Mark Scheme (Results)

Summer 2012

GCE Economics (6EC03)
Paper 01

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General Marking Guidance

- All candidates must receive the same treatment. Examiners must mark the first candidate in exactly the same way as they mark the last.
- Mark schemes should be applied positively. Candidates must be rewarded for what they have shown they can do rather than penalised for omissions.
- Examiners should mark according to the mark scheme not according to their perception of where the grade boundaries may lie.
- There is no ceiling on achievement. All marks on the mark scheme should be used appropriately.
- All the marks on the mark scheme are designed to be awarded. Examiners should always award full marks if deserved, i.e. if the answer matches the mark scheme. Examiners should also be prepared to award zero marks if the candidate's response is not worthy of credit according to the mark scheme.
- Where some judgement is required, mark schemes will provide the principles by which marks will be awarded and exemplification may be limited.
- When examiners are in doubt regarding the application of the mark scheme to a candidate's response, the team leader must be consulted.
- Crossed out work should be marked UNLESS the candidate has replaced it with an alternative response.

If an incorrect key has been chosen, the maximum score is 2 out of 4 **except on question 6.**

Incorrect options can be knocked out, if relevant economic reasoning is given. If more than one key is knocked out for the same reason this will earn one mark only. There must be different reasons for each knock out. Marks are **not** awarded if the rationale is that 'it's not A because it is B' – there must be some valid economic rationale.

Up to two knock out marks can be awarded for each supported choice question.

Question Number	Answer	Mark
1	**E** Horizontal integration or merger defined, e.g. merging of businesses at the same stage of a production process (1 mark) meaning that there are economies of scale and/or type economy of scale (1 mark) with other application to building maintenance e.g. use of capital equipment (1 mark), reasons for or benefits of integration, increased market share (1+1).	**(4)**

Question Number	Answer	Mark
2	**C** Definition or one characteristic of perfect competition (1) Diagram (up to 3 marks): **Short run**: AR=MR horizontal for firm and/or supernormal profits (1) **Long run**: AR=AC=MC=MR for firm normal profits and/or fall in output for firm (1) **Industry diagram**: showing supply shifting right showing fall in price (1) Equivalent verbal analysis: no barriers to entry mean that other firms will enter (1) supernormal profit acts as a signal or incentive (1) this will reduce price because of increased competition/total output in the market increases as industry supply increases (1) and each individual firm's output will fall (1) and firm will only make normal profit in the long run (1).	**(4)**

Question Number	Answer	Mark
3	**D** Vertical integration definition e.g. joining with a firm involved at a different stage of the **same** production process/same industry/same final product (1 mark). Role of Ofgem/regulator e.g. surrogate for competition/to promote competition/act in the consumers' or public interest (1). Explanation: that these firms can control or dominate suppliers or customers/outlets (1 mark) with application or consequence e.g. new firms cannot get onto distribution networks, or other barriers to entry (1 mark). Use of data, e.g. calculation of concentration ratio (1). Example of knockout mark: it is not E because EDF has 24% of the industry, but a legal monopoly is 25% or over (1)	**(4)**

Question Number	Answer	Mark
4	**A** Definition or formula for marginal cost (1 mark) Explanation of Law of Diminishing Returns: there is at least one fixed factor (1 mark) marginal costs rise as more factors are added/marginal product falls as more factors are added (1) Application to any context (1) e.g. too many rice pickers in a field cannot add much to total output Diagram (1) showing **gradient** of TC rising having been rising more slowly up to X. Example of a knockout mark: it is not E because economies of scale are a **long run** concept or drawing of long run average costs (1)	(4)

Question Number	Answer	Mark
5	**C** Definition of profit maximisation, e.g. MC=MR (1 mark) Calculation of Total Revenue (TR) column (1 mark) Calculation of Marginal Revenue (MR) column (1 mark) Calculation of Total Costs (TC) column (1 mark) Calculation of Total Profits column (1 mark) Firm is price maker, or downward sloping demand curve (1 mark) Application mark: MC=MR when they are both £6 Allow answers to be written between cells rather than in cells (technically correct, which makes output 2.5 profit max) (1 mark for correct inference of output 2.5 or 3)	**(4)**

Quantity	Price (£)	Total Revenue (TR)	Marginal revenue (MR)	Total costs (£)	Marginal costs (MC)	Total Profit (TR-TC)
0	11	0	-	5	-	-5
1	10	10	10	9	4	1
2	9	18	8	14	5	4
3	8	24	6	20	6	4
4	7	28	4	28	8	0
5	6	30	2	38	10	-8

