



**ADVANCED**  
**General Certificate of Education**  
**January 2011**

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## **Economics**

Assessment Unit A2 1

Business Economics

**[AE211]**

**FRIDAY 28 JANUARY, AFTERNOON**

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**MARK  
SCHEME**

## General Marking Instructions

This mark scheme is intended to ensure that the A2 examinations are marked consistently and fairly. The mark scheme provides examiners with an indication of the nature and range of candidate responses likely to be worthy of credit. It also sets out the criteria which they should apply in allocating marks to candidates' responses. The mark schemes should be read in conjunction with these general marking instructions which apply to all papers.

### Quality of candidates' responses

In marking the examination paper, examiners will be looking for a quality of response reflecting the level of maturity which may reasonably be expected of 18-year-olds which is the age at which the majority of candidates sit their A2 examinations.

### Flexibility in marking

The mark scheme is not intended to be totally prescriptive. For many questions, there may be a number of equally legitimate responses and different methods by which the candidates may achieve good marks. No mark scheme can cover all the answers which candidates may produce. In the event of unanticipated answers, examiners are expected to use their professional judgement to assess the validity of answers. If an answer is particularly problematic, then examiners should seek the guidance of the Supervising Examiner for the paper concerned.

### Positive marking

Examiners are encouraged to be positive in their marking, giving appropriate credit for valid responses rather than penalising candidates for errors or omissions. Examiners should make use of the whole of the available mark range for any particular question and be prepared to award full marks for a response which is as good as might reasonably be expected for 18-year-old candidates. Conversely, marks should only be awarded for valid responses and not given for an attempt which is completely incorrect and inappropriate.

### Types of mark schemes

Mark schemes for questions which require candidates to respond in extended written form are marked on the basis of levels of response which take account of the quality of written communication. These questions are indicated on the cover of the examination paper. Other questions which require only short answers are marked on a point for point basis with marks awarded for each valid piece of information provided.

### Levels of response

Questions requiring candidates to respond in extended writing are marked in terms of levels of response. In deciding which level of response to award, examiners should look for the 'best fit' bearing in mind that weakness in one area may be compensated for by strength in another. In deciding which mark within a particular level to award to any response, examiners are expected to use their professional judgement. The following guidance is provided to assist examiners.

**Threshold performance:** Response which just merits inclusion in the level and should be awarded a mark at or near the bottom of the range.

**Intermediate performance:** Response which clearly merits inclusion in the level and should be awarded a mark at or near the middle of the range.

**High Performance:** Response which fully satisfies the level description and should be awarded a mark at or near the top of the range.

## Marking calculations

In marking answers involving calculations, examiners should apply the “own figure rule” so that candidates are not penalised more than once for a computational error.

## Quality of written communication

Quality of written communication is taken into account in assessing candidates’ responses to all questions that require them to respond in extended written form. These questions are marked on the basis of levels of response. The description for each level of response includes reference to the quality of written communication. Where the quality of candidates’ economics is not matched by the quality of written communication, marks awarded will not exceed the maximum for Level 2 in questions which have three levels of response or the maximum for Level 3 in those which have four levels of response.

For conciseness, quality of written communication is distinguished within levels of response as follows:

Level 1: Quality of written communication is limited.

Level 2: Quality of written communication is satisfactory.

Level 3: Quality of written communication is of a high standard.

Level 4: Quality of written communication is excellent.

In interpreting these level descriptions, examiners should refer to the more detailed guidance provided below:

**Level 1 (Limited):** The candidate makes only a limited attempt to select and use an appropriate form and style of writing. The organisation of material may lack clarity and coherence. There is little use of specialist vocabulary. Presentation, spelling, punctuation and grammar may be such that intended meaning is not clear.

**Level 2 (Satisfactory):** The candidate makes a reasonable attempt to select and use an appropriate form and style of writing, supported with appropriate use of diagrams as required. Relevant material is organised with some clarity and coherence. There is some use of appropriate specialist vocabulary. Presentation, spelling, punctuation and grammar are sufficiently competent to make meaning evident.

