

Edexcel (A) Economics A-level

A-level Paper 1: Markets and Business Behaviour

Example answers

June 2017

6a) With reference to Figure 1 and Extract A, explain one likely reason for the change in the four firm concentration ratio of the supermarket sector between 2010 and 2015. (5)

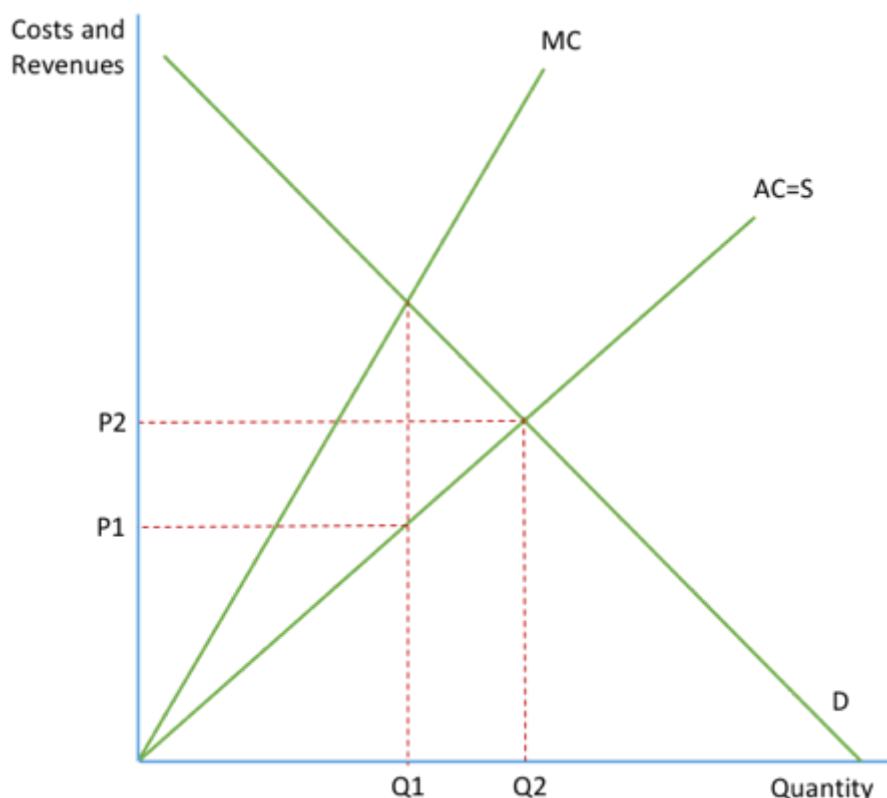
A four firm concentration ratio is the percentage of market share held by the four biggest firms. In 2010, it was 76.1% and in 2015 it was 72.5%. One reason for this may be due to the rise in other, cheaper supermarkets like Aldi and Lidl due to changing consumption habits. Less people buy from the main four supermarkets since they are buying from these new supermarkets instead. Increased competition reduces market share as consumers have more choices. The choices are cheaper and consumers may switch.

Teacher's comments: 4/5

Key point- are they shopping online? More frequently?

b) With reference to Figure 2 and Extract A, discuss the possible impacts of supermarket monopsony power on both food suppliers and consumers. (12)

Firstly, for suppliers, monopsony power reduces prices and hence reduces profits. Monopsony power is when a firm is the main buyer of a good and so supermarkets have monopsony power because they are so large. This causes a fall in price because firms know that if they do not sell their products to these supermarkets then they may not have a buyer. They are forced to accept low prices or risk not being able to sell their goods at all. As seen in the diagram, a monopsonist will buy where the cost to them is equal to the value they get from them ($MC=D$) and at the price of supply. This means they buy Q_1 at price P_1 , compared to Q_2 at P_2 in a competitive market.



This fall in prices and output will lead to lower profits for the suppliers. The lower profit is seeing many firms struggling to stay in the market- this number has increased by “more than 50% over the past year”. The effect of the monopsony power will depend on the government’s ability to limit power through regulation. It is clear regulation has not been successful since more than 30% of food suppliers complained about Tesco. The situation is worsened because the suppliers are small and medium sized.

