize growingly in activities that it has a comparative advantage. However, trade-driven may also lead to undesirable effects like environmental degradation.</b>
(a)	Explain why countries embrace free trade. [10]
(b)	Discuss the policy options for a government in correcting the market failure arising from an export-led growth. [15]

**Suggested Solutions:**

(a) Explain why countries embrace free trade. [10]

**Introduction:**

Free trade is the exchange of goods and service between individuals, regions of the country or between countries, where there are no presence of barriers to trade like that of trade tariffs or quota restrictions. Trade activities has become an integral part of most, if not all economies in the globalised world today. Since the 2000s, world exports have increased by close to 200%, while world imports have grown by approximately 180%. Clearly, there are strong reasons for embracing free trade as countries become more closely interrelated through the exchange of goods and service.

**Body:**

1a) Free trade with specialisation increases world output and consumption according to the theory of comparative advantage\*.

- Define Comparative Advantage. Define Specialisation.
- Explain how differences in relative opportunity costs of producing the goods and services enable countries to reap gain from specialisation and trade.
- Mutually beneficial trade can take place whenever opportunity cost ratio differs.
- Draw tables showing PPCs of two countries before and after trade, to illustrate gains from trade.
- Highlight that trade can be mutually beneficial even if a country has absolute disadvantage in production of certain goods as compared to another country. It depends on the terms of trade.
- Conclude that total world production increases; both countries consume combination of goods outside their production possibility curve.

1b) There is wider variety of goods and services available for consumption.

- Explain that a wider variety of goods and services consumed raises standard of living in both small and large economies.
- Especially important for small economies which lack natural resources although large economies can still benefit from international trade.

\*Theory of comparative advantage has assumptions which must be mentioned.

2) International free trade expands market size which brings about cost savings(EOS).

- International trade allows expansion of market for products from domestic markets to international market.
- Explain that in expanding production, firms can achieve internal economies of scale.
- Explain the links between cost savings, lower international price, increased competitiveness and greater export revenue.
- Both consumers and producers will benefit.

3) Trade as an 'engine of growth'.

- Explain how can trade as a component of aggregate demand can bring about actual economic growth
- Reinforce by explaining the benefits of economic growth.

**Conclusion:**

Indeed, benefits from free trade encourages economies to continue advocating free trade. However, the gains from trade may not be equally distributed in the economy and may even bring about negative impacts on an economy. Growth brought about by increased trade could lead to negative

externalities such as environmental degradation. As such, government needs to intervene to correct for the resulting market failure, which would be address in (b).

**Level of Response Marking Scheme (LORMS)**

<b>Knowledge, Understanding, Application, Analysis</b>		
<b>L3</b>	For an answer where valid reasons are thoroughly explained, one of which is based on theory of comparative advantage. (i.e. considered assumptions, concept of opportunity cost, gains from trade before and after trade.) OR Incomplete CA + 2 well explained supporting point (Max 7m) OR Complete CA + 1 well explained supporting point (Max 8m)	<b>7 - 10</b>
<b>L2</b>	For an answer where valid reasons are underdeveloped, <b>without</b> reference to the theory of comparative advantage(i.e. other reasons including wider variety of goods and services, EOS and increased competition). OR Mere explanation of theory of Comparative Advantage without any other supporting reasons (Max 6m)  Three reasons other than Comparative Advantage, very well explained (Max 7m).	<b>5 - 6</b>
<b>L1</b>	For an answer that is largely descriptive without economic analysis. (E.g. Merely stating reasons without any explanation)	<b>1 - 4</b>

(b) Discuss the policy options for a government in correcting the market failure arising from an export-led growth. [15]

**Introduction:**

- Identify the case of market failure as negative externality in production.
- Define and explain market failure in general.
- Establish the link between export-led growth and negative externalities in production in the contextual discussion of environmental degradation stated in the preamble. For example, air pollution and deforestation from the production of goods countries have comparative advantage in.

