Certificate of Education
Advanced Subsidiary Level and Advanced Level

UNIVERSITY OF CAMBRIDGE
INTERNATIONAL EXAMINATIONS General

ECONOMICS 9708/21 Paper 2 Data Response and Essay (Core) **May/June 2011 1 hour 30 minutes**

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the

Booklet. Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A
Answer this question.
Brief answers only are required.

Section B
Answer any **one** question.

You may answer with reference to your own economy or other economies that you have studied where relevant to the question.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

This document consists of **3** printed pages and **1** blank page.

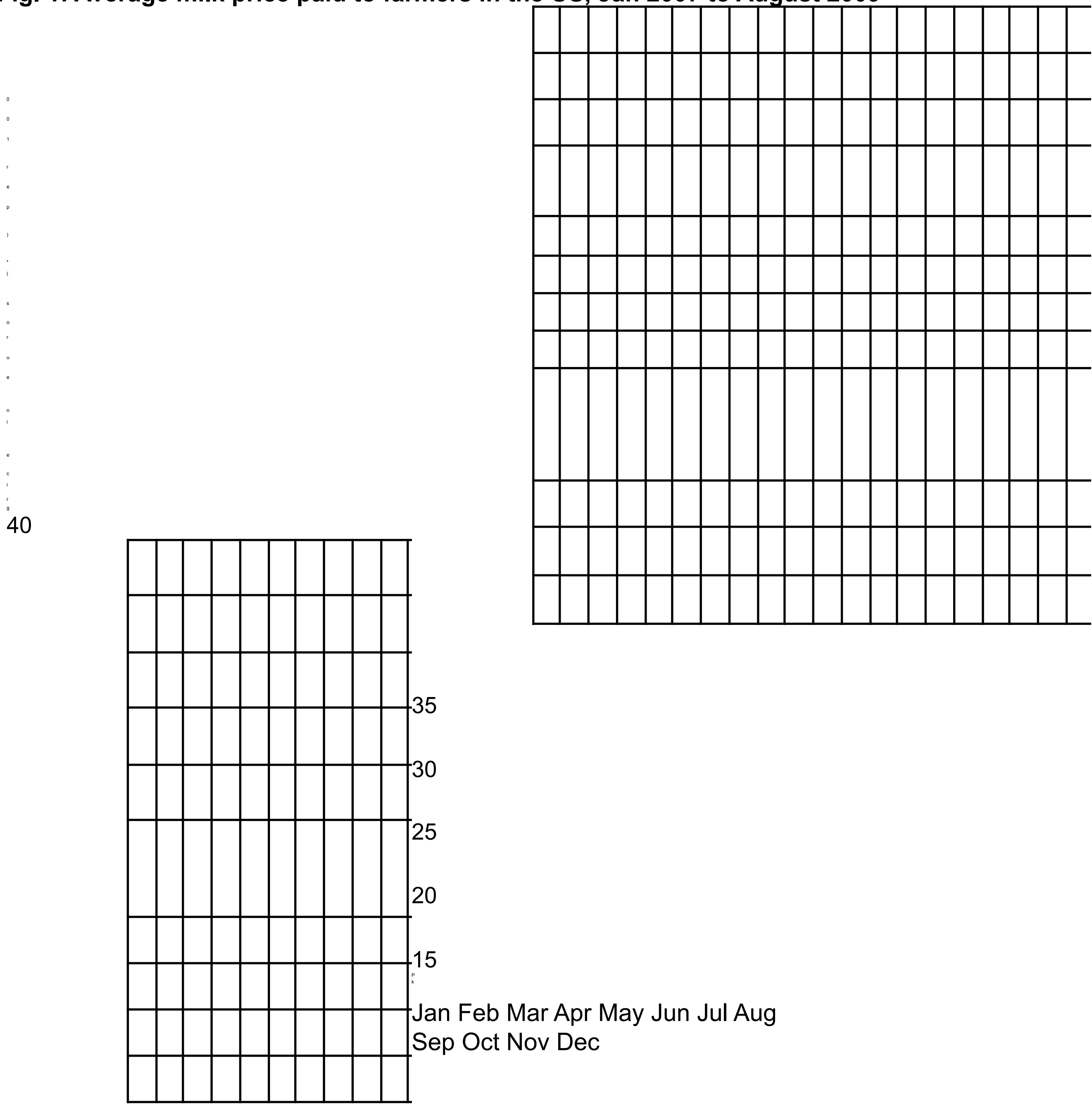
Section A

Answer this question.

1 Problems for Dairy Farmers in the United States

Milk is used to make a range of products, including butter, cheese and ice cream, as well as serving as a drink. This was of no help to US dairy farmers in 2009 when they faced a falling price for their milk. Fig. 1 shows the extent of the price change in recent years. While consumers purchase milk by volume (litres), farmers are paid by weight (kilograms).

Fig. 1: Average milk price paid to farmers in the US, Jan 2007 to August 2009



A price fall was also experienced by New Zealand as shown in Table 1.