On top of this, for consumers, it will lead to lower prices. The monopsony power of the supermarkets allows them to keep prices low because their costs are low. This has been the case as food prices paid by consumers have fallen by 1.7%. However, this fall may be more determined by the hypercompetitive nature of the supermarket industry and the lack of ability to collude (because there are too many firms and it is unstable). Prices have fallen because of price wars and firms like Aldi who have been able to undercut the market. Not all monopsonists cause a fall in prices and it is likely other factors have played a part in falling prices.

Teacher’s comments: 9/12

Good KAA but evaluation needs development e.g. supermarkets may not pass on benefits of lower prices.

c) Examine measures the government might use to restrict the monopsony power of supermarkets. (8)

One way the government could restrict a monopsony’s power is by reducing its monopoly power in the market it is selling. Firms are only able to have large purchasing power if they then sell these goods on, so have a higher proportion of the onsell market. Therefore, the government could use merger policy to limit the size of these monopolists, or deregulation to reduce barriers to entry and make the market more contestable.

Moreover, they could introduce regulation. The Groceries Code Adjudicator (GCA) regulates the supermarket industry. This regulation will include ensuring fair prices for suppliers and not using anti-competitive practices, such as collusion with other firms to keep prices low. This will reduce their power since they will not be able to treat suppliers unfairly and they will be monitored to prevent them abusing their power.

However, the problem with both of these is regulatory capture where the regulation becomes no longer unbiased and impartial. Regulation will become much weaker and they will struggle to limit the monopsonist’s power as action won’t be harsh enough to prevent power. Another issue is the fact that they can only fine supermarkets 1% of their annual revenue, which offers little incentive for firms to treat their suppliers fairly.

Teacher’s comments: 6/8

Unclear wording at the start

d) Assess the extent to which ‘information gaps’ (Extract B, lines 5 and 6) and ‘irrational behaviour’ (Extract B, line 11) are the main causes of food waste in the UK. (10)

Firstly, information gaps are where there is a lack of information in the market and so individuals are unable to maximise their own gain. These causes food waste because firms do not know how much stock to buy/sell and so they produce excess food which ends up being wasted. This is clearly a huge cause since it leads to 4.1 million tonnes of food waste. However, not all of this waste will be able to be prevented since it is not possible for firms to have perfect information about how much of each good will be demanded by consumers, so waste is inevitable in this area.

On top of this, waste is caused by irrational behaviour, where consumers do not make decisions to maximise their own welfare. Food waste can be caused by bulk buys, when consumers buy too much of a good and end up throwing it away because it goes off. It is also caused by impulse buys, when consumers buy a good they don't need or want just because of temptation. In both these cases, supermarkets can be blamed for the irrational behaviour because it is their marketing which has caused over-buying. Irrationally, it can also be caused by the impact of habitual behaviour, where consumers continue to buy the same goods every week out of habit (particularly common where they are able to repeat order online), even if they know most of this ends up as waste.

However, it can also be caused by supermarkets. If stock is not handled properly then food with short expiry dates will go to the back of shelves and won't be bought by consumers. Some supermarkets have begun to donate food which would have otherwise been thrown away to homeless shelters etc., so they are doing more to reduce waste.

Overall, 11.1 million tonnes of waste are caused by consumers and suppliers to supermarkets, which is mainly caused by information gaps and irrational behaviour. This is much greater than the 0.2 million tonnes wasted by supermarkets. Although there are other causes of this 11.1 million tonnes, such as supermarket marketing, information gaps and irrational behaviour are the most important causes.

Teacher's comments: 8/10

Talk about the impossibility of predicting amount and quality of harvest

e) Discuss the likely problems for Sainsbury's and Morrisons if the suggested merger between them goes ahead. Refer to Figure 1, Extract C and your own knowledge in your answer. (15)

Sainsburys and Morrisons would be an example of a horizontal merger, where firms in the same industry at the same stage of production merge together. They would have 27.4% of the market. One issue of this could be problems associated with higher risk as they are now more concentrated in one market. If consumers habits continue to change and more consumers get their products from cheaper supermarkets, such as Aldi and Lidl, then Sainsburys and Morrisons would see issues. Consumers may shift to firms like Amazon for their grocery shopping. All of this leads to the decline of the traditional supermarket and so Sainsburys and Morrisons would lose out because they had a greater stake in the current market. They would have larger profits to lose and may

have more investment which would be lost. It may be more logical for Sainsburys to merge with a firm like Aldi, who have a different business plan as this would see them adapting to fit the current market. However, Sainsburys and Morrisons together would be more capable of dealing with these changes than they would be alone. They would have larger profits and a greater market share so any declines in their market would mean they could still make huge profits. On top of this, their economies of scale may mean they can lower costs and prices further and so therefore could be more able to compete with firms like Aldi.

