



Rewarding Learning

**ADVANCED
General Certificate of Education
2014**

Economics

Assessment Unit A2 1

Business Economics

[AE211]

TUESDAY 13 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. Some material may be included in the mark scheme for the benefit of teachers and pupils preparing for future examinations. Candidates are not expected to have provided this information. Such material is printed in the mark scheme in italics.

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 selects 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 selects 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 (a) Austrian economist Joseph Schumpeter coined the seemingly paradoxical term creative destruction in his 1942 book, *Capitalism, Socialism and Democracy*. The term is used to describe the process by which former dominant companies or technologies are pushed out of the market by new innovative and dynamic ideas or entrepreneurs. The process can be seen in the rapid decline of Nokia, who once had a 40% share of the cell phone market but have now been overtaken by more innovative companies such as Apple, Samsung and new comers to the market such as HTC and ZTE.

[3] for explanation of process of creative destruction

[2] for use of appropriate example

[5]

- (b) Supernormal profits are defined by economists as any profit, over and above the minimum required to keep the factors of production in their current use.

Supernormal profits are profits which exceed what an entrepreneur would normally be expected to earn through the employment of a similar combination of factors of production.

Firms earn supernormal profits whenever the average revenue received for selling goods is greater than the average cost associated with their production.

To determine whether Apple is earning supernormal profits an economist could compare the Apple's profits with those of other firms in the industry, with those of firms in the same industry in other countries or with those of similar sized firms in other industries. Source 2 states that in 2011 Apple earned a net profit of \$26bn on sales revenue of \$108bn. This gives it a net profit ratio of just over 24%.

It is interesting to note that each year, on a Friday in late November (called 'Black Friday') Apple reduce the prices of their products by 10% in all their stores worldwide and on the web. It seems reasonable to assume that this is something aimed at increasing their annual profits. For this to be the case, the reduced price must cover all their costs, implying that the usual price must more than cover costs, indicating supernormal profits.

Areas for analysis and development include:

- Definition of supernormal profits
- Explanation of how profits are measured
- Reference to comparing Apple's profits with that of other firms
- Reference to accounting formula such as ROCE or Net Profit Ratio
- Use of appropriate diagrams
- Numerical examples
- Reference to other indicators such as takeovers and high dividends

Level 1 ([1]–[3])

Candidate shows little understanding of the term supernormal profit or of how an economist would determine whether Apple was earning supernormal profits. Quality of written communication is limited.

Level 2 ([4]–[7])

Candidate shows some understanding of the term supernormal profit and how an economist would determine whether Apple was earning supernormal profits. Quality of written communication is satisfactory.

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Level 3 ([8]–[10])

Candidate shows detailed understanding of how an economist would determine whether Apple was earning supernormal profits. Quality of written communication is of a high standard. [10]

- (c) Governments around the world use the patent system to protect the intellectual property rights of firms, as they believe that it is the most effective way of encouraging innovation and dynamic efficiency. A patent acts as a barrier to entry and allows innovative firms to earn supernormal profits from their original ideas. If firms were able to simply copy the innovations of rival firms, no rational firm would spend time or money on research and development as it would be in their best interest to free ride on the innovations of others. Therefore in the absence of a patent system there would be little innovation and hence little dynamic efficiency.

Not only do patents and the subsequent supernormal profits provide the incentive for innovation they also provide the funds for continuing innovation. Innovative firms spend much of their supernormal profits on R&D in the hope of developing further product or process innovations that will allow them to continue to earn supernormal profits.

Others however argue that the patent system encourages inefficiency and can reduce innovation as firms can continue to earn supernormal profit on previous innovations. For this reason most patents, particularly in high tech industries and biomedical sciences are time limited. They also argue that patents allow firms to charge higher prices and therefore they reduce the welfare of consumers. Finally critics of the patent system argue that they stifle innovation by reducing the spread of information and limiting cooperation.