**Level 3 (High Standard):** The candidate successfully reflects and uses an appropriate form and style of writing, supported with the effective use of diagrams where appropriate. Relevant material is organised with a high degree of clarity and coherence. There is widespread use of appropriate specialist vocabulary. Presentation, spelling, punctuation and grammar are of a sufficiently high standard to make meaning clear.

**Level 4 (Excellent):** The candidate successfully reflects and uses the most appropriate form and style of writing, supported with precise and accurate use of diagrams where appropriate. Relevant material is extremely well organised with the highest degree of clarity and coherence. There is extensive and accurate use of appropriate specialist vocabulary. Presentation, spelling, punctuating and grammar are of the highest standard and ensure that meaning is absolutely clear.

- 1 (a) • the number of pubs has fallen from 59,673 to 53,464. This represents a 10.4% reduction in the number of pubs in the UK
- the number of independently owned pubs has fallen from 19,073 to 16,039. This represents a fall of 15.9%
  - the number of pubs owned by pub companies fell from 31,700 to 28,336. This represents a fall of 10.6%
  - the number of pubs owned by breweries has increased from 8,900 to 9,089. This represents a 2.1% increase.

[3] for identification of trends and selection of appropriate data

[2] for manipulation of data to show relative performance

[5]

- (b) Source 2 identifies a number of factors which may account for the increased number of pub closures in 2009.
- the recession and resultant reduction in disposable income
  - the smoking ban which has encouraged smokers to drink at home
  - tax rises on alcohol
  - regulatory burdens which have increased the cost of running a pub
  - supermarkets selling alcohol as a loss leader
  - the fact that consumer preferences have changed and some pubs have failed to follow suit.

#### Level 1 ([1]–[3])

Candidate shows very limited understanding of the factors which may account for the decline in the number of UK pubs. At this level the candidate may simply quote directly from the source without explaining how these factors are likely to lead to an increasing number of pub closures. There is no significant analysis and application of the issues and quality of written communication is limited.

#### Level 2 ([4]–[7])

Candidate provides some understanding of the factors which may account for the decline in the number of UK pubs. There is a degree of analysis and application and quality of written communication is satisfactory.

#### Level 3 ([8]–[10])

Candidate provides a clear and comprehensive understanding of the factors which may account for the decline in the number of UK pubs. At this level the candidate will identify a number of factors and will provide a clear explanation of how these factors are likely to lead to an increasing number of pub closures. There is significant analysis and application and quality of written communication is of a high standard.

[10]

(c) The UK pub industry displays a number of characteristics of an oligopolistic industry.

- An oligopolistic market is one where supply is dominated by a small number of large firms each of which has significant market power. Source 2 states that “almost 40% of pubs in the UK are owned by the five largest pub companies”
- Oligopolistic industries have high barriers to entry. In the pub market the most obvious barrier is the requirement to hold a licence for the sale of alcohol. These licences are limited in number
- The products sold in pubs are similar but are differentiated through branding. Both branded pubs and branded drinks
- Pubs are interdependent in the fact that action by one pubco is likely to provoke a reaction by another. If one pub has a happy hour others are likely to follow suit
- The pub companies are able to earn supernormal profits. Source 2 states that the top five pub companies operate on profit margins in excess of 50% – nine times that of Tesco.

#### **Level 1 ([1]–[3])**

Candidate shows little understanding of the extent to which the UK pub market could be described as oligopolistic. At this level a candidate may simply list the characteristics of an oligopolistic industry but make no attempt to apply these to the UK pub industry. Quality of written communication is limited.

#### **Level 2 ([4]–[7])**

Candidate shows some understanding of the extent to which the UK pub market could be described as oligopolistic. There is a degree of analysis and application. Quality of written communication is satisfactory.

#### **Level 3 ([8]–[10])**

Candidate shows comprehensive understanding of the extent to which the UK pub market could be described as oligopolistic. There is significant economic analysis and application, with some degree of evaluation and quality of written communication is of a high standard.

