Please check the examination details below before entering your candidate information

Candidate surname	Other names
StemUp Model Solution	

Centre Number | Candidate Number

Pearson Edexcel Level 3 GCE

Monday 5 June 2023

Morning (Time: 2 hours)

Paper reference **9EC0/03**

Economics A

Advanced

PAPER 3: Microeconomics and Macroeconomics

You do not need any other materials.

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- There are two sections in this question paper.
- In Section A, answer **all** questions 1(a) to 1(c) and **one** question from 1(d) or 1(e).
- In Section B, answer **all** questions 2(a) to 2(c) and **one** question from 2(d) or 2(e).
- Answer the questions in the spaces provided
  – *there may be more space than you need.*

Information

- The total mark for this paper is 100.
- The marks for **each** question are shown in brackets
  – *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Check your answers if you have time at the end.

Turn over ▶

P72982A

©2023 Pearson Education Ltd.
N:1/1/1/1

P 7 2 9 8 2 A 0 1 3 6

Pearson

SECTION A

Read Figures 1 and 2 and the following extracts (A and B) before answering Question 1.

Answer ALL Questions 1(a) to 1(c), and EITHER Question 1(d) OR 1(e).

Write your answers in the spaces provided.

You are advised to spend 1 hour on this section.

Question 1

The UK economy

Figure 1: UK gas prices in pence per therm, August 2002 to August 2022

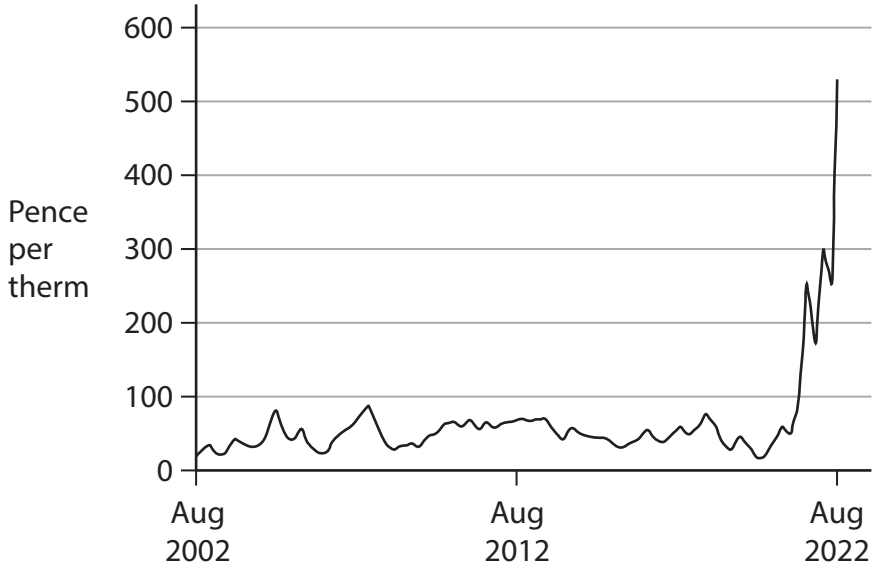
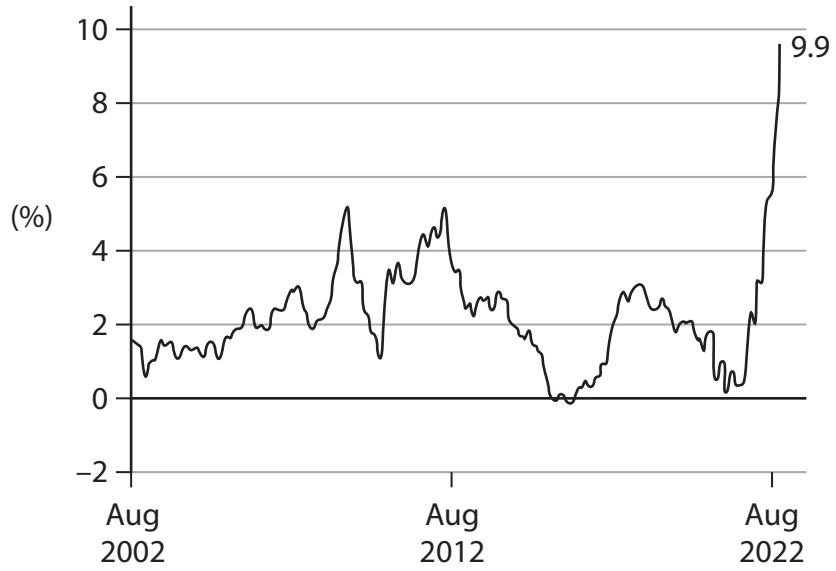


Figure 2: UK inflation, CPI, August 2002 to August 2022



DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Extract A

Fiscal policy changes in the UK, Autumn 2022

After many changes in policy, people earning above £150 000 will now no longer benefit from the tax cut in the September 2022 mini-budget, which proposed the removal of the 45% tax band. The proposed change in the main 20% standard rate of income tax moving to 19% has been postponed.

In April 2022, a 1.25% rise in national insurance contributions was implemented, labelled as a health and social care levy. It was cancelled in Autumn 2022. Britain's poorest households would have lost £7.56 a year from the national insurance rise. The richest 10% of households, earning an average of £108 000, would have lost £1 800.

Another measure in the Truss Government's £30 billion tax cut proposals that would have benefitted the rich, was the removal of the 2023 planned rise in corporation tax from 19% to 25%. The former chancellor wanted to cut the tax to 15% but this was the wrong time to do this. The former chancellor also removed the 2014 cap on bankers' bonuses, clearly an unfair decision at the time when public sector workers were told to accept pay caps to keep inflation under control.

The reflationary fiscal policy triggered warnings that the Monetary Policy Committee of the Bank of England would raise interest rates further – having already raised them from 0.1% in 2021 to 2.25% in September 2022. This meant an end to the fiscal rules set by the government in the recent past: debt to be falling as a share of national income by 2024 and no borrowing for day-to-day spending.

