AQA A-LEVEL ECONOMICS · 7136

ECONOMICS



EXAM QUESTION PACK

3.1.3 PRICE DETERMINATION IN A COMPETITIVE MARKET

SCORE	PERCENTAGE
/376	%

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1. Apple sells iPhones and iPads at considerably lower prices in the USA than in the UK market, but sources the products from the same factories in the Far East.

Explain why firms, such as Apple, might be able to charge different prices for the same product in different markets.

[15 marks]

2. Distinguish between price elasticity of demand and income elasticity of demand, **and** analyse why, when people have medical insurance, the price elasticity of demand for medical treatment might be 'very low' while the income elasticity of demand is 'likely to be high' (**The European Union Context Extract E**, lines 22 to 24).

[9 marks]

3. Which one of the following situations would lead to an increase in equilibrium price?

A Demand is perfectly inelastic and labour costs rise ⬭

B Demand is perfectly elastic and labour costs rise ⬭

C Supply is perfectly elastic and the price of a substitute good falls ⬭

D Demand is perfectly inelastic and labour costs fall ⬭

[1 mark]

4. In recent years, the EU has decided that the agricultural sector must become 'more responsive to market forces' (**The European Union Context Extract F**, line 12).

Using the data and your economic knowledge, discuss whether UK farming would benefit from greater responsiveness to market forces and less intervention by the UK government and the EU.

[25 marks]

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5.

THE EUROPEAN UNION CONTEXT

Extract E: The price of health

The European Health Insurance Card (EHIC) is issued free to EU citizens via national governments. It allows anyone entitled to state health care in their home country to receive basic medical treatment in another member state for free or at a reduced cost. While there is no charge for the EHIC, insurance-based health care systems generally involve the purchase of a policy from a company which then pays for treatment for people whose medical conditions are covered.

The UK's National Health Service (NHS) is predominantly in the public sector and is mostly paid for out of taxation. Treatment is 'universal', available to all UK citizens, and usually to visitors as well. While there are some treatments for which charges might be made, for example, for some dental work and spectacles, a guiding principle of the founders of the NHS was that treatment should be based on 'need' rather than 'ability to pay', and provided 'free at the point of use'. In the UK there is also a private sector consisting of hospitals and other facilities. They mostly work with commercial health insurance companies, but they can undertake some work on contract for the NHS.

In Germany, private health care is used approximately twice as much by patients as it is in the UK, but this does not necessarily mean that patients pay directly for their treatment. Roughly one-third of German hospitals are owned by the state, another third are not-for-profit organisations and the remaining third are in the private sector. German citizens can use any hospital in the system.

The founders of the NHS thought that its costs would fall as living standards rose and the population became healthier. However, when the state or an insurance company acts between the patient and the health provider, the patient's price elasticity of demand for medical treatment is likely to be very low, while income elasticity of demand is likely to be high. Costs have increased due to these unusual elasticities, together with new drugs, more sophisticated medical technology, a wider range of treatments, more complex procedures and increased life expectancy.

6.

Small, independent coffee shops face competition from large multinational companies with well-promoted brands. In the High Street of a major British city, one such independent business advertises in the following way:

'Cappuccino or Pot of Tea: £1.19 before 12 noon; £1.39 during lunch time (12 − 2.30 pm); and only 99p after 2.30 pm.'

Explain how such a pricing strategy is influenced by price elasticities of demand, revenues and costs.

[15 marks]

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7. Traditional economic theory assumes that consumers make rational decisions that maximise their economic welfare, but behavioural economists disagree.

The Government would like to improve the well-being of the population by encouraging people to adopt a healthy diet. Using your knowledge of **both** traditional economic theory **and** behavioural economics, assess alternative policies that the Government might adopt to try to achieve its objective

[25 marks]

8. **THE EUROPEAN UNION CONTEXT**

Extract F: The EU milk market

Over recent decades, the governments of most industrialised countries have intervened in their agricultural markets to offer support through subsidies and other measures. In Europe, agriculture employs less than 5% of the workforce, while agricultural intervention has traditionally taken about 50% of the EU budget.

Aimed at limiting state spending on the dairy sector, controlling milk production, and stabilising both milk prices and producer incomes, the EU introduced a milk quota system in 1984 as part of the Common Agricultural Policy (CAP). Milk quotas place a limit on the amount of milk that a farmer can sell every year without paying a 'levy' or penalty to the EU. The CAP has forced dairy farmers to work below capacity and even to dump milk, damaging the EU's reputation for economic efficiency.

The EU plans to end milk quotas in 2015 and wants agriculture to be less influenced by government intervention and more responsive to market forces. As quotas are removed, farms might be expected to become fewer, larger and more intensive. In Spain, for example, the industry has been allowed three times as much milk output since 1993, while the number of dairy farms has fallen drastically and productivity has risen. Meanwhile, like the UK government, the Spanish government has intervened to try to negotiate new pricing contracts between farmers, food processors and retailers. There is always a risk that government intervention in such negotiations in any market can adversely affect efficiency.

Sources: news reports and government information, 2012

9. When a firm increases the price of its product from £50 to £55, the total revenue generated increases from £10,000 to £11,000. Over this price range, the price elasticity of demand for the product is

A elastic. ⬭

B unit elastic. ⬭

C inelastic. ⬭

D perfectly inelastic. ⬭

[1 mark]

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10. All other things being equal, a rise in which one of the following would shift an economy's short-run aggregate supply curve to the left?

