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Mark Scheme (Results)

Summer 2015

Pearson Edexcel International Advanced Level in Economics (WEC03/01)

Unit 3: Business Behaviour

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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.

Section A: Essay questions

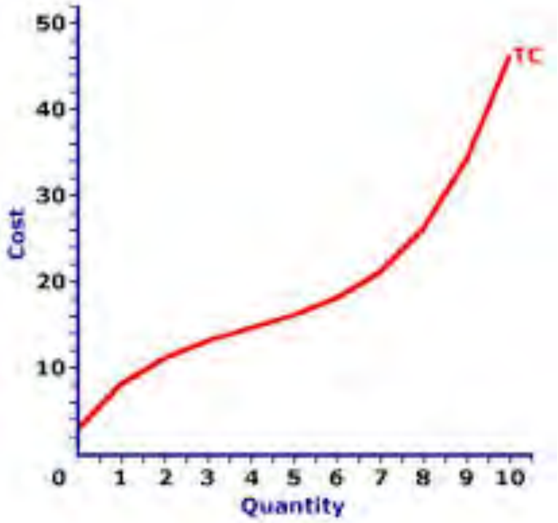
NB: Use levels based mark scheme (20 marks) to mark this section.

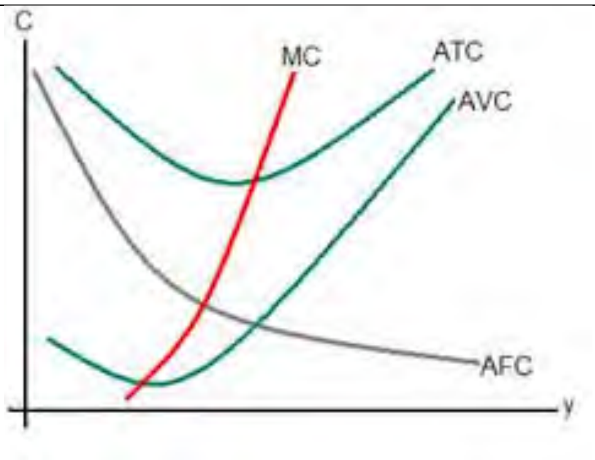
Question Number	Answer	Mark
1	**Indicative content** Definitions: public sector is owned and controlled by the government (the state), unlike the private sector which is non-government. A range of organisations in each sector – public sector includes: • government departments (e.g. typically – health, education, defence, law & order) and • more commercially oriented organisations (this will vary according to the country but may include for example, transport, postal services, utilities). Private sector organisations includes: • for profit (e.g. companies) and • not for profit (e.g. charities) Key objectives for those in the **public sector** are likely to include: • meeting people's needs – e.g. healthcare, education, housing • meeting security needs of the country – e.g. defence, law and order • providing a service to the community – e.g. public transport, social services • furthering macroeconomic objectives – e.g. full employment, redistribution of income & wealth, protection of the environment • in commercially oriented organisations the main objective may be to ensure that there is sufficient supply of the good or service at an affordable price, and a profit objective may also be apparent • references to public goods and merit goods The prime objective of most **private sector** organisations is to make a profit. This may be: • profit maximisation • profit satisficing Other objectives may include: • revenue or sales maximisation • growth • increasing market share	**(20)**

	ACCEPT DIAGRAMMATIC ANALYSIS The private sector also includes co-operatives, mutuals and not for profit organisations where the interests of its members and/or the wider needs of society will be paramount **Evaluation**: Can be significant <u>differences</u> when comparing the objectives within the 2 sectors • most organisations in the private sector must make a profit to survive in the long run, whereas public sector organisations can be financed through tax revenues so profit motive may be non- existent or less important • private sector organisations may be more geared towards being efficient in order to achieve objectives • public sector more likely to have greater emphasis on social objectives <u>Similarities</u> of objectives • Some private sector organisations are non-profit making, others may prioritise social factors e.g. co-operatives • Commercially-based public sector organisations often have a profit objective much the same as in the private sector. May be a question of the extent to which profit is an absolute requirement for survival and/or growth • Changes in emphasis within the public sector over time e.g. the impact of privatisation and the diminishing importance of nationalisation (Unit 1 development) • There may be similarities between the public and private sector **in the short run** as they may sustain losses	