(Source: adapted from 'Tax cuts benefit high income earners the most' R Merrick The Independent: 19 September 2022 and FT Source: adapted from Sebastian Payne and Chris Giles in London 29 August 2022)

Extract B

Inequality to rise in the UK

The rising cost of living is expected to affect low-income families the most. Inflation in Autumn 2022 is expected to hit 14% for families in the poorest tenth of the income distribution, compared with 8% for families in the richest tenth, driven in large part by rising energy costs and food prices. Around half of the food consumed in the UK is imported, and the 20% fall in the value of the pound in 2022 has affected lower income groups more because food is a higher proportion of their spending. The government's decision to freeze benefits, rather than allowing them to rise in line with current inflation, means that the support provided is a real terms cut for families currently receiving high levels of benefits. A two-year freeze on energy price caps will now only last until April 2023, which would have kept the average energy bill at £2 500 rather than £3 500.

(Source: adapted from IFS Report: Living standards, poverty and inequality in the UK: July 2022 and https://www.ft.com/content/6de5b52e-64c8-4997-8939-e1c59172daa7?shareType=nongift)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

1 (a) Explain the difference between a positive and a normative statement, using an example of each from Extract A.

(5)

(b) Examine **two** reasons for the rise in inflation in the UK. Refer to the information provided in your answer.

(8)

(c) Discuss the likely impact of a rise in gas prices on a firm that uses a large amount of gas in its production process. Use a cost and revenue diagram to support your answer.

(12)

EITHER

(d) Evaluate microeconomic and macroeconomic policies that could be used to reduce inequality in the UK.

(25)

OR

(e) Evaluate the likely microeconomic and macroeconomic effects of tax cuts in the UK.

(25)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(a) Explain the difference between a positive and a normative statement, using an example of each from Extract A.

(5)

A positive statement is an objective statement of fact that can be tested against evidence and shown to be true or false. A normative statement is a subjective value judgement, based on opinion about what ought to be, so it cannot be tested or proven.

An example of a positive statement in Extract A is that the Bank of England had 'already raised them from 0.1% in 2021 to 2.25% in September 2022'. This can be checked against Bank of England data, so it is objective. Another is that 'Britain's poorest households would have lost £7.56 a year' from the national insurance rise.

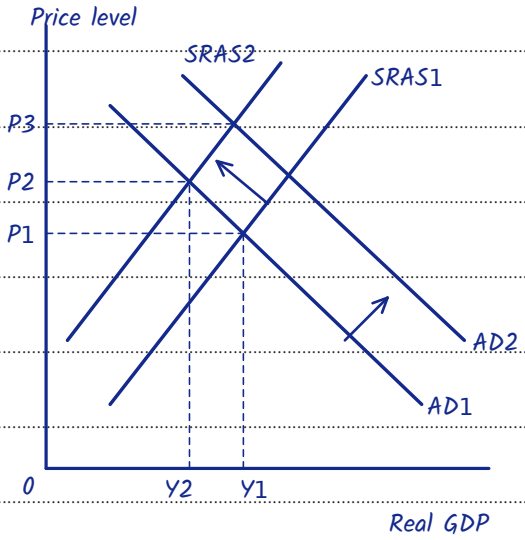
An example of a normative statement is that removing the cap on bankers' bonuses was 'clearly an unfair decision', or that cutting corporation tax to 15% came at 'the wrong time to do this'. Whether a decision is fair depends on personal values, so it is subjective and cannot be proven right or wrong.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(b) Examine **two** reasons for the rise in inflation in the UK. Refer to the information provided in your answer.

(8)

Inflation is a sustained increase in the general price level, measured in the UK by the CPI. Figure 2 shows CPI inflation rising sharply from below 1% in early 2021 to 9.9% in August 2022, far above the 2% target.



The first reason is cost-push inflation caused by rising energy prices. Figure 1 shows UK gas prices rising from below 50 pence per therm in 2020 to over 500 pence per therm by August 2022, more than a tenfold increase. Gas and electricity are inputs for almost all firms, so costs of production rise and SRAS shifts left from SRAS1 to SRAS2 in the diagram, raising the price level from P1 to P2 while real output falls from Y1 to Y2. Household energy bills also rise directly, with the average bill expected to reach £3,500 once the price cap freeze ends (Extract B), and food prices are rising.

The second reason is imported inflation from the 20% fall in the value of the pound in 2022 (Extract B). A depreciation raises the sterling price of imports, and around half of the food consumed in the UK is imported, so food prices rise. Imported raw materials and components also become dearer, adding to firms' costs and shifting SRAS further left. In addition, the reflationary £30 billion package of tax cuts, such as scrapping the rise in corporation tax from 19% to 25%, raises disposable income and consumption, shifting AD right from AD1 to AD2 and adding demand-pull pressure, so the price level rises further to P3.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

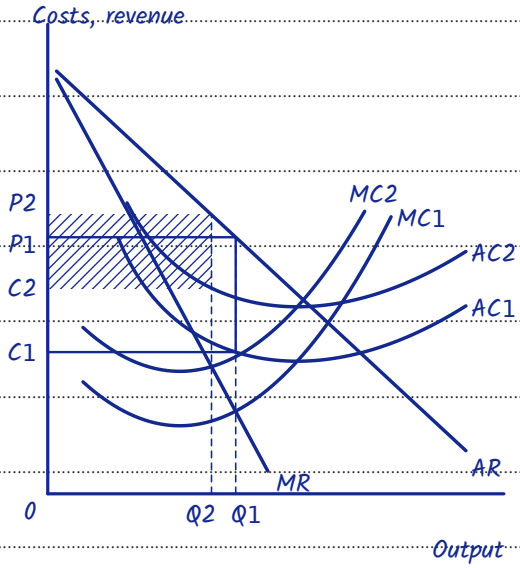
However, the energy price rise is mainly an external supply shock caused by global events, so it may be temporary: once gas prices stabilise, inflation should fall back in the long run. Cost-push factors are probably more significant than demand-pull, because the tax cuts were largely reversed and the MPC has raised interest rates from 0.1% to 2.25%, which will reduce AD after a time lag. In reality a combination of factors caused the rise, as the weaker pound made dollar-priced gas even more expensive.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(c) Discuss the likely impact of a rise in gas prices on a firm that uses a large amount of gas in its production process. Use a cost and revenue diagram to support your answer.

