

2015 specification
first exams in 2017



Topic Tests for A Level Edexcel A

Theme 3: Business Behaviour and
the Labour Market

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Teacher's Introduction

This resource consists of a set of Topic Tests that have been written to support the teaching of A Level Edexcel A Theme 3. It allows teachers and students to check their understanding and consolidate knowledge of each part of the Edexcel specification. In each Topic Test there is a mixture of numerical, multiple-choice, short-answer and essay-style questions of a variety of different difficulties. There are 9 Topic Tests in this resource, following the topics of the A Level specifications.

Importantly, each Topic Test is accompanied by a set of detailed answers that could be handed out to students as a basis for 'model' answers in the examination. Note that although the Topic Test questions aren't always in exam format, the questions within have been written carefully with the intention of testing the range of Assessment Objectives and often borrow aspects that are similar to those in the exam.

Most of the case studies in the Topic Tests include up-to-date economic data and scenarios that should place economic theory in recent history, enrich students' general knowledge of the subject, and prepare students for the Data Response aspects of the examination. Moreover, the resource also includes plenty of opportunities for students to practise the Quantitative Skills outlined in the Appendix of the Edexcel specification.

Most Topic Tests contain 30–40 marks worth of questions, although some tests are shorter to cover each specification topic appropriately according to its scope. It is intended that the longer Topic Tests will take about one hour to complete and should be presented to students *after* teaching the parts of the specification that are to be tested. However, the Topic Tests could also be given to students as homework in order to consolidate their knowledge outside of the classroom, or certain aspects could be used as a supplement to in-class learning.

It is important to note that this resource should be used as a complement to other resources such as textbooks and practice exam papers, and not in isolation. These Topic Tests include plenty of explanation of the theory in the mark scheme, but students should be encouraged to access information as widely as possible.

It is hoped that this resource, as well as offering support for teaching the essential elements of the Edexcel microeconomics specification, will help students fully prepare for their A Level examinations. The economic environment is constantly in flux, and full of fascinating current issues. This resource attempts to share some of these current issues as a basis for teaching in the most interesting way possible, meanwhile encouraging further study from the next generation of Economists!

Happy teaching!

October 2019

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Mark Scheme: Levels of Response Tables for Long-answer Questions

10 marks

Knowledge (2), application (2) and analysis (2)		
	0	No relevant answer given.
Level 1	1–2	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	3–4	Some knowledge of economic concepts is shown, partially linked to reasoning skills, but may focus too much on one side of an argument.
Level 3	5–6	Knowledge of the economic concepts is very accurate. Links to the question are clear. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (4)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question with insufficient reasoning.
Level 2	3–4	Accurate, balanced evaluative comments are made, supporting a response directly to the question.

12 marks

Knowledge (2), application (2) and analysis (4)		
	0	No relevant answer given.
Level 1	1–2	A few concepts and examples may be identified correctly, but may be inconsistent. Absence of thought behind the causes and effects.
Level 2	3–5	Some knowledge of economic concepts is shown, partially linked to reasoning skills, but may focus too much on one side of an argument.
Level 3	6–8	Knowledge of the economic concepts is accurate. Links to the question are clear. Examples are given. Analysis is well reasoned, logical and appropriate for the question.
Evaluation (4)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question with insufficient reasoning and evidence.
Level 2	3–4	Accurate, balanced evaluative comments are made, supporting a response directly to the question.

15 marks

Knowledge (3), application (3) and analysis (3)		
	0	No relevant answer given.
Level 1	1–3	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	4–6	Some knowledge of economic concepts is shown, partially linked to reasoning skills, but may focus too much on one side of an argument.
Level 3	7–9	Knowledge of the economic concepts is very accurate. Links to the question are clear. Examples are given. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (6)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question with insufficient reasoning.
Level 2	3–4	Clear evidence of evaluative comments, though they may be unfair or biased. Reasoning / supporting evidence is provided but may be weak.
Level 3	5–6	Accurate, balanced evaluative comments are made, supporting a response directly to the question.

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20 marks

Knowledge (4), application (4) and analysis (6)		
	0	No relevant answer given.
Level 1	1–3	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	4–6	Some knowledge of economic concepts is shown, partially linked to theory or basic reasoning skills.
Level 3	7–10	Good knowledge of the relevant economic concepts is displayed, linked to evidence to support the main arguments. Analysis is well developed on one side of an argument.
Level 4	11–14	Knowledge of the economic concepts is very accurate. Links to theory and examples. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (6)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question with insufficient reasoning.
Level 2	3–4	Clear evidence of evaluative comments, though they may be unfair or one-sided. Reasoning / supporting evidence is provided but may be limited.
Level 3	5–6	Accurate, balanced evaluative comments are made, supporting a conclusion directly to the question.

25 marks

Knowledge (4), application (4) and analysis (8)		
	0	No relevant answer given.
Level 1	1–4	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	5–8	Some knowledge of economic concepts is shown, partially linked to theory or basic reasoning skills.
Level 3	9–12	Good knowledge of the relevant economic concepts is displayed, linked to evidence to support the main arguments. Analysis is well developed on one side of an argument.
Level 4	13–16	Knowledge of the economic concepts is very accurate. Links to theory and examples. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (6)		
	0	No evaluation.
Level 1	1–3	Limited attempt at evaluation – may be only loosely related to the question with insufficient reasoning.
Level 2	4–6	Clear evidence of evaluative comments, though they may be unfair or one-sided. Reasoning / supporting evidence is provided but may be limited.
Level 3	7–9	Accurate, balanced evaluative comments are made, supporting a conclusion directly to the question.

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Mark Breakdown Test-by-test

Topic Test	
3.1	
3.2	
3.3a	
3.3b	
3.4a	
3.4b	
3.4c	
3.5	
3.6	

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Topic Test 3.1 Business Growth

1. Explain, using one or more examples, the difference between public sector and private sector organisations.
2. Which of the following is *not* an example of a not-for-profit organisation.
A Bill & Melinda Gates Foundation
B Wikipedia
C Nike
D International Red Cross
3. Distinguish between horizontal and vertical integration.

Integration between firms occurs frequently. Volkswagen, for instance, took over Skoda for £3.6 billion. Volkswagen already owns brands such as Audi, Skoda, Bentley and Porsche. Supermarkets tend to be fairly vertically integrated, owning manufacturing plants and farms that allow them to make their 'own brand' products cheaper than branded competitors.

4. Evaluate the costs and benefits of integration to individuals, firms, and the government.
5. Explain **two** factors that influence the growth of firms.

In 2014, The Gym Group and PureGym – Britain's leading low-cost fitness operators – announced a proposed merger after the UK's Competition and Markets Authority (CMA) began an investigation. Although the management at PureGym was convinced that the merger would help them expand in many areas across the UK, the CMA was concerned that the horizontal integration would substantially decrease competition in the sector, leading to poor outcomes for consumers.

6. Explain the factors that influence business growth other than regulation that could lead to the failure of such a merger.
7. In 2013, Lloyds TSB, one of the UK's 'Big Four' commercial banks, demerged into two individual financial institutions, under the names of Lloyds Bank and TSB respectively. Lloyds TSB was compelled to demerge. Explain two motivations for firms to demerge.
Lloyds TSB was compelled to demerge. Explain two motivations for firms to demerge.
8. Assess the likely impact of a demerger on (i) a business, (ii) its workers and (iii) its customers.

