



Rewarding Learning

ADVANCED
General Certificate of Education
2015

Economics

Assessment Unit A2 1

assessing

Business Economics

[AE211]

MONDAY 11 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 The changing nature of UK book publishing

- (a) The growth of the UK book publishing market can be measured by volume or by value. The volume measurement simply calculates the percentage increase in the number of books sold. The value measurement on the other hand measures the increase in the total revenue received from selling books. Clearly if books are sold at a very low price, this will increase the volume measurement by much more than the value measurement. Source 1 states that, many of the e-books were sold at zero-price or for just a few pence. While these sales add to total volume book sales they add very little to the value of book sales. In addition the average price of e-books has fallen over recent years and as a result the growth in sales will be lower when measured in value.

For accurate selection of relevant data only, [3] marks; for explanation of ideas of value and volume award [2] marks. [5]

- (b) A monopoly is normally considered to exist whenever a single firm provides a good or service for which there is no close substitute. However the Competition and Markets Authority define a monopoly as occurring whenever a firm has more than 25% market share. By this definition Penguin Random House could be described as a monopoly since they will control approximately 29% of the UK book publishing market. This level of market share will allow Penguin Random House to exert significant market power and influence both the fee it pays its writers and the price at which retailers sell books.

An oligopoly on the other hand occurs when a few large firms dominate a market. Source 2 states that the top six firms, account for approximately 88% of the UK book publishing market, and therefore the industry could be described as oligopolistic. The UK book publishing market displays many of the features of oligopolistic industries such as price rigidity, non-price competition, interdependent decision making, and attempts to collude and fix price.

Areas for analysis and discussion include:

- Definition and explanation of monopoly
- Definition and explanation of oligopoly
- Explanation of why UK book publishing could be described as a monopolistic industry
- Explanation of why UK book publishing could be described as an oligopolistic industry
- Reference to assumptions and features of monopoly – price setting powers, supernormal profits
- Reference to assumptions and features of oligopoly – price rigidity, non-price competition, collusion
- Appropriate diagrams
- Appropriate examples

Level 1 ([1]–[3])

Candidate shows very limited understanding of why the UK book publishing market could be described as both monopolistic and oligopolistic. There is no significant analysis and application of the issues and quality of written communication is limited.

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Level 2 ([4]–[7])

Candidate provides some understanding of why the UK book publishing market could be described as both monopolistic and oligopolistic. 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 why the UK book publishing market could be described as both monopolistic and oligopolistic. There is significant analysis and application and quality of written communication is of a high standard. [10]

- (c) Economists have identified a number of different types of efficiency which include; allocative efficiency, productive efficiency and dynamic efficiency. Some economists would suggest that, when two firms such as Penguin and Random House merge to create one larger firm with monopoly power, the firm is likely to become less allocatively and productively efficient. They argue that the reduction in competition will allow the firm to raise prices above the allocatively efficient level and the supernormal profits earned from these higher prices will reduce the incentive to be productively efficient. They also argue that if the merged firm becomes so powerful that it faces little competition there will be no incentive to invest in research and development and therefore it will also reduce dynamic efficiency.

Others however argue that this merger may actually improve efficiency in the UK book publishing industry. Firstly they argue that the merger allows Penguin Random House to produce on a greater scale and therefore avail of economies of scale. Source 2 states that Penguin Random House expects average costs to fall by 2–3% as a result of the merger thus improving productive efficiency. They also argue that any extra profits earned as a result of the merger could be reinvested in the company in new talent and technology and so lead to innovation and dynamic efficiency.

Those in favour of the merger argue that Penguin Random House will continue to face significant competition and therefore are unlikely to be able to raise prices significantly above the allocatively efficient level. They argue that the very tight margins available in the market (Penguin Random House had a combined operating profit of £272 mn on sales of £32.5 bn which equates to a 0.8% profit ratio) ensures that the merged firm will continue to seek to be productively and dynamically efficient.