**Body:**

- 1) Government can correct for the negative externality through **taxation**.
  - a. Indirect taxation
    - Explain the case of market failure with a specific example.
    - Explain the case of market failure including a diagrammatic analysis clearly identifying the dead weight loss to the society.
    - Highlight the case of overproduction and negative externalities generated which results in welfare loss to the society.
    - Explain how taxation can correct for the market failure by influencing producers to internalize the external cost and reduce production to the social optimal output.

Evaluate on the effectiveness of indirect taxes to reduce over-production.

- Limited information on the value of marginal external cost in order to set a tax that is equal to MEC and accurately attain the socially optimal quantity  $Q_s$ . Social welfare may improve with indirect taxation, but may not fully remove the social welfare loss.

- Difficulty in implementation and enforcement of taxes due to limited financial resources (especially common in developing countries where legal system is underdeveloped and regulatory mechanisms are weak).
  - Government can use tax revenue earned to fund other projects to deal with the costs of the externality. For example, reforestation.
- 2) Government can correct for market failure through **regulation**.
- Explain how regulation can correct for market failure where compliance involves firms investing in equipment to treat their emissions, which are negative externalities in production.
  - Similarly, this results in producers internalising the external cost and reducing production to the social optimal output.

Evaluate on the effectiveness of regulation to reduce over-production.

- Difficulty in setting up strong regulatory body to ensure compliance due to limited financial resources.
- 3) Government can correct for market failure through implementation of **tradeable permits**.
- Explain how tradeable permits correct for market failure where firms are required to attain a permit in order to emit a certain quantity of pollutant.
    - o Limited supply of permits may be auctioned. The price will hence be determined by the demand for permits by firms and the limited supply by government.
    - o As firms who pollute are paying a price for the permit, they are internalizing the external costs of their actions, and hence production is reduced to the socially optimal level of output.

Evaluate on the effectiveness of tradeable permits to reduce over-production

- Limited information to set the right amount of permits which allow production to be at the socially optimal level to maximise social welfare.
- Limited funds to maintain a tradeable permit system and monitor firms that pollute within the amount permitted and impose punitive measures if there is any non-compliance.

Additional evaluation across policies

- Taxes and tradeable permits, are efficient, market-based solutions where measures are imposed on per unit emissions and not on the firm per se. In real life, firms do not face the same cost of reducing pollution. Taxes hence give them an option of doing so or not based on their own cost structures. Only firms whose cost of reducing pollution is greater than paying the tax, will pay the tax.
- But they might be more difficult to design and enforce as compared to regulation. Government just needs to set a regulatory limit and ensure that all firms comply with the regulations. That having said, problem of inefficiency and inflexibility arises with regulation because the same regulation is imposed on all firms. Different firms face different cost of reducing pollution as mentioned, and firms who can reduce pollution at a lower cost will have no further incentive to do so once they have complied with the standards set by the government.

### **Conclusion:**

Summary of ideas and personal insights

### **Level of Response Marking Scheme (LORMS)**

<b>Knowledge, Understanding, Application, Analysis</b>		
<b>L3</b>	For a well-developed answer that considers both the advantages and disadvantages of policies listed. Policies are thoroughly explained and addresses the problem of over-production.	<b>9 - 11</b>
<b>L2</b>	For an underdeveloped answer that only regurgitates the	<b>6 - 8</b>

	mechanics of policies without application. OR An underdeveloped answer that only explains the merits of policies stated and not consider the limitations.	
<b>L1</b>	For an answer that is largely descriptive without economic analysis. (E.g. Merely stating policies without any explanation)	<b>1 - 5</b>

<b>Allow up to 4 additional marks for Evaluation</b>		
<b>E2</b>	Judgements supported by analysis(i.e. weighing based on criteria in the question context).	<b>3-4</b>
<b>E1</b>	Unsubstantiated Judgements.	<b>1-2</b>