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Topic Test 3.2 Business Objectives

1. Illustrate, and explain, why profits are maximised when $MR = MC$.
2. (i) Explain why a firm's revenue is maximised at the point at which $MR = 0$.
(ii) Illustrate, using one or more diagrams, revenue maximisation.
3. (i) State the *sales maximisation* formula.
(ii) Illustrate, using one or more diagrams, sales maximisation.
4. In Economics, we typically assume firms are aiming to maximise profits. Explain the profit maximisation objective and why a firm might choose that objective.
5. Explain the business objective of profit satisficing.
6. Explain **two** reasons that a firm's management might choose to satisfy rather than maximise profit.

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Topic Test 3.3a Revenues and Costs

- What is meant by the term marginal cost?
- Table 1 shows partial details on a firm's production costs.

Output ('000)	Total fixed cost (TFC)	Average fixed cost (AFC)	Total variable cost (TVC)	Average variable cost (AVC)	Total cost (TC)
1	£12,000	(a)	£2,000	£2	(b)
2	£12,000	£6	£3,500	(c)	£15,500
3	£12,000	£4	(d)	£1.50	£16,500
4	(e)	£3	£7,000	£1.75	£19,000
5	£12,000	£2.40	£12,500	£2.50	£24,500

Calculate values for (a–g). Show your working.

- Explain the difference between short- and long-run costs.

4.

Labour	Total Output	Average Total Cost	Total Labour Cost	Total Fixed Cost
0	-	-	0	£1,000
1	10	10	£100	£1,000
2	32	22	£200	£1,000
3	62	30	£300	£1,000
4	102	40	£400	£1,000
5	122	20	£500	£1,000
6	130	8	£600	£1,000
7	134	4	£700	£1,000

- Explain, using information from the table 2, how the law of diminishing returns affects the shape of the marginal cost curve.
- Explain the relationship between the marginal cost (MC) curve and a firm's short-run cost curves.

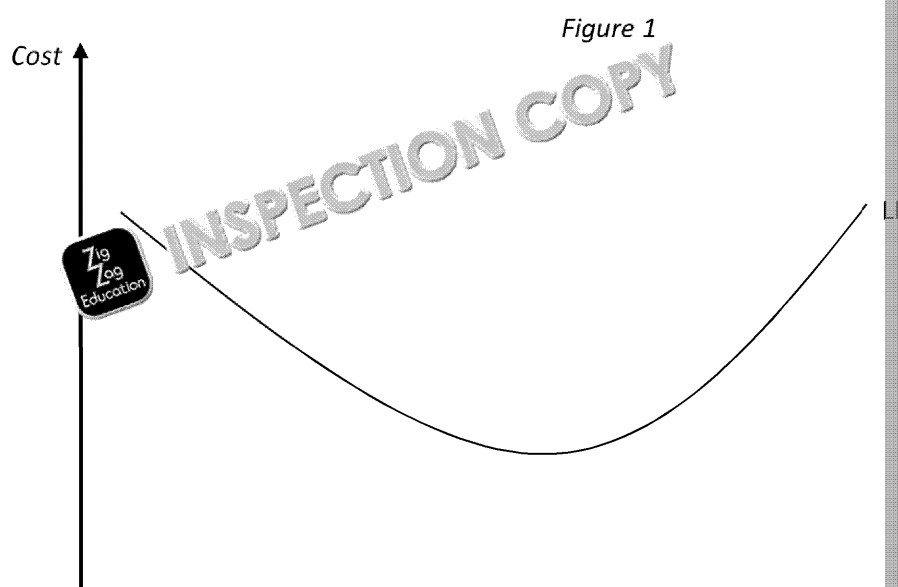
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Topic Test 3.3b: Economies of Scale and Profit and Loss

- What is meant by the term 'economies of scale'?
- Lower per-unit costs that are achieved by the expansion of the individual firm are known as economies of scale. Which of the following type of economies of scale?
 - External economies of scale
 - Internal economies of scale
 - Internal diseconomies of scale
 - External diseconomies of scale
- Identify and explain an example of an internal economy of scale.
- What is meant by external economies of scale? Provide an example.
 - Identify and explain an example of an external economy of scale.
- Assess **two** benefits of economies of scale to a business
- Which of the following is a correct explanation of the concept of 'minimum efficient scale' (MES)?
 - MES is the level of output consistent with the minimum point of a firm's short-run average cost curve.
 - MES is the level of output at which there is no market failure.
 - MES is the level output necessary for a firm to officially be declared a monopoly.
 - MES is the level of output consistent with the minimum point of a firm's long-run average cost curve.
- The graph below illustrates a typical long-run average cost curve (LRAC).



Explain the shape of the LRAC using the theory of economies and diseconomies of scale.

- In 2015, Apple made a profit of \$53.4 billion, making it the most profitable business in the world. Explain why the profit of a single business alone is greater than the GDP of many of the world's nations.

Assess the role of profit in a market-based economy.
- Explain the difference between super-normal and normal profit.
- Illustrate, using one or more diagrams, the short-run shutdown point.
- Illustrate, using one or more diagrams, the long-run shutdown point.
- Explain why the short-run and long-run shutdown points differ.

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Topic Test 3.4a Market Structures: Introduction (3.4.1–3)

- Allocative efficiency is achieved...
 - When resources are allocated equally across society.
 - When resources are distributed optimally in society according to consumer preferences, therefore, maximising utility.
 - When firms in a society produce at minimum cost, choosing an optimal combination of inputs and using them to produce the maximum possible output.
 - When resources are allocated in such a way that no redistribution of them could make one individual better off without making another individual worse off.
- 'When firms in a society produce at minimum cost, choosing an optimal combination of inputs to produce the maximum possible output.' Which of the following does this describe?
 - Social efficiency
 - Productive efficiency
 - Allocative efficiency
 - Economic efficiency
- Explain the difference between static and dynamic efficiency.
- Which of the following is a definition of x-inefficiency?
 - When a firm has competitive pressure to reduce costs.
 - When a firm has no competitive pressure to reduce costs.
 - When output of one good cannot be increased without decreasing the output of another good.
 - When a firm cannot allocate resources efficiently in the short-run.
- Explain what is meant by a *perfectly competitive* market.
- Explain, using an appropriate diagram, how perfect competition can result in an efficient allocation of resources.
 - Explain one reason that this allocation of resources might not be allocated efficiently.
- Explain, using a diagram, the reason that an individual firm's demand curve is perfectly elastic.
- Why is it only possible for firms to make super-normal profits in the *short-run* in a perfectly competitive market?
- Explain the reason that a perfectly competitive market tends to be productively efficient but a monopoly does not.
- How does the model of monopolistic competition differ from that of perfect competition?
- Illustrate the short-run equilibrium for a firm in a monopolistic market.

London's streets are filled with fast-food chicken shops that fundamentally serve the same product – chicken – but differentiate themselves through branding, design, quality and other factors. This type of market is an example of monopolistic competition.

- Explain the importance of non-price competition for a monopolistic market.
- What is the implication of 'freedom of entry' on a monopolistic competitive market?

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Topic Test 3.4b Market Structures: Oligopoly and Conte

1. Oligopoly is an imperfectly competitive markets structure in which there tends to be a few dominating the market, and these firms exhibit a degree of interdependence.

[2 marks for a clear explanation of oligopoly; 1 mark for an explanation that is less clear but which conveys the general meaning]

2. Barriers to entry in an oligopolistic market can be split between *natural* and *artificial*. Natural barriers include things such as economies of scale of incumbent firms, resource ownership. Artificial barriers include things such as predatory pricing strategies, high marketing costs.