Question Number	Answer	Mark
2	**Indicative content** • Explanation of merger/takeover – may include forms of integration; horizontal, vertical, conglomerate • Explanation of the term organic growth – internal expansion not through acquisitions **Benefits of organic growth (compared to merger/takeover)** • The owner(s) are likely to keep control of its operations • No likelihood of potential culture clashes • Organic growth may be cheaper and quicker. Acquisitions may be expensive and it could take a long time to recoup the costs • Lower risks associated with organic growth – merger/takeover can be into unfamiliar markets • With organic growth expansion may be at a more sensible pace for the organisation. Merger/takeover may result in a business over-expanding and incurring high fixed cost and the firm may experience greater financial problems if growth in the economy slows • Gains from economies of scale (but also true of merger/takeover) • There may be a lower risk of diseconomies of scale with organic growth • Unlikely to be adversely affected by government competition policy – regulators etc. ACCEPT DIAGRAMMATIC ANALYSIS **Evaluation** **Disadvantages of organic growth:** • Growth of the business is mainly dependent on the growth of the overall market • Harder to build market share if business is already a market leader • Slower growth than inorganic methods – shareholders may prefer more rapid growth	**(20)**

	Benefits of merger / takover • Increase market share/increased market power – especially by horizontal merger • Gain economies of scale (e.g. by combining production capacity) • Secure better distribution/control of supplies – vertical merger • Opportunities for synergy • Method of acquiring brands, patents, trademarks • Overcome barriers to entry in new markets • Opportunity to take advantage of deregulation in an industry Overall judgement • Much depends on the objectives of the owners/stakeholders – focus on short run or long run; growth or profit? **Candidates may take either perspective for KAA and the reverse perspective for evaluation.**	

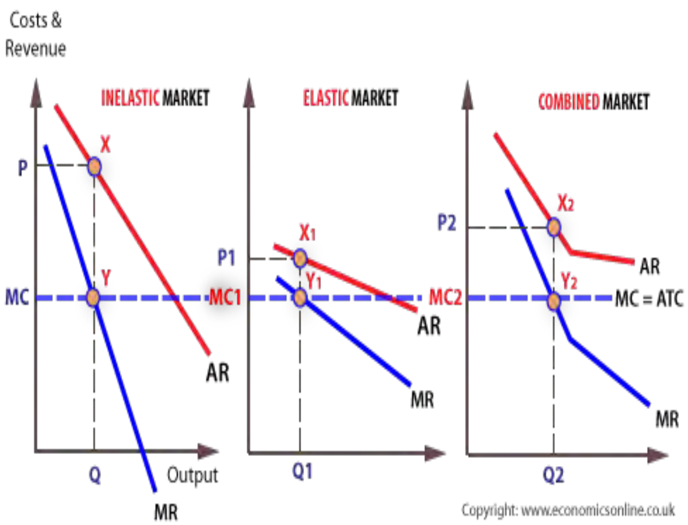
Question Number	Answer	Mark
3	**Indicative content** Explanation of diminishing marginal productivity (DMR) – as unit of variable factor(s) are added to at least one fixed factor output is rising at a slower rate. Applies only in the short run. Explanation of various costs, which may include – marginal cost, average total cost, average variable cost, average fixed cost, total cost. Analysis of the impact of DMR on cost curves may include : • Total costs will be rising at an increasing rate • Rising marginal costs • Rising average variable costs • Relationship between ATC and MC Total costs – TC rising at a faster rate due to DMR – TC curve gets steeper  MC, AVC & ATC – DMR causes MC to rise which will subsequently cause AVC & ATC to rise	**(20)**