Another issue could be diseconomies of scale. By merging Sainsburys and Morrison may see disadvantages and inefficiencies. This could be problems of coordination and control, particularly when the merger initially takes place. It will be difficult to coordinate their “hundreds of thousands of employees”. Rationalisation would mean shutting down many stores in similar locations to cut costs, and this could lead to staff becoming unmotivated. They may suffer from a lack of synergies, where the two firms’ ideologies don’t mix well together and so staff will have different aims. Both of these issues will cause staff to become unproductive and so output will reduce and costs will increase. However, Sainsbury’s and Morrisons are very similar businesses and so coordination and control will not be an issue in the long term- whilst in the short term it may be as they close shops and cut staff.

They are likely to see benefits from economies of scale. As a larger firm, they may experience distribution economies where it is cheaper to transport their goods as they can use larger trucks and regional distribution centres. They may have more monopsony power and so be able to get lower prices from their suppliers which will allow them to cut costs. On top of this, they may be able to appoint more specialist managers for each section of the business since labour represents an indivisibility. These will have more knowledge in each area and be more efficient. Overall, this will reduce costs and lower their AC curve, helping to increase profit. They may also be able to lower costs, which will help them deal with competition.

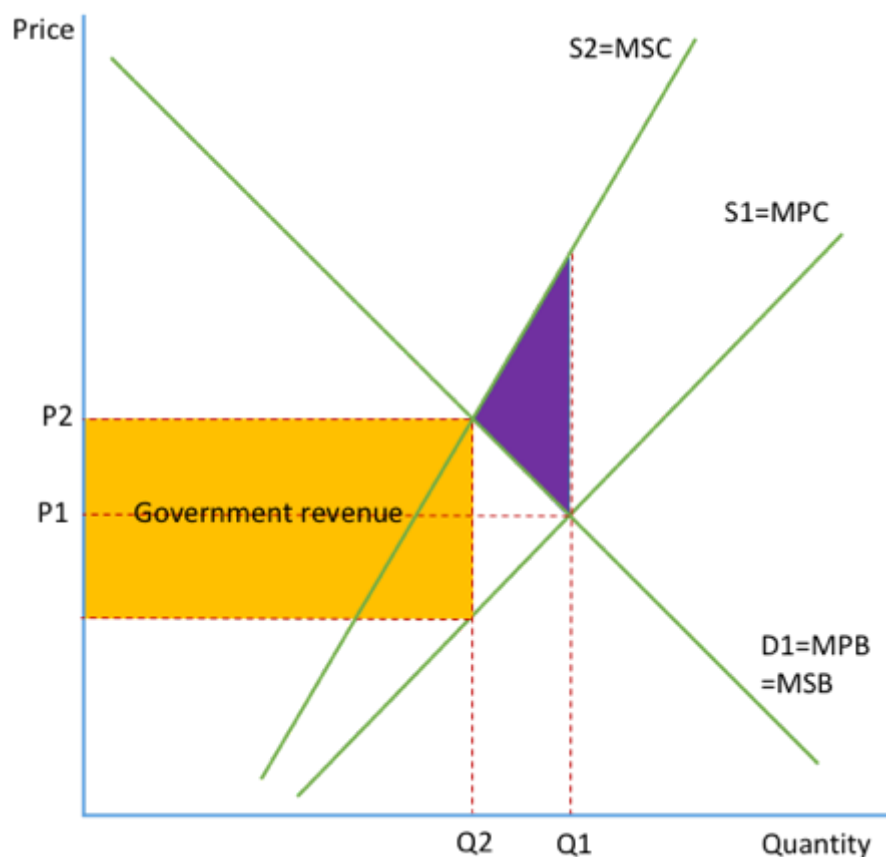
Overall, the merger will put Sainsburys and Morrisons at the same market share as Tesco. The fact that Tesco has been reporting falling profits suggests that this may not be overly beneficial for Morrisons and Sainsburys. The problems of the merger will depend on the aims of the merger. If they aim to shift to meet new consumer habits and become more adaptable then in the long run they are likely to gain. If they don’t, they will still be faced with the problems of changing consumer habits which cause large issues over time.