Areas for analysis and discussion include:

- Definition and explanation of different measurements of efficiency – productive, allocative and dynamic efficiency
- Explanation of the negative impact merger could have on efficiency if Penguin Random House gains significant market power
- Reference to economies of scale
- Reference to supernormal profits
- Reference to the fact that significant levels of competition will still exist after the merger
- Reference to the low profit margins available in the industry and discussion of the impact this will have on productive and dynamic efficiency

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- Reference to the impact of increased competition from self-published authors and online businesses such as Amazon and Google.
- Relevant diagrams
- Appropriate examples

Level 1 ([1]–[3])

Candidate provides very limited examination of the likely impact of the Penguin Random House merger on the efficiency of the UK book publishing market. 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 examination of the likely impact of the Penguin Random House merger on the efficiency of the UK book publishing market. 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 examination of the likely impact of the Penguin Random House merger on the efficiency of the UK book publishing market. There is significant analysis and application to the case study with some degree of evaluation. 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 by all legal measures. In the case of Amazon they argue that the managers of Amazon are entirely correct to set their company up in such a way as to minimise its tax responsibilities in different nations. They argue that as long as Amazon is working within the laws of the state they have no responsibility to pay more tax than the minimum legally required. They argue that any 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 multinational companies such as Amazon have responsibilities not just to shareholders but to a wide range of stakeholders including, employees, customers, the local community, the government and the environment. They argue that Amazon is using its size to exploit loopholes in the tax system and that they are seeking to benefit from the UK's infrastructure and business environment without making a fair contribution to its maintenance. They argue that while Amazon may be working within the limits of the tax laws as they stand they are breaking the spirit of the tax laws.

Areas for analysis and discussion include:

- Discussion of the need to maximise profit to survive
- Discussion of the legal obligation on Amazon's managers to maximise shareholder value
- Discussion of the fact that Amazon pay all taxes they are legally obliged to pay
- Reference to the jobs and wealth created by amazon in the UK

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- Discussion of the other taxes that Amazon pays – VAT, NICs, Rates etc.
- Discussion of corporate social responsibility and moral duty to give something back to the society in which you operate
- Discussion of business objectives other than profit maximisation
- Impact of poor publicity on corporate image and ultimately consumer demand
- Reference to the normative nature of moral, social and ethical arguments
- Discussion of how firms can use Corporate Social Responsibility (CSR) as a marketing tool
- Discussion of the need to change the legislation rather than castigate companies who operate within the law.
- Appropriate examples
- Appropriate diagrams

Level 1 ([1]–[5])

Candidate provides little critical examination of the view that multinational companies such as Amazon have a moral and social duty to pay a fair level of corporation tax in the countries in which they operate. There is no significant evaluation of the issues and quality of written communication is limited.

Level 2 ([6]–[10])

Candidate provides some critical examination of the view that multinational companies such as Amazon have a moral and social duty to pay a fair level of corporation tax in the countries in which they operate. 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 critical examination of the view that multinational companies such as Amazon have a moral and social duty to pay a fair level of corporation tax in the countries in which they operate. There is significant evaluation and judgement and quality of written communication is of a high standard. [15]

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2 Non-price competition benefits firms but not consumers

- (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 provides little explanation of the difference between price and non-price competition. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate provides some explanation 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 provides a comprehensive explanation of the difference between price and non-price competition. Quality of written communication is of a high standard. [15]

- (b) Traditional economic theory assumes that consumers benefit from price competition. Price competition between firms leads to lower prices for consumers which increases consumer surplus. Lower prices also lead to an increase in real income and an increase in efficiency as firms are forced to reduce costs.

However some economists argue that, in the long term, intense price competition can be detrimental to consumers since it leads to smaller/less efficient firms leaving the industry. This in turn reduces competition which has a negative impact on choice and quality and can lead to higher prices in the long term.

Those economists who support non-price competition argue that it can lead to price stability which allows consumers to plan more effectively. They also contend that it can lead to improved product quality and improved customer service. They argue that non-price competition can lead to a wider choice of products within a market and that advertising that is associated with non-price competition improves information and therefore competition and efficiency.

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Areas for analysis and discussion include:

- Definition and explanation of price competition
- Examples of price competition
- Impact of price competition on consumer welfare
- Impact of price competition on real incomes
- Long term impact of price competition on competition levels and prices
- Impact of non-price competition on product quality
- Impact of non-price competition on customer service
- Impact of non-price competition on choice (positive and negative)
- Impact of advertising on information, competition and efficiency
- Reference to how some forms of non-price competition are designed to manipulate consumer tastes
- Reference to how some forms of non-price competition can create barriers to entry
- Appropriate diagrams
- Appropriate examples

Level 1 ([1]–[7])

Candidate provides little critical examination of the view that consumers benefit more from price competition than from non-price competition. There is no significant analysis, application or evaluation and quality of written communication is limited.