	 Explanation – in order to continue to raise output by a given amount increasingly more units of the variable factor(s) need to be employed – hence a rising MC **Evaluation** Impact on the business may be reduced when: • Diminishing marginal returns is a **short run concept** -in the long run all factors are variable • In the long run the firm may achieve economies of scale • Fixed costs form a high proportion of total cost – continued falling of AFC as output rises counteracts any rise in MC, AVC • How relevant is the assumption of DMR? Firm may continue to achieve increasing or constant returns until a relatively high level of output is reached (falling MC) • A business may be able to offset the impact of DMR through sourcing its inputs from more than one country • A business may have factories/plant in different low-cost locations – raising output to meet changing demand but still at a low marginal cost • Rising productivity of labour, capital and/or land may offset tendency for DMR to occur	

Question Number	Answer	Mark
4	**Indicative content** Define price discrimination – where a firm is charging different prices to different users for the same product/service • Conditions necessary for Price Discrimination: -monopoly power -different PED's for different consumer groups - arbitrage: supplier is able to split, and maintain separation of, the distinct consumer groups (no switching between consumers). • Charging higher prices to those consumers whose demand is relatively inelastic and lower prices to those consumers whose demand is relatively elastic • Extraction of consumer surplus to increase producer surplus • Examples – airlines, railways, energy providers, cinema tickets, sporting event tickets **Benefits to a large business:** • Higher total profit • Increased revenue/increase size of market • More effective use of resources – e.g. for transport firms, less strain at peak times, more revenue at off peak times to cover costs • Cross-subsidisation of different business activities to avoid losses e.g. profits from peak time travel subsidises off peak travel • Profits reinvested to improve dynamic efficiency and increase long term competitiveness in the market **Benefits to consumers:** - Some consumers will be paying lower prices (elastic demand). Of particular benefit to low income groups - May result in more choice of products/service - Encourages further investment by firms which can improve quality and possibly lower prices due to effects of dynamic efficiency	(20)

Diagrammatic analysis

-Assume profit maximisation
-Output OQ and high price OP where demand is inelastic
-Output OQ1 and lower price of OP1 where demand is elastic
-Higher total profit when compared with combined market



Evaluation

The business:

- Higher revenue/profits depends on the extent to which it can maintain the conditions necessary for price discrimination to apply

- May only apply in the short run if barriers to entry are lowered and new firms are attracted into the market

- Depends on the cost of preventing arbitrage in relation to the profits gained from price discrimination

- The firm's ability to price discriminate will be diminished where: - - there are price controls set by regulatory bodies

  -there is public/media/consumer group/government pressure opposing an array of different prices

Consumers:

- Some consumers will be paying higher prices (those will inelastic demand)

- A significant number of different prices can be confusing and potentially costly for consumers who may inadvertently not choose the lowest price – problem of asymmetric information

Candidates may take either perspective for KAA and the reverse perspective for evaluation.

Section A Questions: Performance Criteria for Mark base 20		
Level 0	0	• No rewardable material
Level 1	1-4	• Displays knowledge presented as facts without awareness of other viewpoints • Demonstrates limited understanding with little or no analysis • Attempts at selecting and applying different economic ideas are unsuccessful • Material presented is often irrelevant and lacks organisation. Frequent punctuation and/or grammar errors are likely to be present and the writing is generally unclear.
Level 2	5-8	• Displays elementary knowledge of well learnt economic facts showing a generalised understanding together with limited analysis i.e. identification of points or a very limited discussion • Displays a limited ability to select and apply different economic ideas • Material presented has a basic relevance but lacks organisation, but is generally comprehensible. Frequent punctuation and/or grammar errors are likely to be present which affects the clarity and coherence of the writing overall.
Level 3	9-12	• Displays knowledge and understanding of economic principles, concepts and theories as well as some analysis of issues i.e. answer might lack sufficient breadth and depth to be worthy of a higher mark • Shows some ability to apply economic ideas and relate them to economic problems • Employs different approaches to reach conclusions • Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
Level 4	13-16	• Displays a good knowledge of economic principles, concepts and theories together with an analysis of the issues involved • Demonstrates an ability to select and apply economic ideas and to relate them to economic problems • Evidence of some evaluation of alternative approaches leading to conclusions • Material is presented in a generally relevant and logical way, but this may not be sustained throughout. Some punctuation and/or grammar errors may be found which cause some passages to lack clarity or coherence.
Level 5	17-20	• Displays a wide range of knowledge of economic principles, concepts and theories together with a rigorous analysis of issues • Demonstrates an outstanding ability to select and apply economic ideas to economic problems • Evaluation is well balanced and critical leading to valid conclusions • Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

