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 Section A and Section 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.

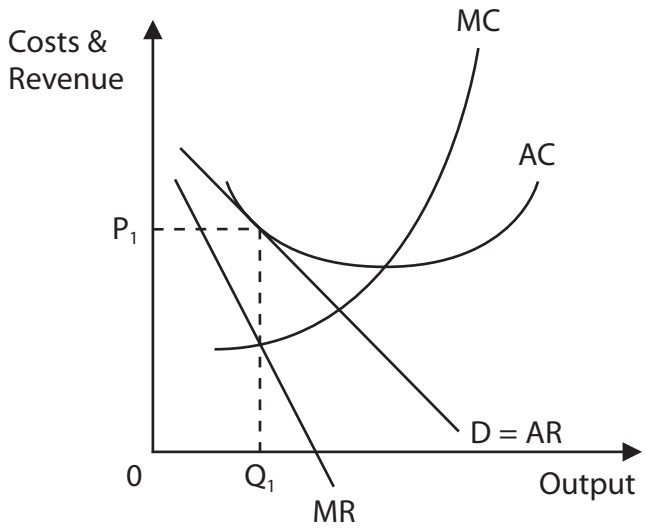
Questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.

1 *Ceteris paribus*, which **one** of the following would reduce the geographical mobility of labour within a country?

- ☐ **A** An increase in relocation grants paid by the government
- ☒ **B** An increase in the costs of relocating from one region to another
- ☐ **C** More accurate information about job opportunities in different locations
- ☐ **D** Similar average house prices in different regions of the country

(Total for Question 1 = 1 mark)

2 The diagram shows the long-run equilibrium for a restaurant in Bangkok, Thailand, operating in a monopolistically competitive market.



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

- ☐ **A** The firm is producing the allocatively efficient level of output at price P_1
- ☐ **B** The firm will leave the industry if average costs fall
- ☐ **C** The firm is producing the productively efficient level of output Q_1
- ☒ **D** The firm is making normal profit

(Total for Question 2 = 1 mark)

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3 The table shows the total costs of a battery manufacturer at different levels of output.

Output	Total costs (£)
0	£4 500
100	£8 000
200	£10 700
300	£13 200
400	£15 300

Which **one** of the following is the average variable cost at 300 units?

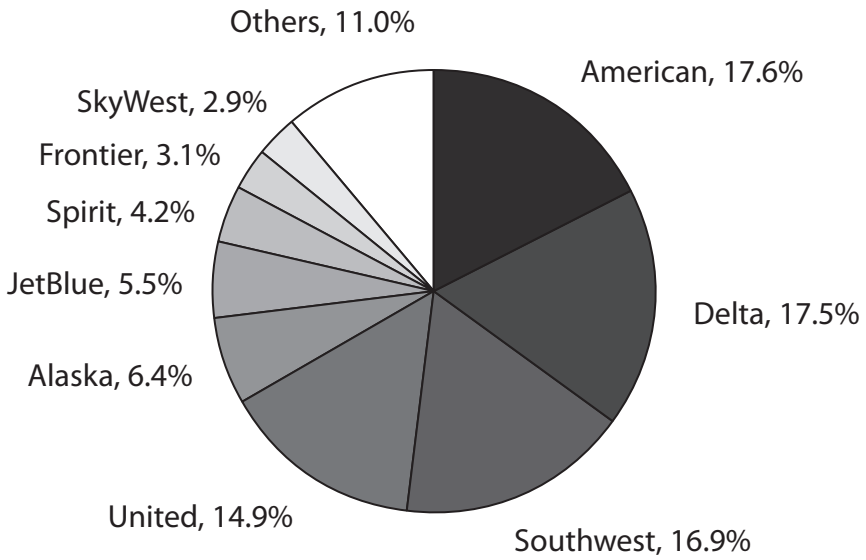
- ☒ **A** £15
- ☒ **B** £27
- ☒ **C** £29
- ☒ **D** £44

(Total for Question 3 = 1 mark)

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4 The chart shows the market share, by revenue, for airlines operating domestic flights in the USA, February 2019–January 2020.