A Wage rates ⬭

B Imports of consumer goods ⬭

C The money supply ⬭

D Labour productivity ⬭

[1 mark]

11. Inferior goods always have a

A positive price elasticity of demand. ⬭

B negative income elasticity of demand. ⬭

C positive cross elasticity of demand. ⬭

D negative price elasticity of supply. ⬭

[1 mark]

12. If the price elasticity of supply of a good is +4.0 and its price increases by 10%, the increase in quantity supplied is

A 0.4% ⬭

B 2.5% ⬭

C 25% ⬭

D 40% ⬭

[1 mark]

13. In 2013, two key aims of the UK Government were: to move the budget deficit towards a surplus over the course of the Parliament and to ensure that the main burden of deficit reduction would be through reduced government spending, rather than increased taxation.

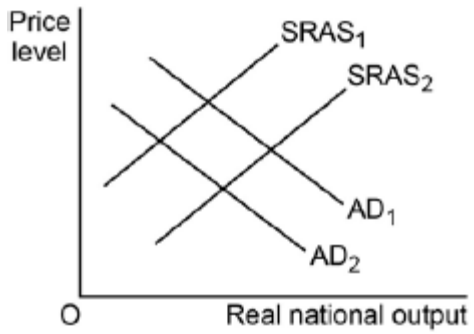
Explain the possible demand-side consequences of an increase in taxation in the UK.

[15 marks]

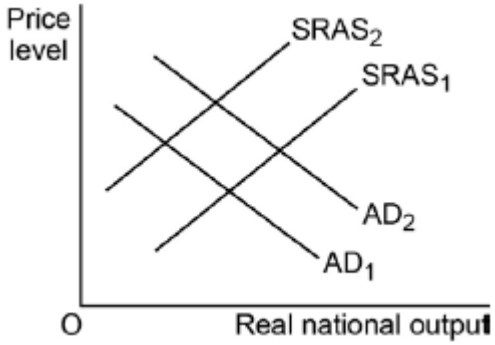
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14. The four diagrams below show aggregate demand (AD) and short-run aggregate supply (SRAS) curves for the UK economy. All other things being equal, which one of the diagrams **A**, **B**, **C** or **D** shows the most likely effects of an increase in raw material prices and an increase in income taxes on consumers?

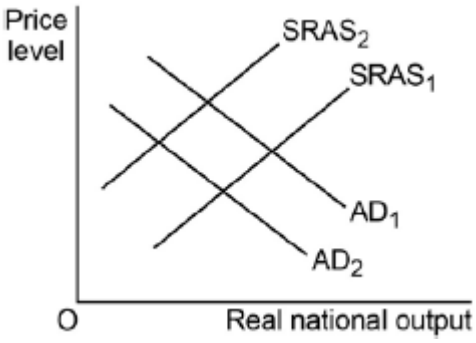
A



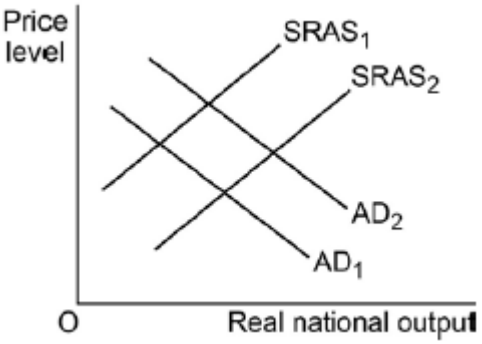
B



C



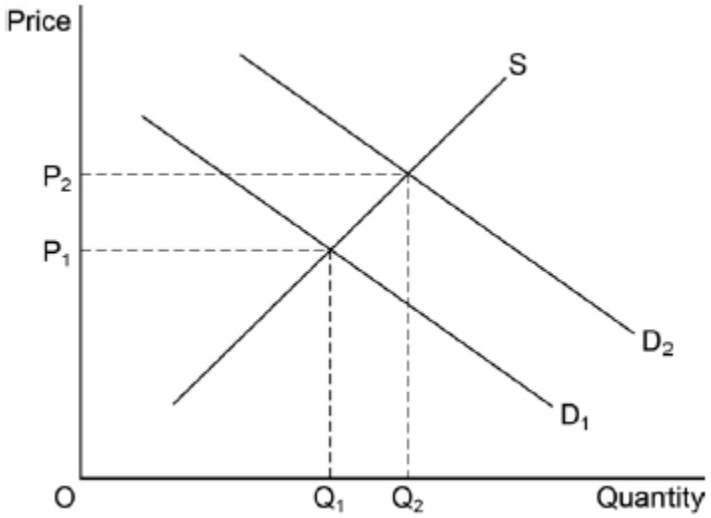
D



[1 mark]

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15. The diagram below shows the market demand and supply curves for electric light bulbs.