Section B: Data response

Question Number	Answer	Mark
5(a)	**Knowledge and Application (up to 4 marks)** **Knowledge** – up to 2 marks Oligopoly (1) with **one** characteristic of oligopoly e.g. small number of dominant large firms (1). May or not be a large number of smaller firms (1). Interdependence of firms (1). High concentration ratio (1). **Application –** up to 2 marks Calculation of concentration ratio – 3 firm 63(%), 4 firm (75%), 5 firm (85%), 7 firm (95.2%). (2 marks for an accurate calculation) Figures show current account holders only, not taking into account any other form of customers (2) Rest of the banks have 4.8% between them (1) Any other valid application point - up to 2 marks	**(4)**

Question Number		Mark
5(b)	Knowledge, Application and Analysis – Indicative content	**(12)**

- Standard economic model of oligopoly predicts that the banks are less likely to conduct price competition – interest rates on loans and overdrafts, bank charges
- Model predicts non-price competition – in this case - range of financial products, quality of service, opening hours, gift cards, loyalty points, advertising
- Banks may compete by opening new branches – attempting to gain market share
- Compete through internet banking services
- Extract 1 also suggests collusion may be present in the form of interest rate fixing and a general lack of competition
- Purpose of collusion is to achieve joint-profit maximisation within a market or prevent price and revenue instability in an industry. Firms are, in effect, acting as a monopoly to consumers
- Banks may look to merge or takeover other banks in the market
- Banks may grow through diversification and lower LRAC (economies of scale)

Level	Marks	Descriptor
0	0	A completely inaccurate response.
1	1-3	Shows some awareness of how firms compete in a concentrated market. Material presented is often irrelevant and lacks organisation. Frequent punctuation and/or grammar errors are likely to be present and the writing is generally unclear.
2	4-6	Understanding of how firms compete in a concentrated market, with some application to context. Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
3	7-8	Clear understanding of how firms compete in a concentrated market, with effective application to context. Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

Evaluation – Indicative content		
	• In an oligopolistic market firms are interdependent – the actions of one firm is likely to prompt a reaction from others • Government investigations may result in banks competing more in areas such as fees for overdrafts and late payments • More competition from new entrants influence incumbent firms behaviour – pressure to become more competitive (or defensive) • Government competition policy may discourage further merger activity and collusion between banks • Non price competition methods may be costly and ineffective	

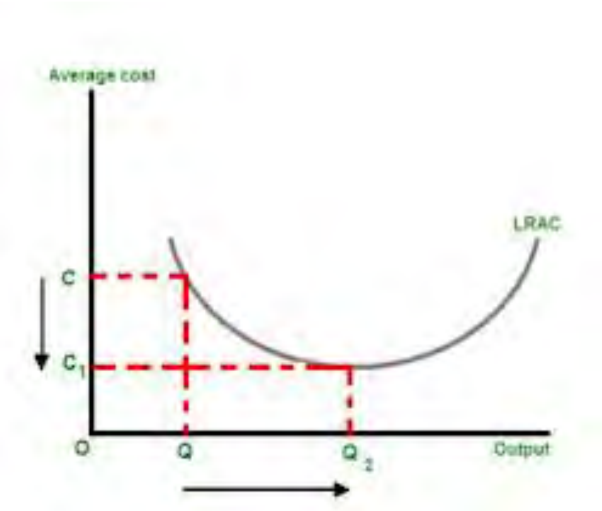
Level	Marks	Descriptor
0	0	No evaluative comments.
1	1-2	For identifying evaluative comments without explanation.
2	3-4	For evaluative comments supported by relevant reasoning.