Which **one** of the following is the five-firm concentration ratio for airlines operating domestic flights in the USA?

- ☒ **A** 66.9%
- ☒ **B** 73.3%
- ☒ **C** 77.9%
- ☒ **D** 78.8%

(Total for Question 4 = 1 mark)

5 In January 2021 the UK Government set up a new national construction products regulator to ensure that homes are built from safe materials.

Which **one** of the following would limit the impact of government intervention in the housing market?

- ☒ **A** Perfect mobility of resources
- ☒ **B** A flexible labour market
- ☒ **C** Perfect knowledge of the housing market
- ☒ **D** Regulatory capture

(Total for Question 5 = 1 mark)

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6 Prior to 2016 there was a competitive labour market for nurses in Argentina. Following the introduction of a universal healthcare system there is now a monopsony employer of nurses in the country.

Which **one** of the following combinations is the most likely impact of the introduction of this monopsonistic labour market?

		Wages	Number of employees
☒	**A**	Lower	Lower
☒	**B**	Lower	Higher
☒	**C**	Higher	Lower
☒	**D**	Higher	Higher

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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SECTION B

Study Figures 1 and 2 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 percentage change in Amazon's revenue between 2010 and 2020.

(2)

(b) With reference to Figure 2, explain the market structure of cloud infrastructure providers.

(4)

(c) With reference to Extract A, analyse the likely impact on consumers of **two** methods by which Amazon competes with other retailers.

(6)

(d) With reference to Extract A, examine **two** likely effects of the global health crisis on Amazon's profits.

(8)

(e) With reference to Extract B and your own knowledge, discuss reasons why many SMEs in South Africa shut down in 2020.

Illustrate your answer with an appropriate diagram.

(14)

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7 (a) With reference to Figure 1, calculate the percentage change in Amazon's revenue between 2010 and 2020.

(2)

Percentage change = (new value − old value) ÷ old value × 100

= (386.06 − 34.20) ÷ 34.20 × 100

= 351.86 ÷ 34.20 × 100

= 1028.83% (an increase of about 1029%)

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(b) With reference to Figure 2, explain the market structure of cloud infrastructure providers.

(4)

The market for cloud infrastructure is an oligopoly; a market dominated by a few large firms which are interdependent, so each firm must consider how its rivals will react to its decisions on price and output. Oligopolists have some market power and the market is protected by high barriers to entry.

In Figure 2, Amazon web services has a 33% market share and Microsoft Azure has 18%, so the two-firm concentration ratio is 33% + 18% = 51%. Adding Google Cloud (8%) and IBM Cloud (6%) gives a four-firm concentration ratio of 65%, and the five-firm ratio is 70%, so the market is highly concentrated.

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(c) With reference to Extract A, analyse the likely impact on consumers of **two** methods by which Amazon competes with other retailers.

(6)

1. Low prices. Amazon competes on price, using its huge scale (revenue of $386.1 billion in 2020) to gain economies of scale and charge lower prices than many rival retailers. This makes Amazon more price competitive. Consumers benefit because they pay less for the same products, which increases consumer surplus and their real income, and encourages them to switch from alternative retailers to Amazon. However, if rivals are driven out, consumers may eventually face less competition.

2. Convenience and fast delivery. Amazon operates mainly online, and over 28% of consumers complete an order in three minutes or less and 50% in under 15 minutes. This is a form of non-price competition through better customer service. Consumers do not have to travel to a physical store, which saves them time and travel costs, and fast delivery means they receive their goods without delay. This raises consumer welfare and satisfaction, so consumers are more likely to stay loyal to Amazon. Amazon also offers wide choice, selling its own products such as Kindle and Echo alongside millions of products from third party suppliers, which helps consumers find exactly what meets their needs.

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(d) With reference to Extract A, examine **two** likely effects of the global health crisis on Amazon's profits.

(8)

Profit = total revenue – total cost, so the health crisis affected Amazon's profits through both its revenue and its costs.