(12)

A firm that uses a large amount of gas, such as a glass, steel, ceramics or fertiliser manufacturer, will see its costs of production rise sharply. Figure 1 shows the gas price rising from about 50 pence per therm in 2021 to over 500 pence per therm in August 2022.



Gas used in production is a variable cost, because more gas is needed for each extra unit of output, so marginal cost and average cost both rise. In the diagram MC1 and AC1 shift upwards to MC2 and AC2. A profit-maximising firm produces where MC = MR, so output falls from Q1 to Q2 and price rises from P1 to P2. Supernormal profit falls from the outlined rectangle P1 to C1 to the smaller hatched rectangle P2 to C2, so producer surplus and profitability fall. If instead the firm's energy bill does not vary with output, it is a fixed cost and only AC shifts up: price and output stay the same but profit still falls.

The higher price passed on to consumers reduces the quantity sold, so the firm may lose market share to foreign rivals with lower energy costs, reducing its international competitiveness. Lower retained profits leave less finance for planned investment and research and development, reducing dynamic efficiency in the long run. The firm may cut costs in other areas of the business, for example through redundancies or wage freezes, or switch to alternative energy sources such as

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

renewable electricity. If price falls below average variable cost the firm will shut down; if it cannot cover average total cost in the long run it will leave the market or switch to more profitable activities.

However, the impact depends on the proportion of total costs that gas makes up: for a glass or fertiliser maker it may be over a third, but for most firms it is far smaller. It also depends on the price elasticity of demand for the product. If demand is price inelastic, or all competitors face the same cost rise, the firm can pass most of the increase on to consumers with little fall in sales; in a highly competitive market with elastic demand it must absorb the cost and profits fall further.

The firm may stay in business and make a loss in the short run, as long as price covers average variable cost, especially if it expects gas prices to fall. Time scale and volatility matter: Figure 1 shows gas prices were stable at under 100 pence per therm for almost twenty years, so the spike may be temporary, and firms that hedged with fixed-price forward contracts are protected in the short run. In the long run the firm can become more energy efficient or develop alternative fuels, but this takes time and capital. Government support, such as a price cap on business energy bills, would also reduce the impact.

Overall, the rise in gas prices is likely to reduce profits significantly for energy-intensive firms, with the greatest effect on those in competitive markets with price elastic demand that cannot switch fuel quickly.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

EITHER

(d) Evaluate microeconomic and macroeconomic policies that could be used to reduce inequality in the UK.

(25)

OR

(e) Evaluate the likely microeconomic and macroeconomic effect of tax cuts in the UK.

(25)

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 1(d)** ☒ **Question 1(e)** ☒

Write your answer here:

Question 1(d)

Inequality is the unequal distribution of income (a flow) or wealth (a stock) between households, measured by the Gini coefficient or the Lorenz curve. Extract B shows inequality is rising: inflation in Autumn 2022 is expected to hit 14% for the poorest tenth of families compared with 8% for the richest tenth, because energy and food make up a larger share of their spending.

One microeconomic policy is to raise the National Minimum Wage. This directly raises the incomes of the lowest paid, narrowing the gap between low and high earners, and increases the incentive for the economically inactive to enter work. In a monopsony labour market, such as social care, a higher minimum wage can raise both wages and employment. However, in a competitive labour market a minimum wage above equilibrium creates an excess supply of labour, so some low-skilled workers may lose their jobs, which would increase inequality. Firms may pass higher costs on as higher prices, and many of the poorest households have no one in work, so they gain nothing.

The government could also uprate benefits in line with or above inflation rather than freezing them, as the freeze is a real terms cut for families on high levels of benefits (Extract B). Targeted energy support, such as extending the energy price cap that keeps

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

the average bill at £2,500 rather than £3,500, or means-tested cost of living payments, protects the poorest from the 14% inflation they face. Benefits in kind, such as free school meals and childcare vouchers, raise real incomes and allow parents to work. However, higher benefits can create a poverty trap and reduce the incentive to work, and a universal price cap is costly and poorly targeted, because it also helps rich households with large homes.

Subsidies or maximum prices on essential goods such as food and fuel would cut the cost of living for low-income households, although a maximum price below equilibrium causes shortages and black markets, so subsidies are usually better. Restoring the cap on bankers' bonuses, which the former chancellor removed (Extract A), would limit very high incomes, but banks may simply raise basic salaries or move staff abroad.

At a macroeconomic level, fiscal policy can redistribute income through more progressive taxation. Keeping the 45% additional rate on incomes over £150,000, raising corporation tax from 19% to 25% and reinstating the national insurance rise, which would have cost the richest 10% £1,800 a year but the poorest only £7.56 (Extract A), would reduce post-tax inequality and raise revenue for public services. The Lorenz curve would move towards the line of equality and the Gini coefficient would fall. However, the Laffer curve suggests higher rates may raise less revenue than expected because of avoidance, evasion and the migration of high earners, and higher corporation tax may deter FDI and so reduce job creation.

Supply-side policies, such as spending on education, training and apprenticeships, raise the human capital and productivity of low-skilled workers, increasing their earning power and reducing occupational immobility. This shifts LRAS to the right, so growth occurs without inflation. Regional policies and infrastructure investment, for example grants to attract FDI to deprived areas, create jobs where unemployment is high and reduce regional inequality. These tackle the causes rather than the symptoms of inequality, but they are costly and

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

have long time lags. Cutting interest rates would ease loan repayments for poorer borrowers and boost employment, but with inflation at 9.9% the MPC is raising rates, so this conflicts with price stability. Trickle-down policies, such as the Truss tax cuts, aim to create growth and jobs that generate more tax to redistribute, but the evidence is weak and in the short run they mainly benefit the rich.

