

Mark Scheme (Results) January 2008

GCE Level

GCE Economics (6354) Paper 1

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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.

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- Note: if incorrect option is selected, a maximum of two explanation marks can be awarded.
- Note: Up to two marks can be awarded for knocking out two incorrect answers with valid reasons.

Question Number	Answer	Mark
1	<p>B</p> <p>Notes</p> <p>Three characteristics of perfect competition, at least one applied to wheat / agriculture (1+1+1). If no reference to wheat award a maximum of two explanation marks.</p> <p>Many buyers & sellers (farmers) / homogenous product / price takers / low entry & exit barriers / normal profits in long-run / perfect market knowledge.</p> <p>Also award for diagram of a perfectly competitive firm in short-short-run or long-run equilibrium (1).</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
2	<p>E</p> <p>Notes</p> <p>Definition of concentration ratio e.g. the combined market share of the nth largest firms in the industry (1).</p> <p>3-firm concentration ratio in 1999 is 78.55% (1) and in 2006 76.19% (1).</p> <p>Also award for a fall in the three-firm concentration ratio of 2.36 percentage (points) (2)</p> <p>Note: Award a maximum of two marks for the calculations</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
3	<p>C</p> <p>Notes</p> <p>Definition or formula of Average Revenue or Marginal Revenue (1)</p> <p>Total revenue is rising at a decreasing rate so MR and AR must be falling (1).</p> <p>Application to total revenue diagram e.g. a fall in the marginal revenue is shown by the gradient on the total revenue curve or marginal revenue is zero when total revenue is maximised (1).</p> <p>Also award for diagram of falling AR and MR curves (1).</p> <p>The firm is operating in an imperfect market (1).</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
4	<p>D</p> <p>Notes</p> <p>Definition of privatisation e.g. the sale of state / public sector assets to the private sector (1).</p> <p>Any two benefits of privatisation e.g. lower prices for raise revenue for government / increase competition / increase efficiency / consumer benefits (1+1).</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
5	<p>C</p> <p>Notes</p> <p>Definition of contestability e.g. the ability of firms to enter & exit a market / a market with low entry & exit barriers / low sunk costs . Also accept definition of a non-contestable market (1).</p> <p>Advertising expenditure is an entry barrier / sunk cost since it creates brand loyalty (1) and puts pressure on new entrants to increase advertising spending (1).</p> <p>Advertising expenditure has increased - leading to an increase in entry barriers / sunk costs to the market (1).</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
6	<p>A</p> <p>Notes</p> <p>Annotation of the diagram up to (3).</p> <p>The increase in marginal cost curve (1), depicting higher equilibrium price & lower equilibrium output (1), the increase in average cost curve leads to lower profits (1).</p> <p>Full marks can be achieved without annotation of the diagram, as long as detailed analysis offered e.g. raw material costs are variable costs and so both the MC and AC curves increase, leading to lower profits. The firm will raise price to try and pass on costs to consumers. The new equilibrium profit maximising level of output will be lower as marginal costs increase (3).</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
7	<p>A</p> <p>Notes</p> <p>As long-run average costs increase there are 'diseconomies of scale' (1).</p> <p>Diagram showing 'diseconomies of scale' (1).</p> <p>Application and explanation of diseconomies of scale e.g. co-ordination problems, or lack of synergies, rising labour or raw material costs for GUS (1+1).</p> <p>Any benefits of the demerger e.g. increased specialisation / focus on core markets / better quality service (1+1).</p>	<p>(1)</p> <p>(3)</p>