[Maximum 1 mark per correct response.]

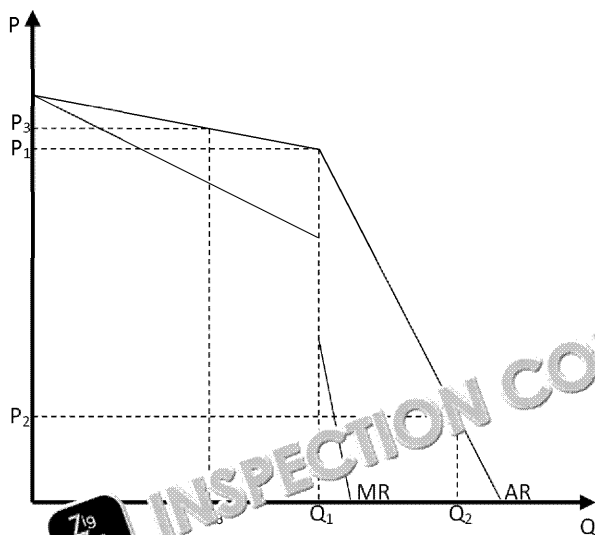
3. An oligopoly can be identified by the *market conduct* of firms in a particular industry. This includes the price and non-price decisions, as well as other market policies, of firms in an oligopoly. Crucially, firms in an oligopolistic market are *interdependent* – meaning the decisions of one firm affect the decisions of other firms – and so seeking out indicators of interdependence in an oligopoly.

[2 marks for a clear explanation of how an oligopoly can be identified in terms of market conduct; 1 mark for an explanation that is less clear but which conveys the general meaning]

4. Non-price competition is important in oligopolistic markets because it can help firms avoid price competition and price wars. Interdependence is an important characteristic of oligopolistic markets. A firm's pricing decision will have effects on the pricing decisions of other firms. When McDonald's introduced a \$2.00 deal, it was immediately responded to by its closest competitors. Ultimately, the profitability of these firms – something they no doubt would be keen to avoid – was reduced. Firms might choose to invest in advertising in order to differentiate their product without having to lower prices. Firms could also compete on the basis of quality and product differentiation. Firms could offer loyalty cards in order to incentivise return visits and gain market share. Essentially, non-price competition can help oligopolistic firms avoid a demand curve price war. Yet, non-price competition is not always successful. For example, if McDonald's introduced a 'premium' meal, its competitors could also introduce a similar meal. Moreover, if the cost of implementing a non-price strategy exceeded the potential benefits, a firm might choose to engage in a price war instead (especially if they can absorb the cost).

[3–4 marks for a well-argued assessment of the significance of non-price competition; 1–2 marks for a less clear argument; 0 marks for unrelated response]

5.



The kinked demand curve model of an oligopoly is a model that is intended to explain the behavior of oligopolistic firms. It highlights the effect of a firm's pricing decisions on the behavior of other firms in the oligopolistic market.

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The kinked demand curve model recognises that the price elasticity of demand for a firm's product tends to depend on the reaction of rival firms.

First, competitors are *not* expected to match any price increase of the individual firm. Therefore, the firm's demand curve *above* the initial price is likely to be price-elastic because any increase in price is expected to lead to a disproportionate fall in quantity demanded.

Second, competitors are expected to match any price decrease of the individual firm to maintain their share and profitability. Therefore, the firm's demand curve below the initial price is likely to be price-inelastic because the price decrease is expected to be matched by the competition and this prevents a large increase in output demanded.

Therefore, the PED for prices above P_1 (e.g. P_3) is *elastic*, the firm could increase its price, and the PED for prices below P_1 (e.g. P_2) is *inelastic*, the firm could increase its price. Hence, prices tend to be stable and interdependent in an oligopoly.

[Up to 2 marks for a clear, labelled diagram, and up to 2 marks for a clear explanation of pricing decisions]

- 6 (a) If Airbus chose a 'high' pricing strategy, the best response for Boeing would be to choose 'low' in order to undercut by its competitor and cream off revenue from the market. If Boeing chooses 'high' its payoff would be 10, but if it chooses 'low' its payoff is 15. Therefore, Boeing will choose 'low' when its competitors chooses 'high.'
- (b) If Airbus chose a 'low' pricing strategy, the best response for Boeing would be to choose 'low' too in order to avoid being undercut its competitor. If Boeing were to choose 'high' its payoff would be 1, which is less than the payoff of 5 it can expect when adopting the 'low' strategy. Therefore, Boeing's best strategy would be to choose 'low' when its competitors choose 'low.'
- (c) Notice that Boeing's strategy regardless of Airbus's decision should be to adopt 'low' as this is Boeing's *dominant strategy* because this is the strategy it should play in order to maximise its payoff irrespective of what Airbus chooses to do. Moreover, since the table is symmetric, Airbus's strategy will also be to adopt a 'low' price point. Therefore, the market outcome is a 'low' price strategy in which each manufacturer earns a payoff of 5. Neither Boeing nor Airbus can improve its position by choosing 'low' they are maximising their pay-off given the other's strategy.
- (d) Note that a 'low' pricing strategy equilibrium rewards Boeing and Airbus with a payoff of 5 each, however, is not the best possible outcome for either airline manufacturer – if both adopt a 'high' strategy and receives a payoff of 10 each. But, neither Boeing nor Airbus has an incentive to play a 'high' strategy to 'high' without communicating with each other. If they could communicate and agree to a 'high' price strategy that would yield them a payoff of 10, instead of a payoff of 5, this *outcome, however, will reflect on the incentives for either airline manufacturer to form a cartel. Boeing or Airbus could undercut the cartel by sneakily offering a lower price to gain an additional market share at the expense of its competitor.*

[Maximum 2 marks per correct answer. Award 1 mark for each correct answer and 1 mark for explanation completing the answer.]

- 7 (a) $CR_3 = 27.6 + 16.1 + 15.7 = 59.4\%$
[1 mark for correct answer; 1 mark for showing working]
- (b) $CR_5 = 27.6 + 16.1 + 15.7 + 10.0 + 10.0 = 78.6\%$
[1 mark for correct answer; 1 mark for showing working]
- (c) Both CR_3 and CR_5 measures of market concentration would indicate that the market is highly concentrated and, therefore, an oligopolistic market. Just *three* firms (Tesco, Sainsbury and Asda) account for a significant enough proportion of the market at 59.4%, and adding the process of the next two firms (Morrisons and Lidl) up to 78.6% which would make it one of the most concentrated UK industries.
[2 marks for a clear explanation of the reasons that the industry can be thought of as an oligopoly; 1 mark for an explanation that is less clear]

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8. 'Predatory' pricing occurs when a business such as Stagecoach deliberately price in order to force rival businesses out of the market. It is clear that Stagecoach would not be predatory because pricing a product for free is surely below the firm's average cost curve. When a business sets its prices low enough to deter entry of other firms into the market, predatory and limit pricing are both tactics of lowering prices, their intentions are different and their entry restrictions are different respectively.

[2 marks for a clear distinction between predatory and limit pricing; 1 mark for a definition of predatory pricing which conveys the general meaning]

9. Essentially, barriers to entry are those factors which prevent potential entrants from entering a market. Barriers to entry protect incumbent firms from the threat of competition. Note that barriers to entry can be *natural* – e.g. a firm's control of an essential resource – or *artificial* – e.g. a patent.