Question Number		Mark
5(c)		**(12)**
Knowledge, Application and Analysis – Indicative content		
	• Define contestable market – one with few, if any barriers to entry and exit. Lower sunk costs. • The threat of new competitors acts as a pressure on firms to, for example,: - reduce supernormal profit/ earn normal profit – lower prices - increase output - become more efficient – be more competitive • Entry of TSB can potentially increase contestability • It automatically lowered the market share of Lloyds – the largest bank • It may have an impact on the other banks in the market and alter their market behaviour in order to become more competitive • Possibility of hit and run tactics in the market • Data refers to emergence of other new entrants – M&S, Tesco & Virgin Money • New rules making it easier for customers to switch banks provides opportunities for greater competition and contestability. A significant reduction from 8 weeks to 1 week • Trend towards more online banking may provide greater opportunities for new entrants	

Level	Marks	Descriptor
0	0	A completely inaccurate response.
1	1-3	Shows some awareness of a contestable market. Material presented is often irrelevant and lacks organisation. Frequent punctuation and/or grammar errors are likely to be present and the writing is generally unclear.
2	4-6	Understanding of a contestable market with some application. Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
3	7-8	Clear understanding of a contestable market with effective application to context. Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

Evaluation – Indicative content		
	• TSB has a relatively small market share so it may not have any significant effect on the other banks • Other new entrants (M&S etc.) are very small in relation to the dominant banks in the market • Extract 1 refers to entry and exit barriers – having small branches and cost of new technology (a sunk cost) – may leave smaller entrants at a competitive disadvantage • Contestability will depend on the degree of customer loyalty • May require government intervention (e.g. deregulation, subsidies, limits on growth of larger banks), to encourage more firms to enter the market • Can smaller banks survive in the long run? **NB: candidates may reverse KAA & Evaluation**	

Level	Marks	Descriptor
0	0	No evaluative comments.
1	1-2	For identifying evaluative comments without explanation.
2	3-4	For evaluative comments supported by relevant reasoning.

Question Number		Mark
5(d)		**(12)**
Knowledge, Application and Analysis – Indicative content		
	Size of business – may include reference to: number of branches, number of customers, annual profits, capital invested, annual revenue. Types of efficiency – productive, allocative, dynamic Benefits of being large: • Gain economies of scale – define – fall in LRAC as size of firm (bank) increases  • Larger bank able to lower AC to OC1 by increasing output from OQ to OQ1 (scale, number of branches) Application of types of economy of scale may include: • Technical – larger branch size, capital investment (unlike TSB) • Marketing – advertising economies. More choices of media • Managerial – more specialist managerial staff • Purchasing – bulk buying – equipment, office supplies etc. Consideration of productive efficiency (lowest point of AC) Larger bank has the funds to invest more in new technology – dynamic efficiency These advantages may be passed on to the consumer in the form of: - lower charges - wider range of services - more efficient service	

Level	Marks	Descriptor
0	0	A completely inaccurate response.
1	1-3	Shows some awareness of the efficiency gains of a larger firm. Material presented is often irrelevant and lacks organisation. Frequent punctuation and/or grammar errors are likely to be present and the writing is generally unclear.
2	4-6	Understanding of the efficiency gains of a larger firm, with some application to context. Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
3	7-8	Clear understanding of the efficiency gains of a larger firm, with effective application to context. Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

Evaluation – Indicative content

- Larger banks may experience diseconomies of scale – independent divisions, communication and co-ordination problems (see Extract 2)
- Large banks may become complacent and have little incentive to innovate and invest – x-inefficiency
- Quality of service may be impaired – impersonal, call centres etc. Personal service of small banks(Extract 3)
- Growth of internet banking can be a benefit to small as well as large banks – so no real advantage for large banks

NB: candidates may reverse KAA & Evaluation

Level	Marks	Description
0	0	No evaluative comments.
1	1-2	For identifying evaluative comments without explanation.
2	3-4	For evaluative comments supported by relevant reasoning.