Question Number	Answer	Mark
11(b)(i)	<p>Price fixing apparent since (up to 4 marks):</p> <ul style="list-style-type: none"> • The market is oligopolistic, with four airlines. This increases the likelihood of price fixing / sharing market information (1). • Figure 1 shows 7 out of 10 identical air fares for BA and Virgin (1). • Same increases in fuel surcharge to ticket prices / same timing of price increases (1). • Quote from director of Independent Tour Operators suggests BA is price leader (1). • Price fixing investigations usually triggered by confession from a guilty company (1). <p>Note: Development of any of the above points could warrant an additional 1 mark.</p> <p>Note: Award a maximum of three marks if no specific reference made to the information.</p> <p>Evaluation: (up to 2 marks for one factor) Consideration of view that no price fixing / insufficient information.</p> <ul style="list-style-type: none"> • Figure 1 shows three examples of different air fares between BA and Virgin (1). • Virgin spokesman suggesting the airlines simply responding immediately to increases in oil prices (1). • The identical air fares could be an example of great price competition between airlines (2). • Insufficient information - no air fares shown for American Airlines and United Airlines (2) or need price data from longer time period. <p>Note: If candidate focuses on view that price fixing does not occur then this could count as analysis and application marks. Award up to 4 marks.</p>	(6)

Question Number	Answer	Mark
11(b)(ii)	Identify a collusive practice (1) and explanation (2). Explanation could include an example of collusion and the possible outcome in terms of profits. <ul style="list-style-type: none"> • Agreed output quotas / market shares. • Information sharing such as technical data or potential new entrants. • Agreed limits to marketing expenditure. • Joint research & development projects. • Strategic alliances e.g. BA and American Airlines. Firms may share each other's airport facilities including check-in staff, luggage staff, business class lounges and frequent-flier rewards. • Tacit collusion - the extract suggests BA is price leader and other airlines simply follow. 	(3)

Question Number	Answer	Mark
11(c)	<p>Economic efficiency (up to 3 marks for explanation)</p> <ul style="list-style-type: none"> • Understanding of term as productive or/and allocative efficiency (1). • Efficiency likely to decrease due to lack of competition / long run supernormal profits / x-inefficiency / rising average costs / less investment (2). <p>Consumer welfare (up to 3 marks for explanation)</p> <ul style="list-style-type: none"> • Understanding of term e.g. value for money, product quality, firms meeting customer demand (1). • Consumer welfare likely to decrease due to lack of competition / rising prices / capturing consumer surplus / deterioration in customer services & product quality (2). <p>Evaluation (2+2 marks)</p> <p>Consideration of the extent of decrease in economic efficiency and consumer welfare:</p> <p>Candidates may discuss any collusive practices in any industry.</p> <ul style="list-style-type: none"> • The impact depends upon how much prices are fixed above their free market competitive levels. • Time span - will price fixing remain in long run now that investigation under way? • Extract indicates the investigation will take long time so could mean lengthy period of abuse. • The tighter legislation and tougher penalties may discourage collusive practices. • Prioritise between economic efficiency & consumer welfare // demonstrate how they are closely linked. <p>Argue that economic efficiency & consumer welfare could increase since:</p> <ul style="list-style-type: none"> • Higher profit / revenue means more funds available for investment. • Stable environment for firms might lead to increased investment. • Non-price competition might increase - offering greater product variety and improved customer services. 	(10)

Question Number	Answer	Mark
11 (d)	<ul style="list-style-type: none"> • Understanding ‘contestability’ in terms of reducing entry & exit barriers to a market / increasing possibility of entry to a market (1). • The British & American governments could end the agreement of permitting just four major carriers between London Heathrow and US (1). • More airlines will be able to enter the transatlantic market e.g. relatively easy to do since already own airplanes / have air crew / expansion of Heathrow airport via terminal five will increase capacity (2). <p>Also award credit for government subsidies to new entrants but candidates must take a critical view.</p> <p>Evaluation (up to 2 marks for one point)</p> <ul style="list-style-type: none"> • Difficult for new firms to enter market since strong loyalty to existing carriers. • Finite number of flight slots - cost of buying these costly prohibitive. • Easier to focus on expanding number of flights between other London airports and US e.g. Gatwick, Stansted, Luton. 	(6)

