Please check the examination details below before entering your candidate information

Candidate surname: StemUp Model Solution

Other names:

Centre Number

Candidate Number

Pearson Edexcel International Advanced Level

Time 2 hours

Paper reference **WEC13/01**

Economics

International Advanced Level
UNIT 3: Business behaviour

You must have:
Source Booklet (enclosed)

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 in Sections A and B.
- Answer **TWO** questions in 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 80.
- 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.

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SECTION A

Answer ALL questions in this section.

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 ☒.

1 In 2020 the Turkish airline AtlasGlobal ceased its operations. Which **one** of the following will cause a firm to shut down in the short-run?

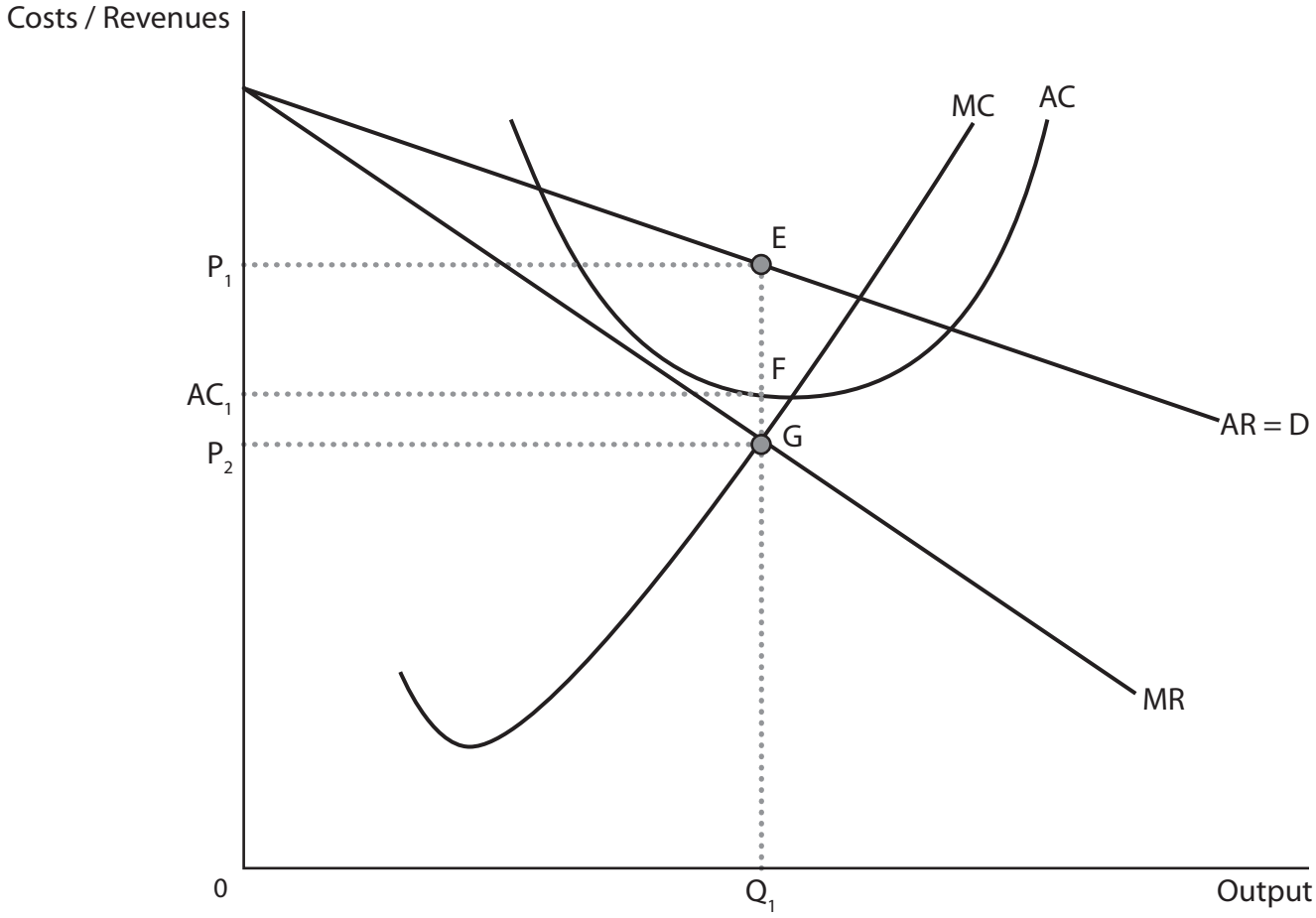
- ☒ **A** Average revenue was below marginal revenue
- ☒ **B** Average revenue equalled marginal cost
- ☒ **C** Average revenue was below average variable cost
- ☒ **D** Average revenue equalled average cost

(Total for Question 1 = 1 mark)

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2 The diagram shows the short-run cost and revenue curves for a hairdresser operating in a monopolistically competitive market in Mumbai.



