



Rewarding Learning

**ADVANCED
General Certificate of Education
2011**

Economics

Assessment Unit A2 1

assessing

Business Economics

[AE211]

FRIDAY 20 MAY, MORNING

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, punctuation and grammar are of the highest standard and ensure that meaning is absolutely clear.

1 Car manufacturers struggle in economic downturn

- (a)
- a five firm concentration ratio measures the combined market share of the top five firms in an industry
 - in 2009 the five firm concentration ratio was 46.1%
 - in 2008 the five firm concentration ratio was 48.4%
 - the industry has become less concentrated.

[2] for calculating concentration ratio for 2008 and same for 2009

[1] for any other relevant point

[1] for each relevant point up to a maximum of [5] [5]

- (b) There are a number of reasons which might explain why the luxury car market has been hardest hit by the economic downturn:
- luxury cars are more income elastic than smaller cars and therefore any fall in income caused by the recession will have a proportionally larger impact on them
 - luxury cars tend to be less fuel efficient than the norm and therefore the sharp increases in fuel prices are likely to have a larger impact on them as consumers switch to more fuel efficient cars
 - quality of luxury cars is so good that consumers consider second hand as a new model with large delivery miles. Therefore people are likely to purchase second hand luxury cars rather than new ones
 - scrappage scheme is less effective in stimulating demand for luxury cars, as the £1000 subsidy from government is a smaller proportion of the overall price
 - many of those who may be thinking of buying a new luxury car may already drive an older luxury model whose resale price is greater than the subsidy
 - many luxury cars are sold as fleet cars to companies. These companies may be feeling the effects of the economic downturn and would therefore reduce their expenditure on non-essential items such as cars.

Level 1 ([1]–[3])

Candidate shows little understanding of the factors which may explain why the luxury car market has been hardest hit by the fall in demand. There is no significant analysis or application, and quality of written communication is limited.

Level 2 ([4]–[7])

Candidate provides some understanding of the factors which explain why the luxury car market has been hardest hit by the fall in demand. 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 explain why the luxury car market has been hardest hit by the fall in demand. There is significant analysis and application, and quality of written communication is of a high standard. [10]

- (c) Growing the firm through merger and acquisition can lead to a number of benefits for Fiat. These benefits include:
- economies of scale. Merging with or acquiring another firm will allow a company to grow quickly and therefore gain economies of scale. The source states that Fiat needed a partner to reach an output level of 5.5 million to 6 million units a year, the scale believed to be necessary to survive the car industry crisis
 - diversification. Merging will enable the Fiat to diversify its output and will therefore help to reduce the risk to the firm of changes to demand conditions
 - market power. Growing the firm through horizontal integration will automatically increase the firms' market share and will therefore also increase their market power
 - gain specialist knowledge. Merging with another company allows the firm to bring new skills and specialised departments into the business which will compliment the skills and expertise of the original business.

However, the completion of a merger or takeover is no guarantee of success, indeed growing the firm through merger and acquisition can lead to a number of difficulties and can actually lead to a net loss in value rather than a gain. Experience would seem to suggest that a large number of mergers do in fact result in a loss of value to the acquiring company.

The difficulties created through merging include:

- diseconomies of scale. Merging with or acquiring another firm may lead a company to grow too large too quickly and therefore experience diseconomies of scale
- incompatible corporate cultures. Different companies have different cultures and different ways of getting things done. Bringing two firms together can cause these two cultures to clash and therefore cause resources to be diverted away from new investment or research and development towards measures to correct the conflict of cultures
- attracts regulation. Growing the firm through horizontal integration leads to an increase in the market share enjoyed by the merged firm. However, if this market share becomes too large this may lead to an investigation by the competition authorities which can be both expensive and time consuming
- for general critique of mergers without application to Fiat, max Level 2.

Level 1 ([1]–[3])

Candidate shows little understanding of the likely consequences for Fiat of a merger with Opel and Chrysler. There is no significant analysis, application or evaluation of the issues and quality of written communication is limited.

Level 2 ([4]–[7])

Candidate provides some understanding of the likely consequences for Fiat of a merger with Opel and Chrysler. There is a degree of analysis and application with some degree of evaluation, and quality of written communication is satisfactory.

Level 3 ([8]–[10])

Candidate provides a clear and comprehensive understanding of the likely consequences for Fiat of a merger with Opel and Chrysler. There is significant analysis, application and evaluation, and quality of written communication is of a high standard. [10]

- (d) Classical economists argue that the market is the most efficient mechanism for allocating resources. They argue that economies which accept the creative destruction of the market system will ultimately be more successful. They argue that government intervention to support failing car firms will simply slow down the natural reallocation of resources from these inefficient and unprofitable firms towards more efficient and profitable forms of production.

Other economists, however, argue that targeted intervention by government can help to smooth the harsher aspects of the capitalist system and protect jobs and incomes in times of economic difficulty.