Question Number	Answer	Mark
11(e)	<ul style="list-style-type: none"> • Definition / understanding of price discrimination (1) • Relevant diagrammatic analysis and explanation (5) • 2 sub markets + market model depicting: <ul style="list-style-type: none"> • Industry equilibrium • Different PEDs in sub-markets • Higher price where PED is less elastic (Friday & Saturday flights) & lower price where PED is more elastic (Sunday & Monday flights). • Higher profit areas • Constant AC = MC curves • Evaluation (2+1 marks for two factors) <ul style="list-style-type: none"> • Profits may increase as long as conditions are met - separate consumers into different markets with no leakages + different PEDs + some degree of market power. • Market separation can be achieved by the different PED associated with the day of travel and the tight regulations on ensuring each seat has a specific passenger name. Firms are able to capture consumer surplus and so increase profits. • The costs of separating the markets must not exceed the increase in revenues otherwise airline profits would not increase. • Market power might be weak since competition actually exists between airline companies. This might undermine price discrimination by any one company and therefore its profitability. 	(9)

Question Number	Answer	Mark
12(a)	<ul style="list-style-type: none"> • US market share declining and Japanese market share rising (1). • Decline in US market share is from 70.0% in 1998 to 54.8% in 2006 (1). Also accept a fall of 15.2% (percentage points) • Rise in Japanese market share is from 15.0% in 1998 to 32.2% in 2006 (1). Also accept a rise of 17.2% (percentage points) <p>Also accept estimation of changing market shares by 1% of the figures.</p> <p>Also accept reference to individual US and Japanese motor vehicle firms but award a maximum of 2 marks overall.</p>	(3)

Question Number	Answer	Mark
12(b)	<p>Identification of a reason (1), application and analysis factors (this may include an appropriate example) (3)</p> <ul style="list-style-type: none"> • Exploits economies of scale. Note this must be linked to locating production facilities overseas e.g. risk bearing, purchasing, marketing, technical, managerial and financial. • Cheaper production costs, for example, labour, land, construction of factories. • Enter new markets - so spread risks. • Achieve higher growth. • Increase profits. • Avoid import controls e.g. tariffs or quotas • To exploit tax differences (transfer pricing) • To exploit the advantages of a single currency • Government subsidies. <p>Evaluation (1 mark for one factor)</p> <ul style="list-style-type: none"> • Short-run versus long-run e.g. achieve higher growth to secure long term profits. • The newly industrialising countries offer great scope for car sales. • Magnitude - economies of scale could be significant. 	(5)

Question Number	Answer	Mark
12(c)	<ul style="list-style-type: none"> • Diagram showing rising average costs (1), rising marginal costs (1), falling average revenue and marginal revenue (1), and losses (1). Also award for showing initial position of the firm making supernormal or normal profits (1). Note a maximum of 4 marks can be achieved from the diagram. Also cap at 2 marks if a firm in perfect competition diagram is shown. • Explanation of rising costs in terms of healthcare costs or wage costs (1). • Explanation of falling demand due to producing vehicles that use a lot of fuel rather than energy efficient vehicles (1). 	(6)

Question Number	Answer	Mark
12(d)	<p>Definition of a type of inefficiency (1) and application and analysis (3)</p> <ul style="list-style-type: none"> • Productive inefficiency <ul style="list-style-type: none"> ➤ (AC≠MC) or firms are not producing at lowest average cost position. ➤ Development of productive inefficiency, for example: not all the firm's resources are being fully utilised or there is waste. This may include reference to the extract e.g. Figure 2 shows assembly hours per vehicle to be higher for US manufacturers, or, US cars cost on average \$2000 - \$2500 more than their Japanese counterparts. • Allocative inefficiency <ul style="list-style-type: none"> ➤ Allocative inefficiency as (MC≠AR or MC≠Price) ➤ Development of allocative inefficiency, for example, firms are not producing what consumers want to purchase e.g. the extract refers to pick-up trucks & SUVs which are gas guzzlers but the demand is for fuel efficient vehicles. <p>Also accept X-inefficiency, dynamic or technical inefficiency (1+3).</p> <p>Evaluation (Up to 2 marks for one factor)</p> <ul style="list-style-type: none"> • Productive inefficiency may not be too significant as Figure 2 shows the US car manufacturers have similar assembly hours per vehicle to that of Japanese car manufacturers. The problem is more to do with company healthcare costs for employees. • Allocative inefficiency is highly significant since the ten most popular fuel efficient cars in the US are either Japanese or German models. The American firms have misread the market in terms of changing consumer tastes. • Short-run versus long-run - Long term trend of improvement to productive efficiency since US car manufacturers have made progress in reducing assembly hours per vehicle as shown in Figure 2 over past ten years. • Magnitude - Inefficiency is highly significant since the US car manufacturers are making massive financial losses which cannot be sustained. 	(6)