Which **one** of the following can be deduced from the diagram?

- ☒ **A** At output Q_1 the firm is maximising its total revenue
- ☒ **B** At output Q_1 the firm is minimising its average cost
- ☒ **C** At output Q_1 the firm is making normal profit
- ☒ **D** At output Q_1 the firm is making supernormal profit

(Total for Question 2 = 1 mark)

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3 The table shows the number of international subscribers for Netflix and its total revenue for Q4 in the years 2017 to 2020.

	International subscribers (millions)	Total revenue ($ million)
Q4 2017	110.64	3 286
Q4 2018	139.26	4 187
Q4 2019	167.09	5 467
Q4 2020	203.66	6 644

Which **one** of the following can be deduced from the table?

- ☒ **A** Average revenue was $32.62 in Q4 2017
- ☒ **B** Average revenue was $29.70 in Q4 2018
- ☒ **C** Average revenue was $32.72 in Q4 2019
- ☒ **D** Average revenue was $30.07 in Q4 2020

(Total for Question 3 = 1 mark)

4 Total revenue for American Airlines fell from $45.77 billion in 2019 to $17.34 billion in 2020. In response, American Airlines made 31 000 staff redundant.

Which **one** of the following was the most likely reason for these staff redundancies?

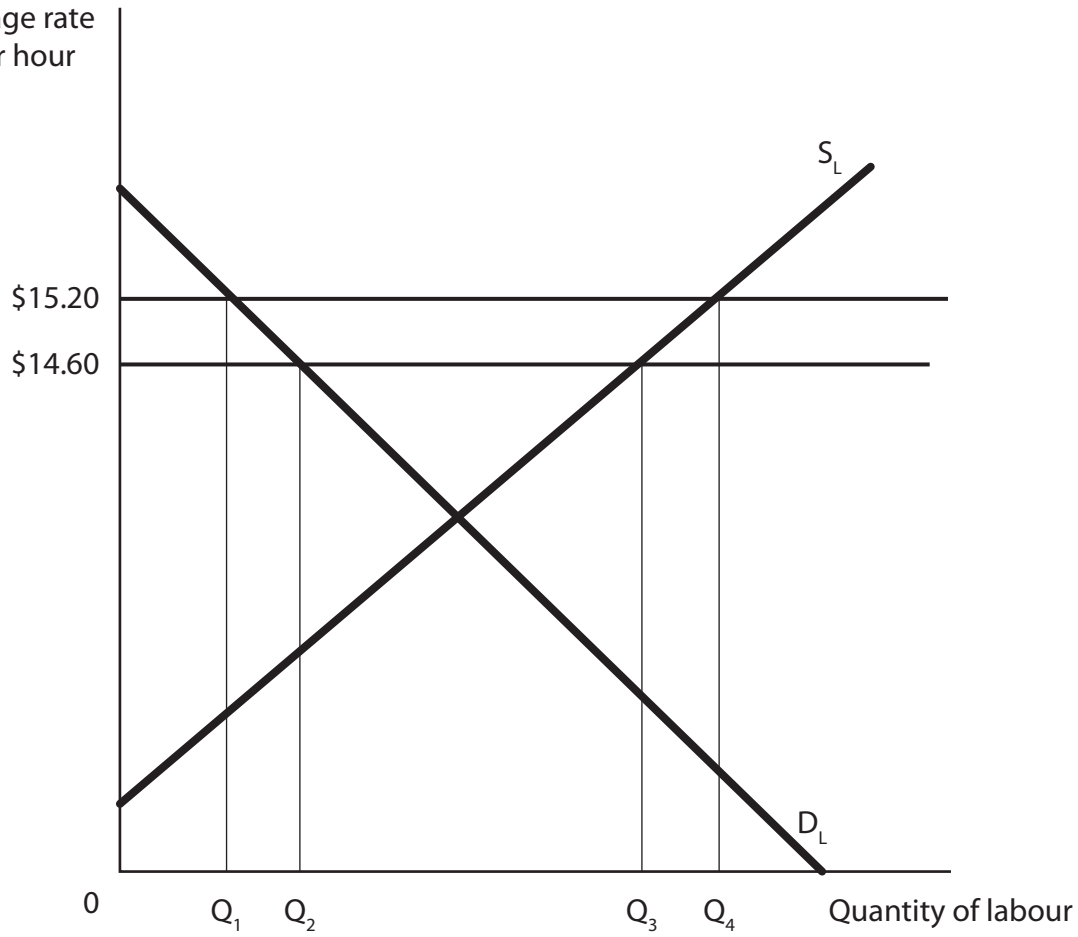
- ☒ **A** The number of airline passengers rose
- ☒ **B** The derived demand for labour fell
- ☒ **C** Government employment subsidies to airlines increased
- ☒ **D** Taxation on airline employees decreased

(Total for Question 4 = 1 mark)

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5 The diagram shows an increase in the minimum wage in British Columbia, Canada. In 2021 it rose from $14.60 to $15.20 per hour.