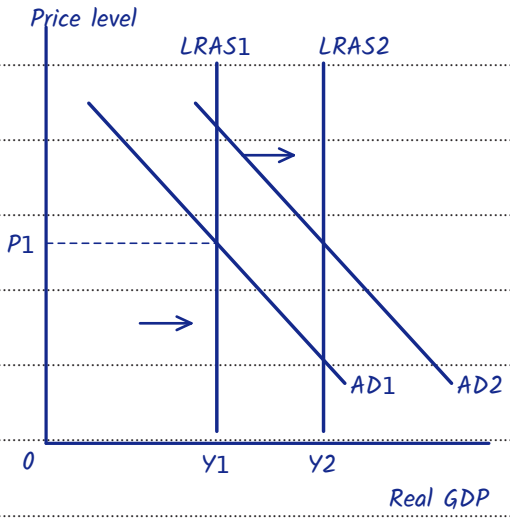
The effectiveness of these policies depends on several factors. There is a conflict between equity and efficiency: redistribution through higher taxes and benefits may reduce incentives to work and invest, slowing growth. Government failure may occur because of information gaps, administrative costs and unintended consequences. Policies also depend on whether the aim is to reduce income or wealth inequality: much UK inequality is in wealth, such as property and pensions, which income tax and the minimum wage do not affect, so wealth or inheritance taxes would be needed. In the short run targeted support is the quickest way to protect the poor from the cost of living crisis, while in the long run education and regional policy are more sustainable. Fiscal space is limited by high national debt and rising interest rates, and some inequality is inevitable and rewards work and risk taking, so it can never be removed completely.

In conclusion, the most effective approach is a combination of policies. In the short run, uprating benefits with inflation and targeted energy support, funded by a progressive tax system, protect the poorest from the 14% inflation they face; in the long run, education and training raise the earning power of low-income groups. Targeted rather than universal policies should be the priority, as they give the greatest reduction in inequality for each pound spent.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Question 1(e)

Tax cuts are a form of expansionary fiscal policy. The Truss Government proposed a £30 billion package, including removing the 45% additional rate, cutting the basic rate from 20% to 19%, cancelling the 1.25% rise in national insurance and scrapping the planned rise in corporation tax from 19% to 25% (Extract A).



Cutting income tax and national insurance raises households' disposable income, so consumers spend more. Firms selling normal and luxury goods see higher demand and revenue: where demand is income elastic (YED > 1), sales rise more than proportionately. Lower marginal tax rates also increase the incentive to work longer hours or to join the labour force, raising the supply of labour in occupations facing shortages and helping firms recruit. However, the income effect may offset the substitution effect, as workers can earn the same income in fewer hours.

Keeping corporation tax at 19% rather than 25% raises firms' retained profits, a cheap source of finance for investment in capital and research and development, increasing dynamic efficiency. In a cost and revenue diagram the profit-maximising output where MC = MR is unchanged, but post-tax profit rises. Lower corporation tax also encourages multinationals to locate in the UK, creating jobs and regenerating particular areas. Cuts in indirect taxes such as VAT or fuel duty lower firms' costs, shifting supply to the right and reducing prices. On the other hand, lower tax revenue may lead to cuts in funding for schools, hospitals and social care, reducing the quality of services used most by low-income households.

Tax cuts also affect particular markets. A cut in stamp duty, also in the mini-budget, raises demand for housing, pushing up house prices where supply is price inelastic and

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

benefiting estate agents and housebuilders. Higher retained profits may be paid out as dividends to shareholders rather than invested, limiting the supply-side benefit.

At a macro level, higher consumption and investment shift AD to the right from AD1 to AD2 in the diagram, and through the multiplier real GDP rises by more than the initial injection, reducing unemployment. If the economy is close to full capacity, however, the main effect is demand-pull inflation: with CPI already 9.9% (Figure 2), the tax cuts would worsen inflation, which is why the MPC was expected to raise interest rates further from 2.25%. Supply-side economists argue that lower income and corporation taxes increase incentives to work, save and invest, raising productivity and attracting FDI, which shifts LRAS from LRAS1 to LRAS2, so output can grow to Y2 without inflation in the long run.

Tax cuts increase the budget deficit and national debt, ending the fiscal rule that debt should be falling as a share of national income by 2024 (Extract A). Higher borrowing may crowd out private investment and raise bond yields. Cuts aimed at high earners worsen income inequality: removing the 45% rate benefits only those earning over £150,000, so the Lorenz curve moves away from the line of equality and the Gini coefficient rises, while poor households, who pay little income tax, gain little and relative poverty may rise. More spending on imports may also worsen the current account.

The effects depend on which taxes are cut. Cutting the 20% basic rate benefits far more people, many with a high marginal propensity to consume, so the multiplier is larger than for cutting the 45% rate, where much of the gain is saved. The Laffer curve suggests cutting a very high tax rate could raise revenue by reducing avoidance, but at current UK rates revenue would probably fall. Magnitude matters: £30 billion is only about 1% of GDP, and the multiplier is reduced by the UK's high marginal propensity to import. The effect also depends on the output gap and the shape of LRAS: with record vacancies the economy is near full capacity, so the cuts would be mainly inflationary. Policies may

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

conflict: the Bank of England would raise interest rates to offset the inflation, cancelling out much of the rise in AD and raising mortgage costs. Many measures were temporary or reversed, which damaged confidence, and supply-side effects take years to appear.

In conclusion, tax cuts can raise disposable income, profits and growth, but in Autumn 2022, with inflation near 10% and little spare capacity, their main effects were likely to be higher inflation, interest rates, borrowing and inequality. Targeted cuts for low earners would be more effective than cuts for the highest earners.