Level 2 ([8]–[13])

Candidate provides some critical examination of the view that consumers benefit more from price competition than from non-price competition. There is some attempt at analysis, application and evaluation and quality of written communication is satisfactory.

Level 3 ([14]–[19])

Candidate provides in-depth critical examination of the view that consumers benefit more from price competition than from non-price competition. There is significant analysis, application and evaluation of the arguments and quality of written communication is of a high standard.

Level 4 ([20]–[25])

Candidate provides clear and comprehensive critical examination of the view that consumers benefit more from price competition than from non-price competition. There is a thorough analysis, application, evaluation and judgement of the arguments and quality of written communication is excellent.

[25]

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3 Traditional theories of the firm are outdated and unrealistic

- (a) A market is said to be perfectly competitive when individually buyers and sellers believe that their own actions will have no influence on the market price.

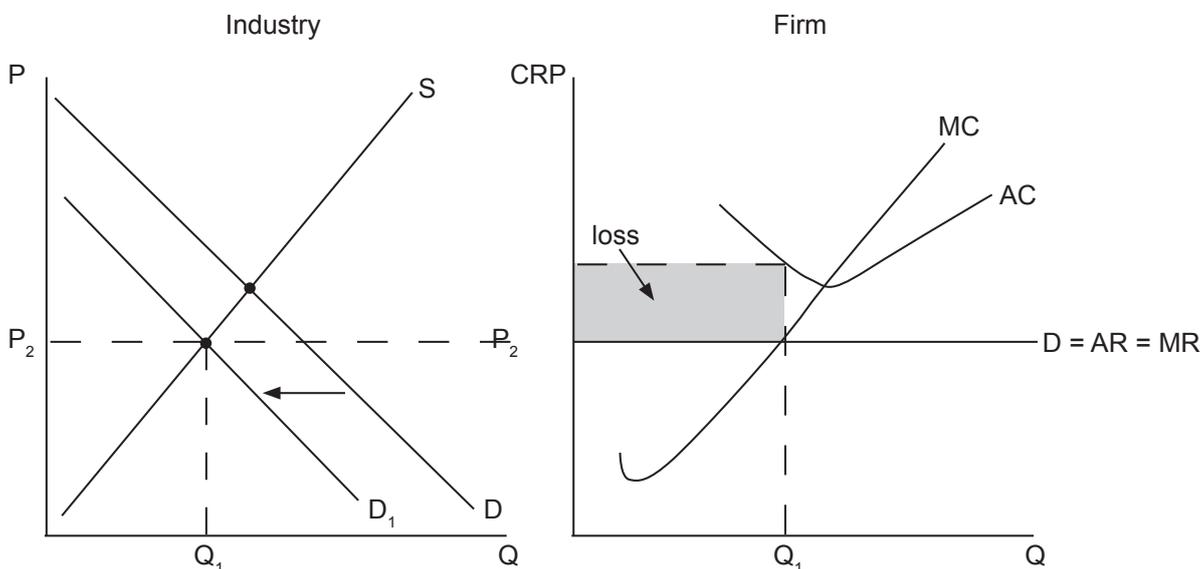
Perfectly competitive markets do not exist in the real world; however agriculture and market gardening, and the foreign exchange markets are often regarded as the closest examples since they demonstrate many of the characteristics of perfect markets.

The model of perfect competition is based on a number of simplifying assumptions.

1. There are a large number of buyers and sellers who buy and sell such a small amount that they cannot affect market demand or supply.
2. The firms produce homogeneous products
3. There is perfect knowledge of market conditions for both buyers and sellers
4. There are no barriers to entry. Firms are free to enter and leave the industry
5. There are no externalities

A fall in market demand will lead to a decrease in the price firms receive for their products. In the short run, perfectly competitive firms will not earn enough revenue to cover their costs and so will make losses.