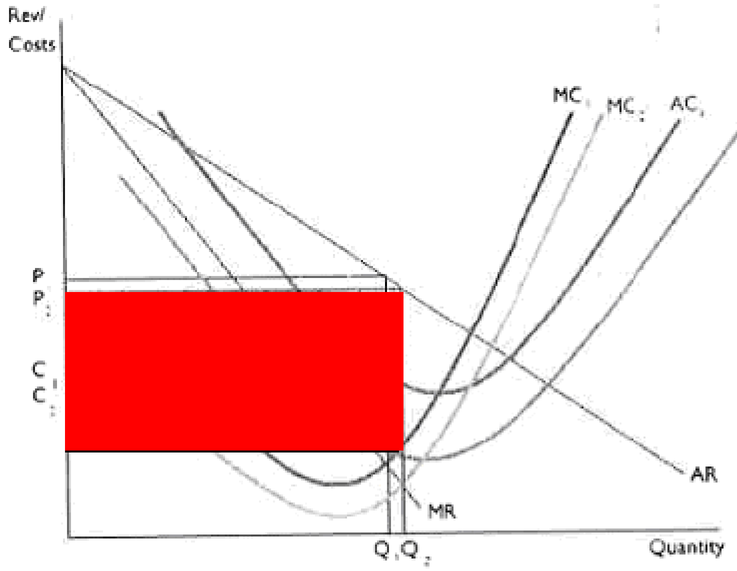
Question Number	Answer	Mark
6	**E** Definition or formula of AC or AVC (1) costs per unit, or variable costs per unit Explanation of predatory pricing e.g. **losses made in short run** to remove competitors or deter new entry (1 mark). Role of OFT/regulator (1) Diagram (1): AR<AVC or AR<AC with loss shown Shut down point: if firms cannot cover AVC they must stop production in the short run (except predator) (1) because they are not making a **contribution** to fixed costs (1) Illegal (1) Application in the context of bus services (1) Role of fines (1) e.g. as a deterrent Other long run implications, that prices will rise, choice will be reduced, profits will be increased (1) Allow **up to 3 marks for the explanation** of wrong answers A and D, where candidate has read the question as a **limit pricing** question, i.e. simply to deter new entrants rather than to force other firms out. In these cases do not award the mark for the key but allow definition of allocative efficiency (if A is chosen) or revenue maximisation (if D is chosen)	**(4)**

Question Number	Answer	Mark
7	**A** Definition of cartel (1) e.g. a system of collaboration/collusion/agreement between firms, or, when individual firms act as a single firm in decision making Firms are operating in an oligopoly/interdependent (1) Correct application of payoff matrix showing short term profits for breaking collusion (1) Verbal analysis, for example using the explanation of the prisoners' dilemma, which may be illustrated by the payoff matrix (up to 3 marks): • show that collusion maximises joint profits/revenues (1) • incentive to **undercut** rival, e.g. if there is scope for gaining short term winnings at the expense of the other firm or firms (1). • long term equilibrium where both firms are worse off than if colluding (1) • incentive to form a new cartel (1) • price war might follow, other firm will copy (1) • other second round effects, e.g. breaking a collusive agreement can ruin the chance of future deals (1) Application or example (1) e.g. a country in OPEC might increase output against the agreement Illegal (1)	**(4)**

Question Number	Answer	Mark
8	**E** Explanation of private finance initiative (PFI) or public private partnership (PPP) e.g. meaning that private firms supply major projects (1) that are then rented or leased to the government (1) **Profit motive / competition may change behaviour**, e.g. the private firm keeps the profits, or they are more efficient in reaching targets than public sector (1) Wider scope of projects because it means that projects that might not have been achievable are more likely to happen, e.g. taxes do not have to rise, there is a budget deficit, national debt(1) Reference to current sovereign debt crises and austerity measures, or other application to current context (1) Higher cost involved than if paid for up front (1) Function of penalties, e.g. if work is not finished in time (1) Allow knockout of B: there are performance targets in the public sector, ***if backed up*** with an example (teacher appraisals and NHS waiting list targets) or further explanation of how a performance target can improve efficiencies (1)	**(4)**