[2 marks for a clear explanation of barriers to entry; 1 mark for an explanation that conveys the general meaning]

10. William Baumol developed the theory of contestable markets, in which the presence of zero barriers to entry can produce a competitive equilibrium even in a market dominated by a small number of firms. The presence of zero barriers to entry means that incumbent firms will voluntarily price at their average cost and only make *normal* profit in the long-run because any other firms that are readily able to enter the market. If there are no barriers to entry and technology are freely available; resources are not controlled by the incumbent firms, brands, etc. – then entrants could enter the market without a competitive disadvantage and erode the firm's super-normal profit. Moreover, the lack of barriers to exit means that firms can exit the market if any super-normal profits have been eroded – this is also known as a strategy of 'hit-and-run' competition. Therefore, in order to avoid hit-and-run competition, it is best for incumbent firms to price at a normal profit level. Hence, the behaviour of business in a contestable market is determined by the actual competition they face, but the threat of competition.

[Maximum 4 marks for clearly explaining the significance of zero barriers to entry; 2 marks for an explanation that is less clear but conveys the general meaning]

11. 'Sunk costs' are the costs of operating a business that are *irrecoverable*. If a business can sell off this capital and recover some of the money that was spent on it. However, if the capital is extremely specific to a certain industry. If an industry has too high sunk costs, it acts as a 'barrier to entry or exit' and so reduces the degree of contestability.

[2 marks for a clear explanation of the term 'sunk costs' and its relevance to contestable markets; 1 mark for an explanation that is less clear but which conveys the general meaning]

12. Primarily, the most important advantage of a perfectly contestable market is that competition forces firms to price output such that only normal profit is being made. If a firm prices its output at a level that is consistent with super-normal profit – e.g. the profit-maximising level – then new entrants can enter the market and erode this profit away. Therefore, the incumbent firm tends to price at a normal profit level to avoid the threat of hit-and-run competition.

Moreover, in the long-run firms operating in a contestable market will produce at the minimum point of their average cost curve, and, therefore, contestable markets can produce a situation of perfect competition. If a firm is operating at the bottom of its average cost curve, an entrant that can produce at the same level can produce at the bottom of theirs and undercut the incumbent in terms of price. Incumbent firms must price at a normal profit level in order to stay competitive in the industry. Furthermore, over time firms in contestable markets will become more productively efficient. Moreover, because $MC = AC$ at the minimum point of the average cost curve, the firm will produce at a productively efficient level.

Contestability also means that the price of an item might be lower than in a monopoly. Therefore, in contestable markets there should be higher consumer surplus. However, prices are more often higher if incumbent firms regularly try to cream off profit and avoid the threat of hit-and-run competition. Price stability is an important macroeconomic policy objective.

[1 mark per advantage identified (up to 2); 1 additional mark per advantage assessed]

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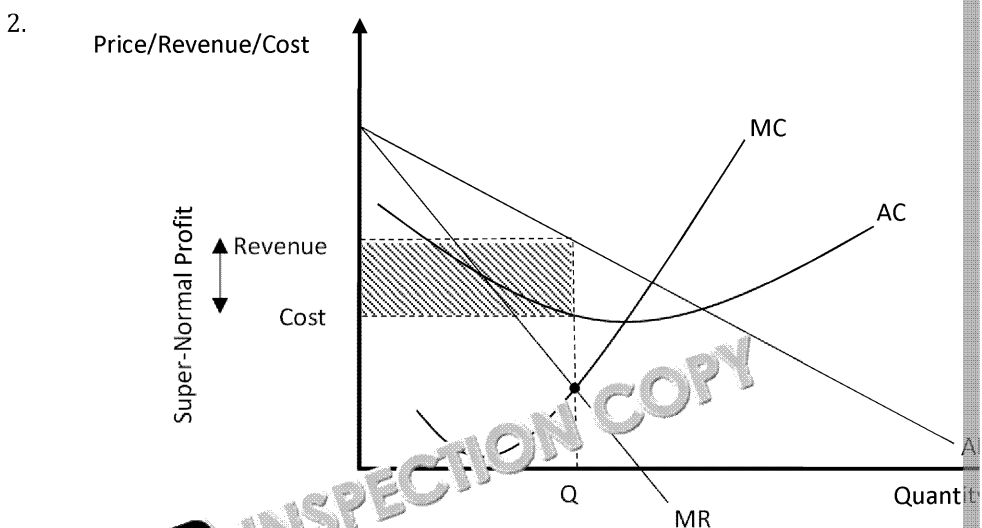
Topic Test 3.4c Market Structures: Monopoly and Monop

1. (a) A monopolist's demand curve is *downward-sloping* because the monopolist is the only supplier of the industry's product. Therefore, the monopolist's individual demand curve must in fact be the demand curve for the industry. Naturally, this demand curve will have an inverse relationship to price according to the law of demand.

[2 marks for a clear explanation of why a monopolist's demand curve is a downward-sloping curve; 1 mark for an explanation that is less clear but conveys the general meaning]

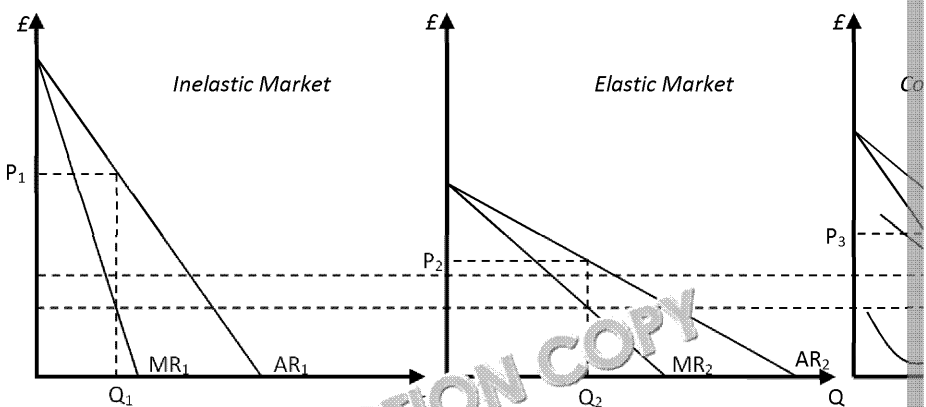
- (b) If a monopolist's demand curve is downward-sloping, this implies that the monopolist has a significant influence over the price of the industry's product. Monopolists will choose the level of output that maximises profit (usually where $MR=MC$ – e.g. *profit maximisation*) and this level of output will be determined by the demand schedule. Note, however, that the monopolist is still constrained by market demand, but along the demand curve.

[2 marks for a clear explanation of the implications of a downward-sloping demand curve; 1 mark for an explanation that is less clear but conveys the general meaning]



[1 mark for correctly labelled axes; 1 mark for correctly drawn MR and AR curves; 1 mark for identifying the equilibrium at the profit-maximising point]

3. Diagram:



Primarily, third-degree price discrimination requires that there is different price elasticity of demand between different market segments.

If there is third-degree price discrimination, the firm's revenue and cost curves would look like the second panel of the diagram above which is effectively the normal diagram for a monopoly. The equilibrium price and quantity are P_3 and Q_3 respectively.

Assuming that the firm's marginal cost (MC) is the same in both market segments, PED will have an effect on the market price. If the market is inelastic, profits will be higher.

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will be associated with a price of P_1 . In the elastic market, the firm seeks once again a different shape of the MR and AR curves means that the equilibrium price is P_2 within the elastic market. It makes sense that the price would be lower in a market in which consumers are more price sensitive. Setting a reduced price could allow the firm to increase sales volume and, thus, profit.