1. Higher revenue. In 2020 the global health crisis prevented consumers from visiting physical stores, so many people bought products online from Amazon instead. Demand for goods supplied by Amazon increased, so its sales rose and revenue increased from $280.5 billion in 2019 to $386.1 billion in 2020, a rise of $105.6 billion. Higher total revenue, other things equal, increases Amazon's profit.

2. Higher costs. To meet the extra demand Amazon employed an additional 400 000 workers in 2020, giving 1.3 million workers globally, and its costs of production increased by $4 billion. A fall in labour productivity also raised costs, because the workforce expanded so rapidly that new, untrained workers produced less output per worker, so labour cost per unit rose. Higher total and average costs reduce profit margins and therefore reduce profit.

Evaluation: The overall effect depends on the relative size of the changes in revenue and costs. Revenue rose by $105.6 billion while costs rose by only $4 billion, so the net effect is very likely to be a large increase in profit, which is shown by profit of $167.6 billion for the year ending March 2021. However, the effect may only be short run: once the crisis is resolved and physical shops reopen, some consumers will return to alternatives, so revenue growth may not be sustained. On the cost side, productivity is likely to recover in the long run as new staff become more experienced, and Amazon may substitute capital such as automated warehouses for labour, which would restore profit margins.

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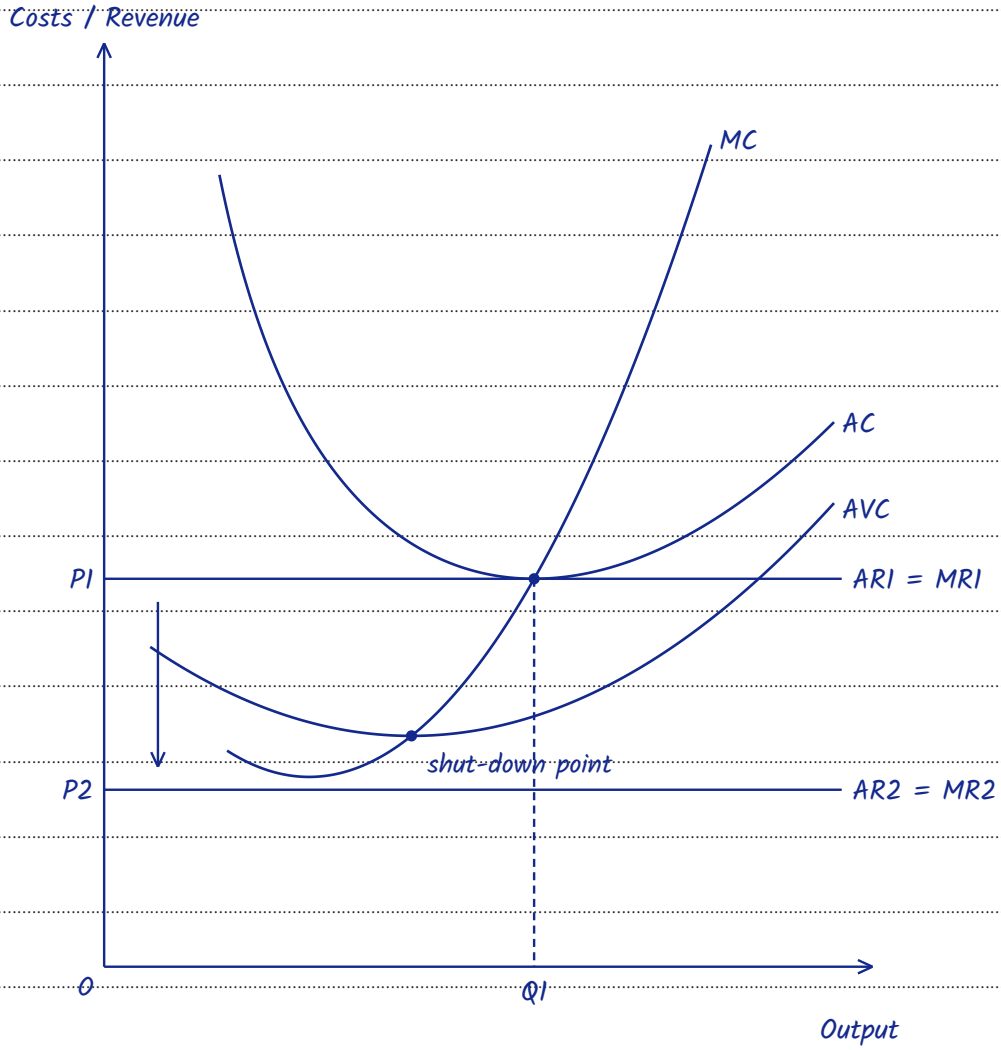
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(e) With reference to Extract B and your own knowledge, discuss reasons why many SMEs in South Africa shut down in 2020.