Question Number	Answer	Mark
6(a)	**Knowledge and Application (up to 4 marks)** **Knowledge** – up to 2 marks: Rising index may be due to: A rise in the exchange rate (1) - making export prices higher (1) Inflation (1) – making export prices higher (1) Increased demand for exports (1) – exporters are able to raise prices as a result of higher demand (1) Rising costs of production (1), passed on to consumers (1) Accept any other valid point – up to 2 marks **Application** – up to 2 marks: Index of export prices grew from 83 in 2007 to 132 by 2011 (1), a difference of 49 (2) – a rise of 59% (2) Export prices rose by 32% from 2009 to 2011 (2) Accept any other valid point (2marks if valid calculation)	**(4)**

Question Number		Mark
6(b)		**(12)**
Knowledge, Application and Analysis – Indicative content		
	An understanding/definition of international competitiveness – the extent to which a country's products /services are demanded on world markets Kenya has shown signs of becoming more internationally competitive: • Rose to 96th most competitive nation in the world • Rapid development in financial markets – making it easier for savers and particularly investors in the economy • Good innovation rating – high company spending on R &D which should lead to higher productivity/efficiency • Lower non-wage costs – making Kenyan goods more price competitive • Increases in government spending on education in percentage terms- better educated population/workforce resulting in greater output & improved quality of output	

Level	Marks	Descriptor
0	0	A completely inaccurate response.
1	1-3	Shows some awareness of the concept of international competitiveness. Material presented is often irrelevant and lacks organisation. Frequent punctuation and/or grammar errors are likely to be present and the writing is generally unclear.
2	4-6	Understanding of the benefits of the concept of international competitiveness with some application to context. Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
3	7-8	Clear understanding of the concept of international competitiveness with effective application to context. Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

<table>
<tr><th colspan="4">Evaluation – Indicative content</th></tr>
<tr><td></td><td colspan="2">Kenya is not internationally competitive –
Ill heath leading to low productivity and low life expectancy
Low overall provision of education compared to middle-income countries – just 35% of population complete secondary education; 10% have never attended school
Relatively high unit labour costs – likely to make Kenyan goods less competitive unless offset by lower non-wage costs
Significant rise in index of export prices – so exports less competitive unless matched by higher export prices of competing nations (data does not show relative prices)
% figures for education spending – not spending in real terms nor per capita
Overall judgement
NB: candidates may reverse KAA & Evaluation</td><td></td></tr>
<tr><th>Level</th><th>Marks</th><th colspan="2">Descriptor</th></tr>
<tr><td>0</td><td>0</td><td colspan="2">No evaluative comments.</td></tr>
<tr><td>1</td><td>1-2</td><td colspan="2">For identifying evaluative comments without explanation.</td></tr>
<tr><td>2</td><td>3-4</td><td colspan="2">For evaluative comments supported by relevant reasoning.</td></tr>
</table>

Question Number		Mark
6(c)		**(12)**
Knowledge, Application and Analysis – Indicative content		
	• Greater levels of spending on education and training – which will raise investment in human capital and improve productivity levels. Should also result in reduction in unit labour costs • More spending on health care – healthier more productive workforce • Incentives for investment/exporters- more tax breaks for exporters, extension of the EPZ programme, lower interest rates • Deregulation – to attract FDI (Extract 2) – remove red tape, lower start-up costs. Rates of FDI/GDP (0.6%) are relatively low. Perhaps use EPZ as a model for competitiveness in other parts of the economy, not just for exporters • Protectionist measures – devalue the currency, subsidies to domestic producers, import controls • Labour market reforms- increased flexibility of labour to raise efficiency levels and labour mobility	