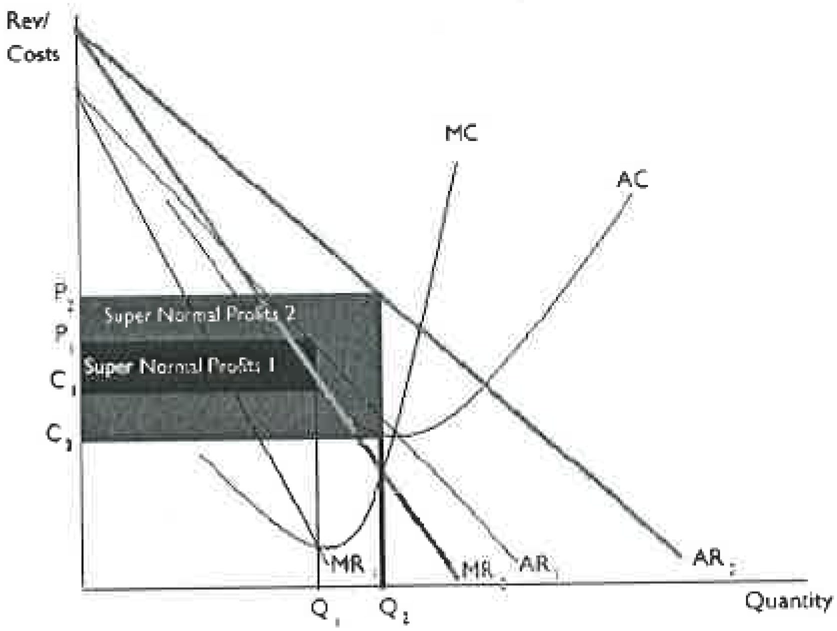
Question Number	Answer	Mark
9(a)	**2 theory + 2 application** 2 marks for **one** benefit: Identification of a likely benefit, e.g. economies of scale, increased market share/combat supermarkets' monopsony power/gaining own market power/gain own monopsony power (1 mark) with explanation of why this was a benefit, e.g. bulk buying (1 mark) 2 marks for application: Use of Figure 1 to show the benefit of merger in context of high concentration ratios of supermarkets (this explains their monopsony power) (1) better terms with own suppliers (1) or better deals in supplying supermarkets (1) example of bulk applying e.g. sugar (1) cost and tax savings (1), £40 million cost saving/profit rise or 2% worth-of-joint-sales of cost reduction/profit rise (1), less bullying of retailers (1)	**(4)**

Question Number	Answer	Mark
9(b)	**1 knowledge + 1 application + 2 analysis (diagram) =4 KAA** **4 KAA + 4 Eval = 8** KAA 4 marks: Demand will rise e.g. by attracting customers from larger out-of-town stores(1 +1); **or** costs will fall because loss making stores are being closed (1 +1) Diagram (2 marks) of which showing shift outwards in AR and MR OR fall in costs AC and MC or if just a fall in fixed costs, just AC (1 mark) and new profit area (1 mark)	



Allow MC shift if clear it is not fixed costs only that will change, e.g. reference to change in number of employees in stores
Allow no MC shift if clear that fixed costs are bring considered, e.g. reference to closing stores
Allow LRAC/long run efficiency increases as 1 diagram mark (fall in costs).

OR



Evaluation (4 marks) Award 2 + 2 or 3 + 1 or 4 + 0.
Points might include:

- Reasons why the projection might be overoptimistic
- Stores have recently been closed showing that the profit is not certain

(8)

	• Comment on the magnitude of profitability • Comment on which factors might be more important, e.g. economies of scale • Consideration of changing elasticities, e.g. consumers are more likely to buy inferior goods in a recession • depends on the size of shift, • whether the demand change is short lived, • There might be other factors shifting demand and supply. • Difficult to tell from information provided, it might be just the recession, • there might be other motives, e.g. increasing brand loyalty	