[10]

(d) Neoclassical economic commentators believe that businesses should be run exclusively with a view to maximising profits and shareholder returns. They argue that there is a legal contract between shareholders and the managers of firms which binds the manager to pursuing the maximisation of shareholder value. They argue that a pub company which assumes responsibility beyond profit maximisation will incur additional costs which could lead to the firm being wiped out by competitors who do not assume such responsibilities.

However, others argue that pub companies have responsibilities not just to shareholders but to a wide range of stakeholders including, employees, customers, the local community and the environment.

**Issues for analysis and discussion include:**

- discussion of the need to make a profit to survive
- discussion of the legal obligation to maximise shareholder value
- discussion of impact of profit maximisation on efficiency
- discussion of Corporate Social Responsibility (CSR)
- discussion of alternative objectives
- discussion of the impact of pubs on the local community – both positive and negative
- ethical arguments – particularly with regard to the sale of a product such as alcohol
- discussion of how firms can use CSR as a marketing tool
- appropriate examples – e.g. Drinkaware.

**Level 1 ([1]–[5])**

Candidate displays little understanding of the view that it is wrong for pub companies to seek to maximise profits at the expense of their social and environmental responsibilities. There is no significant evaluation of the issues and quality of written communication is limited.

**Level 2 ([6]–[10])**

Candidate provides some understanding of the view that it is wrong for pub companies to seek to maximise profits at the expense of their social and environmental responsibilities. There is a degree of evaluation though this may lack depth or be one sided. Quality of written communication is satisfactory.

**Level 3 ([11]–[15])**

Candidate provides a clear and comprehensive understanding of the view that it is wrong for pub companies to seek to maximise profits at the expense of their social and environmental responsibilities. There is significant evaluation and judgement and quality of written communication is of a high standard. [15]

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**2 Competition Commission criticised for being weak and ineffective**

- (a) A natural monopoly occurs whenever maximum efficiency is achieved through a single supplier rather than through a number of competing suppliers.

A natural monopoly generally occurs in industries where the fixed costs of production are so high that it is not profitable for a second firm to enter and compete.

In the water industry there is a “natural” reason for the existence of a monopoly, namely that the Minimum Efficient Scale (MES) occurs at such a large proportion of total output that only one firm could produce at the point where AC are minimised. For example, if the MES occurred at 70% of the total output of the water industry then clearly only one firm could operate in this industry efficiently.

**Areas for analysis and discussion include:**

- definition of monopoly
- discussion of economies of scale
- discussion of fixed costs
- relevant examples
- relevant diagrams
- discussion of MES.

**Level 1 ([1]–[5])**

Candidate shows little understanding of why some industries are natural monopolies. Quality of written communication is limited.

**Level 2 ([6]–[10])**

Candidate shows some understanding of why some industries are natural monopolies but this may be incomplete or contain errors. Quality of written communication is satisfactory.

**Level 3 ([11]–[15])**

Candidate shows clear and comprehensive understanding of why some industries are natural monopolies. Quality of written communication is of a high standard.

[15]

- (b) There are a range of measures available to government to deal with market dominance and the abuse of monopoly power.

These include:

- the use of regulation and price controls
- the use of taxation
- breaking the monopoly up
- removing barriers to entry to make the market more competitive or contestable
- the use of subsidies
- nationalisation.

Clearly each of these policies has their advantages and disadvantages.

**Areas for analysis and discussion include:**

- the efficiency of government regulation
- the difficulty in setting an appropriate price (RPI–X formula)
- discussion of regulatory capture
- evaluation based on contestable markets
- the costs and efficiency of nationalisation
- the opportunity cost of using subsidies
- welfare implications of taxation
- appropriate examples
- appropriate diagrams
- reference to UK competition policy.

**Level 1 ([1]–[7])**

Candidate shows little understanding of the measures available to government to deal with market dominance and the abuse of monopoly power. There is no significant analysis or evaluation and quality of written communication is limited.