Which **one** of the following is the most likely impact of this increase in the minimum wage on shop assistants in the retail industry in British Columbia?

- ☒ **A** Unemployment would rise to Q_1–Q_4
- ☒ **B** Unemployment would rise to Q_2–Q_3
- ☒ **C** The demand for labour would extend from Q_1 to Q_2
- ☒ **D** The supply of labour would contract from Q_4 to Q_3

(Total for Question 5 = 1 mark)

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6 A small fruit farm in Namibia is operating in a perfectly competitive market. Which of the following is true for such a firm in long-run equilibrium?

	Allocative efficiency	Profit
☒ **A**	No	Supernormal
☒ **B**	No	Normal
☒ **C**	Yes	Supernormal
☒ **D**	Yes	Normal

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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SECTION B

Study Figure 1 and Extracts A and B in the Source Booklet before answering Question 7.
Write your answers in the space provided on the following pages.

7 (a) With reference to Figure 1, calculate the four-firm concentration ratio for the US car market in 2019.

(2)

(b) With reference to Extract A, explain what is meant by 'horizontal integration'.

(4)

(c) With reference to Extract A, analyse **two** barriers that Stellantis are likely to experience when trying to increase market share in China.

(6)

(d) With reference to Extract A, examine the impact of an increase in car sales in the USA on the profits of Stellantis.

Illustrate your answer with an appropriate diagram.

(8)

(e) With reference to the information provided and your own knowledge, discuss the possible impact of the merger between PSA Group and Fiat Chrysler on workers and consumers.

(14)

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7 (a) With reference to Figure 1, calculate the four-firm concentration ratio for the US car market in 2019.

(2)

Four-firm concentration ratio = combined market share of the four largest firms

= 16.9% (GM) + 14.0% (Ford) + 14.0% (Toyota) + 13.0% (Fiat Chrysler)

= 57.9%

(b) With reference to Extract A, explain what is meant by 'horizontal integration'.

(4)

Horizontal integration is when two firms in the same industry and at the same stage of the production process merge, or one takes over the other.

In Extract A, PSA Group and Fiat Chrysler are both car manufacturers at the same (final assembly) stage of production. In January 2021 they agreed to merge to create Stellantis, the world's third largest car manufacturer by volume, which now owns brands such as Peugeot, Citroen and Vauxhall alongside Alfa Romeo, Jeep and Lancia.

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(c) With reference to Extract A, analyse **two** barriers that Stellantis are likely to experience when trying to increase market share in China.

(6)

Barriers to entry are factors that prevent or make it difficult for new firms to enter a market, or for small firms in it to gain market share.

1. Brand loyalty and strong existing competition. In 2020 Chinese car firms had a 40% market share and well-established firms such as Volkswagen, Honda and Toyota already operate in China, while PSA Group and Fiat Chrysler had a combined share of only 1%. Chinese consumers are likely to be loyal to the brands they already know and buy habitually, so Stellantis would have to spend heavily on advertising, dealerships and price discounts to persuade buyers to switch. This raises its costs and risks, so gaining market share is likely to be slow and expensive.

2. Lack of market knowledge and high sunk costs. With only a 1% share, Stellantis has little experience of Chinese tastes, language, culture and regulations, which makes it harder to adapt its cars to what consumers want, for example the fast-growing demand for electric cars (38% of global electric car sales were in China in 2020). Building a distribution network, showrooms and possibly factories in China involves large sunk costs that cannot be recovered if the expansion fails. This increases the risk of trying to expand, so Stellantis may be deterred from investing enough to win a large share of the market.