Illustrate your answer with an appropriate diagram.

(14)

A firm shuts down when it stops production. In the short run a firm will shut down if the price (average revenue) it receives does not cover its average variable cost (AVC), because by staying open it would lose more than its fixed costs. In the long run a firm will leave the market if it cannot cover its average total costs (AC), so it cannot earn at least normal profit.



In the diagram an SME is initially at P1, where AR = AC at output Q1, so it makes normal profit. Extract B says the revenues of many South African enterprises fell significantly because of the global health crisis. Lockdowns and falling incomes reduced demand, so the price the firm can charge falls from P1 to P2 (AR1 = MR1 shifts down to AR2 = MR2). P2 is below the

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minimum of the AVC curve, the shut-down point, so at any output the firm cannot cover its variable costs such as wages and materials. Producing would add to its losses, so the profit maximising (loss minimising) output is zero: it shuts down. Extract B confirms that "the revenue of many SMEs did not cover their variable costs and they were forced to shut down", and 21% of the 4 500 enterprises surveyed were closed.

Rising costs also caused closures. Health measures and supply disruption raised costs, which shifts AVC and AC upwards, so even firms with unchanged prices may fall below the shut-down point. SMEs were especially vulnerable: they were 26 times more likely to close than much larger enterprises. This is because they lack economies of scale, so their average costs are higher, and they have little retained profit or access to cheap loans to cover losses until demand recovers. They would need R1.1 trillion of government financial support to remain open in 2021, which shows how severe their cash flow problems were.

Evaluation: Not all SMEs were forced to shut down permanently. Of the enterprises that were closed, 64% expected to reopen, which suggests a short-run shut down: firms stopped producing while price was below AVC but stayed in the industry, expecting demand to recover. Only a firm that cannot cover AC in the long run leaves the market for good.

Also, the impact was not the same for every firm. SMEs offering essential services such as food saw revenues increase, and profits remained constant or increased, so demand shifted out for them. Many firms also survived by cutting costs: 70% of SMEs cut back on spending and over half of medium-sized enterprises closed parts of the business or reduced capacity, which lowers variable costs so that AR can still cover AVC.

Finally, whether more SMEs close in 2021 depends on government support. If the R1.1 trillion is

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provided, many firms can cover their costs and survive, but this is a very large sum and the government may not be able to afford it. Overall, the main reason for the shut downs was the fall in revenue below variable cost caused by the crisis, made worse by the weak financial position of small firms, but for most firms this was likely to be a temporary rather than a permanent exit.

(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 2021, the UK-based firm PhotonLens, which produces virtual reality smart glasses, merged with the Chinese firm Shadow Creator, which specialises in virtual reality software.

Evaluate the benefits of growth by merger.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 8 = 20 marks)

9 The tax authority in Singapore offers a tax incentive of up to S$100 000 to new businesses in their first three years of trading. The objective of this scheme is to promote competition.

Evaluate methods that a government could use to promote competition in a market.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 9 = 20 marks)

10 The Indian premium smartphone industry is dominated by three firms: Apple, Samsung and OnePlus. These firms compete mainly using non-price competition.