**Level 2 ([8]–[13])**

Candidate shows some understanding of the measures available to government to deal with market dominance and the abuse of monopoly power. There is some attempt at analysis and evaluation and quality of written communication is satisfactory.

**Level 3 ([14]–[19])**

Candidate shows in-depth understanding of the measures available to government to deal with market dominance and the abuse of monopoly power. There is significant analysis and evaluation of the arguments and quality of written communication is of a high standard.

**Level 4 ([20]–[25])**

Candidate shows clear and comprehensive understanding of measures available to government to deal with market dominance and the abuse of monopoly power. There is significant evaluation and judgement of the arguments and quality of written communication is excellent. [25]

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**3 Mergers should be banned**

- (a) Organic growth occurs whenever a firm increases its production and sales internally through methods such as geographical expansion, product diversification or increased advertising and promotion of its current product range.

A merger occurs whenever two firms agree to join together to form one larger company. Mergers can be classified as horizontal, vertical (vertical forward and vertical backward), lateral and conglomerate.

An acquisition occurs when one firm takes over another firm or buys a part of another firm. Acquisitions can be friendly or hostile.

**Areas for analysis and discussion include:**

- definition and explanation of organic growth
- examples of organic growth
- explanation of different types of merger
- explanation of acquisition
- distinction between friendly and hostile takeovers
- examples of different types of merger
- discussion of benefits of the two types of growth.

**Level 1 ([1]–[5])**

Candidate shows little understanding of the difference between organic growth and growth by acquisition or merger. Quality of written communication is limited.

**Level 2 ([6]–[10])**

Candidate shows some understanding of the difference between organic growth and growth by acquisition or merger but this may be incomplete or contain errors. Quality of written communication is satisfactory.

**Level 3 ([11]–[15])**

Candidate shows clear and comprehensive understanding of the difference between organic growth and growth by acquisition or merger. Quality of written communication is of a high standard. [15]

- (b) Firms engage in mergers and takeovers in an attempt to manage the level of competition they face. From the firm's perspective, mergers and takeovers lead to a number of benefits including:
- economies of scale – mergers allow firms to avail of greater economies of scale which will reduce costs and all other things being equal increase profit margins
  - diversification and risk spreading – mergers also allow firms to diversify their output or increase their geographical coverage both of which help to spread risk
  - market power – mergers, particularly horizontal mergers, increase the firms' market share and therefore increases their power to influence price
  - sharing of specialist knowledge
  - potential for synergies
  - increased profit and potential for research and development.

Some economists argue that as long as the merged firms face some competition or indeed the potential for competition then these benefits will be passed on to consumers in the form of lower prices, greater choice, increased availability and higher quality goods.

Other economists, however, argue that because mergers increase the power of firms none of the above benefits will be passed on to consumers. Indeed, they argue that consumers are likely to be worse off as a result of the merger as firms often increase prices and reduce the range of products sold after the merger. There is therefore a sound economic case for outlawing merger activity which is likely to act against the public interest by significantly reducing the level of competition.

**Areas for analysis and discussion include:**

- discussion of how firms, consumers and economy might benefit from merger activity
- negative impact of mergers on consumers – less choice, higher prices, etc.
- impact of mergers on allocative, productive and dynamic efficiency
- negative impact of merger on firms – diseconomies of scale, the problem of incompatible corporate cultures, the impact of rationalisation on staff morale
- use of appropriate examples
- appropriate diagrams
- difficulty in banning all mergers.

**Level 1 ([1]–[7])**

Candidate shows little understanding of the case for and against the view that all mergers should be outlawed. There is no significant analysis or evaluation and quality of written communication is limited.

**Level 2 ([8]–[13])**

Candidate shows some understanding of the case for and against the view that all mergers should be outlawed. There is some attempt at analysis and evaluation and quality of written communication is satisfactory.

**Level 3 ([14]–[19])**

Candidate shows in-depth understanding of the case for and against the view that all mergers should be outlawed. There is significant analysis and evaluation of the arguments and quality of written communication is of a high standard.