Level	Marks	Descriptor
0	0	A completely inaccurate response.
1	1-3	Shows some awareness of government measures to improve international competitiveness. Material presented is often irrelevant and lacks organisation. Frequent punctuation and/or grammar errors are likely to be present and the writing is generally unclear.
2	4-6	Understanding of government measures to improve international competitiveness with some application to context. Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
3	7-8	Clear understanding of government measures to improve international competitiveness with effective application to context. Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

Evaluation – Indicative content		
	• Kenyan government is already committing high proportion of spending to education. Given low rates of secondary education completion this could take many years to become effective and may prove very expensive for the government • Success in attracting FDI is also dependent on the relative attractiveness of other economies • Attracting more FDI may result in further instances of transfer pricing/tax avoidance - inflicting damage to economic well being • Lower interest rates may be inflationary • Levels of investment will depend on longer term confidence in the economy – incentives may be insufficient/ineffective where confidence is low • Opportunity cost of government spending – more on health care may mean less for business sector (at least in the short run). • Time lags of policies – e.g. tax breaks may be more effective in the short term but investment in education/health may have more long term impact • Overall judgement **NB: candidates may reverse KAA & Evaluation**	

Level	Marks	Descriptor
0	0	No evaluative comments.
1	1-2	For identifying evaluative comments without explanation.
2	3-4	For evaluative comments supported by relevant reasoning.

Question Number		Mark
6(d)		**(12)**
Knowledge, Application and Analysis – Indicative content		
	• Legal action against TNC's which break rules on transfer pricing- recover unpaid taxes from TNC's • Tightening up rules (laws) on transfer pricing – more revenue for government which can be used for the benefit of Kenya's citizens/economy • Stronger legislation and regulation of TNC activities - employment laws, job protection for employees, health & safety, minimum wages, price and profit regulation: – to alleviate poverty and exploitation, to restrict exploitation of consumers, to improve quality standards • Competition policy - controls over mergers and takeover: – to limit purchase of larger Kenyan-based businesses by foreign investors - incentives for domestic firms – to enable Kenyan firms to compete more effectively	

Level	Marks	Descriptor
0	0	A completely inaccurate response.
1	1-3	Shows some awareness of the effectiveness of policies to control the operation of TNC's. Material presented is often irrelevant and lacks organisation. Frequent punctuation and/ unclear.
2	4-6	Understanding of the effectiveness of policies to control the operation of TNC's with some application to context. Material is presented with some relevance but there are likely to be passages which lack proper organisation. Punctuation and/or grammar errors are likely to be present which affect the clarity and coherence.
3	7-8	Clear understanding of the effectiveness of policies to control the operation of TNC's with effective application to context. Material is presented in a relevant and logical way. Some punctuation and/or grammar errors may be found, but the writing has overall clarity and coherence.

Evaluation – Indicative content		
	• Some TNC's are very powerful – Kenya is not a powerful economy • Kenyan government may be concerned of the threat of TNCs pulling out of the economy – negative consequences on economic growth, jobs, incomes, competitiveness etc. • FDI is needed to attain sustainable economic growth (World Bank: Extract 2) • Difficulties in imposing national laws and regulations on transnational organisations • Unwillingness of TNCs to comply • Much may depend on the business environment in similar "rival" economies – e.g. Rwanda & Tanzania • Ranking of measures – which ones may be more effective and why? • Short term/long term impact • Kenya may be too weak to act alone	

Level	Marks	Descriptor
0	0	No evaluative comments.
1	1-2	For identifying evaluative comments without explanation.
2	3-4	For evaluative comments supported by relevant reasoning.

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