(Total for Question 1 = 50 marks)

TOTAL FOR SECTION A = 50 MARKS

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

SECTION B

Read Figures 3 and 4 and the extracts (C to E) before answering Question 2.

Answer ALL Questions 2(a) to 2(c), and EITHER Question 2(d) OR 2(e).

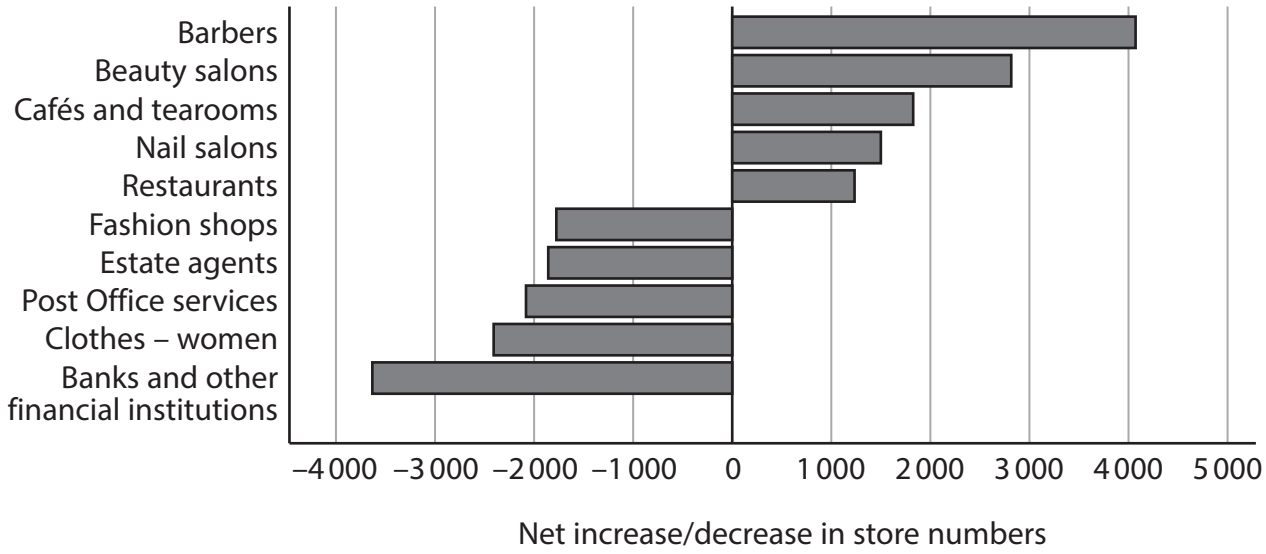
Write your answers in the spaces provided.

You are advised to spend 1 hour on this section.

Question 2

Changes in the nature of UK towns and cities

Figure 3: Growing and declining high street firms – net change in store numbers, 2013–2022



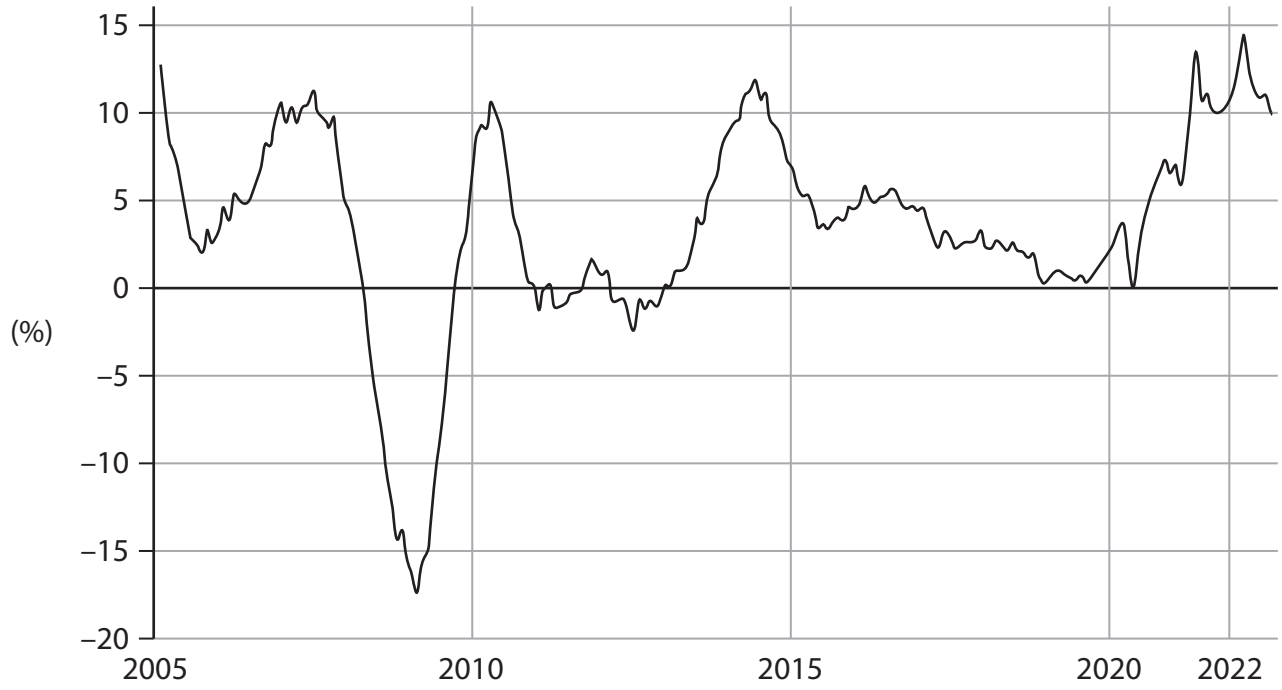
(Source: adapted from https://www2.deloitte.com/uk/en/pages/consumer-business/articles/what-next-for-the-high-street.html)

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

Figure 4: House price changes in the UK (%), 2005 to 2022



(Source: adapted from https://www.theguardian.com/money/2022/sep/28/uk-house-prices-may-fall-20-amid-mortgage-carnage-warn-experts)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Extract C

What next for the high street?