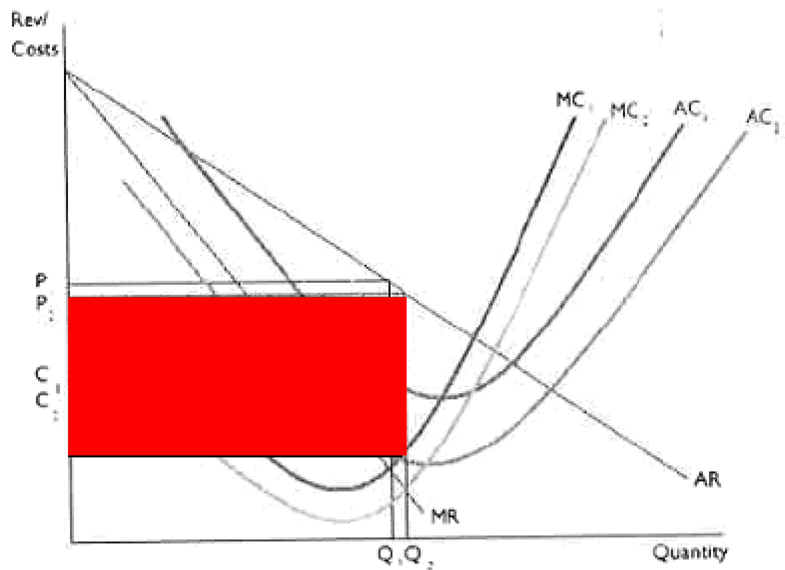
Question Number	Answer	Mark
9(c)*	**6KAA + 6 eval** KAA 6 marks Award up to three applied arguments as 2 + 2 + 2 or 3 + 3 Definition of monopsony as **powerful** or **sole** buyer, or a few dominating buyers (1 mark) • supermarkets forcing down Northern Foods' • handful of large chains, suggesting high level of concentration in buying market e.g. 6 firm concentration ratio is 87.6%. Although the data is for monopoly/oligopoly selling power, there are implications for buying power • degree of monopsony power maybe seen in lower prices and more choice for consumers in short run • retailers quickly change suppliers (for own-label) if they want to Evaluation 6 marks. These may be arguments that monopsony power is weak if the KAA arguments are for strong monopsony power, and vice versa. Award up to three arguments as 2 + 2 + 2 or 3 + 3 Factors might include: • some suppliers such as Nestle and Unilever ave bilateral/counter-balancing/countervailing power • monopsony might attract the attention of	#

	the regulators • Cranswick or Kerry have not suffered, because they have adapted • there are other reasons why profits are low, e.g. x inefficiency • long run consequences of a high level of monopsony power, e.g. less choice for consumers and higher prices than might otherwise have been weighed against short term benefits • the merger of Northern Foods and Greencore would reduce monopsony power • the last paragraph of Extract 1 implies that manufacturers can make it costly/difficult for retailers to change suppliers by changing products/services offered • Lower degree of monopsony pwer in sub-markets such as convenience stores (e.g. 3.5% Tesco market share) and isa 'separate business with a different supply chain' (Ext 3) (3 x 2marks or 2 x 3 marks)	**(12)**

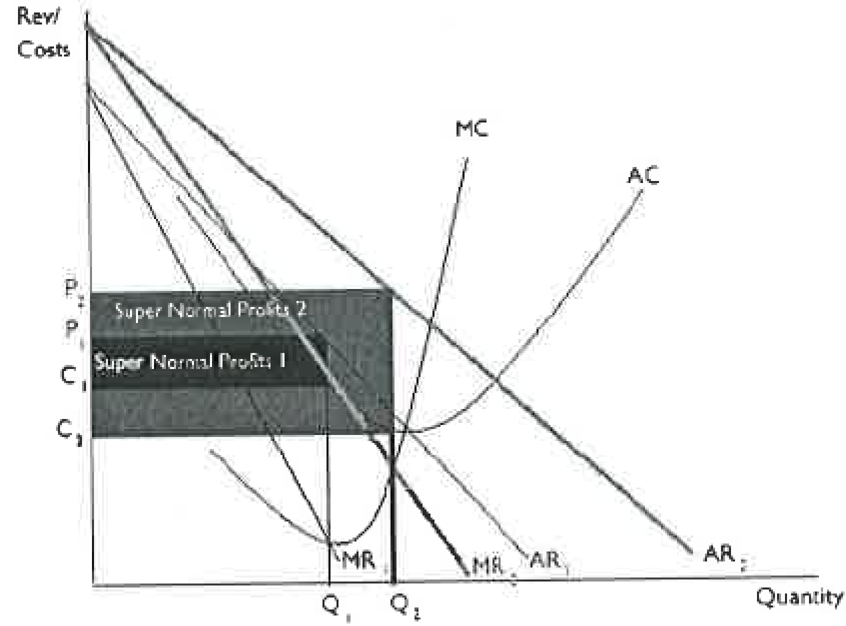
Question Number	Answer	Mark
9(d)*	**8 KAA + 8 evaluation =16** KAA 8 marks. Award the best four points made, or fewer. 4 x 2 marks, 2 x 4 marks, or 3 + 2 + 2 + 1 marks For each point 1 mark identification, 1 mark application, 1+1 marks for analysis Reasons for growth of some firms might include: • Economies of scale (can count as more than one factor) and minimum efficient scale, e.g. bulk buying/monopsony power • Aim to increase market power/ market share/ monopsony power e.g. firms can remain large because of oligopoly power (can count as more than one factor) • Rationalisation in larger firms keeps costs down, so is a motive to grwo • Patents, copyright and other barriers to entry • Successful growth strategies, e.g. sales max, output max, predatory pricing, limit pricing • Risk taking is successful • Diversification e.g. entry into niche markets in US with Fresh & Easy • Control of resources • Opportunities to integrate/M&As • Global trade issues, such as trading blocs	