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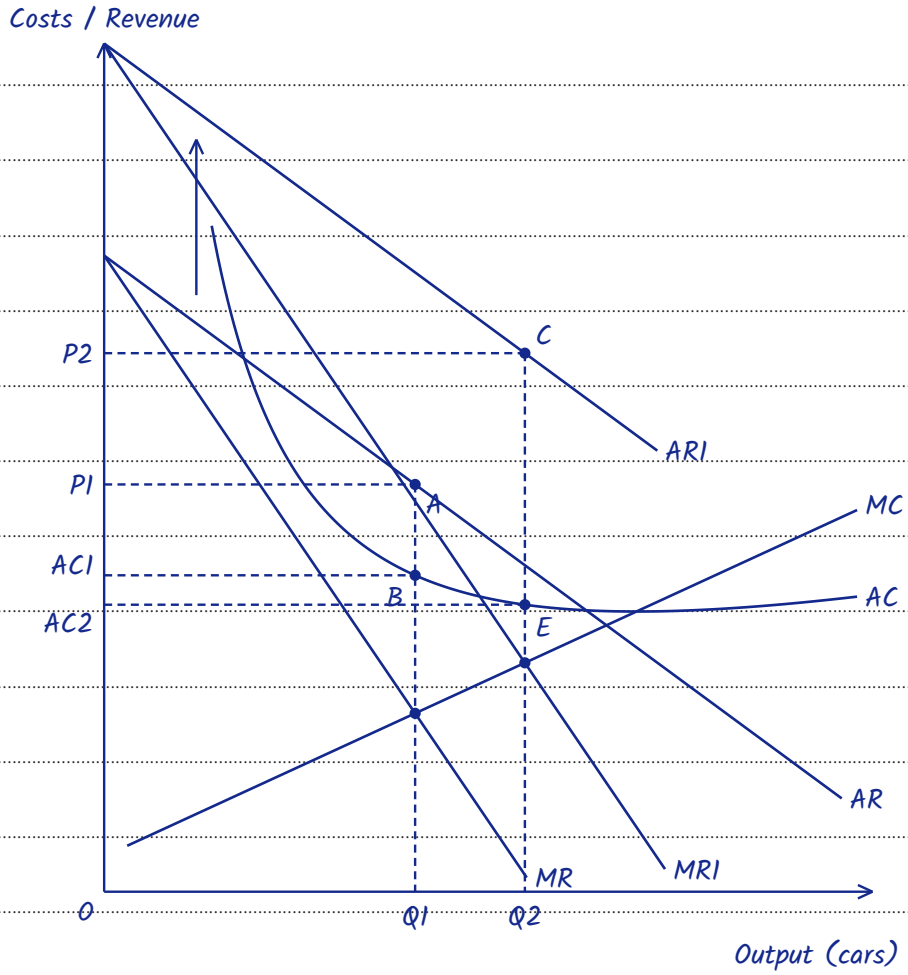
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(d) With reference to Extract A, examine the impact of an increase in car sales in the USA on the profits of Stellantis.

Illustrate your answer with an appropriate diagram.

(8)



Following the merger, PSA Group gained access to Fiat Chrysler's 3 000 car showrooms across the USA, and in Q1 2021 Stellantis experienced a 25% increase in revenue because of higher US car sales. The increase in demand shifts AR outwards to AR1 and MR to MR1. Stellantis profit maximises where MR = MC, so output rises from Q1 to Q2 and price rises from P1 to P2.

Originally supernormal profit was the area P1 A B AC1. After the increase in sales it is the larger area P2 C E AC2, because both the profit per car (AR – AC) and the number of cars sold have risen. Higher output also lowers average cost from AC1 to AC2 as Stellantis gains economies of scale, such as the €3.4 billion annual purchasing savings, so profits rise further.

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However, the impact on profit depends on costs. Rapid growth across many brands and countries may cause diseconomies of scale, such as poor communication and coordination, which would raise AC and reduce the gain in profit. Also, the USA is only one of Stellantis' markets, so total profit also depends on Europe and China, where it has only a 1% share. Finally, the rise in US sales may be temporary, for example a rebound after the pandemic, so the extra supernormal profit may not last in the long run.

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(e) With reference to the information provided and your own knowledge, discuss the possible impact of the merger between PSA Group and Fiat Chrysler on workers and consumers.

(14)

A merger is when two firms join together to form one new firm. PSA Group and Fiat Chrysler merged horizontally to form Stellantis, the world's third largest car maker, which is likely to affect both its workers and the consumers who buy its cars.

Workers: Stellantis owns plants all over the world, including in the Netherlands, the USA and the UK, so there is likely to be duplication of factories. To cut costs it may rationalise by closing plants, and Unite fears this for the 3 000 Vauxhall employees. Workers made redundant lose their income, so their standard of living falls, and lower spending in the local area has a negative multiplier effect on other local jobs. Extract B says the workers are highly specialised, so they are occupationally immobile: without retraining it is very difficult for them to find new jobs, which could cause long-term structural unemployment. They may also be geographically immobile, unwilling to move to areas where car jobs remain. The government may need to fund retraining to give them transferable skills.

Consumers: Purchasing economies of scale are expected to save €3.4 billion a year, lowering average costs. If these savings are passed on, car prices fall and consumer surplus rises. Sharing production expertise and PSA's research into electric cars means Fiat Chrysler brands such as Jeep can offer low-emission models, increasing choice and quality, which matters as demand for electric cars grows. On the other hand, the merger increases market power. With fewer rival firms, Stellantis may raise prices, cut the number of models it sells and reduce choice, while diseconomies of scale from managing many brands could raise costs and therefore prices.

