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ADVANCED

General Certificate of Education

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Economics

Assessment Unit A2 1

assessing

Module 3: Production
and Competition

[A2E11]



WEDNESDAY 28 JANUARY, MORNING

TIME

1 hour 20 minutes.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer Question **1** and **either** Question **2** or Question **3**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 60.

Quality of written communication will be assessed in parts **(b)**, **(c)** and **(e)**, of
Question **1** and all parts of Question **2** or **3**.

Figures in brackets printed down the right-hand side of pages indicate the marks awarded
to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks for each part question in allocating the
available examination time.

You **must** answer this question.

1 The article below was written in March 2008.

Study it carefully and answer the questions which follow.

Ripping off the NHS

Pharmaceutical companies suffer from a bad public image. Many view them as ruthless exploiters of the sick who charge prices for drugs which far exceed their marginal costs. *(Paragraph 1)*

That drug prices are often well above marginal cost cannot be denied. However pharmaceutical companies can defend themselves against the charge of exploiting the sick by highlighting the unusual cost structure of their industry. Most of their costs could be described as “sunk” in that they are incurred well in advance of the actual production of the medicine. It therefore makes commercial sense to charge a price which far exceeds the direct costs of labour and materials used in production. *(Paragraph 2)*

However, sometimes pharmaceutical companies take actions which confirm the public’s negative image of them. Such was the case this week with Reckitt Benckiser (Reckitt) which stands accused of ripping off the National Health Service (NHS) with a secret plan to maintain a monopoly in the supply of Gaviscon, the lucrative heartburn medicine. *(Paragraph 3)*

Internal documents, released by a whistle-blower, showed that the company was engaged in what industry insiders call “evergreening”. This is a strategy to maintain barriers to the sale of a cheaper but identical and unbranded (generic) version of a drug long after its original patent has expired. The former senior executive said Reckitt had “cheated the NHS”. It charged £2.70 for a bottle of Gaviscon which cost 74 pence to produce. It is estimated that a cheaper generic version of Gaviscon could have saved the health service £40 million a year. *(Paragraph 4)*

Under the codename “Project Eric” Reckitt used a variety of ploys to restrict the entry of new competitors:

- Before rival companies can create a generic drug, the body which licenses them must give it an official title. Reckitt claimed that Gaviscon was unique and that such a title could not be issued. It lodged objections in 2000, 2003, 2005 and 2006 and delayed the sale of cheaper generic drugs.
- Reckitt produced Gaviscon Advance, a near identical product with a different name, and tried to persuade doctors to prescribe it. The high pressure sales techniques which it used caused the industry’s regulatory watchdog to make a ruling of unethical behaviour against Reckitt.
- It successfully lobbied the industry regulator (The Medicines and Healthcare Regulatory Agency) that before generic drugs could be sold they must produce a detailed quality specification. This again delayed the introduction of cheaper generic drugs. *(Paragraph 5)*

The House of Commons Health Select Committee is now expected to investigate the Gaviscon case. Richard Taylor MP, a committee member and former doctor, said: “We have regular letters from people with cancer and other serious problems who cannot get the drug they need. That’s where we should be spending the money, rather than giving huge profits on drugs that aren’t really an advance.” (Paragraph 6)

Another MP went further and argued for tighter controls on the price which the NHS was prepared to pay for medications. She said: “There should be a cost plus pricing formula in place which allows the drugs companies to charge the costs of production plus an allowance of 10% for profit. This should be the absolute maximum which the NHS is prepared to pay”. (Paragraph 7)

Source: adapted from The Times March 7th 2008, author Angela Jameson.

- (a) Explain what is meant by a barrier to entry. [3]
- (b) Explain why barriers to entry may be justifiable in the pharmaceutical industry. [6]
- (c) With the assistance of an appropriate diagram show how barriers to entry enable a pharmaceutical company to earn long run super-normal profits. [6]
- (d) In paragraph 4 Reckitt Benckiser is accused of “evergreening”.
- (i) Explain what is meant by “evergreening”. [2]
- (ii) Outline some of the means by which it can be achieved. [4]
- (e) Evaluate the suggestion in paragraph 7 that the NHS should impose a cost-plus pricing formula on its pharmaceutical suppliers. [9]

Answer **either** Question 2 **or** Question 3.

- 2 (a) Explain what is meant by normal profits. [12]
- (b) Analyse the reasons why some firms only earn normal profits in the long run. [12]
- (c) Evaluate the view that profit maximisation is not the goal of most firms. [12]
- 3 (a) Explain the difference between fixed and variable costs. [6]
- (b) Analyse how the law of diminishing marginal returns affects marginal product and marginal cost. [12]
- (c) “Few costs are either totally fixed or totally variable, so it is pointless to try to make this distinction.” Critically examine this viewpoint. [12]

THIS IS THE END OF THE QUESTION PAPER