A high street is typically found in all UK towns and cities. Shops normally encountered in a typical UK high street can include successful small firms such as independent food retailers, cafés, nail and beauty salons, restaurants and charity shops. They differ from out-of-town shopping centres by being more diverse, family-run and offering local or personalised services. Customers are often very loyal. However, the high street may often have limited access by car or expensive parking facilities.

The rise of online retailers such as Amazon and eBay have placed huge pressures on UK high streets, with many well-known shops – and even successful retail chains – forced to close due to lost business. Many high street firms cannot compete on price with online retailers who – because they frequently have very low fixed costs – can significantly undercut the high street shops on price.

Even before online shopping, competition was eroding high street activity, with out-of-town retail parks that were not necessarily cheaper but provide a larger range of shops and offer plentiful parking. They offer a shopping experience that other retailing cannot match – pleasant, safe pedestrian shopping, a clean environment, fun activities for children and spend-the-day-there potential.

While the list of retail and leisure failures might suggest that the high street does not have a future, some analysts argue the opposite. Many believe that the high street is ideally placed to reinvent itself in response to the structural shift in working and shopping patterns that has resulted from the global health crisis 2020–22. The perceived weaknesses of the high street model – its fragmented ownership, lack of centralised coordination and high vacancy rates – become strengths as they lower the barriers to entry for new concepts and operators. They also enable risk taking and innovation that will ultimately lead to a more flourishing and diverse environment on our local high streets.

It should be possible for small firms to flourish even when staff shortages are pushing up wages in the high street, and house price falls damage consumer confidence and spending on perceived luxuries.

(Source: adapted from https://www.designingbuildings.co.uk/ and https://www2.deloitte.com/uk/en/pages/consumer-business/articles/what-next-for-the-high-street.html)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Extract D

UK house prices may fall up to 20%

Turmoil on the UK financial markets has prompted analysts to predict that house prices could fall dramatically, and many lenders in the mortgage sector are withdrawing deals. People coming to the end of their fixed-rate mortgages are seeing rises from 2% to over 5.5%, with increases in the cost of borrowing of over £5 200 a year by 2024 for the average mortgage in the UK. Many people think UK house prices will never fall, but analysts say the fall could be between 10% and 20%.

One mortgage lender said that a lack of housing supply will not keep house prices up when mortgage interest rates are somewhere between 5% and 7%. He claimed that 'the decade-long property bubble is about to burst […] It's a buyer's market now'. The greatest impact will be seen in the southeast of England.

(Source: adapted from https://www.theguardian.com/money/2022/sep/28/uk-house-prices-may-fall-20-amid-mortgage-carnage-warn-experts)

Extract E

UK job vacancies hit record 1.1 million as labour shortages increase

The ratio of jobless people to vacancies is 1.45 to 1, lower than at any point in the last 40 years. Social care for example has 300 000 current unfilled posts.

'Today's figures show that labour shortages are now affecting the whole economy,' said one analyst. 'There are almost a million people fewer in the labour market, largely due to younger people staying in education and older people dropping out of the workforce.' The inactivity rate is 21.1%, and many people are not returning to work after the global health crisis. 'People seeking work do not have the skills or availability that employers need,' said Kitty Ussher, chief economist at the Institute of Directors. Firms offering higher wages does not solve the issue.

(Source: adapted from https://www.ft.com/content/463f4fbd-3a50-45b5-891c-5cb5ba623df8)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

2 (a) Using the data provided in Extract D, explain **one** role of financial markets.

(5)

(b) Examine **two** reasons why retailers on the high street tend to remain small.

(8)

(c) Discuss possible methods of price and non-price competition that firms could use to increase the value of sales on the high street.

(12)

EITHER

(d) Evaluate the microeconomic and macroeconomic effects of falling house prices.

(25)

OR

(e) Evaluate the microeconomic and macroeconomic effects of labour shortages in the UK, or a developed economy of your choice.

(25)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(a) Using the data provided in Extract D, explain **one** role of financial markets.

(5)

Financial markets bring together savers and borrowers. One role is to facilitate lending to individuals and businesses, for example mortgage lenders lend households the funds to buy a house, repaid with interest over many years. This allows people to buy big-ticket items such as homes now rather than saving for decades, which raises consumption, and allows firms to borrow to invest in capital goods. Extract D shows the price of this lending changing: people at the end of fixed-rate mortgages are seeing rates rise from 2% to over 5.5%, increasing the cost of borrowing by over £5,200 a year by 2024, and many lenders in the mortgage sector are withdrawing deals. As borrowing becomes more expensive and harder to obtain, demand for houses falls, which explains why analysts predict house prices could fall by 10% to 20%.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(b) Examine **two** reasons why retailers on the high street tend to remain small.

(8)

The first reason is the limited size of the market. High street retailers such as independent food retailers, nail and beauty salons and cafés serve a local or niche market and offer local or personalised services (Extract C). Demand is limited to customers living nearby, so these firms cannot grow large enough to benefit from economies of scale such as bulk buying. They therefore have higher unit costs and 'cannot compete on price with online retailers' such as Amazon and eBay, which have very low fixed costs, so they are unable to increase sales and grow. Limited access by car and expensive parking further restrict the number of customers they can attract.

The second reason is owner objectives and access to finance. Many high street firms are 'family-run', and the owners may prefer to remain small to keep control of the business, maintain close relationships with loyal local customers and achieve a good work-life balance, satisficing rather than maximising profit. Remaining small also avoids diseconomies of scale such as poor communication. In addition, small firms find it hard to raise finance: banks see them as risky and charge higher interest rates, especially now that rates are rising, so they cannot fund the purchase of new premises or assets.

However, the relative importance depends on whether remaining small is a choice or a constraint. For family-run salons it is mostly a choice, and Figure 3 shows service businesses are thriving, with over 4,000 more barbers and about 2,800 more beauty salons since 2013, because these services cannot be bought online. For retail shops it is a constraint caused by online competition, which may worsen in the short run as staff shortages push up

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

wages and falling house prices damage consumer confidence (Extract C). In the long run, low barriers to entry and high vacancy rates allow risk taking and innovation, so some firms may grow.