Evaluate the use of non-price and price competition in oligopolistic markets.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 10 = 20 marks)

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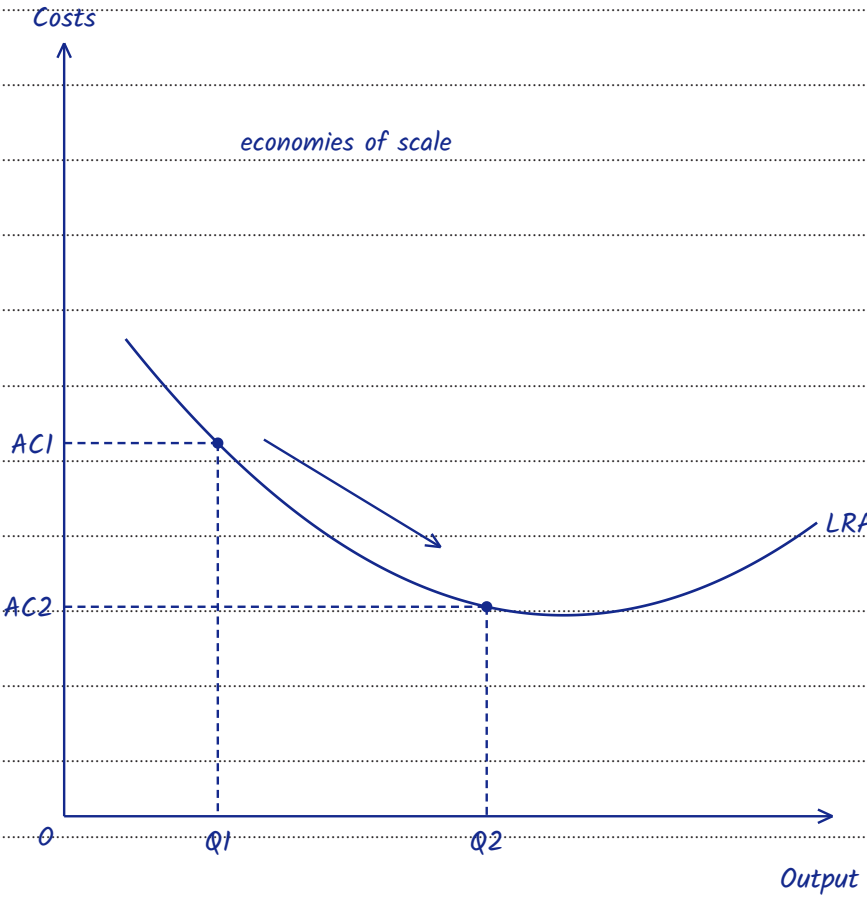
Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Write the answer to your SECOND chosen question on page 22.

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

A merger is when two or more firms join together to form one new organisation. PhotonLens, which makes virtual reality smart glasses, merged with Shadow Creator, which specialises in virtual reality software. Because the firms make complementary products for the same final market, this is a form of conglomerate or vertical integration rather than a merger of direct rivals.

1. Economies of scale. A merger allows a firm to grow quickly, increasing output, so it can benefit from economies of scale and move down its long-run average cost curve (LRAC), as shown below.



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Before the merger each firm produces at Q1 with average cost AC1. After merging, combined output rises to Q2 and average cost falls to AC2, closer to the minimum efficient scale. The merged firm can share research and development costs (technical economies), buy components in bulk (purchasing economies) and borrow more cheaply (financial economies). Lower average costs increase the profit margin on each unit and improve productive efficiency, and the savings can be passed on to consumers as lower prices.

2. Faster growth and higher market share. Growth by merger is much quicker than organic growth, because the firm gains the other firm's customers, brands and distribution network immediately. Higher market share increases sales, revenue and market power, so the firm becomes a price maker and can earn supernormal profits. A horizontal merger also eliminates a competitor.

3. Sharing resources and expertise. PhotonLens and Shadow Creator can combine their human capital and expertise in hardware and software, so they can develop new products more quickly, for example smart glasses designed together with the software needed for them to work. This improves dynamic efficiency, and consumers benefit from higher quality, innovative products.