Areas for analysis and development include:

- Link between patents and continuous innovation
- Impact on efficiency
- Patents as a barrier to entry
- Link to supernormal profit
- Impact on investment and economic growth
- Impact on prices and consumer welfare
- Administration costs to both governments and companies of the patent system – cost of litigation
- Reference to innovation as a public good and the free rider problem in the absence of a patent system
- Negative impact of patents on information sharing

Level 1 ([1]–[3])

Candidate shows little understanding of the case for protecting the intellectual property rights of firms through the use of patents. 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 case for protecting the intellectual property rights of firms through the use of patents. There is a degree of analysis and application and quality of written communication is satisfactory.

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Level 3 ([8]–[10])

Candidate provides a clear and comprehensive understanding of the case for protecting the intellectual property rights of firms through the use of patents. There is significant analysis and application with some degree of evaluation and judgement and quality of written communication is of a high standard. [10]

- (d) Some economists argue that all firms which operate in free market economies will seek to maximise profits (by producing where $MC = MR$) and will place the maximisation of these profits before concerns about worker welfare or the environment. Source 4 highlights how both Apple and Samsung have allowed working conditions in their factories to deteriorate to such a degree that the physical and emotional health of their workers is negatively impacted. Indeed the news is awash with examples of companies that have taken unnecessary environmental or health and safety risks in an attempt to reduce costs and enhance profit margins.

Some economists however believe that it is an unrealistic and unfair generalisation.

They argue that in the real world firms have a wide variety of objectives many of which do not involve the maximisation of profits. They argue that many large firms demonstrate a social conscience and that working conditions and environmental standards are often better in large globalised firms than they are in smaller local firms. They also point to the rise in social enterprises such as the “Big Issue” which do not aim to maximise profits but aim primarily to further their social objectives.

Areas for analysis and discussion include:

- Legal obligation on companies to maximise shareholder value
- Role of profit in allocating resources
- Reference to poor employment or environmental practices of globalised companies
- Reference to alternative objectives – Green objectives – Social objectives
- Examples of social enterprises
- Impact of Corporate Social Responsibility
- Impact of poor publicity on profits
- Divorce of ownership and control
- Difficulty in ensuring that independent suppliers do not violate buying company’s employment or environmental standards
- Reference to costs and benefits to economy of profit maximisation
- Appropriate examples
- Appropriate diagrams

Level 1 ([1]–[5])

Candidate shows little understanding of the view that global companies are certain to pursue the maximisation of profits over their social and environmental responsibilities. There is no significant application, analysis or evaluation and quality of written communication is limited.

Level 2 ([6]–[10])

Candidate shows some understanding of the view that global companies are certain to pursue the maximisation of profits over their social and environmental responsibilities. There is some attempt at analysis and evaluation and quality of written communication is satisfactory.

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Level 3 ([11]–[15])

Candidate shows in-depth understanding of the view that global companies are certain to pursue the maximisation of profits over their social and environmental responsibilities. There is significant application, analysis, evaluation and judgement of the arguments and quality of written communication is of a high standard. [15]

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- 2 (a) One of the most common reasons for wishing to produce on a larger scale is that the firm wants to avail of the economies of scale, which are not available at lower levels of output. Alternatively firms may wish to grow to gain market power in the hope that they will be able to influence the market and earn higher profit levels. In some cases firms may wish to grow simply to satisfy the ego of the owner(s). Others may wish to grow by expanding the range of products they produce in the hope that such diversification will allow them to spread the risk of sudden changes in demand or supply conditions.

Areas for analysis and discussion include:

- Reference to economies of scale
- Reference to economies of scope
- Reference to personal motives for growth – status, ego etc.
- Reference to growth as a strategy to manage level of competition
- Reference to market power
- Reference to desire to make more profits
- Appropriate examples
- Appropriate diagrams

Level 1 ([1]–[5])

Candidate shows little understanding of why firms often strive to produce on a larger scale. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate shows some understanding of why firms often strive to produce on a larger scale. Quality of written communication is satisfactory.

Level 3 ([11]–[15])

Candidate shows a comprehensive understanding of why firms often strive to produce on a larger scale. Quality of written communication is of a high standard. [15]

- (b) Some economic commentators argue that the benefits of large scale production are so significant that small firms will find it difficult to remain competitive and will eventually go bust. They argue that large firms can benefit from significant economies of scale which allows them to price their products at a level which is beyond the ability of smaller firms. They also argue that the greater profits earned by large firms allows them to spend significant sums on research and development and therefore produce more innovative and attractive products. They also argue that the market power that often comes with increased size enables firms to use both price and non-price competition to destroy their smaller rivals.

