Please check the examination details below before entering your candidate information

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| StemUp Model Solution | |

**Pearson Edexcel Level 3 GCE**

| Centre Number | Candidate Number |
|---|---|
| | |

# Monday 18 May 2020

| Morning (Time: 2 hours) | Paper Reference **9EC0/01** |
|---|---|

# Economics A

## Advanced

## Paper 1: Markets and Business Behaviour

**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 three sections in this question paper. Answer **all** questions from Section A and Section B. Answer **one** question from Section C.
- 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* ▶

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## SECTION A

**Answer ALL questions. Write your answers in the spaces provided.**

**Some questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.**

**You are advised to spend 30 minutes on this section.**

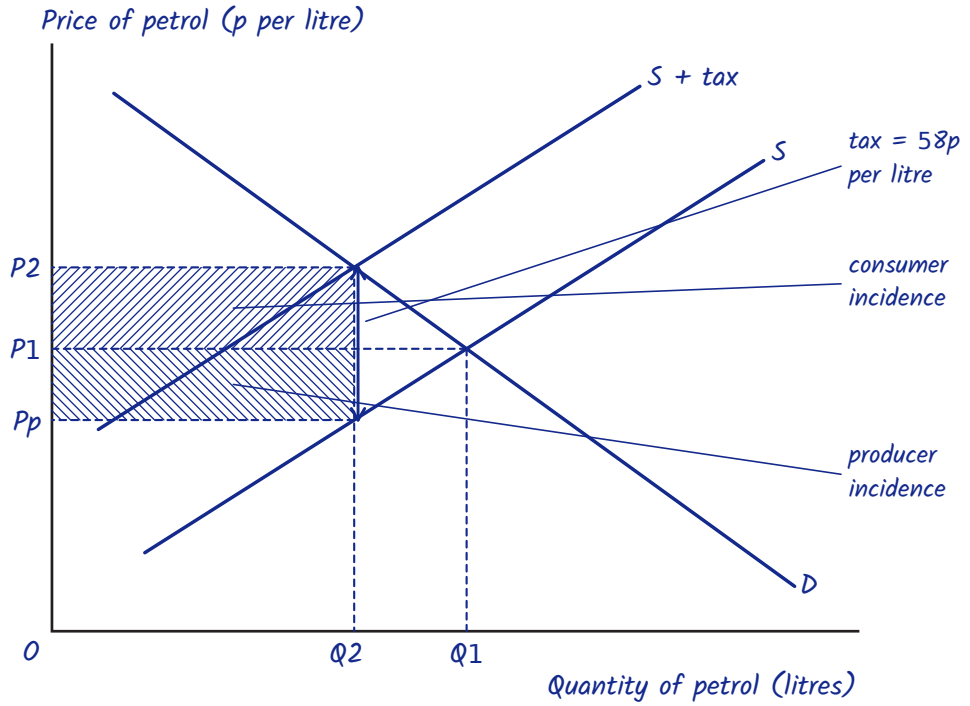
**Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.**

**1** Fuel duty is an excise tax imposed on the sale of petrol, included in the price paid by consumers, set at 58 pence per litre.

(Source: https://www.gov.uk/tax-on-shopping/fuel-duty)

(a) Draw a supply and demand diagram to show the incidence of a specific petrol tax on consumers and producers.

**(4)**




(b) The indirect tax on fuel is increased in a market in which the price elasticity of demand is –0.1. Which **one** of the following is the most likely effect on consumer and producer surplus?

**(1)**

☒ **A** Consumer surplus and producer surplus both decrease

☒ **B** Consumer surplus and producer surplus both increase

☒ **C** Consumer surplus decreases and producer surplus increases

☒ **D** Consumer surplus increases and producer surplus decreases

**(Total for Question 1 = 5 marks)**

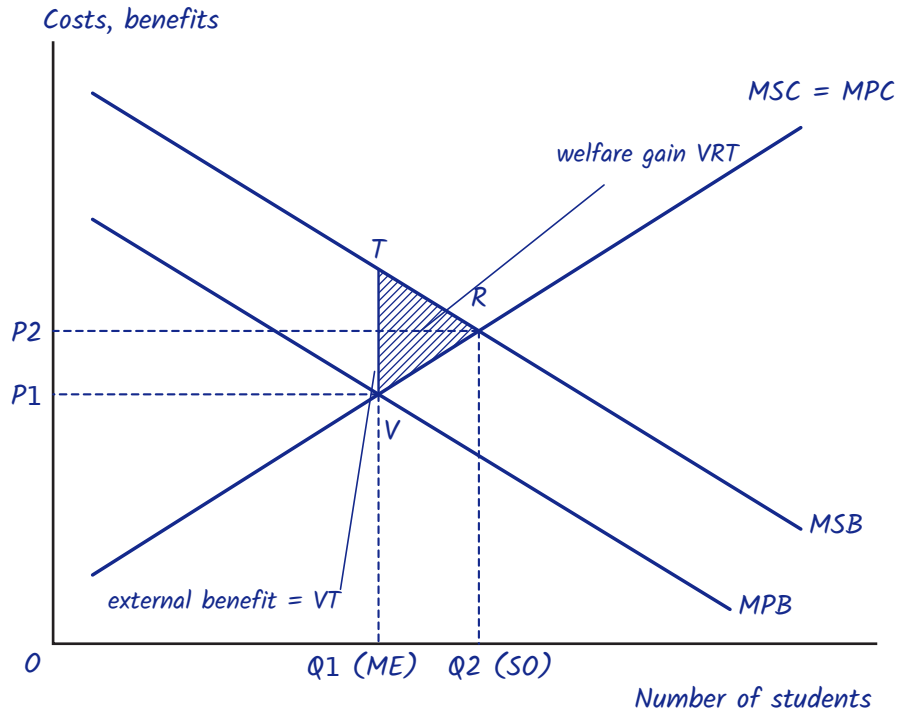
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**2** The external benefits of higher education include increased tax revenue, faster economic growth, greater innovation and labour market flexibility.

(Source adapted from: https://www.timeshighereducation.com/news/higher-education-its-good-for-you-and-society/2008681.article#survey-answer)

(a) Draw an externalities diagram to show the likely impact of the consumption of higher education.

**(4)**




(b) On average, in the UK, a working-age graduate earns approximately £10 000 more per year than a non-graduate.

(Source adapted from: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/701720/GLMS_2017.pdf)

This suggests a university degree provides a substantial

**(1)**

- ☐ **A** external benefit
- ☐ **B** external cost
- ☒ **C** private benefit
- ☐ **D** social cost

**(Total for Question 2 = 5 marks)**

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**3** The EU tradable pollution permits scheme is expected to become more effective by 2020, due to recent reductions in the number of tradable pollution permits.

(Source adapted from: https://ec.europa.eu/clima/policies/ets_en)

(a) Explain **one** likely effect of reducing the number of tradable pollution permits.

**(4)**

*Tradable pollution permits give firms the legal right to emit a set amount of pollution, such as one tonne of carbon dioxide, and firms can buy and sell unused permits in a market. Reducing the number of permits shifts the supply of permits to the left (inwards). With unchanged demand from polluting firms, such as power stations and steel producers, the price per permit is pushed up.*

*The higher price raises the cost of polluting, so firms have a market incentive to cut emissions, for example by investing in cleaner technology, so they can sell spare permits. The negative externality is reduced and output moves closer to the social optimum. If permits are auctioned, government revenue may also rise.*

(b) Regulation of firms that pollute is likely to be a problem because it

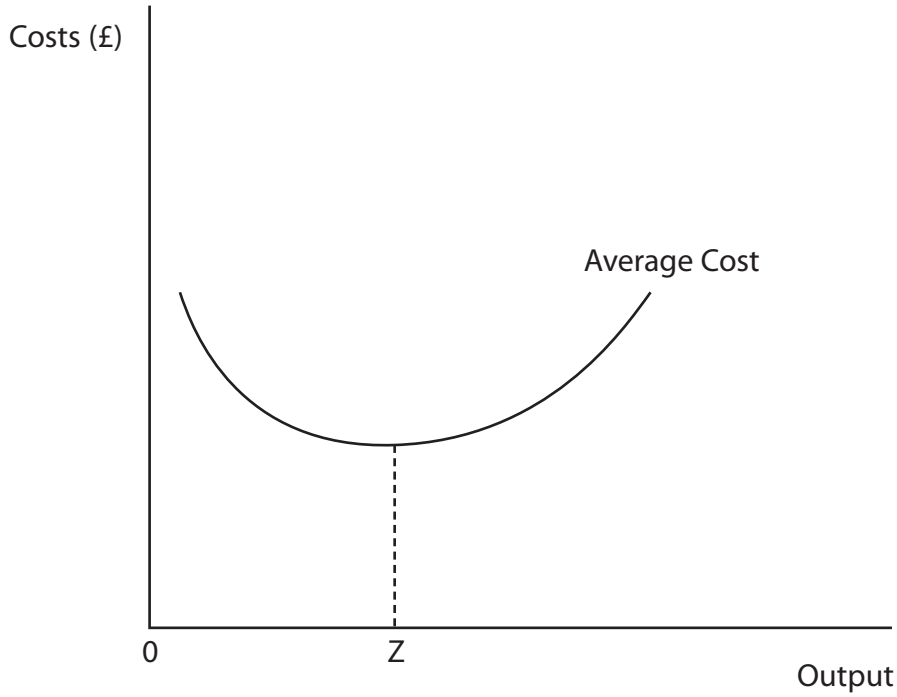
**(1)**

- ☐ **A** allows firms to use price signals
- ☒ **B** creates unintended consequences
- ☐ **C** fills information gaps for businesses
- ☐ **D** means lower administrative costs

**(Total for Question 3 = 5 marks)**

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**4** The following illustrates the daily average cost curve for a doughnut producer:




(a) Explain what happens to total cost at output levels greater than Z.

**(2)**

*Beyond Z marginal cost is greater than average cost (which is why AC rises), so each extra doughnut adds more to total cost than the one before. Total cost therefore continues to rise, and at an increasing rate (more steeply), due to diminishing marginal returns.*

(b) At output levels greater than Z, which **one** of the following correctly identifies what will happen to the cost?

**(1)**

| | | Average fixed cost | Average variable cost | Marginal cost |
|---|---|---|---|---|
| ☐ | **A** | Falls | Falls | Rises |
| ☒ | **B** | Falls | Rises | Rises |
| ☐ | **C** | Rises | Rises | Falls |
| ☐ | **D** | Rises | Rises | Rises |

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(c) For a luxury doughnut producer the average selling price is £2. The average variable cost is 40% of the selling price and its fixed cost per day is £300. Calculate total costs per day assuming it produces 400 doughnuts per day.

**(2)**

*Average variable cost = 40% × £2 = 0.4 × £2 = £0.80*

*Total variable cost = £0.80 × 400 = £320*

*Total cost = TVC + TFC = £320 + £300*

*Total cost = £620 per day*

**(Total for Question 4 = 5 marks)**

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**5** 'Bettys' is a luxury café, first opened in Harrogate in 1919 specialising in afternoon tea service. Since then it has opened a further five branches in Yorkshire. It has no plans to increase the number of cafés. The six branches have 2 million customers a year.

(Source adapted from: https://www.forbes.com/sites/sarahturner/2018/03/22/the-famed-yorkshire-cafe-that-blends-nostalgia-with-profits-and-conservation/#7eb50cec7a4e)

(a) Explain **one** likely reason why this business has remained small.

**(2)**

*The owners may wish to maintain control of the business and its exclusive, luxury image. With 2 million customers a year across six branches they already earn enough profit, so they profit satisfice rather than expand, which would also risk managerial diseconomies of scale and a less personal service.*

(b) Explain why the previous expansion of this business could be described as 'organic growth'.

**(2)**

*The growth was internal: Bettys expanded by opening five new branches of its own in Yorkshire, probably financed by reinvesting profits from its customers, rather than through external growth such as a merger with, or takeover of, another firm.*

(c) Assume 'Bettys' merges with a major tea leaf supplier. Which **one** of the following is most likely to be an advantage as a result of this merger?

**(1)**

- ☐ **A** External economies of scale will increase efficiency
- ☒ **B** Greater control to lower prices of tea
- ☐ **C** Industrial diversification increases risks
- ☐ **D** Lower monopoly power in the café market

**(Total for Question 5 = 5 marks)**

**TOTAL FOR SECTION A = 25 MARKS**

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## SECTION B

**Read Figures 1, 2 and 3 and the following extracts (A and B) before answering Question 6.**

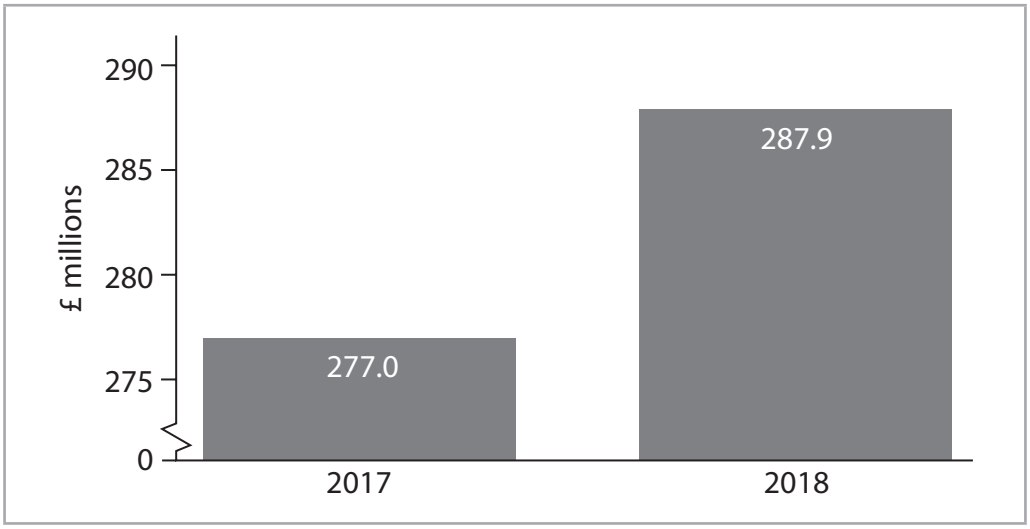
**Write your answers in the spaces provided.**

**You are advised to spend 1 hour on this section.**

**Question 6**

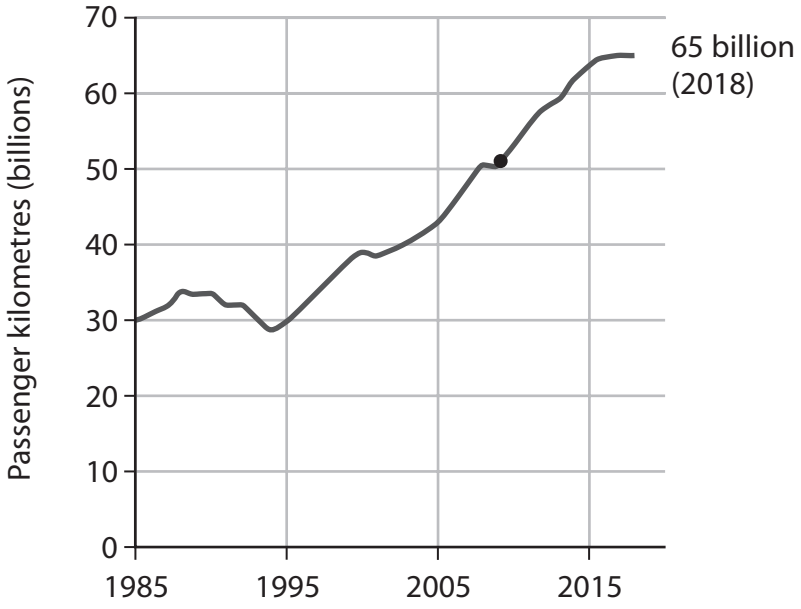
**The UK Rail Industry**

**Figure 1: UK government subsidy to Northern, a train operating company in Northern England**




(Source adapted from: https://www.theyworkforyou.com/wrans/?id=2018-10-18.181280.h)

**Figure 2: Rail passenger kilometres travelled per year in the UK, billions**




(Source adapted from: fullfact.org)

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**Figure 3: Price of a single off-peak train journey, Edinburgh to Leeds Saturday 22nd December 2018 19:00 hours**

| Adult | Young Persons (16–25) Railcard |
|---|---|
| £105.30 | £69.50 |

(Source: https://www.lner.co.uk/buy-tickets/booking-engine)

**Extract A**

**The case for nationalisation**

Privatisation has not made the rail industry cheaper to operate, despite the promise from one government source that it would see private companies bringing: "more competition, greater efficiency and a wider choice of services".

One reason, suggest the critics, is fragmentation. Instead of pushing British Rail into the private sector as a single supplier the government chose to break it into three components of track, train operators and rolling stock i.e. the trains and carriages. This has encouraged each part of the rail industry to prioritise its own profits rather than collaborating to improve the system.

Privatisation, meanwhile, never really worked. The rail network of 2 500 stations and 32 000 km of tracks was renationalised in 2001. This has encouraged the government's transport secretary, a supporter of private sector involvement, to argue that the state Network Rail monopoly should be removed so that companies can bid to build new rail lines to upgrade the railway.

The privately-owned train operators are now the subject of fierce criticism, due to overcrowding and cancelled services. Private companies are supposed to compete to win a bid to be the train operator for a region for a short number of years. However in recent years the number of private companies bidding or renewing their contract as rail operators has fallen. In May 2018 the government rescued the East Coast line by renationalising it. The line had been run by the private rail operator Virgin Rail, which was suffering lower passenger numbers and revenue than forecast.

Some argue that there is a simple solution: reunite track and train in the only feasible manner, nationalisation.

(Source adapted from: https://www.ft.com/content/d82848ca-f7ba-11e7-88f7-5465a6ce1a00)

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**Extract B**

**Southern Rail boss paid £495 000**

The Chief Executive of Southern Rail, the private-sector train operator that has become associated with delays, losses, cancellations and strikes, was paid £495 000 last year. This increased calls for nationalisation and a maximum wage for executives at companies with government contracts. In contrast the average base pay for a train driver in the UK is £47 705, although they can earn up to £63 000.

Nearly a third of Southern Rail trains were late in 2016 as it tried to deal with a labour dispute that involved extensive strike action. The rail trade unions are opposed to planned changes to the role of train guards, which they claim will put passenger safety at risk.

(Source adapted from: Rob Davies, The Guardian 10 April 2017
https://www.theguardian.com/business/2017/apr/10/southern-rail-boss-double-pay-rise)

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**6** (a) Refer to Figure 1. Explain the likely effect of the change in subsidy levels between 2017 and 2018 on rail fares.

Include a supply and demand diagram in your answer.

**(5)**

(b) With reference to Figure 2, examine **two** possible factors which may have influenced demand for rail travel since 2008.

**(8)**

(c) Assess whether complete nationalisation of the rail industry might protect employees.

**(10)**

(d) With reference to Extract A, paragraph 3, discuss whether the rail network can be considered to be a natural monopoly.

**(12)**

(e) Discuss the likely benefits of price discrimination to rail passengers. Use a diagram to support your answer.

**(15)**

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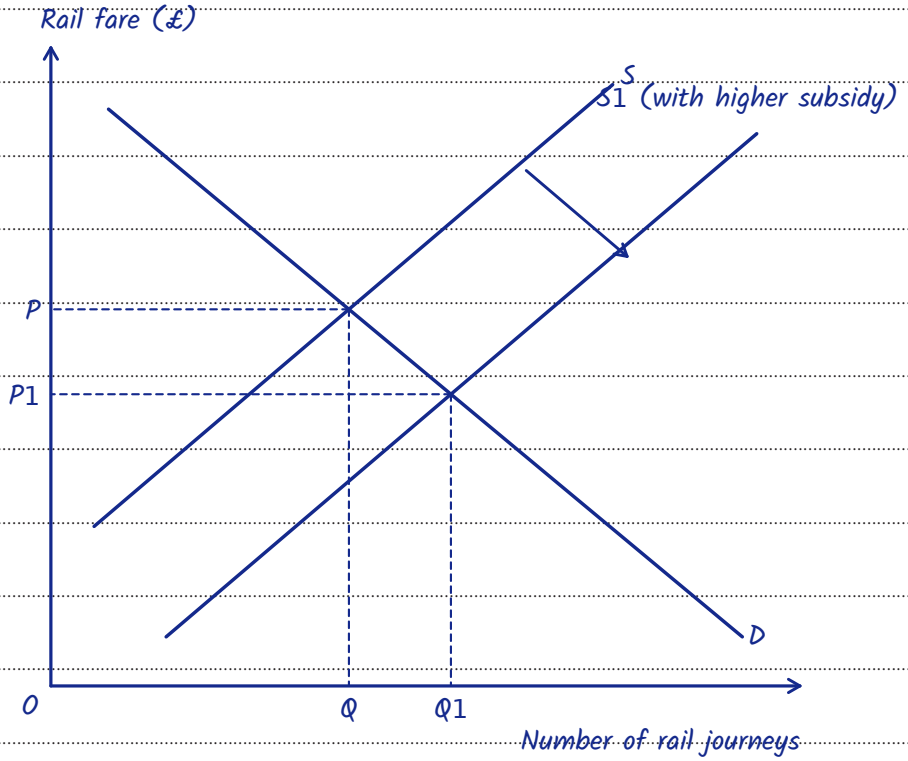
**6** (a) Refer to Figure 1. Explain the likely effect of the change in subsidy levels between 2017 and 2018 on rail fares.

Include a supply and demand diagram in your answer.

**(5)**

A subsidy is a payment from the government to producers which lowers their costs of production. Figure 1 shows the subsidy to Northern rose from £277.0 million in 2017 to £287.9 million in 2018, an increase of £10.9 million or about 3.9%.

The higher subsidy reduces the train operator's costs of running services, so the supply curve shifts to the right from S to S1. At the original fare P there is now excess supply, so fares fall to P1 and the number of journeys extends from Q to Q1. The lower costs are passed on to passengers as lower rail fares (or, as fares are linked to RPI, fares rise by less than they otherwise would have).




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(b) With reference to Figure 2, examine **two** possible factors which may have influenced demand for rail travel since 2008.

**(8)**

Figure 2 shows that rail passenger kilometres rose from about 50 billion in 2008 to 65 billion in 2018, an increase of about 15 billion or around 30%, showing a large increase in demand for rail travel.

Firstly, rising incomes. After the 2008 financial crisis and recession, the UK economy recovered and real incomes grew. Rail travel is a normal good with positive income elasticity of demand, so higher incomes increase demand at every fare, shifting the demand curve to the right. More people in work also means more commuting by train.

Secondly, the rising cost and falling attractiveness of the main substitute, car travel. The cost of motoring, including fuel, insurance and parking, has risen and road congestion has worsened, especially in cities. Rail and car travel are substitutes with positive cross elasticity of demand, so a rise in the relative cost of car travel increases demand for rail. Better quality rail services, such as on-board Wi-Fi which allows passengers to work while travelling, have also changed tastes and preferences in favour of rail.

However, the significance of these factors may be limited. Rail fares have risen every year, linked to RPI, and overcrowding, delays and cancellations, such as nearly a third of Southern Rail trains running late in 2016, reduce the attractiveness of rail. Car travel may still be cheaper for families, and the growth of home working may reduce demand for commuting. Part of the rise may also be due to population growth and people moving to commuter areas, so the importance of each factor is hard to separate.

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(c) Assess whether complete nationalisation of the rail industry might protect employees.

**(10)**

Nationalisation is the transfer of firms from the private sector into public (state) ownership. Complete nationalisation would bring together track, train operators and rolling stock under one state-owned organisation.

Nationalisation may protect employees in several ways. Firstly, job security may be greater: private train operators may cut less profitable routes or staff to increase profits, whereas the government can continue these routes for social reasons, protecting jobs. The planned changes to the role of train guards in Extract B, which unions claim will put passenger safety at risk, might be dropped, so the safety of employees and passengers may be better protected.

Secondly, trade unions may be more successful in negotiating higher wages and better conditions with the government than with private firms whose priority is profit. Rail employees would come under public sector wage setting, and inequality in pay could be reduced: the Southern Rail chief executive was paid £495 000, over ten times the average base pay of a train driver of £47 705, and a maximum wage for executives could be introduced. Better integration of track and trains, as Extract A suggests, could also lead to expansion of the rail network and so more jobs.

However, the protection may be limited. A maximum wage on executive pay could cause shortages of specialist managers, worsening the management of the railway. The government faces budget constraints: if it has to make spending cuts, there may be a lack of funds for investment, so services and staff numbers could be cut and public sector pay frozen, so wages may not rise faster than under private ownership. Without the profit incentive, nationalisation may also reduce efficiency and the 'wider choice of services', and if passenger numbers fall, employment and wages would fall in the long run.

In addition, the effect may be small because parts of the industry are already in the public

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sector: the rail network was renationalised in 2001 and the East Coast line in 2018. Strikes such as those at Southern Rail show that disputes over conditions can occur whoever owns the firm, and ownership may make little difference to executive pay. Overall, nationalisation is likely to improve job security and pay equality for ordinary rail workers in the short run, but the long-term protection depends on how far the government is willing to fund investment in the railway.

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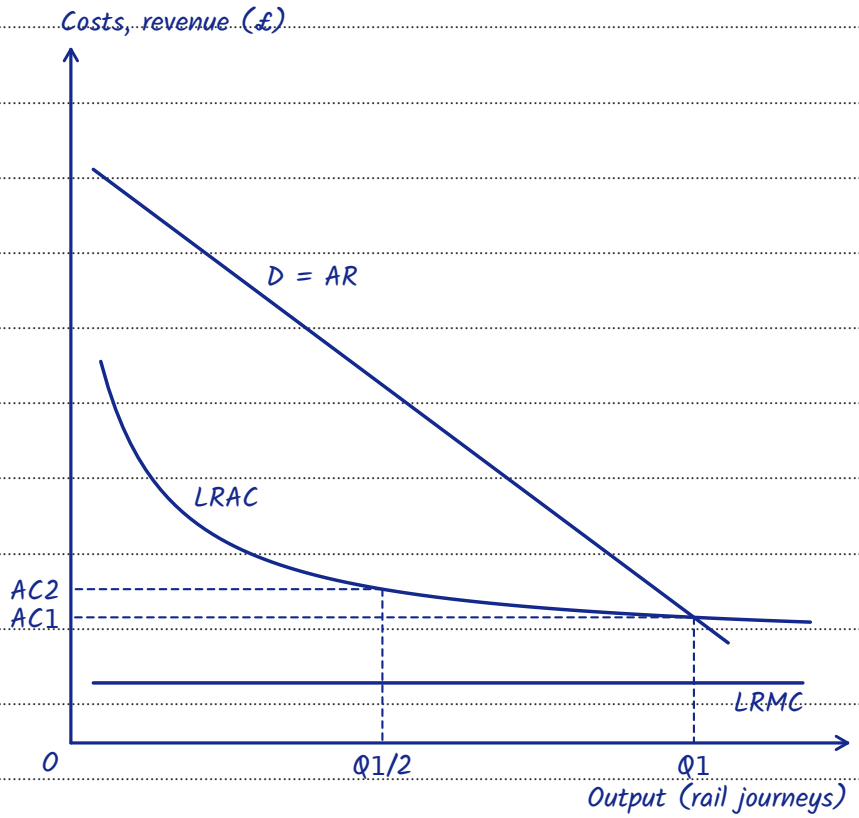
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(d) With reference to Extract A, paragraph 3, discuss whether the rail network can be considered to be a natural monopoly.

**(12)**

A natural monopoly exists when one firm can supply the whole market at a lower average cost than two or more firms could, because of very large economies of scale. The long-run average cost curve keeps falling over the whole range of market demand, so the minimum efficient scale is beyond the size of the market.

The rail network has the key features of a natural monopoly. It has enormous fixed and infrastructure costs: Extract A describes a network of 2 500 stations and 32 000 km of track, which requires huge investment to build and maintain. Once the track exists, the marginal cost of an extra train or an extra passenger is very low, so as output rises the fixed costs are spread and average cost continues to fall. In my diagram LRAC is still falling where it meets demand (AR). If one firm supplies output Q1, average cost is AC1, but if two firms each supplied half the market (Q1/2), average cost would be the much higher AC2.




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Competing networks would mean wasteful duplication of track, signals and stations, which would raise average costs and lead to higher rail fares. Only one network company can fully exploit internal economies of scale, such as technical economies from running many services on the same track, purchasing economies when buying steel and signalling equipment, and managerial economies. This helps to explain why the network was renationalised in 2001 after privatisation failed to bring 'more competition, greater efficiency'. As average cost is high relative to marginal cost, pricing at MC would cause losses, so large subsidies are needed to fund off-peak services.

However, there are arguments that the rail network is not a natural monopoly. The transport secretary argues that the state Network Rail monopoly should be removed so that companies can bid to build new rail lines, which suggests competition in building new lines is possible. Train operating companies already compete for the right to run trains on the lines, and stations or individual lines could be leased out to competing firms, making the market contestable without duplicating the whole network.

In addition, a very large single network may suffer diseconomies of scale, such as managerial slack, poor communication and x-inefficiency, which raise average costs; the closure of rail lines in the past shows that not all of the network is used efficiently. Technological advances may also allow competing rail lines to be built, and road, coach and air travel already compete with rail on many routes.

On balance, the existing track and station network is a natural monopoly, because duplicating 32 000 km of track would be extremely costly and wasteful. However, new lines and train operations on the network can be competitive, so the natural monopoly applies mainly to the infrastructure rather than to the whole rail industry.

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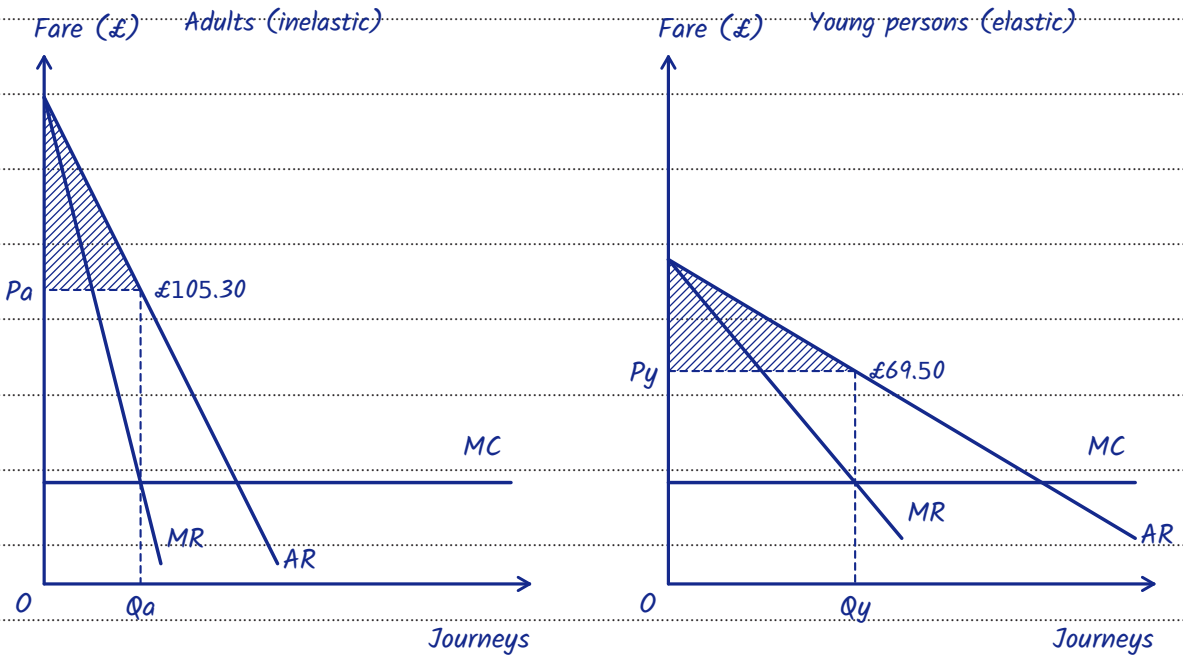
(e) Discuss the likely benefits of price discrimination to rail passengers. Use a diagram to support your answer.

**(15)**

Price discrimination occurs when a firm charges different prices to different groups of consumers for the same good or service, for reasons not related to differences in cost. The firm needs price-setting power, must be able to separate the markets to prevent resale, and the groups must have different price elasticities of demand. Figure 3 shows an example: the same off-peak journey from Edinburgh to Leeds costs £105.30 for an adult but only £69.50 with a Young Persons (16 to 25) Railcard, £35.80 cheaper.

My diagram below shows third-degree price discrimination with a constant MC. The train operator maximises profit where MR = MC in each market. Adults have relatively price inelastic demand, as many travel for work, so they are charged the higher fare Pa. Young people have relatively price elastic demand, as they have lower incomes and can use substitutes such as coaches, so they are charged the lower fare Py.

The main benefit to passengers is lower fares for young people and others with price elastic demand. With a single profit-maximising fare, set at a level such as £105.30, many 16 to




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25 year olds would not travel at all. With the discount they gain consumer surplus, and the price moves closer to the allocatively efficient level where P = MC. Lower fares also allow lower income groups to travel, for example to seek employment or to attend education.

Secondly, price discrimination can give passengers more choice. The extra revenue allows train operating companies to cross-subsidise less popular routes and to fill seats that would otherwise be empty with discount fares. Without this revenue some rail operators may make losses and go out of business, as Virgin Rail did on the East Coast line, reducing the services available to all passengers.

Thirdly, peak and off-peak pricing helps to manage demand. Higher peak fares encourage some passengers to travel at less popular times and encourage 16 to 25 year olds to travel off-peak, reducing overcrowding, which is one of the main criticisms of train operators in Extract A. Finally, the extra revenue can be invested in better customer service, such as new trains, station services, online ticketing, Wi-Fi access and improved food and drink.

However, not all passengers benefit. Adults pay £105.30, which is £35.80 more than young people, so they lose consumer surplus, which is transferred to the operator as supernormal profit; overall consumer surplus may fall, and adult fares are further from the allocatively efficient price. The benefits also depend on how the extra revenue is used: operators may pay higher dividends or executive pay, such as the £495 000 paid to the Southern Rail boss, rather than invest, and passengers still suffer delays and cancellations, with the government having to rescue operators making losses.

Off-peak trains may also become overcrowded with discounted passengers, so operators may have little incentive to keep the young persons' discount. Rail fares are partly regulated by the government, so operators are not pure price makers, which limits how far they can price discriminate, and operators may not know the exact PED of each group. Cuts in the number of guards may make it harder to check railcards, so some adults may travel illegally on discount fares.

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Overall, price discrimination brings significant benefits to young and price-sensitive passengers and can increase choice and reduce overcrowding, but adult passengers lose out. The net benefit to rail passengers as a whole depends on whether the extra revenue is reinvested in better services rather than paid out as profit.

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**(Total for Question 6 = 50 marks)**

**TOTAL FOR SECTION B = 50 MARKS**

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**SECTION C BEGINS ON THE NEXT PAGE**

## SECTION C

**Answer ONE question from this section.**

**Write your answer in the space provided.**

**You are advised to spend 30 minutes on this section.**

**EITHER**

**7** The International Energy Agency has predicted that oil use by cars will peak in 2025 because of the increasing number of drivers switching to electric vehicles.

(Source adapted from: https://www.thetimes.co.uk)

Evaluate the likely microeconomic consequences of consumers shifting from vehicles powered by fuel obtained from oil to electric-powered vehicles.

**(Total for Question 7 = 25 marks)**

**OR**

**8** 'Amazon.com, the giant online retailer, has too much power.' It uses its market power to put a squeeze on publishers, in effect driving down the prices it pays for books. If a publisher refuses, Amazon may take action by 'delaying their delivery, raising their prices, and steering customers to other publishers'.

(Source adapted from: https://www.nytimes.com)

Evaluate the likely costs of a monopsony operating in a market such as book retailing.

**(Total for Question 8 = 25 marks)**

**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 7** ☒ **Question 8** ☒

*Microeconomic consequences are the effects on individual markets, firms, consumers and workers, such as changes in prices, output, profit, welfare and efficiency. Petrol or diesel cars and electric vehicles are substitutes with positive cross elasticity of demand, while cars and fuel are complements, so a switch to electric vehicles affects several related markets. In the markets for oil-fuelled vehicles and for petrol and diesel, demand falls. In my diagram, the demand curve shifts left from D to D1, so the price falls from P to P1 and quantity falls from Q to Q1. Consumer and producer surplus in these markets fall. For car makers specialising in petrol and diesel engines, revenue (D = AR) falls while fixed costs*

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remain, so profits fall, firms may lose economies of scale and some may reach the shut-down point. Workers in oil refining, petrol stations and engine manufacturing face falling demand for their labour, as labour is a derived demand, leading to lower wages and job losses. The government also loses fuel duty and VAT revenue, as a large proportion of the price of petrol is tax.

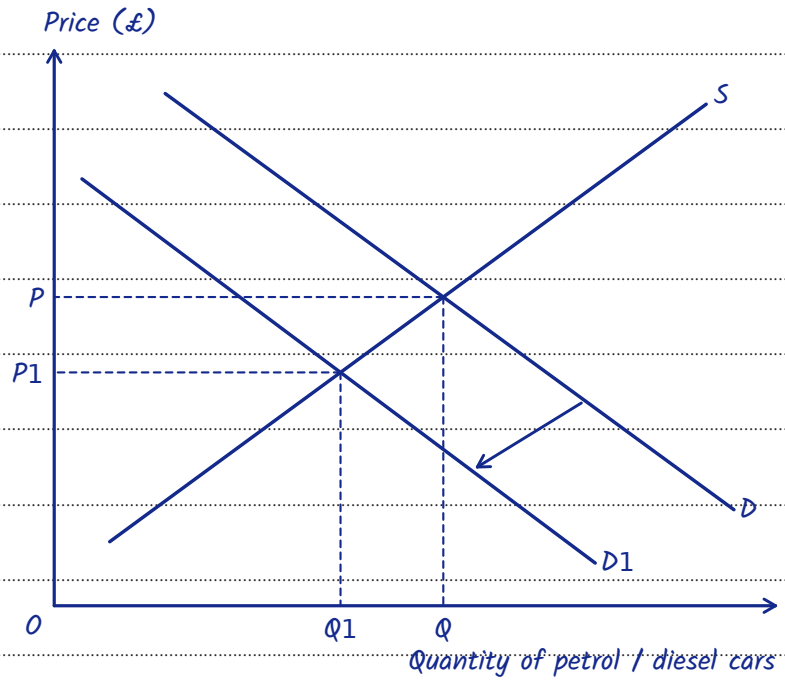
In contrast, demand for electric vehicles, batteries and electricity increases. Electric vehicle manufacturers, dealers and battery producers gain revenue and supernormal profit, attracting new entrants and investment. Higher output allows economies of scale, so average costs and prices of electric vehicles fall, increasing consumer surplus. Supernormal profit can fund research and development, leading to dynamic efficiency, for example longer battery ranges, and employment and wages rise in these industries. Rising competition can improve productive efficiency, while declining oil-based firms may become x-inefficient.

There are also important external effects. Petrol and diesel cars create negative externalities such as air pollution, carbon emissions and noise, so MSC is greater than MPC, leading to overconsumption and a welfare loss. Switching to electric vehicles reduces these external costs, moving the market closer to the social optimum, with external benefits such as better health and lower NHS costs.

However, the size of these consequences depends on several factors. Firstly, the prediction may be wrong. The forecast that oil use by cars will peak in 2025 relies on assumptions; dynamic market forces may cause oil prices to fall, making petrol cars relatively cheaper, while electricity prices may rise as demand increases. If electric cars are only distant substitutes (XED less than +1), due to high purchase prices, limited range and a lack of charging infrastructure, the switch may be slow.

Secondly, the environmental benefit depends on how electricity is generated. If it comes from coal or gas power stations, the negative external costs are partly shifted to the electricity market rather than removed, and battery manufacturing, including the mining of

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lithium and cobalt, creates its own negative external costs. Congestion will not fall, as electric cars still use the roads.

Thirdly, firms may adapt. Many car manufacturers are developing electric models, so they may not lose profit, and oil companies may diversify into electricity supply. Supernormal profits in electric vehicles may create barriers to entry, such as patents and brand loyalty, so a few firms may gain monopoly power and charge higher prices, reducing the benefits to consumers, although some firms may pursue sales maximisation rather than profit maximisation.

Fourthly, the effects differ between geographic markets. Countries such as Norway give large subsidies and tax breaks to electric vehicles and tax oil-powered vehicles, so the switch is faster, while in other countries it may be very slow. The government will need to replace lost fuel duty, perhaps through road pricing. Information gaps may also mean consumers underestimate the lifetime fuel savings of electric cars.

In conclusion, the shift to electric vehicles is likely to reduce profits, employment and tax revenue in oil-related markets while increasing output, profit and dynamic efficiency in electric vehicle markets, and to reduce negative externalities. The most significant

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consequence is the reduction in external costs, but its size depends on how electricity is generated and how quickly charging infrastructure is built. In the short run the effects are likely to be small, but in the long run, as costs fall, they are likely to be large.

Question 8

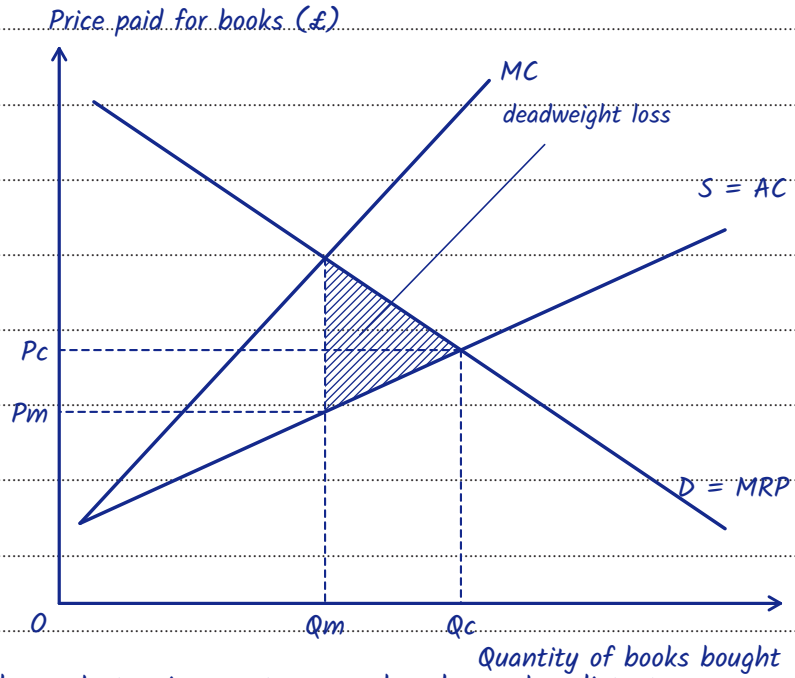
A monopsony is a single buyer, or a dominant buyer with significant bargaining power, in a market. Amazon has monopsony power in buying books because it controls a large share of book sales, so publishers depend on it to reach customers. It can use this buying power to force down the prices it pays, putting a 'squeeze on publishers'.

My diagram shows a monopsonist buying books from publishers. The supply curve of books is the average cost of buying (AC). To buy more the monopsonist must pay a higher price on all units, so the marginal cost of buying (MC) lies above the supply curve. Amazon buys where MC equals its marginal value (D), at quantity Qm, and pays only the price Pm read off the supply curve. In a competitive market the quantity would be Qc at the higher price Pc. The monopsonist therefore buys fewer books at a lower price, and there is a deadweight welfare loss shown by the shaded area.

The costs to suppliers are significant. Publishers receive a lower price and sell less, so revenue, profit and producer surplus fall. Smaller publishers may reach the shut-down point and leave the market. Lower profits mean less finance for investment in new authors, marketing and new titles, reducing dynamic efficiency. If a publisher refuses Amazon's terms, Amazon may take action by 'delaying their delivery, raising their prices, and steering customers to other publishers', which reduces sales further, so publishers have little choice but to accept.

There are also costs to consumers. If publishers leave the market there is less choice and fewer new books, particularly from small specialist publishers. As Amazon is also a dominant seller, its monopsony power may lead to monopoly power: lower buying costs may not be passed on as lower prices but kept as supernormal profit. Raising the prices of some

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publishers' books and steering customers elsewhere also distorts consumer choice. Employees and authors are affected too: publishers facing lower revenue may cut wages and jobs, and authors may receive lower royalties, reducing the supply of new writing.

However, the costs of monopsony may be overstated. Firstly, it is difficult to assess the strength of monopsony power. Other buyers exist, such as supermarkets, bookshop chains like Waterstones and other online retailers, and publishers can sell directly to readers online, so Amazon is not a pure monopsony. Large publishers have their own selling power, creating a bilateral monopoly in which bargaining between two powerful firms leads to a price closer to the competitive level.

Secondly, there are benefits. If lower buying prices are passed on, consumers gain lower prices, greater consumer surplus and a wider choice of books delivered quickly. Monopsony acts as a counterweight to the selling power of large publishers. Suppliers gain a major buyer with a huge customer base, which provides stable revenue and supports long-term investment decisions, and Amazon may form strategic partnerships with publishers. Amazon also benefits from lower costs and higher profits, which it may reinvest in innovation such as e-books and faster delivery, benefiting its employees.

Thirdly, the government can intervene. Competition authorities such as the CMA can

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investigate the abuse of buying power, fine firms or impose codes of practice to protect suppliers and their employees, and can promote competition and contestability, for example by reducing barriers to entry for new online retailers.

In conclusion, a monopsony in book retailing is likely to impose significant costs on publishers, authors and their employees through lower prices, lower output and less investment, and in the long run consumers may lose through less choice and higher prices. The size of these costs depends on how dominant the buyer is, whether suppliers have countervailing power and how effective regulation is. Where a firm like Amazon is also a dominant seller, the costs are likely to outweigh the benefits unless the competition authorities act.

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**TOTAL FOR SECTION C = 25 MARKS**
**TOTAL FOR PAPER = 100 MARKS**

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