Ultimately, the firm will price discriminate if it is possible to make a greater profit by charging different standard prices of its product – that is, $\text{Profit}_{\text{Inelastic}} + \text{Profit}_{\text{Elastic}} > \text{Profit}_{\text{Combined}}$. It is not always a maximising firm to split the markets if this condition holds. Note that the cost of price discrimination may prevent separation being profitable.

[Up to 3 marks for correct diagram; up to 3 marks for a detailed explanation]

4. Advantages:

- **R and D Development:** Monopolies make super-normal profits, while perfect competition makes normal profit. Therefore, monopolies are one of the only market structures that can reinvest profit in R&D. If investment in technology is important in expanding the economy, then monopolies can be thought of positively, compared to competitive markets where firms are competed away and there is no room for investment.
- **Natural Monopoly:** In some industries, the minimum efficient scale of production is so large that it is *necessary* for a monopoly to exist. It wouldn't make sense to break up such a market because firms would inevitably make a loss at smaller quantities of output.
- **International Competition:** If an economy wishes to compete on an international market, a monopoly might be the only market structure in which this is possible – especially if the market is small.

Disadvantages:

- **Inefficiency:** Monopolies are neither allocatively or productively efficient. There is a deadweight welfare loss on society insofar that there could be a better allocation of society's resources.
- **Consumer Surplus Loss:** Since monopolies will charge a *higher* price for their product than in a perfectly competitive market, on the industrial level there will be a reduction in consumer surplus.

[Maximum 6 marks. 5–6 marks for a clear evaluation, mentioning both one advantage and one disadvantage of a monopoly. 3–4 marks for clear evidence and evaluative comments, though they may not be fully balanced. 1–2 marks for limited evaluation and failing to address either one advantage or disadvantage.]

5. Where the Minimum Efficient Scale (MES) of production is small relative to the overall market demand, there is room for competition. However, when the MES of production is large, there might be only room for one firm – this is the case for 'natural monopoly' in which overheads are so high that the firm must operate at an efficient scale.

[2 marks for a clear explanation of MES's relationship to market structure; 1 mark for a statement that conveys the general meaning]

6. **B** – Monopsony is a similar concept to monopoly only that there is a single *buyer* rather than a single seller. Therefore, they therefore exert their monopsony power in purchasing factors of production to influence the market. In the explanation of 'oligopoly,' **C** refers to the concept of a *natural* monopoly and **D** is the concept of a monopoly.



[1 mark for correct response]

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7. Monopsony refers to a particular market structure in which there is a single buyer of labour, as well as a single buyer of the medicine and technology in the healthcare system.

Stakeholder	Costs	
<p>NHS</p> 	<p>If the NHS abuses its monopsonist power in both the labour market and the market for medical goods, eventually it might find that it no longer has a steady supply of the inputs that it needs. Therefore, it would be beneficial for the NHS to limit the abuse of monopsonist power.</p> <p>However, if the NHS abuses its uncompetitive buying position too frequently, its suppliers might start to reduce quality, etc. in order to decrease their own costs and stay profitable. It would be problematic if this occurred because the organisation would begin to deliver poor outcomes.</p>	<p>The NHS as a monopsonist has more power over the population.</p> <p>The NHS as an oligopoly in pharmaceuticals can charge more for medicines, which reduces the ability of the NHS to pass on the savings.</p>
Employees	<p>The NHS could use its monopsonist power to lower the wage rate for NHS workers below the rate that would exist in a perfectly competitive labour market. If the UK's healthcare system were privatised, employees could benefit from an increase in pay. However, it must be noted that the UK's healthcare system isn't completely monopolised by the NHS, so there isn't a completely unchecked ability for the NHS to depress wages.</p>	<p>Alternatively, that the NHS's purchasing power could decrease the budget for other services.</p>
Consumers	<p>If the NHS paying low wages reduced the motivation of its workers and so reduced the quality of healthcare, it is the consumer who would pay the price. Moreover, if the quality of medical inputs drops, again it is the consumer that is disadvantaged the most.</p>	<p>Since the NHS is a monopsonist, it could depress the number of services available.</p>
<p>Suppliers</p> 	<p>The NHS's monopsonist power as a buyer of medical technology and medicine in the UK means that it has the ability to depress the price of these items. Therefore, the NHS's suppliers are likely to see their profitability decrease as the price paid falls. It might be the case that some suppliers leave the market entirely because of a lack of profitability.</p> <p>However, it's important to consider that trade only occurs when it is <i>mutually beneficial</i>, and so eventually trade might collapse between the buyer and supplier. Note that this is particularly relevant in a globalised economy because suppliers could shift their output to more competitive healthcare markets.</p>	

[Maximum 8 marks. 6–8 marks for a strong and well-supported evaluation of the costs and benefits to the stakeholders of the NHS operating as a monopsonist. Analysis is well reasoned, logical and consistent; 4–5 marks for a limited evaluation, displaying basic reasoning skills, but with some inconsistency; 1–2 marks for a weak evaluation, inconsistent and/or inaccurate. The evaluation is not supported by evidence behind the costs and benefits that have been mentioned.]

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Topic Test 3.5 Labour Market

- Increase in Marginal Productivity:** If the marginal productivity of labour increases, a firm acquires capital that boosts the marginal output per worker, there will be an increase in the marginal revenue product of labour. Therefore, at any prevailing wage, the firm will demand a greater quantity of labour because it can produce a greater amount of output for the same cost. All technological improvements will increase the demand for labour – evaluate whether the technology is labour-augmenting or labour-saving.
 - Increase in Marginal Revenue:** Since the M.R.P. is a combination of marginal product and marginal revenue, a change in marginal revenue will also change a firm's labour demand, either outward or inward depending on the direction of the change. In a perfectly competitive market, marginal revenue is equal to the price level, so if there is an increase in price, a firm's marginal revenue increases. This highlights the fact that a firm's labour demand curve is also a demand curve for its product, so price fluctuations reflect changes in the demand for a firm's product, price fluctuations reflect changes in the demand for a firm's product, price fluctuations reflect changes in the demand for a firm's product, price fluctuations reflect changes in the demand for a firm's product.

[Maximum 4 marks for clearly explaining two factors which would increase a firm's labour demand; 1 mark for an explanation that is less clear but explains the general meaning]

- Otto's recent technological development will affect the elasticity of labour demand. One of the most important influences on elasticity is the availability of substitutes. If there is a perfect substitute to labour, we would expect the elasticity of labour demand to be high. If labour in the trucking industry increased, we would expect that trucking firms would hire more labour because there is little difference between using automated technology and labour. However, there were no substitutes for labour in the trucking industry – as has been the case for many years – we would expect an increase in truck driver's wages to be met by far less employment. Notice that the elasticity of labour demand will also be influenced by the availability of substitutes. Otto's technology is actually cheaper than the average trucker's wage, so the labour demand to be more elastic in this case than if the technology cost, say, \$300,000.

[Maximum 2 marks for a clear and accurate explanation of how the elasticity of labour demand in the trucking industry will be affected; 1–2 marks for an explanation that is less clear but explains the general meaning]

- The proportion of labour cost in total cost, time-period (e.g. difference between short and long run), and factor substitutability all influence the elasticity of demand for the firm's output.

[Maximum 1 mark per correct response.]