	• Motives of directors e.g. satisficing shareholders while aiming for growth for other motives such as prestige or sales-performance related pay; aim of increasing profits **If no application to any industry, cap at 6/8 KAA marks** **KAA can be awarded for saying why firms are large and evaluation for why some remain small, and vice versa.** **Evaluation 8 marks.** Can allow reasons why firms do not want to grow or remain small (counterargument to the above) or other forms of evaluation Award the best four points made, or fewer. 4 x 2 marks, 2 x 4 marks, or 3 + 2 + 2 + 1 marks Reasons firms remain small might include (must apply to specific industry): • Niche markets, specialist markets, small market size • Lack of finance and/or retained profits e.g. depends on the degree of lending to small and medium size businesses (allow reference to Project Merlin 2011) (may count as two points) • Different objectives of firms, eg cooperatives, satisficing behaviour of firms, avoid risk, family firm • Parts of processes might be contracted out, leaving smaller core business • Need for personalised service/after care • Tax breaks, VAT thresholds and other government incentives for small firms • Dynamism of small firms • Diseconomies of scale, very low minimum efficient scale, or lack of significant scale economies (may count as more than one factor) • External economies may exist • Nature of the business, e.g. hairdressing • Nature of the market, e.g. monopolistic competition, monopsony power • It may be a matter of time before the smaller firms are swallowed up • Depends on the state of the economic cycle • Firms might stay small to avoid the attention of the competition authorities • Ignorance, or other managerial failure • Firms might stay small to avoid the attention of other firms, e.g. to avoid takeover, predatory behaviour by other firms, limit pricing by other firms. You may award use of game theory in developing such answers.	**(16)**

Question Number	Answer	Mark
10(a)	**2 theory + 2 application** Knowledge (2 marks): Oligopoly (1 mark) where a few firms dominate the market (1 mark) Use of data (2 marks), with at least one mark for use of Figure 1. e.g. calculation of concentration ratio e.g. the 2-firm CR (1) is 35.6% (1) (1 + 1); referring to the ‘Big Three’ or ‘Magnificent 7’ Extract 1 (1).	**(4)**

Question Number	Answer	Mark
10(b)	KAA 4 marks: Demand rose (1) with application e.g. 10% rise, as creditworthiness improves, willingness of banks to lend(1 +1); **or** costs fell (1) with application e.g. narrower range, factories closed, employee numbers reduced (1 +1) Diagram (2 marks) of which showing shift outwards in AR and MR OR fall in costs AC and MC or if just a fall in fixed costs, just AC (1) and new profit area (1)  Allow MC shift if clear it is not fixed costs only that will change, e.g. reference to change in number of employees Allow no MC shift if clear that fixed costs are bring considered, e.g. reference to closing 17 factories, salaries not being paid. Allow LRAC/long run efficiency increases as 1 diagram mark (fall in costs).	

OR



Evaluation (4 marks) Award 2 + 2 or 3 + 1 or 4 + 0
Points might include:

- Reasons why the projection might be overoptimistic
- Comment on the magnitude of profitability or revenue/cost changes e.g. Figure 2 shows sales have not yet reached 2007 levels
- Comment on which factors might be more important, e.g. economies of scale
- Consideration of changing elasticities, e.g. consumers are more likely to buy inferior goods in a recession
- depends on the size of shift, they might be cancelled out by changes in costs if demand has been considered, or be magnified when costs and demand are considered together
- whether the demand change is short lived,
- There might be other factors shifting demand and supply.
- Difficult to tell from information provided, it might be just the recession, there might be other motives, e.g. increasing brand loyalty
- Magnitude, eg costs of labour are a very significant element, redundancy payments are high, 17 firms closed, might arouse the suspicion of the regulators if very high
- Improved credit-worthiness/easier bank lending does not necessarily mean that people want to borrow more
- Profits might disappear as Chinese BYD and other competitors enter the market