Areas for analysis and discussion include:

- creative destruction of the market system
- inefficiency of government intervention
- government failure – part of the justification for the scrappage scheme is that it will reduce carbon emissions, but some argue that it may actually increase emissions
- opportunity cost of the £400 million allocated to fund the scrappage scheme
- possibility of creating a moral hazard – firms may take unnecessary risks if they believe they will be bailed out by government if things go wrong
- how does the government decide which firms/industries deserve support and which do not
- impact of government intervention on jobs and growth
- need for the government to be seen to do something.

Level 1 ([1]–[5])

Candidate displays little understanding of the case for and against the view that government intervention to support failing car firms is a waste of taxpayers' money and does nothing but hinder the efficient reallocation of resources through the market mechanism. 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 case for and against the view that government intervention to support failing car firms is a waste of taxpayers' money and does nothing but hinder the efficient reallocation of resources through the market mechanism. 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 case for and against the view that government intervention to support failing car firms is a waste of taxpayers' money and does nothing but hinder the efficient reallocation of resources through the market mechanism. There is significant evaluation and judgement, and quality of written communication is of a high standard. [15]

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2 UK spends £20 bn on advertising

- (a) Price competition occurs whenever firms use price as the basis for attracting and retaining customers. There are a number of different pricing strategies that firms can use. These include; competitive pricing, destroyer/predatory pricing, psychological pricing and penetration pricing.

Non-price competition refers to all forms of competition other than through the price mechanism. Non-price competition involves firms focusing on areas such as quality, design, after-sales services and other marketing factors such as product differentiation, branding and advertising.

Areas for analysis and discussion include:

- definition and explanation of price competition
- definition and explanation of non-price competition
- discussion of alternative pricing strategies
- discussion of non-price competitive strategies
- use of appropriate examples.

Level 1 ([1]–[5])

Candidate shows little understanding of the difference between price and non-price competition. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate shows some understanding of the difference between price and non-price competition, however, this may be incomplete or contain errors. Quality of written communication is satisfactory.

Level 3 ([11]–[15])

Candidate shows a clear and comprehensive understanding of the difference between price and non-price competition. Quality of written communication is of a high standard. [15]

- (b) Advertising refers to the process of drawing attention to a product, brand or company. The aim of advertising is to inform consumers about a product and to persuade them to purchase the product. Advertising takes place across a wide range of media with the Advertising Association estimating that almost £20 bn was spent on advertising in the UK in 2009.

Critics of advertising argue that it should be restricted because:

- firms use advertising to manipulate people's tastes. Most advertising is psychological rather than informational – it is designed to play on psychological weaknesses to create desires that would otherwise not exist and therefore should be restricted. This is the argument used to justify the ban on cigarette advertising and the calls for restrictions on the advertising of alcohol and junk food
- it impedes competition since it attempts to differentiate products and create brand loyalty. This reduces PED and increases YED and allows the firm to charge a price which is greater than MC, therefore reducing allocative efficiency
- firms can use saturation advertising as a barrier to entry which strengthens monopoly power and therefore results in a loss of productive and allocative efficiency

- recent research suggests that much of the current advertising is actually ignored by consumers (as we switch channels on TV and radio) and therefore much of the £20 bn being spent on advertising is actually wasted.

However, those in favour of advertising argue:

- advertising improves information about the characteristics of a product and therefore allows consumers to make informed choices about what to purchase and thus it enhances the ability of markets to allocate resources efficiently
- advertising increases competition since consumers become aware of all the firms in a particular market. This increase in competition will increase allocative and productive efficiency
- advertising allows new firms to enter a market easily since it gives new firms a means of attracting customers from existing firms. This will make the market more contestable and therefore should improve efficiency
- advertising can act as a signal of quality. Firms would be unlikely to spend huge sums of money advertising a product if they knew it was of poor quality.

Areas for analysis and discussion include:

- discussion of how firms, consumers and economy might benefit from advertising
- negative impact of advertising on consumers – higher prices, artificial desires
- moral arguments about advertising demerit goods or advertising to children
- impact of advertising on levels of competition
- impact of advertising on efficiency
- opportunity cost of advertising
- use of appropriate examples
- appropriate diagrams
- difficulty of restricting advertising/marketing.

Level 1 ([1]–[7])

Candidate shows little understanding of the case for and against the view that advertising should be restricted. 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 advertising should be restricted. 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 advertising should be restricted. 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 advertising should be restricted. There is significant evaluation and judgment of the arguments, and quality of written communication is excellent. [25]

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3 Profit is not the only motive!

- (a) In the absence of other constraints profit maximising firms will produce at the point where MC equals MR (when MC is upward sloping) and will 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 diagram
- explanation of why profits are maximised at the point where MC = MR
- explanation/calculation of profit
- distinction between the short run and the long run
- use of an appropriate numerical example
- reference to price discrimination.