Assuming that electric light bulbs are a normal good, the shift in the demand curve from D_1 to D_2 and the rise in the equilibrium price from P_1 and P_2 can be explained by

A an increase in household incomes. ⬭

B an increase in the price of electricity. ⬭

C a decrease in the rate of value added tax (VAT) on light bulbs. ⬭

D the introduction of a government subsidy to the producers of light bulbs. ⬭

[1 mark]

16. It is generally accepted that we need to adopt new ways of charging for the use of our roads. This is partly because of worsening congestion, but is also due to the reduction in revenue generated from taxes on fuels as a result of more fuel-efficient vehicles.

Assess the view that a system of road-pricing is the best way to tackle the problem of worsening traffic congestion in the UK.

[25 marks]

17. **International trade Extract B** (lines 12−13) states 'The Government last night released research suggesting a US-EU agreement sweeping away trade barriers would particularly benefit the automotive, financial and chemical sectors.'

With the help of a diagram, explain the extent to which the removal of a tariff might affect the volume of imports into the UK.

[9 marks]

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18. **International trade**

Extract B: Transatlantic free trade?

David Cameron today confronted his critics by making the positive case for continuing European Union membership as he held talks with President Barack Obama over a giant US-EU trade deal that could provide a £10bn annual boost to the UK economy.

With his party in renewed turmoil over Europe, the Prime Minister sought to reassure the White House (where senior figures in the Obama administration have insisted they regard the UK as a crucial member of the union) that the UK are not looking to leave the EU.

The planned agreement would establish a free trade area between the world's two largest trading blocs, creating a transatlantic market of 800 million consumers.

Writing in today's Wall Street Journal, Mr Cameron says: "This deal could add as much as £10bn to the UK economy and £63bn to US GDP. But the rest of the world would benefit too, with gains that could generate €100bn (£84bn) worldwide".

The Government last night released research suggesting a US-EU agreement sweeping away trade barriers would particularly benefit the automotive, financial and chemical sectors. It claimed the deal could be worth £380 a year for each British family.

Karel de Gucht, the European Commissioner for Trade, has cited the deal as a prime reason for the UK staying in the EU, telling The Independent last week that it would be "clear madness" for the UK to leave in light of such a deal.

Source: Adapted from: © **www.independent.co.uk** 13 May 2013

19. Apple sells iPhones and iPads at considerably lower prices in the USA than in the UK market, but sources the products from the same factories in the Far East.

Discuss the view that price discrimination only benefits suppliers, such as Apple.

[25 marks]

20. It is generally accepted that we need to adopt new ways of charging for the use of our roads. This is partly because of worsening congestion, but is also due to the reduction in revenue generated from taxes on fuels as a result of more fuel-efficient vehicles.

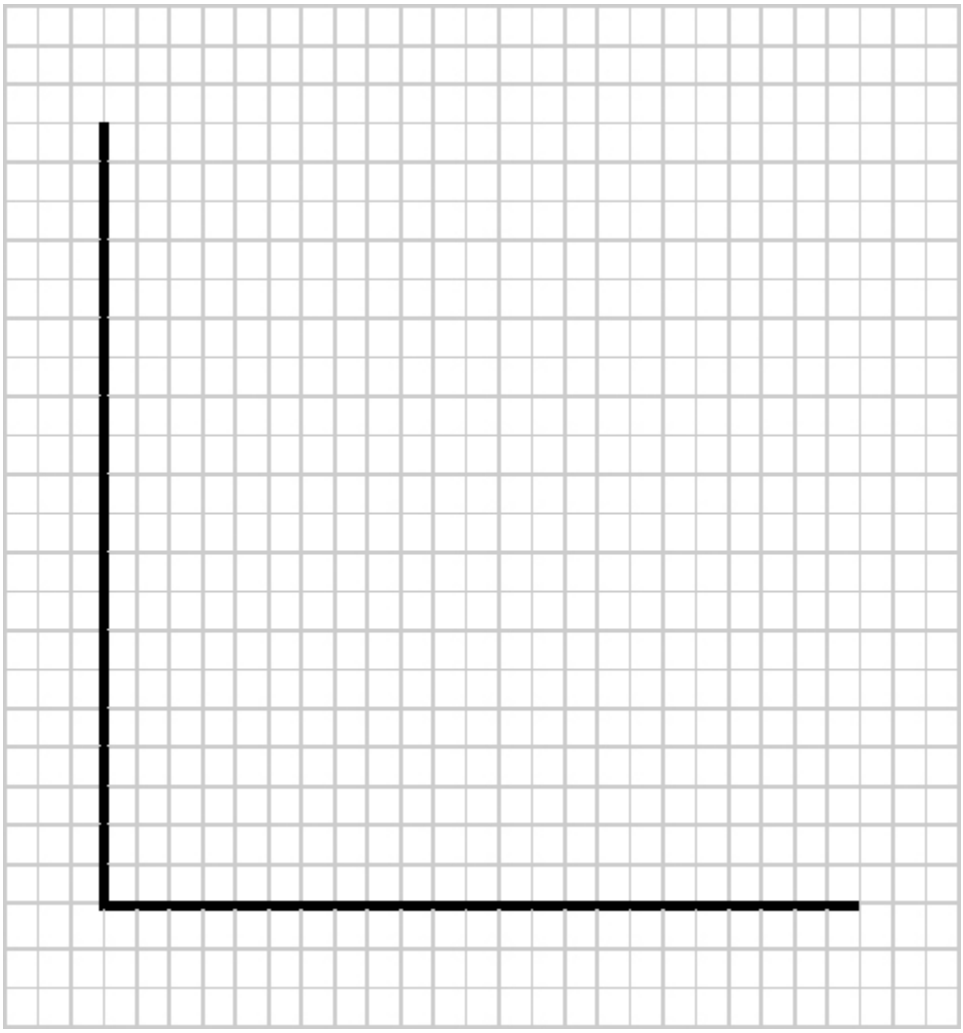
Explain why, in the absence of government intervention, too many journeys are likely to be made by road and too few by rail.