4. Diversification and security of supply. By moving into a market it did not operate in before, a firm spreads its risk: if demand for one product falls, the other can support profits, which is a risk bearing economy of scale. Backward vertical integration guarantees supplies of inputs and lowers their cost, while forward integration secures outlets for the product.

However, the benefits may be smaller than expected. Growth by merger is expensive: the acquiring firm often pays a premium above the value of the other business, plus legal and

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advisory costs, which may reduce profits for years. Many mergers fail to create value because of a culture clash. A UK firm and a Chinese firm have different management styles, languages and working practices, which could cause conflict and poor decisions, harming profits and reputation.

If the merged firm grows too large, diseconomies of scale may set in. Communication and coordination problems between managers in two countries raise average costs, so the firm moves past the minimum point to the rising part of the LRAC, and the cost savings in the diagram are not achieved. Entering new markets where the business lacks expertise may also raise costs. If the merger leads to job losses, the remaining employees may become demotivated and productivity falls.

The benefits to the firm may also come at the expense of others. Greater market power may allow it to raise prices and reduce choice for consumers, so the benefits are not shared. For this reason some mergers are blocked by the competition authorities, so growth by merger is not always an option. The extent of the benefits also depends on the type of merger: technical economies of scale are largest in a horizontal merger, whereas PhotonLens and Shadow Creator gain more from shared expertise than from bulk production.

In conclusion, growth by merger can bring substantial benefits through economies of scale, faster growth and shared expertise, and for firms like PhotonLens and Shadow Creator, whose products work together, the gains in innovation are likely to be significant. However, the benefits depend on how well the two businesses are integrated and on whether the firm avoids diseconomies of scale. Since many mergers fail because of culture clashes and high costs, the benefits are most likely to be realised in the long run, and only if the merger is well managed.

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Write the answer to your SECOND chosen question here.

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

An oligopoly is a market dominated by a few large firms, such as the Indian premium smartphone industry, which is dominated by Apple, Samsung and OnePlus. Oligopolists are interdependent and can compete through price competition (changing the price, such as price wars, limit pricing or predatory pricing) or non-price competition (competing on anything other than price).

Non-price competition includes improving the features, quality and design of the product, such as new camera technology in smartphones, advertising and branding, celebrity endorsements and after-sales service. Its purpose is to increase demand and to make demand less price elastic by building brand loyalty. The demand curve shifts to the right and becomes steeper, so firms such as Apple can sell more phones at a higher price, increasing revenue and supernormal profit. Consumers benefit from better quality products and more choice. Supernormal profits can be reinvested in research and development, so non-price competition promotes dynamic efficiency.

Price competition can also benefit firms and consumers. Because the few large firms each have a high market share and produce large outputs, they benefit from economies of scale, so long-run average costs are low and they can afford to cut prices. Lower prices increase consumer surplus and allocative efficiency. A firm may also use limit pricing, setting price low enough to deter new entrants, or predatory pricing, setting price below average cost to force a rival out of the market and then raising prices later.

However, price competition tends to be avoided in oligopoly, and game theory explains why.

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Suppose Apple and Samsung can each keep a high price or cut the price. The payoff matrix shows their profits ($bn), with Apple's profit first:

		Samsung: High price	Samsung: Cut price
Apple: High price		$10bn, $10bn	$4bn, $14bn
Apple: Cut price		$14bn, $4bn	$6bn, $6bn

Each firm has a dominant strategy to cut its price: if Samsung keeps a high price, Apple earns $14bn by cutting instead of $10bn; if Samsung cuts, Apple earns $6bn by cutting instead of $4bn. The same applies to Samsung, so the Nash equilibrium is that both cut price and earn only $6bn each, whereas both keeping a high price would earn $10bn each. This prisoners' dilemma shows that price competition can lead to a price war in which both firms lose profit. This is why oligopolists prefer stable prices and compete mainly through non-price competition, as in the Indian market.

Evaluation: Non-price competition is costly. Advertising, celebrity endorsements and research are large sunk costs, and if they have little impact on demand, for example because rivals respond with their own campaigns, profits fall and the spending is wasted. These sunk costs do act as a barrier to entry, which protects the incumbents' market power but reduces choice for consumers in the long run. Consumers may also pay higher prices for brand image rather than genuine improvements in quality.