Evaluation: The impact on workers may be smaller than feared. Unite has requested a meeting

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with the head of Stellantis and union bargaining power may prevent or limit closures. If the merger is successful, as the 25% rise in revenue suggests, the derived demand for labour could rise, especially in electric car development. Highly skilled, productive workers may also find jobs in other industries in the long run if training is available, so the unemployment may only be short-run.

For consumers, the risk of higher prices is limited because the car market remains competitive: in the USA, General Motors (16.9%), Ford (14.0%) and Toyota (14.0%) each have a larger share than Fiat Chrysler (13.0%), and in China Stellantis has only 1%. However, there is no guarantee that cost savings are passed on; they may simply be kept as supernormal profit for shareholders. New electric models also take years to develop, so the benefits of shared research are long-run.

Overall, consumers are likely to gain modestly in the long run because competition forces Stellantis to pass on some cost savings, whereas the main costs fall on workers in the short run, particularly if the Vauxhall plants close. The size of the impact depends on whether factories actually close and on how much retraining is available.

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(Total for Question 7 = 34 marks)

TOTAL FOR SECTION B = 34 MARKS

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SECTION C

Answer TWO questions from this section.

8 In 2020 three pharmaceutical firms Lexon, King Pharmaceuticals Ltd and Alissa Healthcare Research Ltd, were found to have illegally shared information in order to keep prices artificially high. Each firm was fined £1.2 million for this collusion by the UK competition authorities.

Evaluate the possible benefits of collusive behaviour between firms.

Use a simple game theory model in your answer.

(Total for Question 8 = 20 marks)

9 In 2019 the New Zealand Government created a new organisation to regulate the local monopolies that supply water. This organisation imposed a price cap that resulted in these water companies making insufficient profit for investment in improving water quality.

Evaluate methods that a government could use to control monopoly behaviour.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 9 = 20 marks)

10 JBS is the largest meat processing firm in the world, as measured by value of sales. Its revenue was $814.5 million in 2020. After a significant increase in sales to China in quarter 4 2020, its total revenue from sales to China rose by 60%.

Evaluate the view that revenue maximisation is always the main objective of a firm.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 10 = 20 marks)

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Write the answer to your FIRST chosen question here.

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 ☒.

Write the answer to your SECOND chosen question on page 22

Chosen question number: **Question 8** ☒ **Question 9** ☐ **Question 10** ☐

Collusion is when firms agree to cooperate, for example on prices or output, rather than compete. It usually happens in an oligopoly, a market dominated by a few large firms that are interdependent, so each firm's best decision depends on how its rivals react. In 2020 three pharmaceutical firms were each fined £1.2 million for illegally sharing information to keep prices high, which is overt collusion (a cartel).

Game theory shows why firms have an incentive to collude. Suppose two firms, Lexon and King Pharmaceuticals, each choose a high or low price. The payoff matrix shows their profits (£m), with Lexon's profit first:

		King Pharmaceuticals
	High price	Low price
Lexon: High price	£10m, £10m	£2m, £14m
Lexon: Low price	£14m, £2m	£5m, £5m

Without collusion, each firm has a dominant strategy to charge the low price. If King charges a high price, Lexon earns £14m by going low instead of £10m; if King charges a low price, Lexon

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earns £5m by going low instead of £2m. The same is true for King, so the Nash equilibrium is low price, low price with only £5m each. This is the prisoners' dilemma: both firms would be better off at high price, high price, earning £10m each. By colluding and agreeing to keep prices high, the firms move to this outcome and their joint profit doubles from £10m to £20m.

The first benefit, for the firms, is higher supernormal profit. Acting together, the colluding firms behave like a single monopolist, restricting output and charging the joint profit maximising price where MR = MC, so consumers must pay more for medicines. Second, collusion reduces uncertainty: firms no longer face the risk of a price war, so they can plan with confidence and save money on aggressive competition such as heavy advertising, which reduces costs and raises profits further.

Third, the extra profit may benefit society through dynamic efficiency. Developing new drugs is expensive and risky, so the supernormal profits can be reinvested in research and development, leading to new and better medicines in the long run. Fourth, stable prices make it easier for health care providers such as hospitals to plan their spending on pharmaceutical products. Finally, sharing information between firms can speed up product development, for example cooperation on vaccine development or sharing safety data, which directly benefits patients.

However, many of these benefits go only to the firms. Higher prices and restricted output reduce consumer surplus and create a deadweight welfare loss, so the market is allocatively inefficient (P > MC). Consumers may also face less choice, and for essential goods like medicines the burden falls heavily on patients and health services. There is also no guarantee that supernormal profits are reinvested in research: they may be paid out to shareholders, and without competitive pressure firms may become X-inefficient, so costs rise.