Question Number	Answer	Mark
12(e)	<p>Identification of two strategies (1+1), application and analysis (2+2)</p> <ul style="list-style-type: none"> • The extract refers to major cuts in Ford’s workforce by 30,000 over coming months and cutting production costs - reducing the scale of production is relevant if diseconomies of scale are being experienced or if there is excess capacity. • Renegotiate healthcare deals for employees as these costs run into billions of dollars every year. Renegotiate wage deals when labour are temporarily laid off. • The extract refers to Ford considering the sale of some of its British interests, notably Aston Martin, Land Rover and Jaguar. This will raise funds to reduce overall losses and borrowing. • Price cuts - this will increase sales and help erase any stockpile of motor vehicles. • Marketing / advertising campaign to increase demand and make more price-inelastic. • Develop new fuel efficient motor vehicles - this appears to be what consumers want as petrol prices continue to increase. <p>Evaluation (2+2 marks)</p> <ul style="list-style-type: none"> • Cutting production costs could come at expense of product quality; it may also mean Ford loses economies of scale, for example, purchasing, technical, financial & marketing economies. • Trade unions may block attempts to reduce healthcare cover for members or reduce wages for temporarily laid off members. Industrial disruption may occur. • Sale of British motor vehicle companies may provide a one-off set of funds but will not overcome the fundamental losses made in long-run. • Sale of British motor vehicle companies may be bad move if they are making profits and likely to continue to do so. • Price cuts could lead to a price war as other motor manufacturers follow. It may be difficult to end price war without engaging in collusion; price war could damage image of company’s motor vehicles. • Marketing / advertising campaign could be very expensive and not work if company still has unsuitable products, that is, larger fuel inefficient vehicles that are environmentally unfriendly. <p>Developing fuel-efficient motor vehicles takes time.</p>	(10)

Question Number	Answer	Mark
12(f)	<p>Knowledge, application and analysis for three entry barriers (2+2+2) or two entry barriers very well explained / analysed (3+3).</p> <ul style="list-style-type: none"> • High marketing / advertising costs to attract US buyers. • Strong customer loyalty to existing US motor vehicle brands. • Difficulty / costs in setting up an effective motor vehicle distribution network (dealers) around a huge country. • Difficulty in setting up a suitable network of component spare part suppliers, for example, head lights, glass, windscreen wipers, gearbox manufacturers etc. • Limit pricing by existing motor manufacturers. • Difficulty in achieving a very high level of product quality / technology for motor vehicles in US market as Chinese companies do not have a reputation in this area. • Also accept import controls placed by US government. <p>Evaluation (2+2 marks)</p> <ul style="list-style-type: none"> • Prioritise or consider magnitude of the entry barriers discussed. • Short-run versus long-run: it may take many years to overcome customer loyalty to US vehicles / gain relevant technology. • Chinese motor vehicle manufacturers might seek suitable partnership with major US firm to gain technology / customer loyalty. • Chinese motor vehicle manufacturers may focus on the cheap end of the US market and find success. • Increasing environmental regulations on motor vehicle pollution emissions could be a major obstacle to setting up. Reference could be made to California. 	(10)

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