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Price competition can also be harmful. A price war reduces the profits of all firms, limiting their ability to invest in new technology, so product quality may fall. Predatory pricing may force firms out of the industry, reducing choice and giving the survivors more power to raise prices, and it is illegal, so firms risk fines from the competition authorities. Because firms are interdependent, a rival's reaction to a price cut is unpredictable, so the outcome is uncertain. Finally, if oligopolists collude, formally in a cartel or tacitly, price competition will not occur at all.

The best strategy depends on the market. In the premium smartphone market, consumers value features, quality and brand, so demand is relatively price inelastic and a price cut would gain few customers while reducing revenue, which makes non-price competition more effective. In markets with similar, homogeneous products and more price-sensitive consumers, such as budget smartphones, price competition is more important.

In conclusion, oligopolists such as Apple, Samsung and OnePlus are right to rely mainly on non-price competition, because it raises demand and profit without the risk of a price war shown by the prisoners' dilemma. Price competition benefits consumers in the short run, but it is risky for firms and can reduce competition in the long run if it drives rivals out. Most oligopolists will therefore use a mix of the two, competing mainly on quality and brand while keeping prices stable.

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Time 2 hours

Paper reference **WEC13/01**

Economics

International Advanced Level
UNIT 3: Business behaviour

Source Booklet

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Sources for use with Section B

The impact of the global health crisis

Figure 1 Amazon's annual revenue, 2010–2020 (billion US dollars)

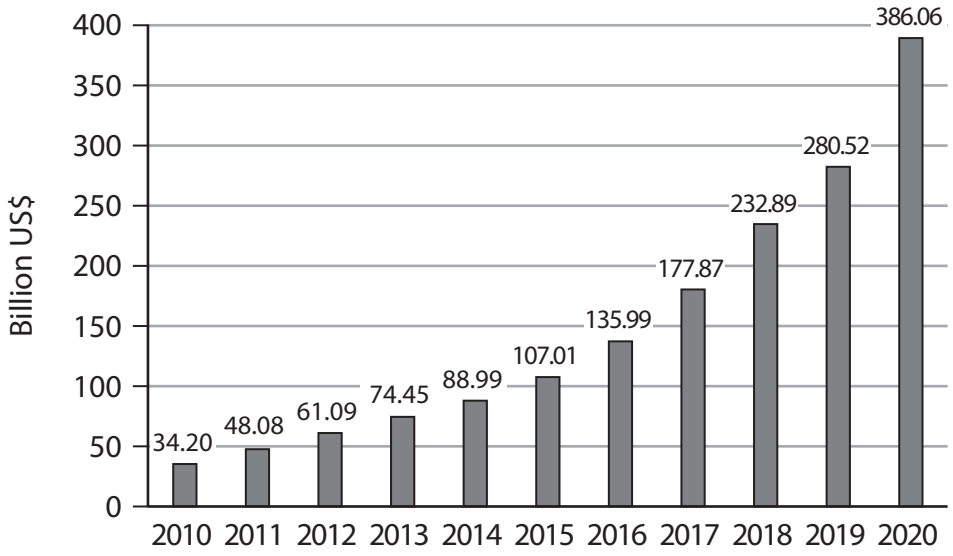
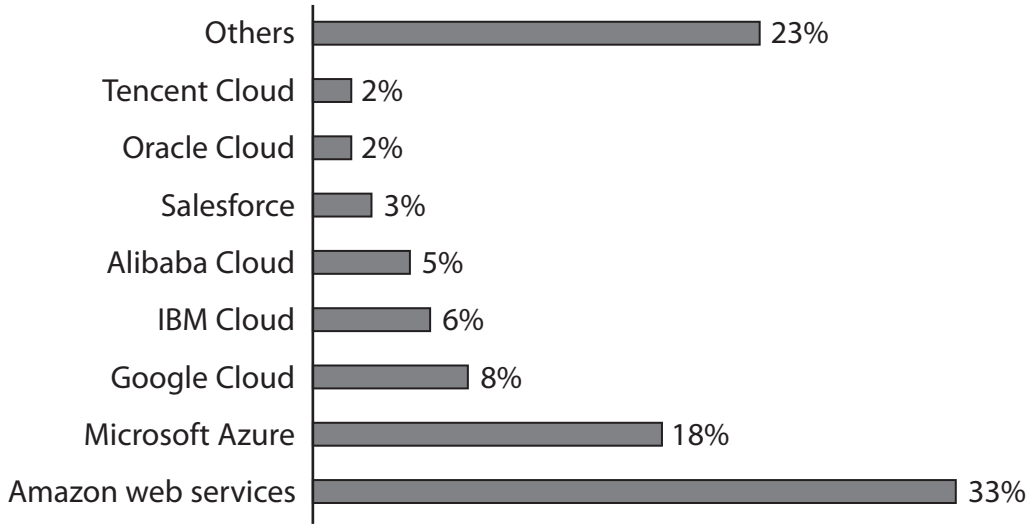