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Moreover, the benefits may not last. Collusion is illegal in most countries and, as in this case, firms that are caught face heavy fines (£1.2 million each) and reputational damage, which may outweigh the extra profit. Collusive agreements are also unstable: the payoff matrix shows that each firm can earn £14m by secretly cutting its price, so there is a strong incentive to cheat, and mistrust often causes the agreement to break down. Collusion is harder to sustain when there are more firms (three here), when costs differ, or when high profits attract new entrants, so it may work in the short run but be difficult in the long run. Collusion can also raise barriers to entry, which harms new firms trying to enter the pharmaceutical market.

In conclusion, collusion clearly benefits the colluding firms through higher and more certain profits, and it may benefit society if those profits fund new medicines or if cooperation is limited to areas such as safety data. However, price fixing like this case mainly transfers welfare from consumers to producers, and its benefits are short-lived because agreements tend to break down and attract fines. The overall benefit therefore depends on what the cooperation covers: cooperation on research can be beneficial, but collusion on price is generally harmful.

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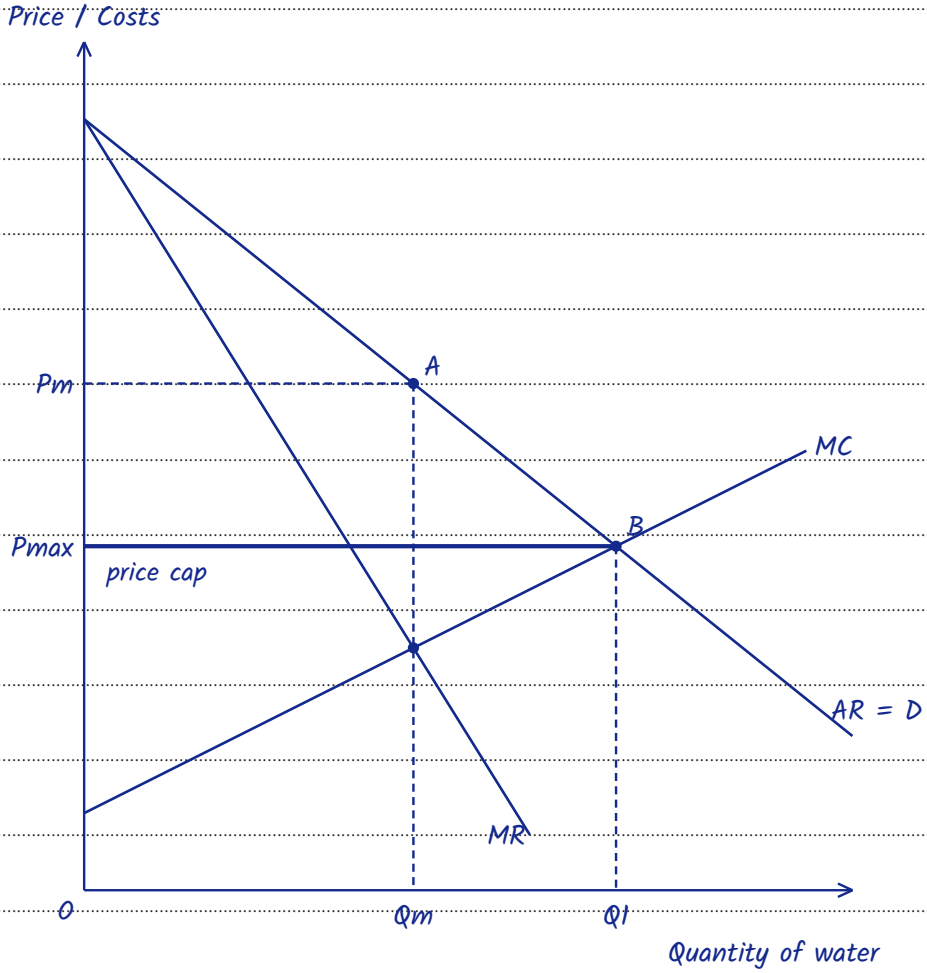
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Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 8** ☐ **Question 9** ☒ **Question 10** ☐

A monopoly is a market with a single dominant supplier (legally, a firm with over 25% market share) that is a price maker. Because it faces little competition, it can restrict output and charge a higher price than in a competitive market, which is a market failure. Governments can use several methods to control this behaviour.

1. Price regulation (a price cap). The government or a regulator sets a maximum price that the monopoly cannot exceed, as New Zealand did for its water companies in 2019. This is shown below.