**Level 4 ([20]–[25])**

Candidate shows clear and comprehensive understanding of the case for and against the view that all mergers should be outlawed. There is significant evaluation and judgement of the arguments and quality of written communication is excellent. [25]

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**4 Firms' behaviour at odds with economic theory**

- (a) In the absence of other constraints, profit maximising firms will produce at the point where MC equals MR and will charge the highest price possible as dictated by the demand curve.

Revenue maximising firms on the other hand will produce at the point where MR is equal to zero and again charge the highest price possible as dictated by the demand curve.

**Areas for analysis and discussion include:**

- definition of marginal cost
- definition of marginal revenue
- use of appropriate diagrams
- explanation/calculation of profit
- distinction between the short run and the long run
- use of appropriate examples.

**Level 1 ([1]–[5])**

Candidate shows little understanding of how the price and output decisions of a profit maximising firm differs from that of a revenue maximising firm. No attempt is made to represent this on a diagram or to illustrate it via a numerical example. Quality of written communication is limited.

**Level 2 ([6]–[10])**

Candidate shows some understanding of how the price and output of a profit maximising firm differs from that of a revenue maximising firm. Some attempt is made to represent this on a diagram or to illustrate it via a numerical example. Quality of written communication is satisfactory.

**Level 3 ([11]–[15])**

Candidate shows clear and comprehensive understanding of how the price and output of a profit maximising firm differs from that of a revenue maximising firm. It is anticipated that an accurate diagram will be drawn or a clear numerical example used to illustrate the distinction. Quality of written communication is of a high standard. [15]

- (b) The neo-classical theory of the firm was initially developed by economists such as Adam Smith and Alfred Marshall and later by economists such as Edward Chamberlin and Paul Sweezy. The models of perfect competition, monopoly, monopolistic competition and oligopoly are an attempt to explain and predict the behaviour of firms in different markets.

As with all economic models both the general theory and the individual models are based on a number of simplifying assumptions and it is these simplifying assumptions which have led to criticism that the models do not reflect the behaviour of firms in the real world and therefore the models are of limited use.

The most common criticism of the theory of the firm is that it assumes that all firms seek to maximise profit and therefore produce at the point where marginal cost equals marginal revenue. Critics suggest that in reality most firms do not equate MC and MR. Indeed some mathematicians have even questioned the validity of the assumption that profits are maximised at the point where MC equals MR.

However, supporters of the neo-classical theory argue that models are not meant to strictly represent the behaviour of individual firms but rather provide a framework or benchmark against which the behaviour of real world firms can be judged.

**Areas for analysis and discussion include:**

- discussion of unrealistic nature of profit maximising assumption
- discussion of alternative objectives
- discussion of unrealistic assumptions of each model, e.g. product homogeneity and perfect knowledge in perfect competition
- discussion of economic models being used only as a framework or benchmark
- discussion of alternative theories of firm behaviour
- discussion of the validity of the law of diminishing marginal productivity and the impact this would have on the shape of the MC curve
- discussion of the validity of the assumption of rational behaviour on the part of firms or consumers
- appropriate examples
- appropriate diagrams.

**Level 1 ([1]–[7])**

Candidate shows little understanding of the view that the theory of the firm is outdated and unrealistic. There is no significant analysis or evaluation and quality of written communication is limited.

**Level 2 ([8]–[13])**

Candidate shows some understanding of the view that the theory of the firm is outdated and unrealistic. There is some attempt at analysis and evaluation and quality of written communication is satisfactory.

**Level 3 ([14]–[19])**

Candidate shows in-depth understanding of the view that the theory of the firm is outdated and unrealistic. There is significant analysis and evaluation of the arguments and quality of written communication is of a high standard.

**Level 4 ([20]–[25])**

Candidate shows clear and comprehensive understanding of the view that the theory of the firm is outdated and unrealistic. There is significant evaluation and judgement of the arguments and quality of written communication is excellent. [25]

**Total**

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**80**