Figure 2 Worldwide market share of cloud infrastructure providers by revenue, Q4 2019



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Extract A Amazon

Amazon, the American global distribution business, increased its revenue from $280.5 billion in 2019 to $386.1 billion in 2020. For the year ending 31 March 2021 its profit was $167.6 billion. The business operates mainly online but it also has several physical stores. Amazon's success has been driven by its methods of competition including its focus on convenience, fast delivery, low prices and choice for its consumers. Over 28% of consumers complete an Amazon order in three minutes or less and 50% of consumers in under 15 minutes. Amazon produces its own products such as Amazon Prime, Alexa, Kindle, Fire and Echo, as well as selling millions of additional products. Amazon also offers the opportunity for third party suppliers to sell on its website.

During 2020, the global health crisis prevented consumers from visiting physical stores. As a result many people used Amazon to purchase products online. This led to an increase in the demand for goods supplied by Amazon. Its costs of production increased by $4 billion, mainly as a result of employing an additional 400 000 workers in 2020. By the end of the year, it employed 1.3 million full-time and part-time workers globally. A fall in labour productivity also caused an increase in costs.

Extract B Small and medium-size enterprises (SMEs) in South Africa

As a result of the global health crisis the revenues of many South African enterprises fell significantly. In July 2020 a management consultancy company conducted a survey of 4 500 businesses in South Africa to examine the impact of the global health crisis. It reported that 21% of enterprises were closed but, of these, 64% indicated that they expected to reopen.

The survey also established that SMEs were 26 times more likely to close than much larger enterprises. In addition, SMEs would require R1.1 trillion of government financial support in order to remain open in 2021. In South Africa SMEs make up 98.5% of the total number of enterprises and contribute 39% to the country's GDP.

In the survey 70% of SMEs reported that they cut back on spending to survive. Over half of medium-sized enterprises were only able to survive by closing parts of their business or reducing capacity until the economic situation improved. However, the revenue of many SMEs did not cover their variable costs and they were forced to shut down.

The survey findings were not all negative. Those SMEs offering essential services, such as food, reported an increase in revenues. Although costs had also risen, profits had either remained constant or had increased.

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Acknowledgements

Figure 1 www.statista.com/graphic/1/266282/annual-net-revenue-of-amazoncom.jpg

Figure 2 https://www.ibtimes.com/infographic-amazon-leads-100-billion-cloud-market-2920755

Extract A

https://s2.q4cdn.com/299287126/files/doc_financials/2021/ar/Amazon-2020-Annual-Report.pdf

https://ir.aboutamazon.com/annual-reports-proxies-and-shareholder-letters/default.aspx

Extract B

https://www.mckinsey.com/~/media/McKinsey/Featured%20Insights/Middle%20East%20and%20Africa/How%20South%20African%20SMEs%20can%20survive%20and%20thrive%20post%20COVID%2019/How-South-African-SMEs-can-survive-and-thrive-post-COVID-19.pdf

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