However others argue that small firms will continue to make up a significant part of any dynamic economy. They argue that small firms are often more flexible and are better able to adapt to changes in market conditions,

therefore they often survive even when larger firms go under. They also suggest that many firms only supply a local market and therefore are likely to remain small. For example in the UK there are a large number of small breweries, which supply pubs in their local area. These breweries do not expand beyond their local area because of the extremely high transport costs associated with a bulky product like alcohol. They also point out that, in a dynamic economy like the UK, new firms are starting up all the time as market opportunities arise. By their very nature these new firms will tend to be small.

Areas for analysis and discussion include:

- Reference to economies of scale which make it difficult for small firms to compete
- Reference to the innovation and product development made possible by the profits earned by large firms
- Reference to large firms using their power to destroy smaller competitors
- Reference to flexibility of small firms and their ability to spot new market opportunities opening up
- Reference to firms who only supply local markets or niche products
- Reference to the fact that in some industries diseconomies of scale exist at relatively low levels of output which encourages the firms to remain small
- Reference to the fact that in some service industries e.g. hairdressing there are very few economies of scale and therefore the desire to grow is less prevalent
- Reference to the fact that governments, in the UK and elsewhere, actively encourage the development of new firms, through business start-up grants and tax breaks for small firms
- Appropriate examples
- Appropriate diagrams

Level 1 ([1]–[7])

Candidate shows little understanding of the view that the advantages associated with large scale production mean that small firms, will become a thing of the past. 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 advantages associated with large scale production means that small firms will become a thing of the past. 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 advantages associated with large scale production means that small firms will become a thing of the past. There is significant analysis and evaluation of the arguments and quality of written communication is of a high standard.

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Level 4 ([20]–[25])

Candidate shows clear and comprehensive understanding of the view that the advantages associated with large scale production means that small firms will become a thing of the past. There is a thorough analysis, evaluation and judgement of the arguments and quality of written communication is excellent.

[25]

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- 3 (a) A perfectly competitive market can be defined as existing whenever individually buyers and sellers believe their own actions will have no influence on the market price. In a perfectly competitive market there are a large number of firms who sell homogenous products. Perfect information exists and there are no barriers to entry or exit, and as a result all firms are price takers.

A perfectly contestable market can be defined as existing where “an entrant has access to all production techniques available to the incumbents, is not prohibited from wooing the incumbent’s customers, and entry decisions can be reversed without cost.” Like perfectly competitive markets a perfectly contestable market has no barriers to entry or exit and all agents have perfect knowledge.

However in a perfectly contestable market the number of firms can vary from one to many and the product can be homogenous or differentiated.

Areas for analysis and discussion include:

- Definition of a perfectly competitive market
- Assumptions of perfect competition
- Definition of a perfectly contestable market
- Assumptions of the contestable model
- Reference to key difference being with regard to the number of firms and the nature of the product produced
- Appropriate diagrams
- Appropriate examples

Level 1 ([1]–[5])

Candidate shows little understanding of the difference between a perfectly competitive market and a perfectly contestable market. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate shows some understanding of the difference between a perfectly competitive market and a perfectly contestable market. Quality of written communication is satisfactory.

Level 3 ([11]–[15])

Candidate shows detailed understanding of the difference between a perfectly competitive market and a perfectly contestable market. Quality of written communication is of a high standard.

[15]

- (b) Traditional economic theory suggests that highly competitive industries are more likely to be economically efficient than those where there is less competition. Intense competition will force firms to charge a price which is

equal to their marginal cost of production and hence allocative efficiency will occur. This pressure on price will in turn force firms to minimise the average cost of each unit produced and so productive efficiency will occur.

However the theory of contestable markets suggests that it is not the actual level of competition a firm faces which forces it to be efficient but the level of potential competition. As long as the firm faces the threat of competition it will be both productively and allocatively efficient. In addition this theory suggests that a large firm, with significant market share, might actually produce in a more efficient manner than a perfectly competitive firm since it will be able to avail of economies of scale and therefore produce at a lower average cost.