[15 marks]

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1. **Extract E** (lines 2–3) states: 'The minimum age for buying alcohol is 18, although in some countries, such as the US, the minimum age is 21'.

Draw a diagram to show the impact on the market for alcohol of raising the age for buying alcohol in the UK from 18 to 21.



[4 marks]

2. The price elasticity of demand for games consoles is -1.2. It can be concluded that a 10% reduction in their price would lead to a percentage change in demand of

A −8.3% ○

B −12.0% ○

C +8.3% ○

D +12.0% ○

[1 mark]

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3.

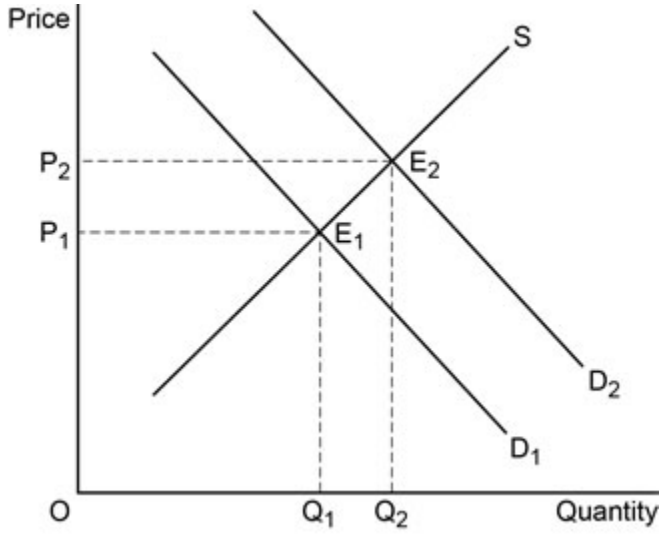
Inequality Extract F (lines 9−10) states that 'concentrating income in fewer and fewer hands eventually leads to bubble economies in which the prices of assets, such as houses and shares, rise continuously'.

With the help of a diagram, explain how growing inequality might lead to a persistent rise in the price of houses.

[9 marks]

4.

The diagram below shows the demand curves (D_1 and D_2) and the supply curve (S) in the market for good X. The initial market equilibrium is at E_1.



The increase in market demand from D_1 to D_2 results in a new market equilibrium at E_2. The market mechanism that leads to the establishment of the new equilibrium is based on

A excess demand for good X at the initial price of P_1. ⬭

B excess demand for good X at the new price P_2. ⬭

C excess supply of good X at the initial price of P_1. ⬭

D excess supply for good X at the new price P_2. ⬭

[1 mark]

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5.

Inequality

Extract F: Against inequality

The main outcome of the post-1980 experiment in neo-liberal (market) economics has been an economy that is much more divided and unhealthy, both of which are closely related. There are three powerful reasons why the global financial crisis of 2008 and 2009 had its roots in excessive concentrations of income and wealth.

First, above a certain limit of inequality, economies develop a natural tendency to deflation. In the UK and US, by cutting the purchasing power to buy the extra output being produced, the long wage squeeze has created consumer societies without enough consumers. The solution has been to allow an unsustainable increase in private debt to fill the gap.

Second, concentrating income in fewer and fewer hands eventually leads to bubble economies in which the prices of assets, such as houses and shares, rise continuously until the 'bubbles' eventually burst. From the early 1990s, the growing inequality created a global mix of increasing company profits, excessive bank lending and rapidly growing personal wealth, all of which contributed to the bubbles in property and share prices. This eventually brought the global economy to its knees.

Finally, excessive concentrations of wealth create dangerous concentrations of economic power. Corporate lobby groups, which promote the interests of the financial sector, are able to promote measures such as weak financial regulation by the state and lower taxes on the wealthy.

Source: Copyright Guardian News & Media Ltd 2011

6. At the initial market equilibrium, the income elasticity of demand for fresh chickens is +1.5, and the price elasticity of supply is +1.0. Then there is a 5% increase in consumers' income.

Which one of the following combinations, **A**, **B**, **C** or **D**, is most likely to show the changes in the market equilibrium price and quantity?

	Price	Quantity	
A	Higher	Unchanged	⬭
B	Higher	Higher	⬭
C	Unchanged	Unchanged	⬭
D	Lower	Higher	⬭

[1 mark]

7. In 2018, the UK Government will impose a new tax on sugary drinks, aimed at tackling obesity. Behavioural economists believe that taxation alone is unlikely to be very effective in reducing consumption. By 2050, obesity is predicted to affect 60% of adult men, 50% of adult women and 25% of children. It is associated with a range of health problems including type 2 diabetes, cardiovascular disease and cancer.

Evaluate the view that imposing a tax is the most effective government policy for reducing the market failures arising from overconsumption of unhealthy food and drink.