- Demographic Changes:** If an economy's demographic changes, say, because of a decrease in the birth rate, then there is likely to be a positive effect on the supply of labour in all industries. If the birth rate increases disproportionately to the death rate, the size of the economy's population will increase over time and this will have an effect on labour supply. Immigration has a similar effect on labour supply.
 - Labour Force Participation:** Labour force participation refers to the proportion of the population that is 'active' – that is, employed or actively seeking employment. If the labour force participation rate increases, this is akin to saying that the overall supply of labour has increased. The increase in labour force participation from the 50s onwards would be an example of an increase in the labour supply.
 - Wages in Alternative Jobs:** If the wage rate in an industry rises disproportionately to the wage rate in other industries, the supply of labour in the higher-paying industry to increase – this is consistent with the upward-sloping labour supply curve. Naturally, then, this means that there are less workers in other industries and therefore we would expect to see an inward shift of the labour supply curve in those industries.
 - Non-Pecuniary Benefits:** Wages are not the only factor that individuals consider when choosing between jobs. Industries that are more pleasant for instance, are likely to have a greater supply of labour. Industries that offer better security, training, pensions, and other benefits are likely to attract more labour than industries that do not. Changes in non-pecuniary benefits will be reflected in the labour supply curve.
 - Non-Monetary Income:** Alternatively, labour supply might be influenced by the availability of non-monetary benefits. If social security payments increase, we might see a decrease in the labour supply as the perceived benefit of switching from wage-paying employment to unemployment increases.

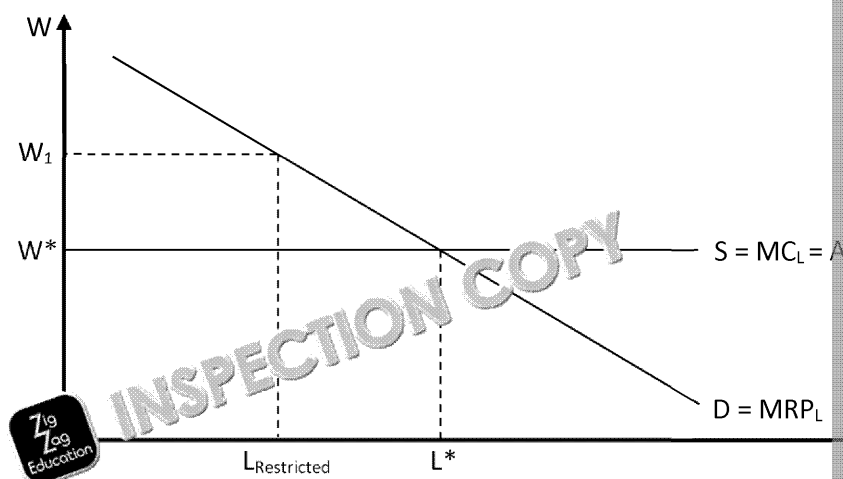
[Maximum 4 marks. 2 marks each for a clear explanation of non-monetary factors that influence an industry's labour supply; 1 mark each for an explanation that is less clear.]

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5. (a)



[Maximum 4 marks for a clearly labelled diagram, correctly illustrating the effect of a labour supply restriction on the individual firm; 2 marks for an adequate illustration, however lacking in detail]

(b) Advantages:

- If the union restricts the supply of labour to a level *below* what the individual firm would employ at the prevailing market wage W^* , the firm can artificially push the wage up to W_1 for the level of labour employed by the firm. Note that it is important that the firm can employ more labour than the union restricts for this action to have an effect.
- It is also possible that wage rate of W_1 might increase workers' motivation and productivity. Union intervention could then be thought of as benefiting the firm.

Disadvantages:

- It is the case that the union will have more power to restrict labour supply if the firm *must* employ unionised workers – e.g. a 'closed shop'. However, if the firm is not required to employ union members, the union's actions might only serve to displace workers from other employment opportunities.
- Unions restricting the labour supply necessarily prevents people from working. If the policy is only aimed at union members that are still employed, while those who are not union members at wage of W^* are forcibly unemployed. If the demand for labour is greater than the supply, there will be a shortage between the employed union members and those that are unemployed. This creates a deadweight loss to society.
- If the labour market is perfectly competitive there is little need for union intervention. Artificially raising the wage rate is inefficient for the wage rate to be artificially raised above the market-clearing level.

[Maximum 4 marks for accurately assessing one clear advantage and one clear disadvantage of restricting the labour supply; 2 marks for an adequate assessment, however it is not clear]

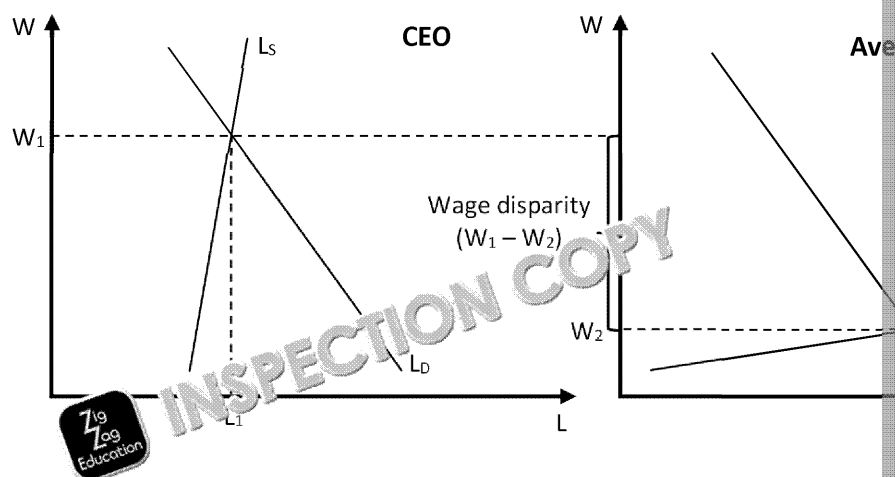
6. It is likely that the labour supply for the Beefeater position is more inelastic than for other military ranks because of *occupational* and *geographic immobility*. Primarily, becoming a Beefeater requires 22 years' service, and the position of Warrant Officer. Naturally then, the labour supply for Beefeaters is less flexible than for other military ranks because a great number of military personnel require the expertise required to become a Beefeater. Therefore, changes in Beefeater's wage rate will result in significant increases in employment in this position. Second, because Beefeaters are based in London, there is a geographical obstacle in that even those with pre-requisite expertise to become a Beefeater might not be able to afford to move to London to perform the role. Individuals might already have emotional ties to a certain area, which would make labour supply for Beefeaters inflexible and hence wage increases might not necessarily bring about an increase in employment.

[Maximum 4 marks. 3–4 marks for clearly explaining the reasons why the labour supply for Beefeaters is more inelastic in the military rank; 1–2 marks for a less clear explanation, with limited detail]

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7.



Disparities in wage rates between occupations exist primarily because of different supply. CEOs, who have acquired very particular skills and expertise in operating more inelastic supply than workers of low-skilled jobs. CEOs are usually highly educated and might have an innate ability in business – this could be true of someone like Donald Trump or any other executive chair of a multinational business. CEO wages therefore can be much higher than those of workers with lower levels of human capital, and this is reflected in the inelasticity of the labour supply curve for CEOs.

In the CEO section of the diagram above, the labour supply of CEOs is shown to be very inelastic – the rarity of a CEO skill-set. In the 'Average' section of the diagram above, we can see that the labour supply of a typical McDonald's worker is highly elastic – this is because the typical worker is drawn from a wide-range of people that would be suitable for such a role. Naturally, then, the difference in labour demand in these two diagrams will bring about differences in the wage rate. The difference in their wages whereby the CEO earns a wage of W_1 and the 'typical' worker earns a wage of W_2 .