(8)

Question Number	Answer	Mark
10(c)*	**6 KAA + 6 evaluation** KAA up to 6 marks for arguing either for or against the argument that the market is contestable. Definition of contestability (low or no sunk costs, or low or no barriers to entry/exit) (1) KAA the market **is** contestable (may be argued that it is not contestable): Award up to three arguments as 2 + 2 + 2 or 3 + 3 with and evidence. Factors might include: • Volkswagen's new saloon made the biggest impact on the opening day at Detroit, 'causing some concern for local manufacturers' • Evidence of fragmenting market (eg Magnificent Seven) as ease of possible entry into the market • Focus on low energy/battery powered cars could create a new **niche** for entrants, eg Chinese BYD • New firms have been able to set up easily, with examples from South Korea and China, • Other firms have left the market implying low barriers to exit • The names of the some new entrants are already well established, so it easier for these firms to enter a market. Evaluation 6 marks (either **for** or **against** high contestability) Award up to three arguments as 2 + 2 + 2 or 3 + 3 Factors that the market is **not** contestable might include: • The 2008 crash allowed Chrysler, GM and Ford to cut costs and increase efficiency – meaning that it will be harder for new entrants to compete with the now leaner incumbents • there are high sunk costs, such as gaining a place on the Detroit platform, R&D • firms find it difficult to enter, and the ones that have entered have economies of scale in other markets, funds e.g. $3bn to spend on marketing, Audi and Volkswagen have new dealerships, can cross subsidise • Toyota 'still has the most efficient system for product development and manufacturing' implying that large	

	scale investment would be required of any new entrant to compete on average costs. • Limited evidence that the new entrants will survive. • Incumbents may have access to better production techniques or other asymmetric information problems • Supernormal profits are evidence of low contestability • National identity is important in the car industry, especially as a large proportion of income is spent (low PED)	**(12)**

Question Number	Answer	Mark
10(d)*	**8 KAA + 8 evaluation** KAA 6 marks + 2 for petrol cost reference. This could be data reference line 38, or gas-guzzlers line 39 as attempt to reduce the amount of petrol used. Reference to battery powered car line 58-59 or hybrids may also be implicitly used, falling spending power after petrol costs and income elasticity arguments based on increased price of petrol. Mark breakdown: award best **four** points up to four marks each, with cap of 6 for KAA excluding petrol costs: e.g. 2+2+2, or 3+3 or 3+ 2+1 or 2+2+1+1 etc. There must be at least 1 pricing and 1 non-pricing policy. If one type is omitted then cap KAA 4/6 marks Strategies must be aimed at increasing sales **revenue**, at least in the long run Pricing strategies might include: • Predatory pricing (must be linked to long run revenues), • limit pricing (must be linked to long run revenues), • profit maximisation (assuming the firm was not profit maximising and was operating at a lower revenue), • sales/output maximisation, • revenue maximisation, • price discrimination • collusion, can be used as pricing or non-pricing strategy Award development using discussion of PED. Non-pricing strategies might include: • improving quality (reference to Toyota), • trade exhibitions (Detroit Motor show ‘parties in full swing’) • advertising, • narrowing brands,	

	- loyalty deals, - mergers and acquisitions, - collusion, can be used as pricing or non-pricing strategy - use of patents, - change in branding to ‘modest’ cars from ‘gas guzzlers’ Award use of game theory to explain the process, e.g. collude then cheat **Reserve 2 KAA marks for application that rising petrol prices is dampening demand for cars** Evaluation 8 marks. Award the best **four** points made, or fewer. 4 x 2 marks, 2 x 4 marks, or 3 + 2 + 2 + 1 marks Reasons might include: - why strategies might not increase revenues in the short or long run, e.g. price war. Award use of payoff matrix/kinked demand to show revenues fall - action of the competition authorities, e.g. fines or imprisonment, - game theory as a critique, e.g. it depends on the action by other firms - discussion of PEDs in context of falling real incomes, after petrol price rises - Discussion of degree of cross elasticity between cars and petrol, or degree of inelasticity of demand for cars, e.g. there is no viable alternative Award use of game theory as evaluation, e.g. kinked demand curve shows that changing price does not raise revenue, or a payoff matrix to show that revenue does not rise in the long run if all firms follow the same strategy	**(16)**

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