[25 marks]

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8. The World Energy Market

Extract A: What is OPEC?

OPEC is an organisation of 13 oil-producing countries. In 2015, OPEC accounted for an estimated 42% of global oil production and 73% of the world's 'proven' oil reserves, enabling OPEC to influence the price of oil. The current members of OPEC are: Algeria, Angola, Ecuador, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela.

OPEC is often cited as a classic example of a cartel, a group of independent producers who collude to increase their collective profits by limiting supply to raise prices. However, OPEC's power is reduced by the expansion of non-OPEC energy sources and by the temptation for individual OPEC countries to exceed production ceilings.

Extract B: The market for energy is changing

The energy industry is going through a period of profound change. Concerns about carbon emissions and global warming have led to policies that are shifting production away from coal towards natural gas and renewable energy. On the demand side, weaknesses in the global economy have meant that energy consumption has only grown slowly, but that will change if global economic growth picks up. The supply of energy has been affected by technological advances that have altered the range, availability and relative cost of producing different fuels. In the US, the shale revolution, allowing oil and gas to be extracted from shale by fracking, has opened up vast, new supplies of these fossil fuels. Other improvements in technology have stimulated growth in the output of renewable energy, particularly wind and solar power. The flip side of this is a fall in the demand for coal.

Changes in the supply and demand for different fuels have significant effects on relative prices. Price changes play a key role in promoting adjustments in energy markets which affect the pattern of consumption and investment in energy.

Extract C: Trends in the world market for energy

Figure 1 Energy consumption by fuel, million tonnes

	2006	2009	2012	2015	2016
Oil	3 984	3 956	4 176	4 341	4 418
Natural gas	2 573	2 676	2 997	3 147	3 204
Coal	3 294	3 476	3 817	3 785	3 732
Nuclear energy	635	614	559	583	592
Hydroelectricity	688	737	832	883	910
Other renewables	93	144	239	367	420
Total	**11 267**	**11 603**	**12 620**	**13 106**	**13 276**

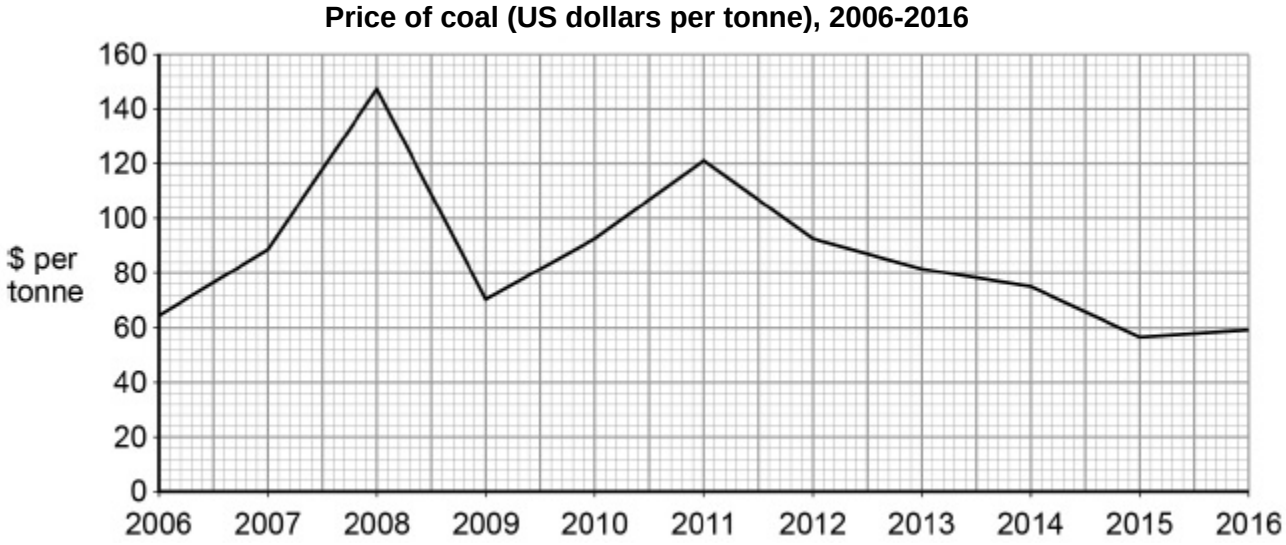
Note: Oil consumption is measured in million tonnes; other fuels in million tonnes of oil equivalent.
Oil, natural gas and coal are fossil fuels.
Other renewables include energy generated from the following renewable sources: wind, solar, geothermal, biomass and waste.

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Figure 2 Average cost of producing oil (US dollars per barrel), March 2016

	Cost ($)
UK	44.33
Nigeria	28.99
Venezuela	27.62
US shale	23.35
US non-shale	20.99
Saudi Arabia	8.98

Figure 3 The price of coal



Extract D: Falling oil prices hit the oil-exporting countries hard

In 2014, despite the rapid fall in the price of oil, Saudi Arabia and the other OPEC countries did not cut production. Some believe that they wanted to make shale oil production in the US unprofitable to weaken a growing threat to OPEC's domination of the world oil market.