However, CEOs can also be thought of as bringing in higher marginal revenues than average workers. There is also a demand-side effect that is occurring. CEOs introduce particular strategies that generate millions upon millions of profit. Typical workers simply undertake the operational tasks. CEOs, therefore, are subject to a much stronger demand than the average worker. By labour-saving technology, CEOs can command higher wages because their contribution to the firm's revenue is much higher, and this has an effect on the 'derived' demand for their labour.

[Maximum 6 marks. 5–6 marks for accurately assessing the reasons by which a CEO's wage is higher than that of an average worker. Answer should be applied accurately to the question, using supply and demand diagrams. 3–4 marks for providing an adequate analysis, might be underdeveloped or lacking in detail. 1–2 marks for poor analysis, which may be unfocused or incorrect.]

8. Improving labour market flexibility and mobility could include policies such as training for the unemployed; information provision about job opportunities; reforming trade union laws to increase their bargaining power.

Training for the unemployed, for instance, might be a useful way to improve occupational skills and reduce geographical immobility. Moreover, whether those that are close to the labour market can benefit from such training is questionable. Training is only beneficial to those that are trained – if unemployment is the result of cyclical factors, training will not solve the structural problems that give rise to an inflexible labour market.

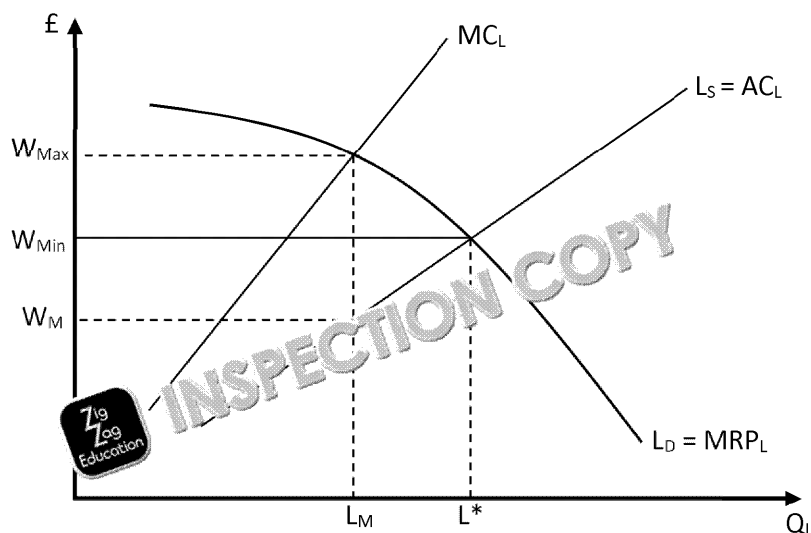
[Maximum 4 marks for a strong, well-supported assessment of one policy that the government could use to improve labour market flexibility. Students should assess the relative merits of a government policy to improve labour market flexibility to achieve maximum marks; 2 marks for a limited assessment of one policy; 1 mark for a poor assessment that is irrelevant and unsupported to the question.]

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9.



Monopsony has the effect of depressing workers' wages and the quantity of labour below that of a perfectly competitive equilibrium in the labour market. Therefore, the government may wish to intervene in the labour market in order to correct this market failure.

If the government introduced a minimum wage at W_{Min} , this has the effect of making the wage constant at W_{Min} . Thus, consistent with a profit-maximising objective, the firm will employ the quantity of labour where the marginal revenue product of labour (MRP_L) will equal the minimum wage. The equilibrium in this labour market will now be achieved at a wage rate of W_{Min} and a quantity of labour L^* , which is the perfectly competitive equilibrium outcome. Notice that the imposition of a minimum wage in a monopsonist labour market doesn't reduce unemployment as would often be the case in a perfectly competitive labour market.

However, it is highly unlikely that any government could have information perfect enough to impose a minimum wage at *exactly* W_{Min} , and indeed even if this constitutes a source of potential market failure, government imposed a minimum wage above or below W_{Min} the government policy would lead to a change in employment. If the minimum wage is above W_{Min} , there would be an increase in employment from L_M to L^* , but if the minimum wage is below W_{Min} , there would be a decrease in employment from L_M to L^* . However, if the government's initiative would actually increase unemployment in the labour market, it would be a failure of the policy.

Moreover, a government tends to legislate minimum wages on a *national* scale – (Note, however, it is sometimes possible to impose different minimum wages in different regions or countries, as has often been the case in East Asian economies). If the minimum wage is *above* the market-clearing wage in some markets that are perfectly competitive, the government's legislation may serve to increase unemployment in those markets while correcting the market failure in the monopsonist labour market.

Yet, if the government is able to impose a minimum wage strictly in the monopsonist labour market, it may inadvertently increase income inequality in the economy. This is because the minimum wage will benefit those that are employed in the monopsonist market, while the poorest people in society, who are not employed, hence reap no benefit of the minimum wage.

[Maximum 6 marks. 5–6 marks for a strong, well-supported evaluation of the effect of a minimum wage, applied accurately to the question, in order to overcome the labour market failure; 3–4 marks for reasonable, but less evaluative content, with some support for a limited attempt at evaluation, likely to be unsupported and irrelevant to the question.]

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Topic Test 3.6 Government Intervention

1.

Advantages of nationalisation	Disadvantages
<ul style="list-style-type: none"> • Tends to provide cheap goods and services for consumers • Leads to more equality in society • Can achieve economies of scale • Profits can be used to fund public facilities • Can provide a public service if necessary 	<ul style="list-style-type: none"> • Can be very inefficient • Main motive • Workers may not be motivated • Can result in overstaffing • Can create monopoly power • If nationalised for public service, privatisation might be better

[2 marks for one clearly explained advantage and for one disadvantage; 1 mark for each lacking detail]

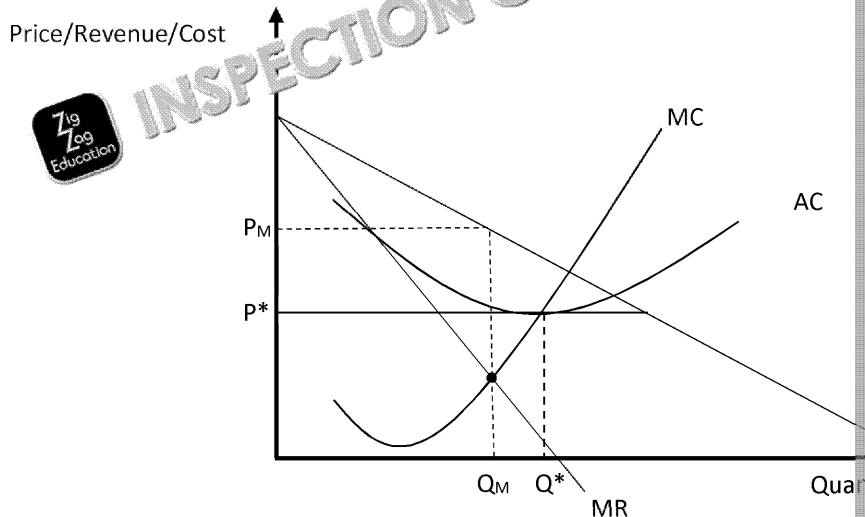
2. 'Regulatory capture' occurs when a government's regulatory bodies are subverted by the interest of those who operate in the industry that the body is charged with regulating, leading to government failure.