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Without regulation the monopoly profit maximises where MR = MC, producing Qm at price Pm (point A). If the cap is set at Pmax, where AR = MC, the firm cannot charge more than Pmax, so its AR curve becomes horizontal at Pmax up to point B and MR = Pmax over this range. It now maximises profit at Q1, where P = MC, so output rises from Qm to Q1 and price falls from Pm to Pmax. The firm becomes allocatively efficient, the deadweight loss is removed, supernormal profit falls and consumer surplus rises. An RPI – X cap also forces the firm to cut its real price each year, removing X-inefficiency.

2. Profit regulation. The regulator limits the rate of return on capital the monopoly can earn. This stops excessive supernormal profit, so the firm must either lower prices or reinvest profit in improving its service.

3. Quality standards and performance targets, backed by fines. For water this could be a minimum legal quality of drinking water, or targets for reducing leaks, which stop the monopoly cutting costs by lowering quality.

4. Competition policy, such as blocking mergers, breaking up the monopoly or reducing barriers to entry to make the market more contestable, so that the threat of entry keeps prices close to cost. Finally, the government could nationalise the monopoly and run it in the public interest.

However, each method has limitations. Price caps can cause government failure. The New Zealand case shows that if the cap is set too low, the water companies make insufficient profit to invest in improving water quality, so dynamic efficiency falls and quality may get worse. Setting the right cap is difficult because of asymmetric information: the regulator relies on the firm for cost data, and the firm has an incentive to overstate its costs so that it is given a generous cap. The level of X-inefficiency is also hard to estimate; if it is overestimated, X is set

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too high and the firm may struggle to stay profitable.

Profit regulation reduces the incentive to cut costs, because any savings simply reduce allowed profit; the firm may even inflate costs, increasing X-inefficiency. Performance targets may lead the firm to focus only on the measured targets, reducing quality in other areas of the business, and they are costly to monitor. Competition policy is less suitable for water, which is a natural monopoly; one network of pipes is cheapest, so breaking it up would lose economies of scale and raise average costs. Nationalisation removes the profit motive, which may cause inefficiency.

In addition, regulatory capture may occur, where the regulator starts to act in the interests of the firms rather than consumers, and a new regulator may lack the resources or legal powers to investigate the monopoly fully.

In conclusion, for a natural monopoly such as water, regulation is more appropriate than breaking up the firm, and a price cap combined with quality standards is likely to be the most effective method because it protects consumers from high prices while forcing minimum quality. However, its success depends on the regulator having good information and setting the cap at the right level; the New Zealand example shows that the cap must allow enough profit for investment, for example by letting prices rise to fund approved investment in water quality.

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Pearson Edexcel International Advanced Level

Time 2 hours

Paper reference **WEC13/01**

Economics

International Advanced Level
UNIT 3: Business behaviour

Source Booklet

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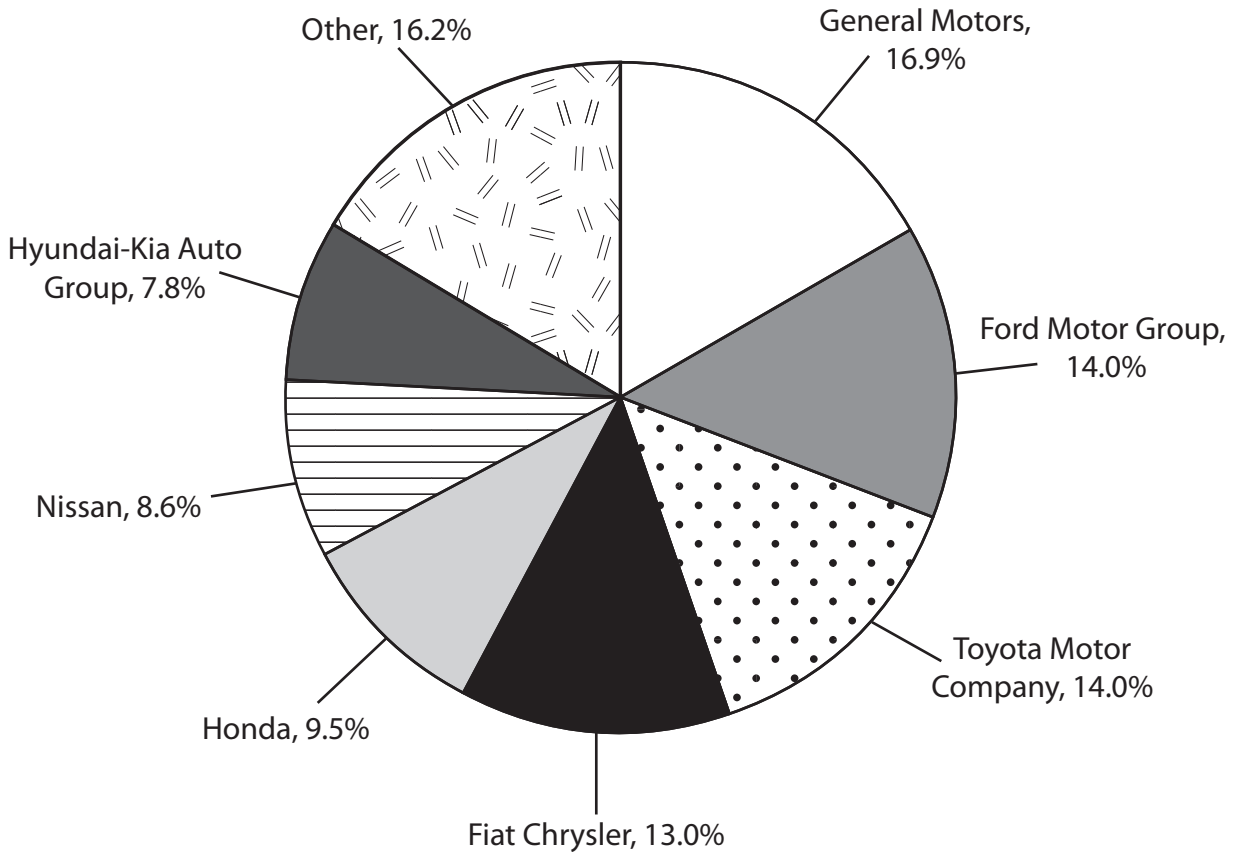
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Sources for use with Section B