A fall in oil prices leads to a contraction of the oil sector in oil-exporting countries and also has other effects on their economies. For example, in the Middle East and North Africa, oil-based revenues often account for more than half of government revenue. A significant loss of government revenue may require a substantial reduction in public spending. A decline in oil prices reduces export revenues, leading to a deterioration in the current account of their balance of payments, usually causing a depreciation in their exchange rates. This is an important mechanism through which the economy can adjust, but it makes imports more expensive, adds to inflationary pressures and is likely to reduce living standards. It may also make it difficult to attract capital inflows and to finance both the balance of payments and budget deficits.

The Nigerian economy has been hit hard by low oil prices and falling oil production. The country went into recession in 2016, with real national income contracting by 1.5%. The annual inflation rate doubled to 18.6%, reflecting the weakness of the Nigerian currency. Even after cuts in capital spending, the budget deficit increased from 3.5% of GDP in 2015 to 4.7% of GDP in 2016.

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Venezuela derives over 95% of its export earnings and almost half of government revenue from oil-related sectors. Falling oil prices aggravated Venezuela's economic crisis and it is estimated that the economy contracted by 10% in 2016 after a similar fall in real GDP in 2015. In 2016, its inflation rate was around 275%. Worsening shortages of food, medicines and other consumer goods are a symptom of the country's very fragile economy. Deteriorating public finances mean that Venezuela is a high-risk debtor, making it hard for the country to attract foreign capital. These difficulties are not all down to the fall in the price of oil. Nevertheless, a fall in the oil price makes it harder to deal with problems that are common to many less economically developed countries.

Extract E: Crisis? What crisis?

In December 2016, the members of OPEC and 11 non-OPEC countries, including Russia, agreed to cut production to 'stabilise' the oil market and raise prices. The initial agreement was for six months but has since been extended for a further nine months. So far, compliance with the production cuts has been very high at 90% and oil prices have stabilised.

The fall in the price of oil has driven some US fracking companies out of business but it has not been as damaging as predicted. Many companies have learnt how to extract more shale oil from each rig, reducing the cost per barrel. Increases in productivity reduce the break-even price of extracting oil from shale by fracking. If oil prices rise, output and investment in the industry are likely to increase again.

Recently, growth in the world economy has picked up. This will boost the demand for oil and put upward pressure on oil prices. In the long run, developments in technology that lower the cost of supplying renewable energy and producing electric cars, buses and lorries will reduce the demand for oil. A high price for oil should incentivise such developments.

INVESTIGATION

Scenario

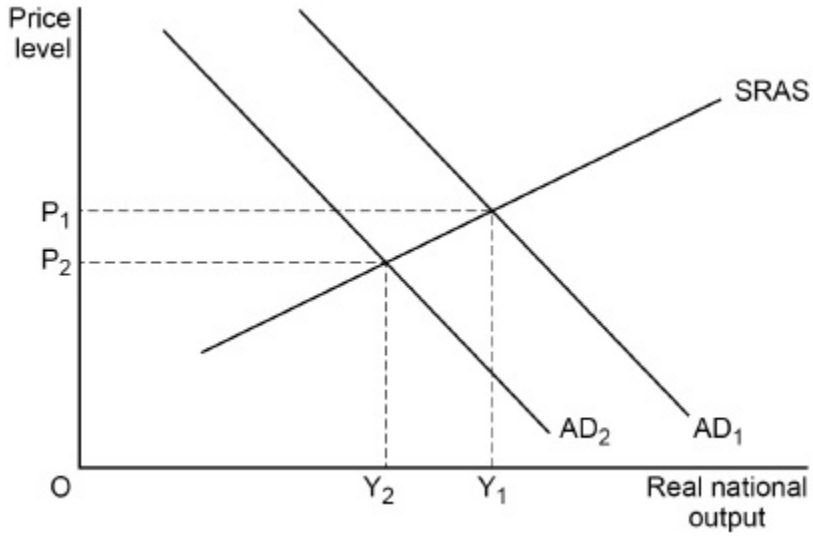
You are an economist working for OPEC (The Organisation of Petroleum Exporting Countries). You have been asked to produce a review of the world energy market.
As part of this investigation, you are to provide answer to the following question.

After considering **Extract E**, and the original evidence in **Extracts A**, **B**, **C** and **D**, would you recommend to the members of OPEC that they continue to restrict the supply of oil to try to raise the world market price of oil? Justify your recommendation.

[25 marks]

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9. The diagram below shows two aggregate demand (AD) curves and the short-run aggregate supply (SRAS) curve for an economy.



All other things being equal, the change in real national output from Y_1 to Y_2 is most likely to have been caused by an increase in the

A government's budget deficit. ⬭

B level of interest rates. ⬭

C size of the labour force. ⬭

D volume of exports. ⬭

[1 mark]

10. The price of good Y, a substitute for good X, rises from 75p to £1. As a result, the quantity of demand for good X rises from 3 million units to 5 million units per month.

What is the value of the cross elasticity of demand for good X with respect to good Y?