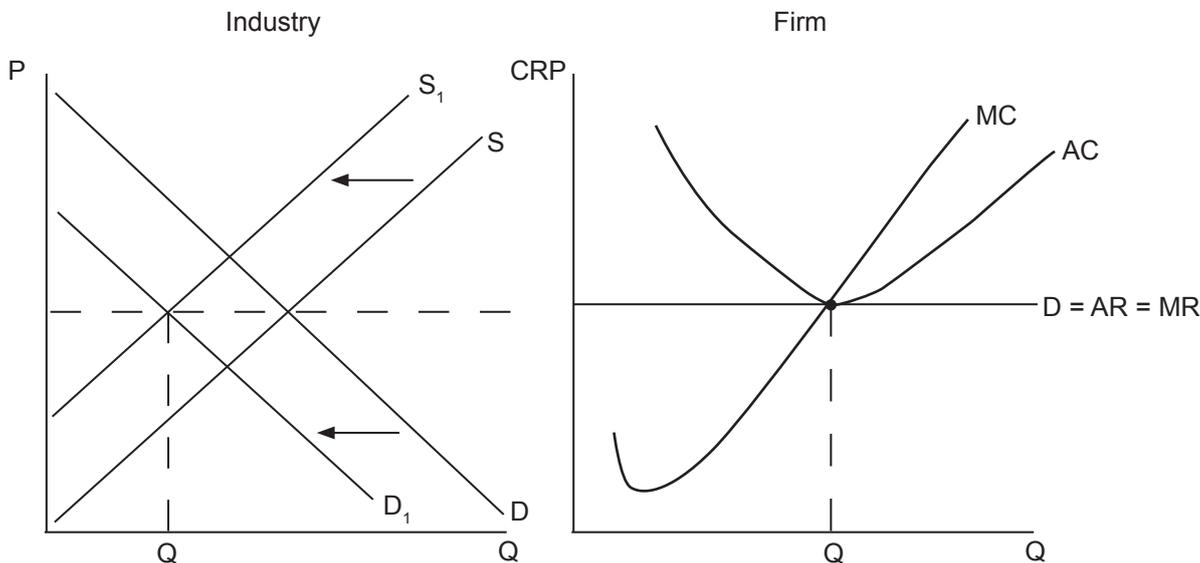
Diagram A



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Those firms who are able to cover their variable costs will remain in the industry in the hope that revenues will recover. Since there are no barriers to exit those firms who cannot cover their variable costs will leave the industry. This will reduce supply in the industry and will push up revenues until normal profits are made by all remaining firms.

Diagram B



Areas for analysis and discussion include:

- Explanation of perfect competition
- Assumption of model
- Explanation of short run and long run equilibrium
- Distinction between fixed and variable costs
- Explanation of shut-down point
- Appropriate diagrams
- Appropriate examples

Level 1 ([1]–[5])

Candidate provides little explanation of how a perfectly competitive industry responds to a fall in demand. A diagram is unlikely to be attempted or where it is attempted it will contain significant errors. Quality of written communication is limited.

Level 2 ([6]–[10])

Candidate provides some explanation of how a perfectly competitive industry responds to a fall in demand. Diagrams will be drawn but they may contain minor errors. Quality of written communication is satisfactory.

Level 3 ([11]–[15])

Candidate provides a detailed explanation of how a perfectly competitive industry responds to a fall in demand in both the short run and the long run. Clear and accurate diagrams will be drawn. Quality of written communication is of a high standard. [15]

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- (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. Indeed critics often point out that in the real world many very large and very small firms coexist in the industries such as brewing and baking.

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 neoclassical 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. They also point particularly to modern developments in the theories of oligopoly which take account of the potential for collusive behaviour as models of best practice.

Areas for analysis and discussion include:

- Discussion of unrealistic nature of profit maximising assumption inherent in all traditional models
- 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 and the view that even theories which are based on unrealistic assumptions can often provide the basis for accurate predictions.
- Discussion of alternative theories of firms' behaviour – contestable markets theory and new models based on behavioural economics
- 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 provides little critical examination of the view that the traditional models of firms' behaviour are of little use to modern economists. There is no significant analysis or evaluation and quality of written communication is limited.

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Level 2 ([8]–[13])

Candidate provides some critical examination of the view that the traditional models of firms' behaviour are of little use to modern economists.

There is some attempt at analysis and evaluation and quality of written communication is satisfactory.

Level 3 ([14]–[19])

Candidate provides in-depth critical examination of the view that the traditional models of firms' behaviour are of little use to modern economists.

There is significant analysis and evaluation of the arguments and quality of written communication is of a high standard.