The car industry

Figure 1

Percentage market share of car manufacturers in the USA, 2019



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Extract A PSA Group and Fiat Chrysler merger

In January 2021 PSA Group and Fiat Chrysler agreed to merge, creating the world's third largest car manufacturer by volume. The new firm, named Stellantis, includes well-known car brands including Peugeot, Citroen and Vauxhall from PSA Group and Alfa Romeo, Jeep and Lancia from Fiat Chrysler. The ownership of the firm is split evenly between the shareholders of PSA Group and Fiat Chrysler. As a result of this merger, Stellantis owns manufacturing plants all over the world including the Netherlands, the USA and the UK. It has an expected annual turnover of over €170 billion.

This horizontal integration is expected to benefit both firms. Each firm will benefit from cost savings by sharing production expertise and technical knowledge. It is estimated that there will be an annual cost saving of €3.4 billion from purchasing economies of scale. PSA Group has gained access to the American car market, where Fiat Chrysler already has a significant market share, with 3 000 car showrooms across the USA. Following the merger, in Q1 2021 Stellantis experienced a 25% increase in revenue as a result of an increase in car sales in the US market.

Fiat Chrysler will benefit from gaining access to PSA Group's research and development into electric cars. This is important for the firm because demand for electric cars is increasing globally. PSA Group has developed a range of low-emission vehicles that Fiat Chrysler does not have the technology to produce. Electric cars are also important when moving into foreign markets such as China. Since 2010, the demand for electric cars in China has been rising steadily. In 2020 38% of global sales of electric cars were in China.

The shareholders of Stellantis hope that the firm will be able to compete more effectively in China, the world's biggest car market. In 2020 PSA Group and Fiat Chrysler had a combined market share of only 1% in the Chinese car market, whereas Chinese car firms had a 40% market share. In addition, a number of other well-established firms are operating in the Chinese car market including Volkswagen, Honda and Toyota. Trying to increase market share in China may prove to be difficult for Stellantis. Good communication and clear management will be essential if Stellantis is to be successful.

Extract B Concerns over factory closures

Trade unions are concerned that Stellantis will close factories to cut costs. Unite, the UK-based trade union negotiating on behalf of the 3 000 Vauxhall employees, has requested a meeting with the head of Stellantis, to prevent possible factory closures. The skilled car workers are highly specialised. Therefore, if these factories were to close, it would be very difficult for the workers to find new jobs without training.

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Acknowledgements

Figure 1 https://www.statista.com/statistics/249375/us-market-share-of-selected-automobile-manufacturers/

Extract A https://www.autoexpress.co.uk/fiat/108280/stellantis-fca-and-groupe-psa-merger-confirmed

https://www.forbes.com/sites/michaeltaylor/2020/12/21/eu-approves-psa-merger-with-fca-in-automotive-deal-of-the-year/?sh=1b5c00e07063

https://www.ft.com/content/8c1192db-125b-46a7-b15b-abaad29583f9

https://www.autonews.com/article/20170127/RETAIL06/301279881/fca-adding-as-many-as-400-u-s-dealerships-sources-say

Extract B https://www.theguardian.com/business/2019/dec/18/peugeot-and-fiat-chrysler-agree-terms-of-38bn-merger