A +0.5 ⬭

B −0.5 ⬭

C +2.0 ⬭

D −2.0 ⬭

[1 mark]

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11. **INVESTIGATION**

Scenario

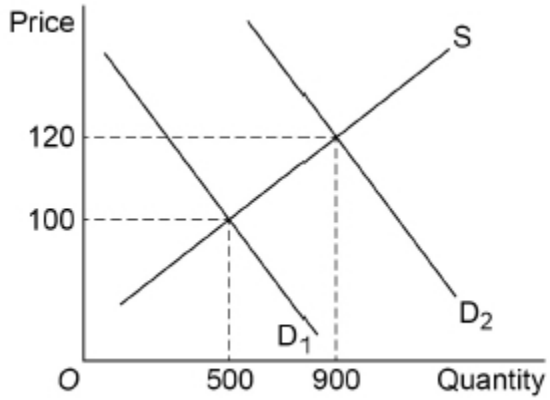
You are an economist working for the Ministry of Housing, Communities and Local Government (MHCLG).
You have been asked to investigate the state of the UK housing market.
As part of this investigation, you are to provide answers to three questions.

Referring to the **Extracts A**, **B**, **C** and **D**, use them and your knowledge of economics to help you answer this question.

Explain the likely causes of the main changes in house prices that have taken place between 2007 and 2017.

[15 marks]

12. The diagram below shows two market demand curves (D_1 and D_2) and the market supply curve (S), for Good X.



The price elasticity of supply of Good X when the demand curve shifts from D_1 to D_2 is

A +0.25 ⬭

B +2.0 ⬭

C +4.0 ⬭

D +7.5 ⬭

[1 mark]

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13. A large Asian steel-producing country dumps its surplus steel on the world market. All other things being equal, if the demand for steel is price elastic, the most likely consequence for the EU market for steel will be to

A reduce excess capacity in the EU steel-making industry. ⬭

B reduce the value of steel imports into the EU. ⬭

C shift the demand curve for EU steel workers to the left. ⬭

D shift the supply curve of EU steel workers to the left. ⬭

[1 mark]

14. **Extract B** (line 18) states that the global trade in sand has been 'made possible by cheaper transportation'.

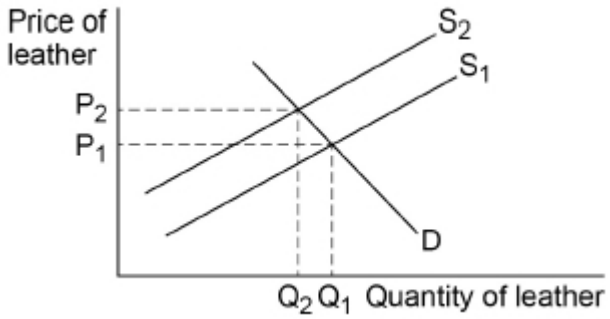
With the help of a diagram, explain how cheaper transportation **and** a construction boom in East Asia have led to growth in the market for sand.

[9 marks]

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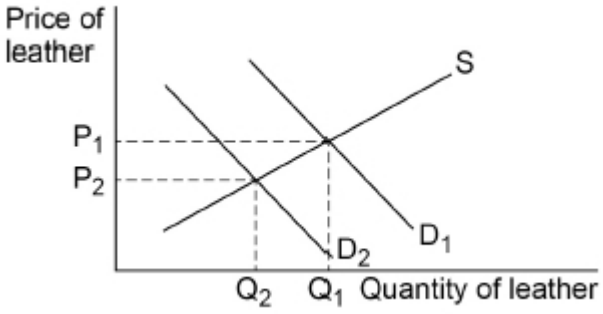
15. Beef and leather are in joint supply. Changes in farming methods have resulted in a significant fall in the price of chicken, a substitute for beef. All other things being equal, which one of the following diagrams, **A**, **B**, **C**, or **D**, best illustrates the effects of the fall in the price of chicken on the market for leather?

A



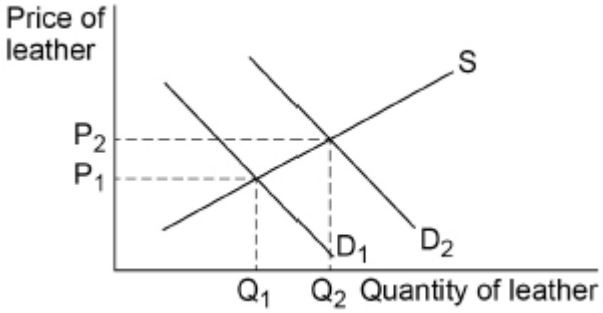
○

B



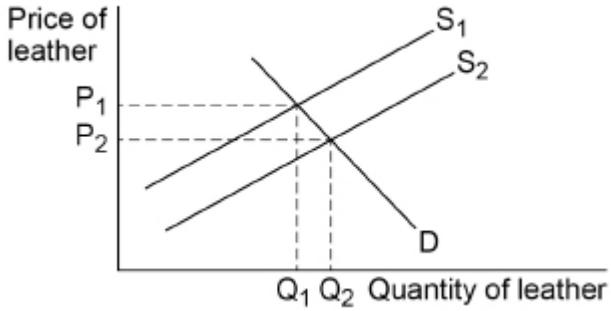
○

C



○

D



○

[1 mark]

16. 'Each time the Government imposes a minimum price or wage, the result is almost always excess supply. What matters is the extent to which this is a problem.'

Explain how the impact of a minimum price for a good or service is affected by its price elasticity of demand and its price elasticity of supply.

[15 marks]

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17. Explain how the data in **Extract D** (Figure 2) show that in the UK, between 2004 and 2017, changes in the demand for rail travel contributed to changes in the price of rail travel.