Level 4 ([20]–[25])

Candidate provides clear and comprehensive critical examination of the view that the traditional models of firms' behaviour are of little use to modern economists. There is significant evaluation and judgment of the arguments and quality of written communication is excellent. [25]

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4 Environmental policies benefit neither the economy nor the environment

- (a) Social costs are the sum of all private costs and all external costs, whereas social benefits are the sum of all private benefits and all external benefits.

If we consider the case of oil extraction and production, the private costs of oil extraction include the cost of drilling and refining the oil and labour costs. The external costs include the cost to society of the visual and noise pollution associated with drilling for oil and the cost to the environment and local economy of any oil spills.

The social benefit includes the private benefit the company receives from producing the oil, the profit, the status etc plus any potential external benefit society gains as a result of the oil extraction. For example suppliers of raw materials and machinery will receive an increase in trade and employees will receive wages and employment.

Alternatively if we consider the case of an individual smoking a cigar, the social cost includes the private costs to the individual of purchasing the cigars and any increased health risk plus the external cost inflicted on society as a result of having to pay for the negative health effects on the individual and third parties. Whereas the social benefit includes, any enjoyment the individual gains from using the cigar plus any potential benefit society might gain from the cigar being smoked, (for example some non-smokers claim to enjoy the smell of cigar smoke).

Appropriate development:

- Definition of social costs and benefits
- Explanation of private costs and benefits
- Explanation of external costs and benefits
- Reference to externalities both positive and negative created through production
- Reference to externalities both positive and negative created through consumption
- Examples of private costs and benefits
- Examples of external costs and benefits
- Appropriate diagrams

Level 1 ([1]–[5])

Candidate provides little or no explanation of the terms social cost and social benefits. There is no significant development through the use of appropriate examples or diagrams and quality of written communication is limited.

Level 2 ([6]–[10])

Candidate provides some explanation of the terms social cost and social benefits. There is a degree of development through appropriate examples or diagrams and quality of written communication is satisfactory.

Level 3 ([11]–[15])

Candidate provides a clear explanation of the terms social cost and social benefits. There is significant development with clear diagrams and appropriate examples and quality of written communication is of a high standard.

[15]

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- (b) A growing number of economists argue that government attempts to protect the environment is damaging not only economic welfare and prosperity but may also be leading to greater levels of environmental degradation.

They argue that environmental regulations are often poorly thought out and are expensive for the business to comply with and the government to police. They argue that some initiatives are so poorly designed that they lead to a worsening of the situation. For example, some economists argue that, attempts to encourage the recycling of paper, actually leads to a reduction in tree planting and therefore increases CO₂ levels in the atmosphere.

They argue that the use of environmental taxation and tradable permits increases the cost of production and so leads to higher prices and a reduction in economic welfare. They argue that subsidies for green production distort markets and are costly to administer. Finally some economists even question the science upon which much of the move towards environmentalism is based.

However other economists argue that environmental pollution is a form of market failure and that governments must take some action to correct the failure. They argue that well designed policies that work with the market can improve outcomes not only for current generations but also future generations.

Areas for analysis and discussion include:

- Definition/explanation of market failure
- Definition/explanation of negative externalities
- Examples of negative environmental externalities
- Reference to range of government environmental policies
- Impact of these policies on businesses and economic welfare (positive and negative)
- Impact of policies on environment (positive and negative)
- Reference to an optimal level of environmental pollution
- Reference to government failure
- Reference to law of unintended consequences
- Reference to examples of failed policies
- Appropriate diagrams
- Appropriate examples

Level 1 ([1]–[7])

Candidate provides little evaluation of the view that government policies for environmental protection are costly and counterproductive. There is no significant analysis, application or evaluation and quality of written communication is limited.

Level 2 ([8]–[13])

Candidate provides some evaluation of the view that government policies for environmental protection are costly and counterproductive. There is some attempt at analysis, application and evaluation and quality of written communication is satisfactory.

Level 3 ([14]–[19])

Candidate provides in-depth evaluation of the view that government policies

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for environmental protection are costly and counterproductive. There is significant analysis, application and evaluation of the arguments and quality of written communication is of a high standard.

Level 4 ([20]–[25])

Candidate provides clear and comprehensive evaluation of the view that government policies for environmental protection are costly and counterproductive. There is a thorough analysis, application, evaluation and judgement of the arguments and quality of written communication is excellent.

[25]

Total

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MARKS**

40

80