DO NOT WRITE IN THIS AREA

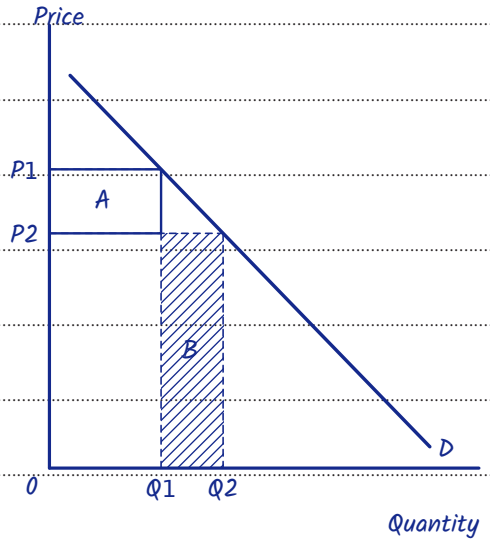
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

(c) Discuss possible methods of price and non-price competition that firms could use to increase the value of sales on the high street.

(12)

The value of sales is total revenue, price multiplied by quantity sold. High street firms face fierce competition from online retailers and out-of-town retail parks (Extract C), so they need effective price and non-price strategies to raise revenue.



One method of price competition is discount pricing, such as sales promotions or loss leaders, where a product is sold below cost to attract customers who then buy other items at full price. Whether this increases the value of sales depends on price elasticity of demand: if demand is price elastic, a cut in price causes a more than proportional rise in quantity demanded, so total revenue rises. In the diagram, cutting price from P1 to P2 on the elastic part of the demand curve raises revenue, because the revenue gained (area B) is larger than the revenue lost (area A). A firm could also aim for revenue maximisation, producing where MR = 0. Price discrimination, such as student discounts or lower prices at off-peak times in cafés and restaurants, charges each group according to its PED and increases total revenue.

However, high street firms have higher unit costs and cannot compete on price with online retailers, which have very low fixed costs (Extract C). Price cuts may start a price war: oligopoly theory and the kinked demand curve suggest rivals will match price cuts, so no firm gains market share and all lose profit. Many high street products, such as convenience goods or personalised services, are price inelastic, in which case cutting price reduces revenue, and small firms cannot

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

afford to sustain losses. Predatory pricing by larger chains could also be investigated by the CMA.

Non-price competition is likely to be more effective. High street firms can focus on customer service and personalised services, which online retailers cannot offer, building customer loyalty. Loyalty cards and local advertising, including social media, increase demand and make it more price inelastic, shifting demand to the right so firms sell more at a higher price. Product development, such as offering experiences, events and fun activities, competes with the shopping experience offered by retail parks. Firms can also develop online provision with click and collect and delivery services, reaching customers beyond the local area, and offer longer opening times or sponsor local events and teams.

However, non-price competition has costs, such as advertising and staff training, which small firms may not be able to afford, and brand loyalty takes time to develop, so short-run profits may fall. Its success depends on consumer incomes: with falling house prices damaging consumer confidence and spending on perceived luxuries (Extract C), demand for services such as nail salons may fall whatever the firm does. Figure 3 suggests that firms competing on experience and quality, such as barbers, beauty salons and cafés, have grown, while fashion shops and banks, which compete on price with online firms, have declined by about 1,800 and 3,600 stores.

Overall, a combination of strategies is likely to be most effective, but non-price competition offers more sustainable growth in the value of sales for small high street firms, since they cannot win a price war against online retailers.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

EITHER

(d) Evaluate the microeconomic and macroeconomic effects of falling house prices.

(25)

OR

(e) Evaluate the microeconomic and macroeconomic effects of labour shortages in the UK, or a developed economy of your choice.

(25)

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 2(d)** ☒ **Question 2(e)** ☒

Write your answer here:

Question 2(d)

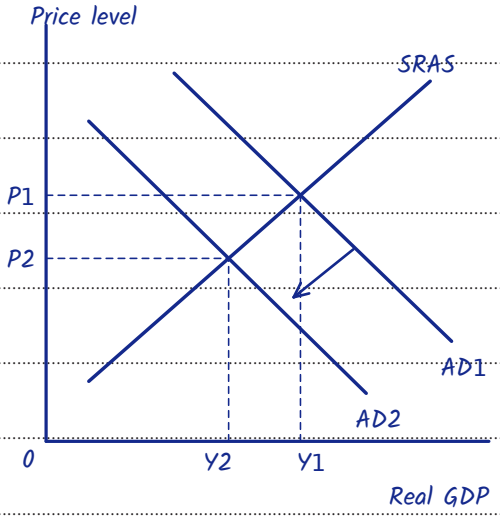
House prices are determined by the demand for and supply of housing. Figure 4 shows annual house price growth of over 10% in 2022, but Extract D predicts prices could fall by between 10% and 20% as mortgage rates rise from 2% to between 5% and 7%. The last time prices fell, in 2008 to 2009, they fell by around 17% a year.

For housebuilders, falling prices reduce revenue, profits and share prices and the incentive to build new homes, so the derived demand for construction workers falls, causing job losses in the industry. Estate agents earn commission based on the price and number of sales, so their revenue falls; Figure 3 shows estate agents have already lost around 1,800 stores. Firms selling goods linked to moving home, such as furniture, carpets and DIY products, face lower demand, and households cut back on luxuries and big-ticket items. Homeowners with large mortgages may fall into negative equity, owing more than their house is worth, so they cannot move, causing geographical immobility of labour. On the other hand, first-time buyers and buy-to-let investors can buy at lower prices in a 'buyer's market', improving affordability for younger people, and fewer houses are put up for sale.