Teacher’s comments: 11/15

A lot of time is spent at the beginning on a minor/weak point! Talk about regulation- they are becoming a legal monopoly

7) In 2015 a report by Public Health England recommended the imposition of a 20% tax on the sale of soft drinks that contain high levels of sugar. Evaluate the likely microeconomic effects of such a tax. (25)

A 20% tax is an example of an ad valorem indirect tax which is a tax that increases with the value of the good and the person who is charged the tax is not the one who ultimately pays it to the government.



Sugary drinks have a negative externality. This means that the marginal cost to society is greater than the marginal cost to the individual. In a free market, consumers aim to maximise their own benefits and so produce where the cost to them is equal to the value they get i.e. where $MPB=MPC$ at Q_1P_1 . However, the social optimum position, the point where social welfare is maximised, is where $MSC=MSB$ at P_2Q_2 . This means that there is a welfare loss of the purple area. The social costs involved with the sugary drinks are the costs to the NHS, which is currently struggling with the problems of obesity. The sugar tax will increase the costs to the individual and therefore shift MPC to MSC. This means production now takes place at the social optimum level. Thus the effect of the tax is to improve societal welfare. The government can spend less money on this particular issue in the NHS, and this spending has a high opportunity cost, and instead spend it elsewhere. This depends on whether the tax has been set at the right level: if it is wrong, then social welfare won't be maximised. It is difficult to measure the exact cost of fizzy drinks to the NHS and the government is likely to suffer from asymmetric information, meaning that it is unlikely the tax is set in the right place.

On top of this, the government is able to raise revenue of the yellow shaded area. This revenue is important as it will mean they can spend money on education to fix the information gaps involved in the consumption of unhealthy foods. This will help to reduce demand for these goods in the future. Moreover, they could help to reduce the cost of healthier alternatives through subsidisation. Healthier options tend to be expensive and unaffordable and by improving their affordability, the

government will further reduce demand for unhealthy options. Since fizzy drinks are likely to be inelastic, the government will raise a high amount of revenue. They are inelastic because of their addictive nature, because it is a habit for consumers to buy them and because this is the most common option for consumers at fast food places/restaurants- there tends to be low availability of substitutes. High revenue means high spending on these areas.

On the whole, it is likely to improve health by disincentivizing individuals from buying fizzy drinks. However, fizzy drinks are inelastic and so therefore a rise in the price may have little impact on quantity demanded. Therefore, it may be ineffective at improving health and increasing social welfare. Moreover, firms may decide to simply cover the cost of the tax themselves. Fizzy drinks firms, such as Coca Cola and Pepsi, have high profits and so may decide to cover the cost of the tax to keep revenue high and to maintain/increase market share. As a result, there may be no fall in the amount bought by consumers. On top of this, there may be unintended consequences. Consumers may switch to alcoholic drinks or find other ways to get their sugar fix, for example chocolate or cake. This will mean there will be no benefit to health and thus the tax is ineffective.

There may also be some negative effects of the tax. It will be regressive and hit those on the poorest incomes the most, especially since the poor are more likely to buy sugary drinks and they can be seen as an inferior good.

Overall, the tax is likely to decrease consumption of sugary drinks. It gives an incentive for firms to reduce the amount of sugar in their drinks and for consumers to switch their consumption habits. In the short run, it may be ineffective and have minimal effects but in the long run, government education will help to make demand more elastic and this will help to make the tax more effective. The tax will not end the obesity problem, as it is just one cause and other action should be taken by the government alongside this tax, such as bans on advertising, regulation and more taxes. Despite this, in the long run, the tax should help to improve the situation.

Teacher's comments: 21/25

Good effort- when talking about substitutes, you could bring in XED? Mention consumer and producer surplus when analysing diagram. Also talk about incidence of tax