Table 1: Average annual milk price (• per 100 kg) in the US and New Zealand, 2007–2009

	2007	2008	2009
US	30.69	27.49	19.30
New Zealand	22.48	25.17	16.21

US farmers blamed their problems on the global recession, the strength of the US$ and high cattle feed prices. At the same time, New Zealand and Australia increased their exports and the European Union (EU) reintroduced its export subsidies on milk products.

The world milk industry has often had support from governments that have paid subsidies to farmers and supplied free milk to young children. US farmers were hoping for extra government intervention.

(a) (i) Compare the average milk price paid to farmers in the US in August 2008 with that in August 2009. [2]

(ii) How far does Fig. 1 suggest that the price of milk is subject to regular seasonal influences? [2]

(b) (i) Compare the changes in milk prices in the US and in New Zealand between 2007 and 2009. [2]

(ii) Explain **two** possible reasons for the different level of milk prices in the US and New Zealand. [4]

(c) Explain how one group, other than dairy farmers, would lose from lower milk prices and how another group would gain from lower milk prices. [4]

(d) Discuss the case for the use of government subsidies for the production of milk. [6]

(a) (i) In August 2008 US farmers were receiving much higher price for each 100kg of milk as compared to August 2009. In August 2008 US farmers on average received 26 euros for each 100 kg of milk which dropped to 18 euros in August 2009.

(a) (ii) To some extent figure 1 supports the idea that milk prices in US are subject to seasonal fluctuations. During summers of 2007 and 2008 milk prices increased but this increase was not very significant in summer of 2009. Therefore overall it will be difficult to objectively conclude that milk prices are always high in summer of each year. But since this is true for two out of three years data that has been provided therefore to some extent the hypothesis can be validated. Data for more years will be needed to objectively prove this hypothesis.

(b) (i) Milk prices in both countries decreased during 2007 and 2009. The fall was greater for US from 2007 to 2008 when milk prices fell by 10.4 percent. This was not the case with New Zealand because during the same period it experienced 11.9 percent increase. However the decrease in milk prices for New Zealand was much greater next year from 2008 to 2009 when its farmers experienced 35.6 percent fall in their product prices which was almost 5 percentage points lower for US farmers and stood at 30 percent.

(c) (ii) Each year from 2007 to 2009 US milk prices stayed at a higher level than price level that prevailed in New Zealand. However from 2008 to 2009 milk prices in US fell whereas there was increase in New Zealand's milk prices. This might be because of increase international demand for country's milk. As stated in the case study, US farmers were struggling from rising cost of cattle feed which would have definitely made their products less competitive. This higher demand for country's milk would have positively affected its prices. Later from 2008 to 2009 milk prices in New Zealand decreased by a greater percentage that was 35.6 percent than that of US prices. This might be because of increased protectionist tools applied against milk exported from New Zealand. As stated in the case study, EU has increased its milk subsides to local producers to limit their reliance on imported milk. Hence such government intervention is expected to reduce demand for imported milk and therefore is expected to adversely affect the prices received by exporting country's farmers. On the other hand, since US might not be major milk exporter and therefore its milk prices might not be much affected following increased protectionism against export of milk.

(d) Lower milk prices are expected to increase consumer surplus because for given willingness to pay they will now be paying lower prices. Moreover increased government subsidies to promote local milk industry will keep milk prices constantly low. Furthermore industries that process milk or use milk as raw material are expected to benefit from cheaper milk prices.

Cheaper milk prices will reduce downstream industries' cost of production and as result is expected to increase their profits. However reduced farmers' income might make them exit the occupation and therefore in the longer run lower supply might adversely affect milk prices causing substantial increase in product's price. Lower income for farmers' families will lower their living standards. Lower affordability will limit their ability to consume necessary goods/services including education and health care.

Moreover tax payers might experience increased burden to help government achieve its objective of maintaining low milk prices. Higher tax rates will reduce tax payers' disposable income and will adversely affect their consumption possibilities. Therefore apart from farmers and their families, tax payers' welfare is also expected to be adversely affected because of government's objective to maintain low milk prices.

(e) Government generally provides subsidies on products' for which lower prices are necessary to ensure citizens' higher living standards. Hence subsidies are often paid on food items or other necessities to life. Lower prices paid by consumers and higher producer surplus enjoyed by producers from subsidies benefit both market groups. This higher consumer and producer surplus however comes at reduced disposal income of tax payers. This adversely affects their consumption possibilities. Moreover presence of deadweight loss mean that tax payers' contribution to national taxation is greater than increase in consumer and producer surplus combined. This is indication of inefficiency that instead of making society overall better-off makes it worse off.

Moreover subsidies are difficult to operate due to high cost of operation for the government. Similarly subsidies are hard to sustain for they pose serious financial burden on government's resources. These resources have substantial opportunity cost in terms of social return received by spending this money on developmental projects. Moreover such deliberate attempts to reduce imports might cause other economies to discriminate against country's exports and therefore protectionism of local industry might adversely affect industries engaged in exports.

Therefore unless governments do not want to ensure higher incomes for local farmers, provision of subsidies is not very effective way to ensure availability of cheaper products to local consumers. These funds can be better utilized on more pressing local problems and reliance on cheaper imported goods will be better to ensure provision of cheaper products to local consumers.