At a macro level, the negative wealth effect is important. Housing is the main form

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

of wealth for most households, so when prices fall homeowners feel poorer, consumer confidence falls and they spend less; they can also borrow less against their homes as equity withdrawal falls. Consumption is around 60% of AD, so AD shifts left from AD1 to AD2 in the diagram, real GDP falls from Y1 to Y2 and the price level falls from P1 to P2. Through the negative multiplier, growth slows and unemployment rises, although lower AD reduces demand-pull inflation, helping bring CPI down from 9.9%.



Government finances suffer because stamp duty and inheritance tax revenues fall while spending on benefits rises, widening the budget deficit. Banks face more bad debts, which may reduce lending and cause a credit crunch as in 2008. Lower prices may reduce foreign investment in UK property, affecting the financial account of the balance of payments. Wealth inequality may fall, as homeowners lose wealth while those who rent can afford to buy.

However, the effects depend on the magnitude and duration of the fall. Figure 4 shows prices rarely fall; analysts may be wrong, and a 10% fall after a 10% rise in 2022 only returns prices to 2021 levels, so the wealth effect may be small. Prices may simply rise at a slower rate rather than fall. The impact varies by region, with the greatest effect in the southeast (Extract D), and by position on the property ladder: older outright owners are barely affected, while recent buyers with large mortgages are hit hardest.

The effect on GDP depends on the position of AD relative to LRAS: with a record 1.1 million job vacancies the economy is near full capacity, so a fall in AD may mainly reduce inflation rather than output. The fall is caused by higher interest

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

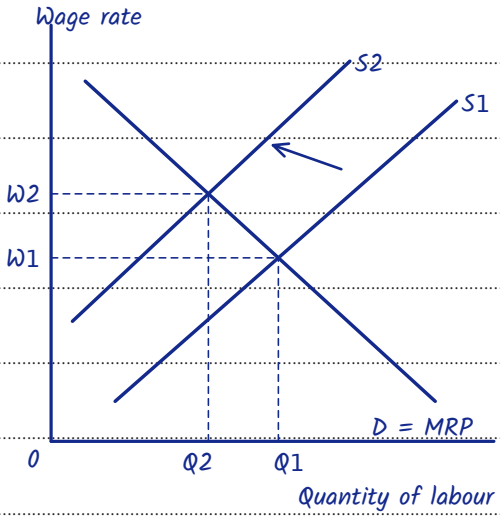
rates, so the impact depends on the MPC's decisions: if rates are cut, prices may recover. Housing supply is price inelastic in the short run, and the lack of housing supply may limit the fall in the long run. Other changes, such as the energy crisis and tax changes, may affect consumption more than house prices, and households may lack information about the value of their homes.

In conclusion, falling house prices are likely to reduce consumption, construction and growth, with the largest effects on recent buyers, housebuilders and estate agents in the southeast. The overall effect depends on the size of the fall and on interest rates, but a moderate fall could help cool inflation and improve affordability for first-time buyers.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Question 2(e)

A labour shortage exists when the demand for labour exceeds its supply at the current wage, shown by unfilled vacancies. In the UK, job vacancies hit a record 1.1 million, the ratio of jobless people to vacancies is 1.45 to 1, the lowest for 40 years, and the inactivity rate is 21.1% (Extract E).



Firms must offer higher wages to attract workers. In the diagram, the supply of labour falls from S1 to S2, so the wage rises from W1 to W2 and employment falls from Q1 to Q2. Higher wages raise firms' costs: MC and AC shift upwards, reducing profits, and some firms may close or cut opening hours; Extract C notes staff shortages pushing up wages on the high street. Services may not be provided at all: social care has 300,000 unfilled posts, which lengthens hospital waiting lists because patients cannot be discharged. Firms may substitute capital for labour, investing in automation such as self-service checkouts, or relocate to areas or countries where labour is available. Workers benefit from higher wages and better conditions, and firms have an incentive to train staff.

At a macro level, rising wage costs shift SRAS left, causing cost-push inflation and adding to CPI inflation of 9.9%, with a risk of a wage-price spiral. Higher wages also raise consumption and AD, causing demand-pull inflation. With almost a million fewer people in the labour market, productive potential is limited, so LRAS and the PPF shift inwards and growth is constrained, with a positive output gap. Higher unit labour costs reduce international competitiveness, worsening the current account. Unemployment is low and low-paid workers may gain higher wages, reducing income inequality. Higher immigration would increase labour supply and shift LRAS right.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

However, the effects depend on the type of labour. Shortages of skilled workers, such as doctors and engineers, are hard to fill in the short run because training takes years, whereas unskilled jobs may be replaced by robots. Extract E says higher wages do not solve the issue, because people seeking work lack the skills or availability employers need, which suggests the supply of labour is wage inelastic in the short run, so wages rise sharply but employment barely changes. The impact on firms depends on labour costs as a percentage of total costs: high in social care and hospitality, low in capital-intensive manufacturing. Where an employer has monopsony power wages may rise little, and firms may offer non-wage benefits such as flexible hours instead. The effect on inflation depends on the position of AD relative to LRAS.

The effects also differ between the short run and the long run. In the short run firms cannot easily replace workers, so output and service quality fall; in the long run they can invest in labour-saving technology, which raises labour productivity and may increase LRAS, so shortages can spur dynamic efficiency. Demographic factors matter too: older people dropping out of the workforce (Extract E) reflects an ageing population, a structural problem that will not reverse, while inactivity caused by long-term sickness after the health crisis may be partly temporary.

In the long run, shortages may ease as young people leave education and join the labour force, and as government policy on immigration, trade bloc membership, education, training and childcare increases labour supply. In conclusion, labour shortages raise wages and inflation and constrain growth in the short run, but their long-run effect depends on the government's response and firms' investment in capital.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(Total for Question 2 = 50 marks)

TOTAL FOR SECTION B = 50 MARKS
TOTAL FOR PAPER = 100 MARKS

BLANK PAGE

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

BLANK PAGE

BLANK PAGE

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA