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Candidate surname

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Other names

Pearson Edexcel
Level 3 GCE

Centre Number

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Monday 20 May 2019

Morning (Time: 2 hours)

Paper Reference **9EB0/01**

Economics B

Advanced

Paper 1: Markets and how they work

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.
- Answer **all** questions.
- 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.
- Try to answer every question.
- Check your answers if you have time at the end.

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Answer ALL questions.

SECTION A

Read the following extracts (A to C) before answering Question 1.

Write your answers in the spaces provided.

Extract A

The growth of sportswear sales

According to research, the global market for sportswear is forecast to reach \$231bn by 2024. Growth in the market is driven by healthier lifestyles and technological developments designed to improve comfort and performance of sportswear. Sports clothing and footwear is a highly popular style statement and fashion trend.

5

Nike remains the global market leader and is amongst the top 20 most valuable global brands. In 2016, *Nike's* sales revenue was \$32.4bn (an increase of 6% from 2015) and in the same period, net profit increased by 15% to \$3.8bn. Whilst *Nike* still has the largest market share it is losing ground to *Adidas*, *New Balance* and *Under Armour*.

China is expected to be the fastest growing region for sales of sportswear and is attracting new entrants to the market. Total sales in China rose in 2016 to \$27bn.

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Chinese brand *Anta* sponsored the 2016 Chinese Olympic team and achieved 10% market share with a total revenue of \$2.7bn. The operating profit margin was 24%.

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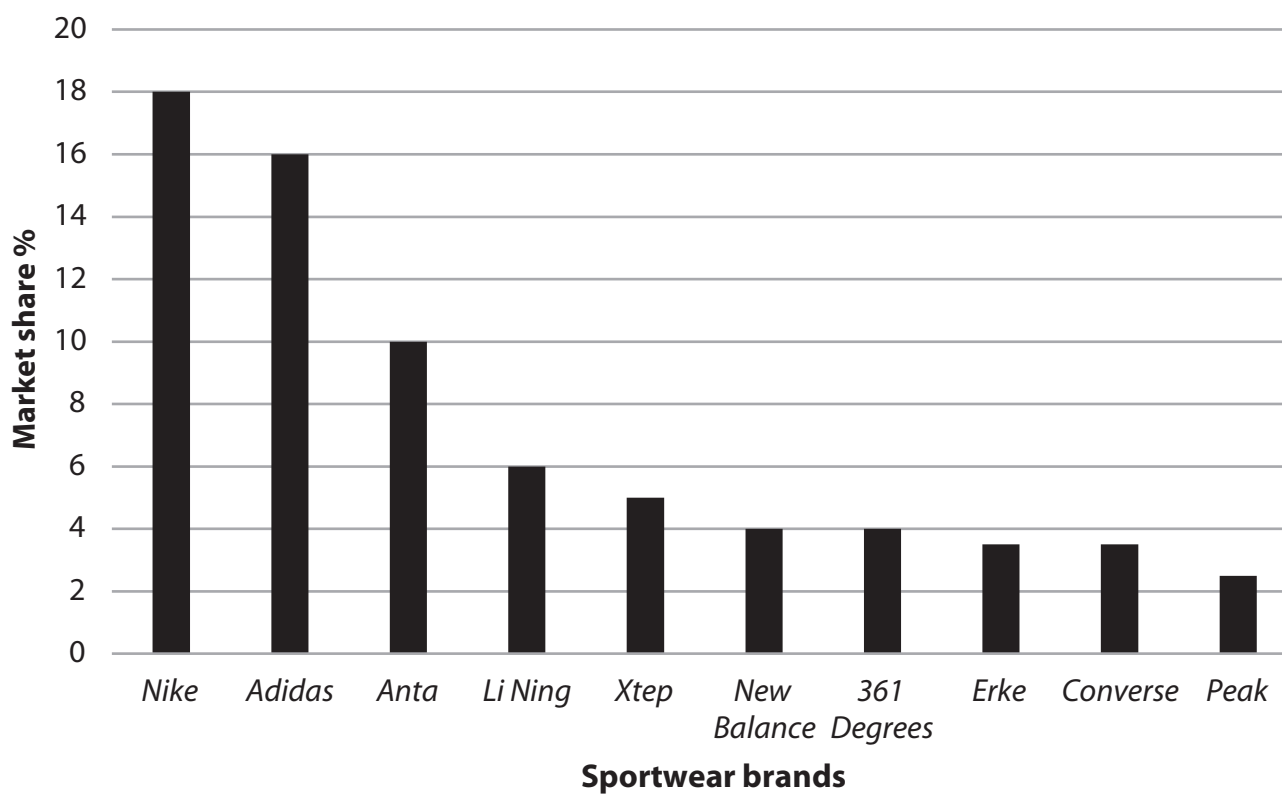
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Extract B

Market share (%) of sportswear brands in China, 2016



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Extract C

New Balance

New Balance was founded in 1906 in Boston, US and today manufactures shoes and sports clothes in America, Europe and Asia. *New Balance* differentiates its products with technical innovations such as gel inserts in its sports shoes, and is one of the few manufacturers to offer the shoes in a wide range of widths and sizes.

5

The *New Balance* premium range of sports shoes is manufactured in the US and UK. This represents a proud tradition of craftsmanship and domestic manufacture using skilled workers and superior raw materials. It is currently the only major sports company to manufacture athletic footwear in the US, where it produces around 4 million pairs per year, which represents a quarter of its sales.

10

New Balance has expanded its UK operations over the last 30 years and now employs over 200 people in its factory in Cumbria. It produces over 13,000 pairs of premium priced shoes a week for domestic and overseas markets.

New Balance is most well known for its running shoes but now manufactures shoes and sportswear for a wide range of sports including tennis, golf, football, cricket and skateboarding.

15

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- 1 (a) Using Extract A, calculate, to 2 decimal places, Nike's profit for the year margin for 2016. You are advised to show your working.

(4)

$$\text{Profit for the year margin} = (\text{profit for the year} \div \text{sales revenue}) \times 100$$

$$\text{Profit for the year (2016)} = \$3.8\text{bn}, \text{ sales revenue (2016)} = \$32.4\text{bn}$$

$$= (\$3.8\text{bn} \div \$32.4\text{bn}) \times 100$$

$$= 0.117284 \times 100$$

$$= 11.73\%$$



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New Balance operates in a competitive market.

- (b) Explain **one** reason why a business such as New Balance differentiates its products.

(4)

New Balance differentiates its products to make them stand out from those of rivals such as Nike and Adidas, so that it can gain market share in a highly competitive market.

For example, it offers technical innovations such as gel inserts in its sports shoes, and it is one of the few manufacturers to offer shoes in a wide range of widths and sizes.

This gives customers a reason to choose New Balance rather than a rival, which may lead to brand loyalty, so demand becomes more price inelastic. New Balance can then increase its sales and charge premium prices, raising its profits.

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- (c) Using Extract A, calculate, to 2 decimal places, Anta's total costs in 2016. You are advised to show your working.

(4)

Total costs = sales revenue – operating profit

Operating profit = \$2.7bn × 24% = \$2.7bn × 0.24 = \$0.648bn

Total costs = \$2.7bn – \$0.648bn

= \$2.052bn

= \$2.05bn

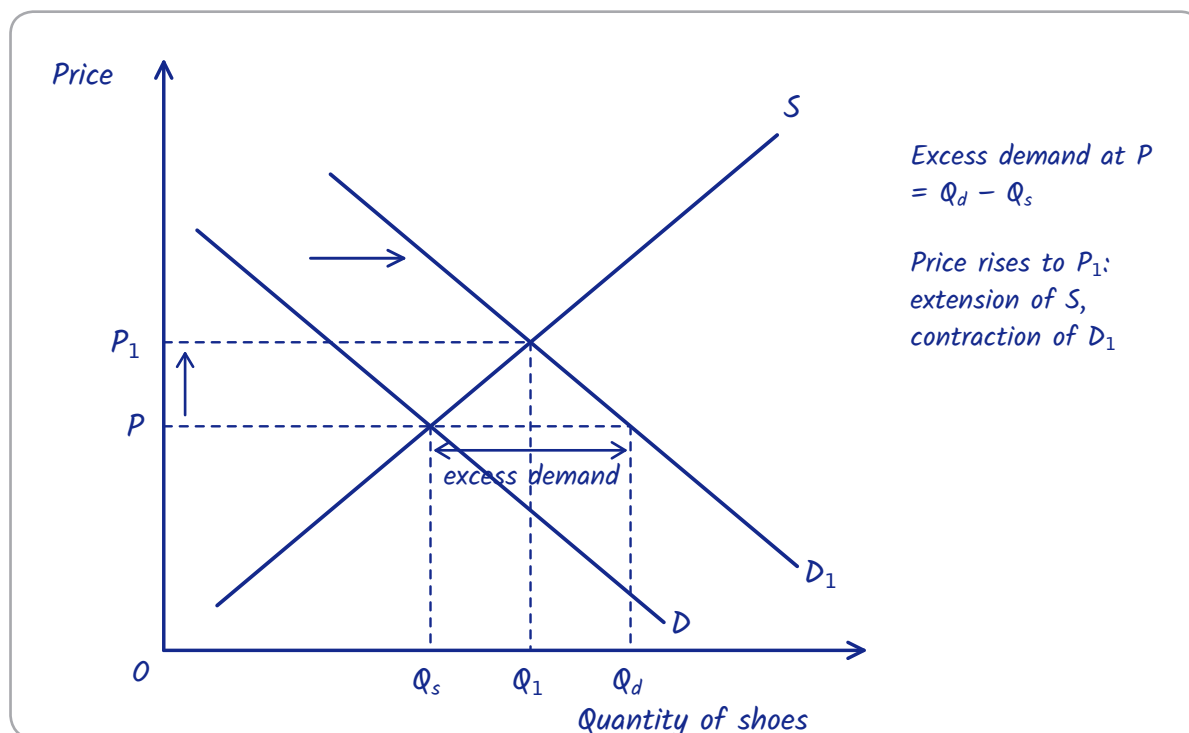


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Pictures of the singer Rihanna wearing New Balance's white leather training shoes appeared in newspapers. This style of shoe temporarily sold out. However people were still trying to buy them in stores and online, leading to excess demand.

- (d) Using a supply and demand diagram to show excess demand, analyse how this may affect the future price of these shoes.

(6)



The photos of Rihanna caused demand for the white leather shoes to shift right from D to D_1 . At the original price P , quantity demanded (Q_d) is now greater than quantity supplied (Q_s), so there is excess demand of $Q_d - Q_s$. New Balance did not have enough stock to meet demand, which is why the shoes sold out.

The excess demand acts as a signal and incentive: buyers compete for the limited shoes, so New Balance (and retailers) can raise the price. As the price rises, there is a contraction of demand and an extension of supply (movements along both curves) until the new, higher equilibrium price P_1 and quantity Q_1 are reached, where excess demand is eliminated. However, as the demand is temporary (a fashion fad), the price may fall back once interest in the trend fades.



- (e) Discuss the extent to which sales maximisation is the main objective for a business such as New Balance.

(8)

Sales maximisation means selling as many units (or achieving as much sales volume) as possible in a given time period, subject to at least covering costs. In theory it occurs where average revenue equals average cost.

Sales maximisation may be an important objective for New Balance because the sportswear market is very competitive: Extract B shows Nike (about 18%) and Adidas (about 16%) lead the Chinese market, with New Balance on only about 4%. Increasing sales would increase market share, which builds a stronger brand, raises consumer awareness and creates more opportunities to increase revenue and future growth. Higher sales volumes also help New Balance gain economies of scale, spreading the cost of research into technical innovations such as gel inserts over more units, which lowers average costs. With the global market forecast to reach \$231bn by 2024, growing sales now could secure a larger share of a growing market.

However, sales maximisation may not be the main objective. Selling as much as possible may require lower prices or heavy promotion, which reduces profit margins. New Balance is a premium brand making shoes in the US and UK with skilled workers and superior raw materials, so it is more likely to aim for high profits to fund investment in products that keep up with changing fashions and trends. Customer satisfaction is also important: offering shoes in a wide range of widths and sizes meets customer needs rather than maximising volume.

Overall, sales maximisation is unlikely to be the main objective for a premium, differentiated business such as New Balance. It depends on the market: in a fast-growing market such as China, gaining market share may be the priority in the short run, but in the long run profit and customer satisfaction are likely to matter more, as profit is needed to finance innovation and protect the brand.



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Interest rates in the UK were stable between 2007 and 2017.

- (f) Assess the possible impact of an increase in interest rates on New Balance's UK operations.

(10)

An interest rate is the percentage rate charged on a loan or paid on savings, i.e. the cost of borrowing and the reward for saving. In the UK, Bank Rate is set by the Bank of England's Monetary Policy Committee.

First, an increase in interest rates raises the cost of borrowing for consumers, which discourages borrowing and spending on credit and encourages saving. Households with variable rate mortgages will have higher repayments and less disposable income for non-necessities and luxury goods. Premium priced shoes from New Balance's Cumbria factory are likely to be income elastic, so UK demand may fall, reducing sales revenue and possibly threatening some of the 200 jobs in its UK operations.

Second, New Balance has expanded its UK operations over the last 30 years. If the expansion was financed with loans at variable rates, higher interest payments will increase its costs and reduce profit. If it passes the higher costs on through higher prices, sales may suffer in this very competitive market, where rivals such as Nike and Adidas could gain market share. Higher rates also make future investment, for example in new machinery, less attractive.

Third, higher UK interest rates attract hot money flows, increasing demand for the pound, so the pound appreciates. A stronger pound makes UK exports more expensive abroad. As the Cumbria factory produces 13,000 pairs a week for domestic and overseas markets, its exports would become less price competitive, while imported raw materials would become cheaper, partly offsetting the higher costs.

However, the impact depends on the size of the rise. After rates were stable between 2007 and 2017, a small increase (e.g. 0.25 percentage points) may have little effect on spending on sportswear, especially if the target market is younger consumers with



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few outstanding loans or mortgages. Fashion items such as premium trainers may be price inelastic, and New Balance's customers may be brand loyal, valuing the 'made in the UK' craftsmanship, so demand may hardly change. It also depends on how the UK operations are financed: the loans may come from US financial institutions or from retained profit, so UK rates would not affect its costs.

Overall, the impact on New Balance's UK operations is likely to be small in the short run, because of brand loyalty and the likely small size of any rise. The biggest risk is to export sales through a stronger pound, so the effect depends most on how much the exchange rate changes and on how much of the Cumbria output is exported.

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(g) Assess the importance of economies of scale to the success of firms such as Nike.

(12)

Economies of scale are the cost advantages a firm gains when it increases its scale of production, so that long run average cost falls as output rises.

Purchasing economies: Nike is the global market leader with sales revenue of \$32.4bn in 2016. Because of its size and global dominance it can buy leather and other materials in bulk and negotiate purchasing discounts from suppliers, reducing its average manufacturing costs. Lower average costs can be passed on as lower prices to attract more customers, or kept as higher margins, helping explain why its net profit grew 15% to \$3.8bn.

Technical economies: Nike can use large-scale mechanised processes, automation and specialist machinery in its factories, which are only cost effective at high output. This lowers average costs and can also improve the consistent quality of its premium ranges.

Marketing economies are also significant: sponsorship deals and global advertising campaigns are spread over a huge number of units, so the cost per pair is small, strengthening its position as one of the top 20 most valuable brands.

Risk-bearing economies: Nike sells a wide range of products in a wide range of markets, so a fall in demand in one market or product line can be offset by others. Smaller firms such as Anta, which relies heavily on China, are more exposed. Financial economies also allow Nike to borrow more cheaply to fund innovation.

Economies of scale also act as a barrier to entry. New entrants into the fast-growing Chinese market cannot match Nike's low average costs, which helps Nike maintain its dominance and market share of about 18% in China.

However, economies of scale may not be the most important factor. Nike produces top of the range products that sell for high prices, so it competes on brand image and quality rather than on cost. Sportswear is a style statement and fashion trend, so



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success depends on maintaining the appeal of its clothing and footwear. The industry is driven by technological developments to improve comfort and performance, so Nike must innovate to meet changing customer requirements. Despite its size, Nike is losing ground to Adidas, New Balance and Under Armour, which shows that scale alone does not guarantee success. Very large firms may also suffer diseconomies of scale, such as poor communication and coordination.

In conclusion, economies of scale are important to Nike's success because they lower costs, fund marketing and innovation, and create barriers to entry. However, they are a necessary rather than sufficient condition: in a fashion-driven, premium market, other factors such as leadership, financial management, marketing strategy and innovation are likely to be more important in determining whether Nike stays the market leader in the long run.

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New Balance has chosen to manufacture its premium shoes in the US and UK rather than in cheaper locations.

(h) Assess the extent to which this may cause stakeholder conflict.

(12)

Stakeholders are individuals, groups or organisations that have an interest in, or are affected by, the activities of a business, such as shareholders, employees, customers, suppliers and the local community. Because they have different interests, conflicts may arise between them.

New Balance produces around 4 million pairs of premium athletic footwear a year in the US, and employs over 200 people in its Cumbria factory. Shareholders and owners expect the business to make a profit and receive a return on their investment. Manufacturing in high-wage countries raises unit labour costs compared with cheaper locations in Asia, so profits and dividends may be lower. Shareholders may therefore prefer to relocate production to a cheaper location to maximise profit, which conflicts with the interests of current employees, who would be at risk of losing their jobs, and with the local community in Cumbria, which depends on the factory for employment and income.

There may also be conflict between employees and shareholders over pay. The skilled workers producing the premium ranges want good working conditions and high wages, but every increase in wages reduces profit margins for the company and dividend payments for shareholders.

Higher production costs may also mean higher prices, which may cause conflict with customers who are price conscious, especially as rivals such as Nike and Adidas manufacture more cheaply in Asia.

However, there may be little stakeholder conflict. Some shareholders may be in favour of maintaining domestic manufacture, as it supports the economy and fits the business's proud tradition of craftsmanship. In the long run, 'made in the US/UK' is a USP that justifies premium prices, which may create more profit and higher dividends



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for shareholders. The made in US and UK shoes may appeal to the ethical stance of some consumers, who are willing to pay a higher price for quality and for supporting domestic jobs. Loyal staff may also be more motivated and productive, producing high quality output with less waste, leading to higher profit margins that satisfy owners and shareholders.

Overall, domestic manufacture may cause some conflict between shareholders and employees in the short run, especially if profits fall. However, as US production of around 4 million pairs represents only about a quarter of New Balance's sales, and its brand image depends on craftsmanship, the extent of conflict is likely to be limited. It depends on whether customers keep paying premium prices: if they do, the interests of all stakeholders are aligned.

(Total for Question 1 = 60 marks)

TOTAL FOR SECTION A = 60 MARKS



SECTION B

Read the following extracts (D to F) before answering Question 2.

Write your answer in the space provided.

Extract D

Office of Gas and Electricity Markets (Ofgem)

The principal objective of Ofgem is to protect the interests of electricity and gas consumers by promoting value for money to consumers. Ofgem regulates the energy industry and is funded by the firms it regulates, who pay an annual licence fee.

In 2016 Ofgem investigated Scottish Power and concluded it had failed to treat its customers fairly. Customer service was found to be inadequate. Scottish Power agreed to pay £18m to its vulnerable customers who were affected by customer service issues. 5

Competition and Markets Authority (CMA)

Ofgem referred the energy sector to the CMA, after concluding customers were failing to switch to cheaper alternative suppliers and were paying too much. 10

The CMA investigated why the 'Big-Six' energy suppliers – *British Gas, SSE, ScottishPower, E.ON, EDF* and *npower* – continued to dominate the supply market, more than 14 years after privatisation of the energy market. The CMA investigated whether suppliers were exploiting loyal customers and tacitly colluding over energy price rises.

The CMA concluded its investigation in 2016 and measures were recommended to drive down costs by increasing competition between suppliers and helping more customers switch to better deals. 15

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Extract E

Market share of gas and electricity supply (UK), 2016

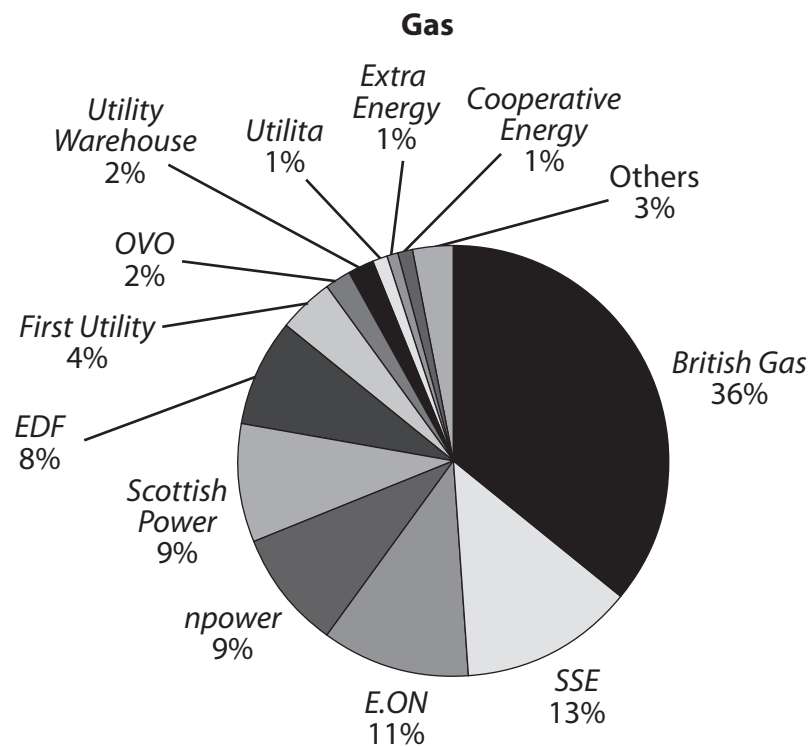


Figure 1

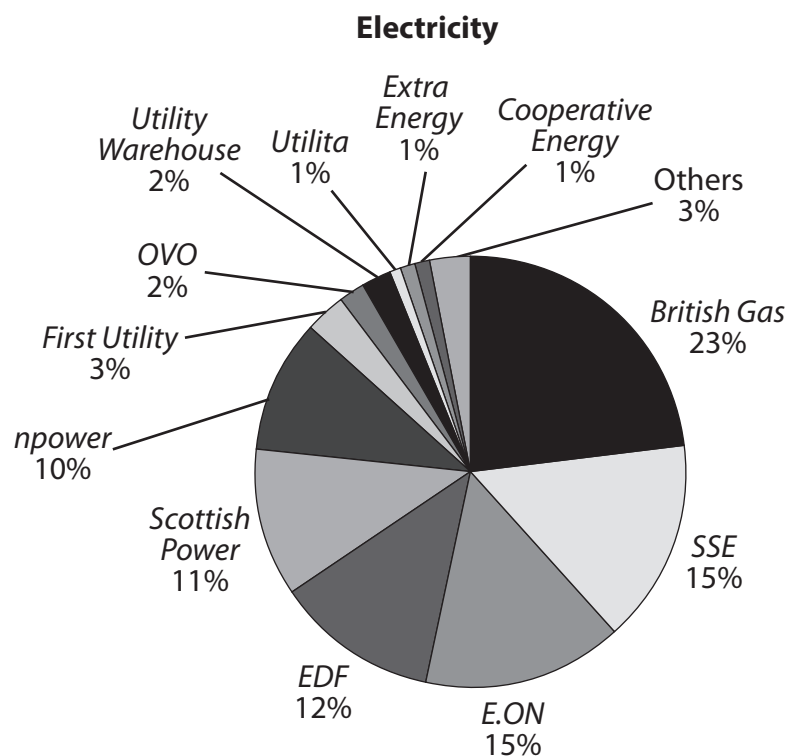


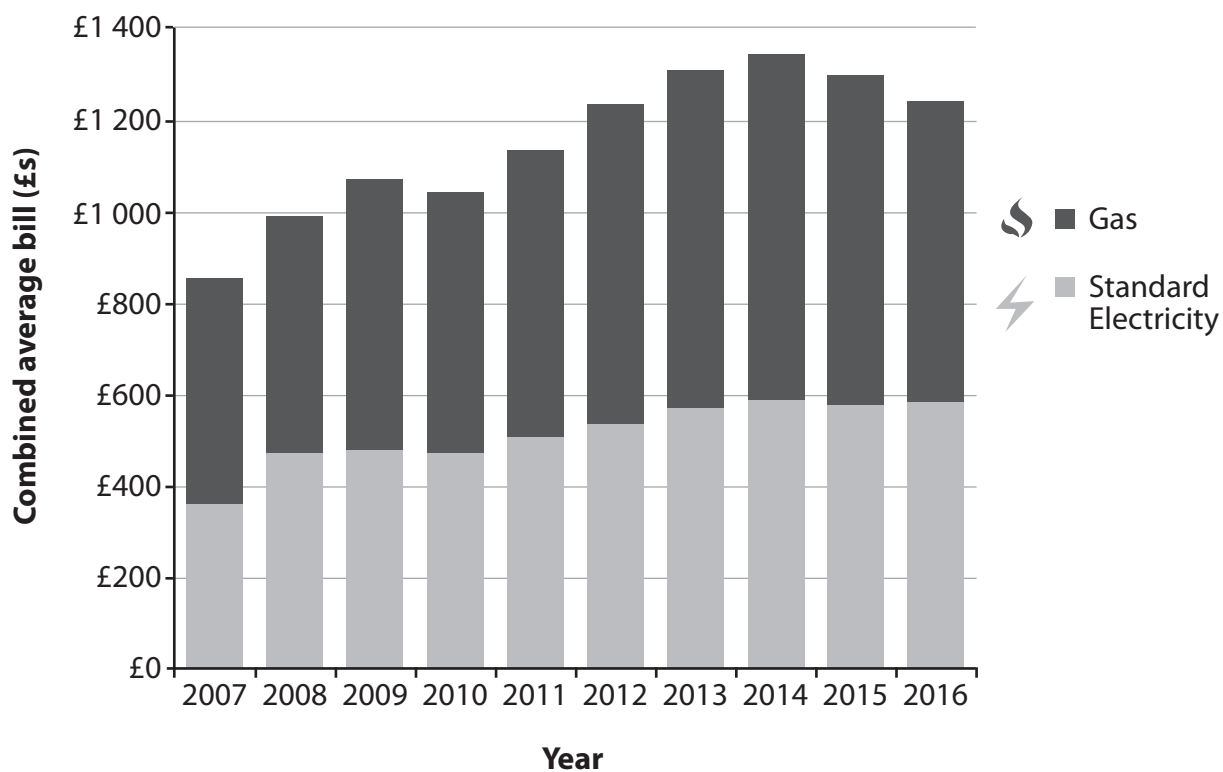
Figure 2

(Sources: Crown Copyright - <https://www.ofgem.gov.uk/data-portal/gas-supply-market-shares-company-domestic-gb> and https://www.ofgem.gov.uk/system/files/docs/2016/08/retail_energy_markets_in_2016.pdf)



Extract F

Average household electricity and gas bills (annual cost)



(Source: © Crown Copyright)



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2 Evaluate the extent to which regulation of the energy market may benefit consumers.

(20)

Regulation is a form of government intervention in a market, by the government or a regulatory body, which sets rules to control the behaviour of firms, for example on prices, quality, service and competition. In the UK energy market, Ofgem's principal objective is to protect the interests of electricity and gas consumers by promoting value for money.

The energy market is an oligopoly dominated by the 'Big Six'. Extract E shows that in 2016 British Gas had a 36% share of gas supply, and the six largest firms together had about 86% of both gas and electricity supply, giving a six-firm concentration ratio well above 80%. Without intervention, these firms have market power and may engage in unfair practices such as charging consumers too much, raising prices above the competitive level and earning supernormal profits. The CMA investigated whether suppliers were exploiting loyal customers and tacitly colluding over price rises. If collusion continued, prices would be pushed up and allocative efficiency would be lost, as price would exceed marginal cost.

Regulation can benefit consumers in several ways. First, Ofgem protects vulnerable consumers: in 2016 it found that Scottish Power had failed to treat its customers fairly, and Scottish Power agreed to pay £18m to vulnerable customers affected.

Without intervention, vulnerable people charged too much may be less able to pay their bills and may fall into debt or fuel poverty. Fines and compensation also create a deterrent, giving firms an incentive to improve customer service.

Second, customers are failing to switch to cheaper alternative suppliers and are paying too much. Regulation that informs consumers and makes switching easier reduces asymmetric information. If consumers switch to better deals, household energy bills fall, which has a positive effect on household budgets and enables spending elsewhere,

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increasing consumer surplus.

Third, the CMA recommended measures to drive down costs by increasing competition between suppliers. Fair competition and lower barriers to entry help new entrants such as OVO, First Utility and Utility Warehouse to grow (each currently 2% to 4% of the market). More competition should bring down the average price in the market and improve choice and quality of service. Extract F shows combined average bills rose from about £850 in 2007 to a peak of about £1,340 in 2014, a rise of around 58%, which suggests intervention was needed to protect consumers.

However, regulation may not benefit consumers as much as expected. Regulation creates an unnecessary burden of costs for energy businesses: they fund Ofgem through an annual licence fee, and compliance with red tape adds to costs. These costs may be passed on to consumers, damaging competitiveness and in fact increasing prices.

Controls and the fear of paying compensation, as in the case of Scottish Power, may give firms an incentive to conceal problems and could encourage tacit price collusion rather than open competition.

There is also the risk of regulatory failure. The CMA may find it difficult to prove anti-competitive behaviour, as tacit collusion leaves no spoken or written evidence, and the regulator suffers from asymmetric information because the firms know their true costs better than it does. Regulators may also suffer regulatory capture. Energy suppliers need to make profits to fund investment in future supplies, so if regulation squeezes profits too much, investment and long-run security of supply may suffer. There is no clear evidence that prices charged are unreasonable.

Furthermore, Extract F shows that household bills had in fact decreased since 2014, to about £1,240 in 2016, before the CMA concluded its investigation. This may indicate that market forces, such as falling wholesale costs and growing small suppliers, were already working, and that increased regulation is not required. Even though Ofgem can



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provide consumers with options to switch, many consumers may not take the opportunity due to inertia, so the benefit of regulation aimed at switching may be limited.

In conclusion, regulation of the energy market is likely to benefit consumers, especially the most vulnerable and those who need to be educated about the options available, because the market is highly concentrated and many customers are loyal and do not switch. The extent of the benefit depends on the type of regulation: measures that increase competition and switching are likely to bring lasting benefits, while heavy-handed controls could have an adverse effect on the price of gas and electricity if regulatory costs and fines are too high and are passed on to consumers. In the short run, compensation and fines bring quick benefits, but in the long run the most important benefit will come from a more competitive market.

(Total for Question 2 = 20 marks)

TOTAL FOR SECTION B = 20 MARKS



SECTION C

Read the following extracts (G to I) before answering Question 3.

Write your answer in the space provided.

Extract G

The cost of going to university

University tuition fees of £1 000 were first introduced by the government in 1998. The cost of going to university in England is now amongst the highest in the world. The average cost for UK university tuition fees is over £9 000 and is set to increase over the next few years. In addition to tuition fees, the UK student has accommodation and living costs to pay, which increases the average cost to £21 000 per year. Average graduates may owe £60 000 when they finish university.

5

Belgium, France, Germany, Italy and Austria charge tuition fees of less than £1 000 per year, whilst Scotland and much of Scandinavia do not charge any fees at all. A Department for Education spokesperson said: "We are determined to make sure that everyone with the potential to benefit from higher education has the opportunity to do so. The UK has some of the best universities in the world. Our reforms will drive up the standard of teaching at universities, so students get the best return for their investment".

10

(Source: University tuition fees in England now the highest in the world, new analysis suggests, by Benjamin Kentish)



Extract H

World University Rankings 2016-2017: top 10

2016-17 rank	2015-16 rank	Institution	Country
1	2	University of Oxford	United Kingdom
2	1	California Institute of Technology	United States
3	3	Stanford University	United States
4	4	University of Cambridge	United Kingdom
5	5	Massachusetts Institute of Technology	United States
6	6	Harvard University	United States
7	7	Princeton University	United States
8	8	Imperial College London	United Kingdom
9	9	ETH Zurich – Swiss Federal Institute of Technology Zurich	Switzerland
10	13	University of California, Berkeley	United States

(Source adapted from: <https://www.timeshighereducation.com/news/world-university-rankings-2016-2017-results-announced>)



Extract I

Government launches 30 hours a week of free early education and childcare

All 3 to 4 year olds in England get 15 hours a week of free early education or childcare, which is funded by the government. Early education is provided by nurseries, play schemes and registered childminders.

From 2018 a limited number of parents will be eligible to claim 30 hours a week of free early education, which will benefit up to 15,000 families. Education Secretary Justine Greening said: "Early education and high-quality childcare not only helps our children get the best start in life, it benefits their future education and it supports many parents who need to work".

5

(Source: © Crown Copyright)



- 3 The UK government intervenes in the education sector. Education is considered a merit good.

Evaluate the likely impact on the UK economy of government intervention in the education sector.

(20)

A merit good is a good which, when consumed, provides external benefits to third parties and is under-consumed in a free market, because its benefits are not fully recognised (imperfect information) or people are unable to pay. Education is a merit good: the marginal social benefit (MSB) is greater than the marginal private benefit (MPB), so the free market quantity is below the socially optimal quantity, a form of market failure. The government therefore intervenes through state provision, subsidies (such as free early years childcare) and regulation of standards.

Consumption of education generates positive externalities and external benefits for the UK economy. A better educated workforce is more productive and innovative, which increases labour productivity, shifts the LRAS curve to the right and raises the economy's long-run productive potential and international competitiveness. Higher earnings also raise tax revenue and reduce spending on welfare.

Extract 1 shows the government funds 15 hours a week of free early education for all 3 to 4 year olds, and from 2018 some parents can claim 30 hours, benefiting up to 15,000 families. This helps children get the best start in life, improving future education outcomes. It also helps parents, especially mothers, to return to work, increasing the supply of labour and the participation rate. This raises output, household incomes and tax revenue, and reduces the cost of welfare benefits.

However, government intervention in higher education has moved the other way. Tuition fees were introduced at £1,000 in 1998 and now average over £9,000, among the highest in the world, and with living costs the average cost is £21,000 per year. Students may graduate owing £60,000. This may lead to the under-consumption of

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higher education, particularly by students from low income households, so the economy may suffer from a lack of skilled graduates, damaging its long-term prospects. The prospect of a £60,000 debt may also encourage students to study and work abroad, for example in Germany or Scandinavia where fees are under £1,000 or zero, leaving a potential skills gap in the UK.

On the other hand, if the government spent more on free or subsidised university education, there would be an opportunity cost: higher taxes or less spending elsewhere, such as on healthcare, which could also benefit the economy. Charging students means those who receive the private benefit of higher lifetime earnings pay part of the cost.

Fees may help universities maintain standards, the quality of teaching and their reputation: Extract H shows the UK has three universities in the world top 10, with Oxford ranked first. High standards in higher education should improve innovation and productivity, and attract international students who bring export earnings.

In addition, students deterred from going to university may choose a different route, such as an apprenticeship, which may arguably be of more benefit in terms of a skilled workforce that meets employers' needs. Government intervention can also suffer from government failure, for example if spending is allocated inefficiently or the government lacks information on which courses add most value, so not all intervention improves outcomes.

The impact also depends on the time period. Spending on early education raises the labour supply quickly, but the main benefits of education, higher productivity and economic growth, are only felt in the long run, and their size is hard to measure.

In conclusion, government intervention in education is likely to have a positive impact on the UK economy because, without it, people may underestimate the benefits of education and undervalue it, leading to under-consumption. Free early years provision has clear benefits for the labour market. However, the impact of high tuition fees is less



certain: they may protect quality but risk deterring students, which in the long term could affect skill levels, productivity and competitiveness. The overall impact depends on whether intervention targets the groups most likely to under-consume and on the opportunity cost of the spending.

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(Total for Question 3 = 20 marks)

TOTAL FOR SECTION C = 20 MARKS
TOTAL FOR PAPER = 100 MARKS