[2 marks for a clear explanation of the problem of regulatory capture; 1 mark for a definition which conveys the general meaning]

3. **Minimum Price:** A monopsony can be regulated in the opposite way to a monopoly. The government can impose a minimum price (e.g. the minimum wage) such that the market moves to a level below a welfare-maximising level.

[2 marks for a clear explanation of a method of controlling monopsony power; 1 mark for a definition which conveys the general meaning]

4. Diagram:



Knowledge:

- **Monopoly:** Typically, a profit-maximising monopolist will produce a quantity where the profit-maximisation principle that $MR=MC$. At $MR=MC$, there would be no profitable production, therefore the firm will produce a quantity of output equal to Q . The monopolist's demand curve – which is equal to D – and its cost of production will be determined by the AC . At Q , the firm's total revenue will exceed its total cost and the firm will make a profit. Note that a monopolist is neither *productively* or *allocatively* efficient; as a result, it reduces society's well-being.
- **Maximum Price (Ceiling):** If the government intervenes and imposes a price ceiling below the current monopolist price of P_M . If the government chooses to impose a price ceiling at P^* , it might be able to force the monopoly into effectively operating similar to that of a competitive market – this is because a price of P^* would be consistent with the socially efficient point. Imposing a maximum price at P^* affects the shape of the monopoly demand and marginal revenue (MR) curves such that they are flat at P^* , but become downward sloping above P^* .

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reaches the firm's original revenue curves. At P^* the firm's profit-maximising level of output, the new MR and MC, which is at an *allocatively* and *productively* efficient point, the monopolist would make *only* normal profit. Note that the equilibrium quantity is less than the socially efficient level.

Evaluation:

- **Globalised Economy:** If the firm is discontented by having a price ceiling imposed on a market where there are no governmental regulations. It could result in a market where there is arguably a *worse* form of market failure. Obviously, there are other considerations when deciding which markets to operate in, but in a globalised economy the threat of globalisation is an important consideration.
- **Information Failure:** It is extremely difficult for a government to know what the marginal costs are of a firm. Imposing a price ceiling at a level that would be allocatively efficient would be extremely difficult. If the government's maximum price is set too low, the firm might make losses and might require a subsidy to continue operating. A price ceiling would be allocatively efficient, but not productively efficient.
- **Reduces Abnormal Profit:** Since the government's price ceiling reduces the firm's profit from an abnormal to normal level, there may be less capital investment. Ultimately, the firm will be disadvantaged because of a lack of dynamic efficiency.

[Maximum 8 marks. 6–8 marks for a clear evaluation using a correctly labelled diagram; 4–5 marks for an adequate analysis, might be underdeveloped or lacking in attempt at evaluation, likely to be unsupported.]

5. Governments might regulate monopoly power through price regulation, quality standards, etc.

[1 mark per valid response up to a maximum of 3]

6. • The Competition and Markets Authority would investigate the proposed acquisition of Just Eat by Hungryhouse in order to understand whether the merger would produce uncompetitive markets for takeaways and restaurants.
- Merger between Just Eat and Hungryhouse might mean that the firm can merge and increase the transaction costs for consumers wishing to purchase takeaways.
- Likewise, the merger might mean that Just Eat could force participating restaurants to provide online services to its customers.
- Of course, the CMA would investigate whether the merger damages competition (e.g. by reducing the number of firms in the market), and whether it is against the public interest for the merger (e.g. by reducing consumer choice).

[2 marks for a clear explanation of how the Competition and Markets Authority will investigate the merger; 1 mark for a limited explanation lacking detail]

7. Positive:

- **Non-Price Competition:** It's possible that regulation could force firms to compete on non-price grounds. Where the Big Six are limited in their ability to charge higher prices, they might be forced to compete in such a way to attract consumers through a non-price competitive approach. From this perspective, regulation might encourage firms to focus on consumer satisfaction and service.
- **Improve Efficiency:** Primarily, regulation's principal function is to force firms to behave as if they were perfectly competitive. It could be possible, for instance, to force firms to compete more competitively by removing barriers to entry (e.g. preventing the vertically integrated firms from supplying and power-generating firms) in order to make the market more competitive. This would force the Big Six to act competitively, even if the market is not traditionally competitive. It might be possible to limit the Big Six's ability to charge higher prices by imposing a maximum price on their prices down to a level that would be closer to an allocatively efficient perfect competition level. Ultimately, the objective of regulation is to force firms to behave competitively.

Negative:

- **Introduction of Inefficiencies:** If the Big Six benefit from considerable economies of scale, introducing inefficiencies (particularly productive inefficiency) into the market could be costly. For example, the energy market is an example of a 'natural monopoly' and so fragmenting production into many small firms could introduce inefficiencies that could make society worse-off. Note that the minimum efficient scale for the energy market tends to be high, so regulating the Big Six might involve a trade-off between efficiency and the losses to productive efficiency. If productive efficiency decreases, the cost of energy in the industry could in fact rise.

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- **Less Reinvestment:** It's also important to consider that regulation will have a negative impact on the margins of firms. It might be considered important to decrease these firms' ability to invest in welfare-improving technology, and so regulation may have a negative impact on static and dynamic forms of efficiency.

Evaluation:

- **Nature of Regulation:** Regulation's effect on the behaviour of firms will depend on the type of regulation. If a price ceiling is introduced but the price is not too low, it might serve to reduce the number of smaller firms from operating in the market (e.g. because these firms will not be able to achieve the scale to operate). However, forcing vertical integration is likely to improve efficiency.
- **Inertia of Custom:** The inertia of the Big Six does little to tackle the essential problem of inertia. It would be better to focus on ways to improve consumers switching costs, for instance.

[Maximum 8 marks. 6–8 marks for providing a clear evaluation of the impact of regulation on firms in the UK's energy industry. Applied accurately to the question using supporting evidence; 4–5 marks for an adequate evaluation, however might be underdeveloped or lack depth; 1–3 marks for a limited analysis, may be unfocused or incorrect.]

8.

Advantages	Disadvantages
1. Improvement in efficiency: privatising state-owned enterprises will give firms a profit incentive and cut costs. This will lead to an incentive for other firms to enter the industry and, therefore, promote competition and enhance efficiency.	1. Monopoly: Private state-owned monopolies. There is a focus on profit, not the benefits of competition. The structure post privatisation may not be the best for the government's objectives and priorities.
2. Reduction in state interference: state-owned enterprises often employ too many workers, leading to inefficiency and a reduction in competition. Privatising state-owned enterprises will, therefore, improve economic decision-making by choosing the optimal amount of workers to employ in order to enhance efficiency and, therefore, promote competition.	2. Many state-owned enterprises are in the public interest to provide essential services, but will also make a profit. This will create an incentive to earn more, leading to higher prices. To prevent this, enterprises normally have a public service obligation.
3. Long-term improvements: privatising state-owned enterprises will create long-term benefits, as firms will become more efficient and make improvements in R & D as well as in technology, thereby improving the long-term performance of the enterprises and promoting healthy competition.	3. Privatising state-owned enterprises may lead to fragmentation, which in turn can lead to confusion and inefficiency, particularly in the case of public services.

[Maximum 8 marks. 6–8 marks for a clear and well-supported evaluation of the advantages and disadvantages of privatising state-owned enterprises in order to promote competition. Analysis is well supported by evidence; 4–5 marks for an accurate evaluation, displaying basic understanding of the question; 1–3 marks for a limited evaluation that does not fully address the question, or missing key points of reasoning.]

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