[4 marks]

18. Explain how the data in **Extract A** (Figures 1 and 2) show that expansion in the global sand market is leading to prices of construction sand rising in real terms.

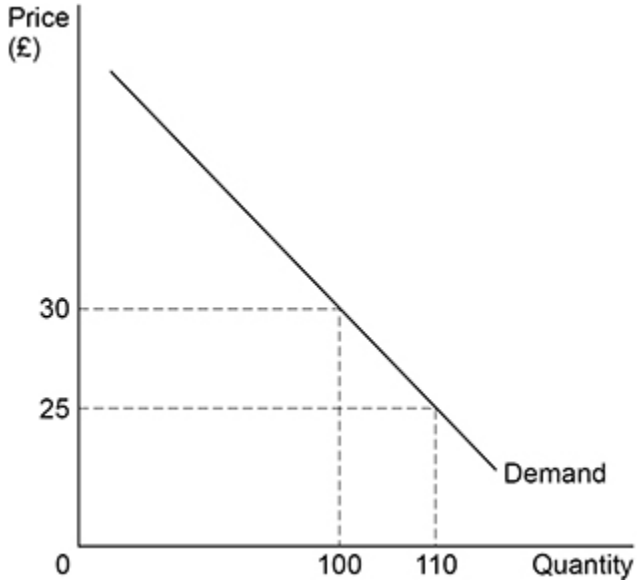
[4 marks]

19. In December 2018, the Competition and Markets Authority (CMA) announced a range of policies to prevent firms charging existing customers more than new customers. Firms supplying financial services, mobile phones and broadband are no longer allowed to discriminate against loyal customers renewing their contracts.

Assess the view that price discrimination is always damaging.

[25 marks]

20. The diagram below shows the demand curve for a firm's scarves.



Which one of the following statements is true when the price of scarves is reduced from £30 to £25?

A Demand for scarves is price elastic. ⬭

B Price elasticity of demand is –0.5. ⬭

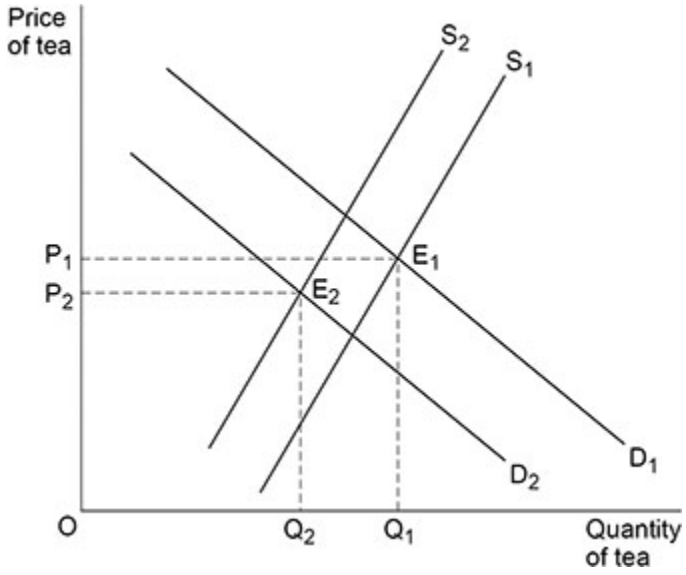
C The firm's total revenue falls. ⬭

D The firm's total revenue increases. ⬭

[1 mark]

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21. The diagram below shows two demand (D_1 and D_2) curves and two supply (S_1 and S_2) curves in the market for tea.



Tea and coffee are substitutes. All other things being equal, which one of the following is the most likely explanation of the move from E_1 to E_2 in the market for tea?

A A fall in the price of tea and a rise in productivity in coffee production ⬭

B A rise in the price of coffee and an increase in the cost of producing tea ⬭

C An increase in competition in the market for tea and a fall in the price of coffee ⬭

D The removal of a subsidy to tea producers and a fall in the price of coffee ⬭

[1 mark]

22. Vaping, the use of e-cigarettes, is argued by many UK health experts to be a much less harmful substitute than smoking tobacco cigarettes. E-cigarettes contain fewer harmful chemicals such as tar, but they still contain addictive nicotine. The industry has been attacked for promoting sales amongst teenagers. This has led to San Francisco banning the sale of e-cigarettes.

Explain how the concept of cross elasticity of demand can be used to understand the relationship between markets.

[15 marks]

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23. Which one of the following is a reason why the supply of cars is likely to be price elastic in the short run when the price of cars increases?

A Car manufacturers' stocks of unsold cars are low ⬭

B The demand for cars is also price elastic ⬭

C The marginal cost of producing cars increases significantly with output ⬭

D There is considerable spare capacity in the car industry ⬭

[1 mark]

24. Explain the factors that a commercial aircraft manufacturer, such as Boeing or Airbus, should consider when forecasting the future sales of its aircraft.

[15 marks]

25. **Essay 1**

The government has promised that everyone will be able to access superfast broadband by 2025. As more people have switched to studying and working remotely, good Internet connections have become more important. Low-income households have difficult choices to make between high-speed Internet and essential items such as food, heating and clothing.

Explain how the price mechanism allocates resources in a market economy.

[15 marks]

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