Alternatively it could be argued that it is those firms which operate in less competitive or contestable markets that are more likely to be efficient. The argument suggests that firms in oligopolistic or monopolistic markets are more likely to invest in research and development and therefore these industries are more likely to achieve dynamic efficiency.

Issues for discussion and evaluation include:

- Different measures of efficiency-
 - Allocative efficiency
 - Productive efficiency
 - Technical efficiency
 - Dynamic efficiency
- Comparison of equilibrium position of a perfectly contestable market with that of monopoly, oligopoly, perfect competition or monopolistic competition
- Reference to minimum efficient scale of production
- Reference to economies of scale
- Reference to unrealistic assumption of model of contestable markets
- Appropriate examples
- Appropriate diagrams

Level 1 ([1]–[7])

Candidate shows little understanding of the view that contestable markets lead to a more efficient allocation of resources than any other market structure. 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 contestable markets lead to a more efficient allocation of resources than any other market structure. 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 contestable markets lead to a more efficient allocation of resources than any other market structure. There is significant analysis and evaluation of the arguments and quality of written communication is of a high standard.

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Level 4 ([20]–[25])

Candidate shows clear and comprehensive understanding of the view that contestable markets lead to a more efficient allocation of resources than any other market structure. There is significant evaluation and judgment of the arguments and quality of written communication is excellent. [25]

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- 4 (a) Market share is defined as the proportion of total sales in a market that is accounted for by a particular brand, product or company. It is normally calculated by taking a company's sales revenue and dividing it by the total value of sales in that particular market. Alternatively it can be calculated by taking the company's total volume of sales and dividing it by the total volume of units sold in that market.

The term market power (or monopoly power) refers to the ability of a firm to alter the market price of a good or service by exercising control over its demand, supply or both. A firm (or group of firms) would be considered to have market power if they have the ability to raise and maintain price above the level which would prevail under perfect competition. Market power is much more difficult to measure than market share. *The most common method is the Lerner Index which measures the extent to which price exceeds marginal (or variable) cost.*

While market share and market power often go hand in hand one does not necessarily depend upon the other. It is possible for a firm to have significant market share yet have little power to influence the price of the product, while firms in other markets may have more market power despite having a much lower market share.

Areas for analysis and discussion include:

- Definition of market share
- Explanation of how market share is measured
- Reference to measurements based on volume or value
- Definition of market power
- Explanation of how market power is measured
- Reference to monopoly or monopsony power
- Reference to market share tests being used to measure market dominance
- Appropriate examples
- Appropriate diagrams

Level 1 ([1]–[5])

Candidate shows little understanding of the difference between market share and market power. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate shows some understanding of the difference between market share and market power. Quality of written communication is satisfactory.

Level 3 ([11]–[15])

Candidate shows clear and comprehensive understanding of the difference between market share and market power. Quality of written communication is of a high standard. [15]

- (b) There are a range of measures available to government to reduce the market power of companies such as Tesco. These include:
- Removing barriers to entry to make the market more competitive or contestable
 - Breaking the monopoly up – by forcing Tesco to sell stores to smaller rivals and hence increase competition
 - Use of planning regulations to limit the expansion of Tesco or to stop Tesco land banking
 - The use price controls – forcing Tesco to pay higher prices to its suppliers, limiting the price it charges its customers
 - The use of taxation – imposition of windfall taxes on supernormal profits
 - The use of subsidies to encourage competition
 - The use of legislation to restrict the range of products a company such as Tesco is permitted to sell

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 opportunity cost of using subsidies
- Welfare implications of taxation
- Appropriate examples
- Reference to UK competition policy

Level 1 ([1]–[7])

Candidate shows little understanding of the measures a government could use to reduce the market power of a company such as Tesco. 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 a government could use to reduce the market power of a company such as Tesco. 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 a government could use to reduce the market power of a company such as Tesco. 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 a government could use to reduce the market power of a company such as Tesco. There is significant evaluation and judgment of the arguments and quality of written communication is excellent. [25]

Total

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