Level 1 ([1]–[5])

Candidate shows little understanding of how the price and output of a profit maximising firm would be determined in the short run. No attempt is made to represent the profit maximising point on a diagram or to illustrate it by 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 would be determined in the short run. Some attempt is made to represent the profit maximising point on a diagram or to illustrate it by 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 would be determined in the short run. It is anticipated that an accurate diagram will be drawn or a clear numerical example is used to illustrate it. Quality of written communication is of a high standard. [15]

- (b) Classical economic theory assumes that firms will seek to maximise profits and will therefore produce where MC equals MR. Although most economists would argue that this is a fair enough assumption to make, particularly when trying to model real world behaviour, some economists believe that it is an unrealistic assumption.

They argue that in the real world, firms have a wide variety of objectives, many of which do not involve the maximisation of profits. Social enterprises such as the “Big Issue” do not aim to maximise profits but aim to further their social objectives. However, it could be argued that to effectively meet their social objectives these firms need to make profits.

Areas for analysis and discussion include:

- green objectives
- social objectives/growth of social enterprises
- examples of social enterprises
- impact of corporate social responsibility
- the need to make a profit to further social objectives
- cost plus pricing
- limit pricing
- alternative objectives such as revenue maximising and sales maximising
- legal obligation on directors to maximise shareholder value
- divorce of ownership and control
- appropriate examples
- appropriate diagrams.

Level 1 ([1]–[7])

Candidate shows little understanding of the alternatives to profit maximisation. There is no significant application, analysis or evaluation, and quality of written communication is limited.

Level 2 ([8]–[13])

Candidate shows some understanding of the alternatives to profit maximisation. 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 alternatives to profit maximisation. There is significant application, 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 alternatives to profit maximisation. There is a thorough analysis and evaluation of the arguments. Quality of written communication is excellent.

[25]

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4 OFT to investigate UK grocery market as industry becomes more concentrated

- (a) An oligopolistic industry has a number of features many of which are illustrated in the UK supermarket industry. These include:
- high concentration ratio – An oligopolistic market is one where supply is dominated by a small number of large firms each of whom has significant market power. The UK grocery market is highly concentrated with TESCO, Sainsbury, ASDA and Morrison's having a combined market share in excess of 60%
 - high barriers to entry – In the grocery market large firms have been accused of buying up land in and around towns to prevent competitors using this land to open stores. This process is known as land banking. Other examples include below cost selling
 - interdependence – Supermarkets are interdependent in the fact that action by one supermarket is likely to provoke a reaction by another. If one supermarket begins selling alcohol at a loss others are likely to follow suit
 - ability to earn supernormal profits – The supermarkets are able to earn supernormal profits. In 2009 TESCO reported a pre-tax profit of £3.13 bn, up 10% on the previous year. (It should be noted, however, that TESCO earns a significant proportion of its profits from non-grocery sales.)
 - potential for collusion – UK supermarkets have faced charges of price-fixing in a range of products from milk to petrol.

Candidates may choose to illustrate these features with reference to industries other than supermarkets.

Level 1 ([1]–[5])

Candidate shows little understanding of the features of oligopoly. At this level a candidate may simply list a few characteristics of an oligopolistic industry, but make no attempt to apply these to any market. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate shows some understanding of the features of oligopoly. Quality of written communication is satisfactory. There is a degree of economic analysis though this may be superficial or contain errors.

Level 3 ([11]–[15])

Candidate shows clear and comprehensive understanding of the features of oligopoly. There is significant economic analysis and application, and quality of written communication is of a high standard.

[15]

- (b) Increased concentration is normally assumed to be bad for consumers on the grounds that the consequent reduction in competition will lead to higher prices, poorer quality services, less innovation and less choice.

On the other hand, higher levels of concentration can lead to benefits to consumers since the firms may be able to avail of economies of scale, which in turn, could lead to lower prices.

Areas for analysis and discussion include:

- impact on efficiency
- impact on prices – Real grocery prices have continued to fall despite increased concentration
- impact on quality
- impact on choice – Evidence suggests that both choice of store and choice of products has been reduced somewhat as a result of increased concentration.
- increased concentration does not necessarily mean less competition, some highly concentrated industries are fiercely competitive
- analysis of economies of scale
- impact on consumer surplus
- appropriate diagrams
- impact on suppliers.

Level 1 ([1]–[7])

Candidate shows little understanding of the impact of greater concentration in the UK supermarket industry. There is no significant application, analysis or evaluation, and quality of written communication is limited.

Level 2 ([8]–[13])

Candidate shows some understanding of the impact of greater concentration in the UK supermarket industry. 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 impact of greater concentration in the UK supermarket industry. There is significant application, 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 impact of greater concentration in the UK supermarket industry. There is a thorough analysis and evaluation of the arguments and they are clearly applied to the UK grocery market. Quality of written communication is excellent.

[25]

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Total**80**