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

Friday 20 October 2023

Morning (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 It is estimated that Japan's population of working age will fall from 65.3 million in 2017 to 60.8 million in 2025.

Ceteris paribus, which **one** of the following might result from this fall in Japan's population of working age?

- ☒ **A** A decrease in job vacancies
- ☒ **B** An increase in the rate of unemployment
- ☒ **C** A decrease in immigration into Japan
- ☒ **D** An increase in wage rates

(Total for Question 1 = 1 mark)

2 In 2022 the Government of Canada updated its competition policy in order to increase market contestability.

Ceteris paribus, which **one** of the following would increase market contestability?

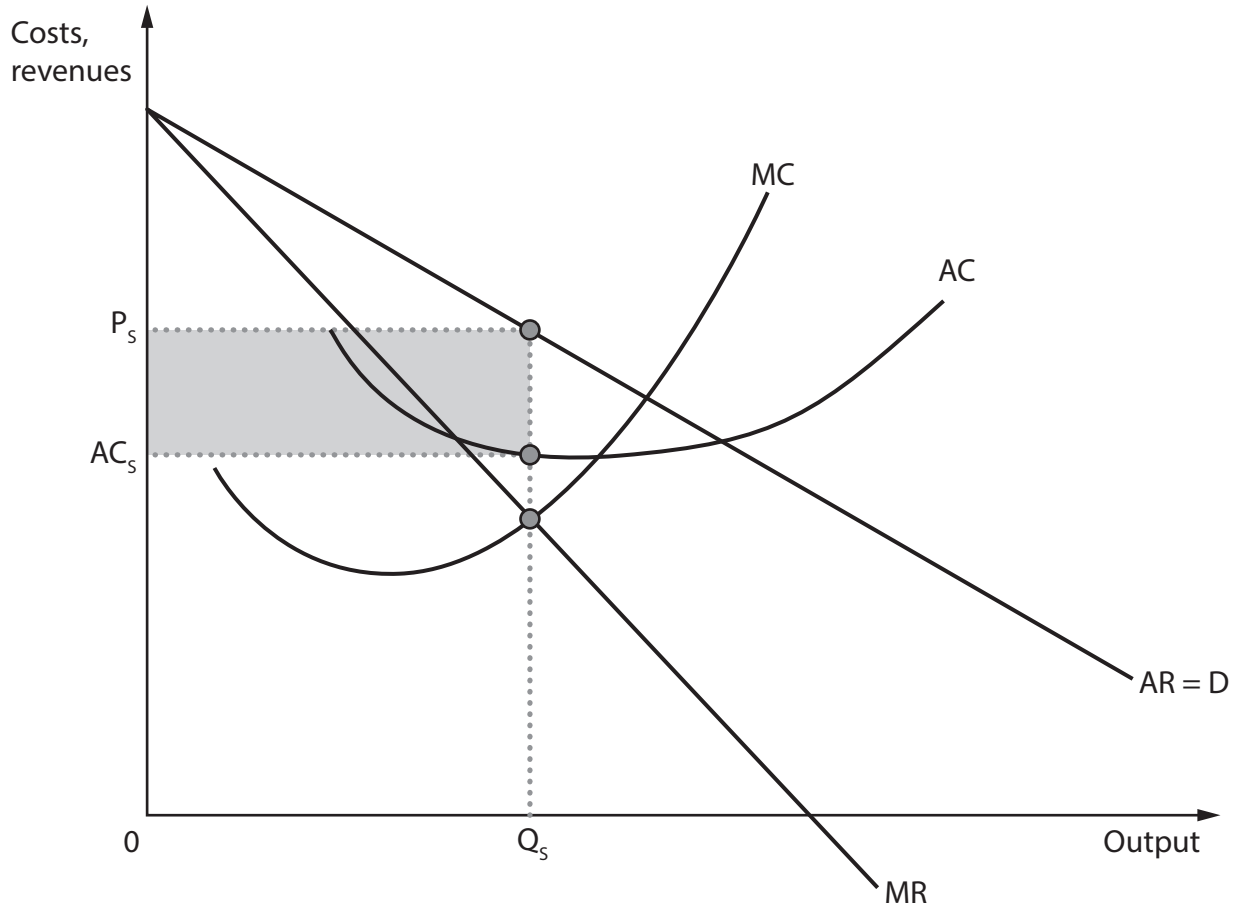
- ☒ **A** An increase in legal costs to start a business
- ☒ **B** An increase in legislation to control mergers
- ☒ **C** An increase in patent protection
- ☒ **D** An increase in regulatory capture

(Total for Question 2 = 1 mark)

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3 The diagram illustrates the profit-maximising output for a street food seller in Taiwan operating in a monopolistically competitive market.



Which **one** of the following can be deduced from this information?

- ☒ **A** The street food seller is operating at the short-run equilibrium output
- ☒ **B** The street food seller is operating at the long-run equilibrium output
- ☒ **C** The street food seller is operating at the productively efficient level of output
- ☒ **D** The street food seller is operating at the allocatively efficient level of output

(Total for Question 3 = 1 mark)

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4 Big Bazaar is a large grocery retailer in India. It faces a downward-sloping average revenue curve and is making supernormal profits. In 2022 rental costs increased by an average of 6.5%.

Ceteris paribus, which **one** of the following combinations indicates the impact of this increase in rental costs on Big Bazaar?

		Profit	Price
☒	**A**	No change	No change
☒	**B**	Rise	Decrease
☒	**C**	Fall	No change
☒	**D**	No change	Decrease

(Total for Question 4 = 1 mark)

5 The table shows the total costs of a shirt manufacturer at different levels of output.

Output	Total costs $
0	100 000
5 000	120 000
10 000	150 000
15 000	170 000
20 000	180 000

Which **one** of the following is the average fixed cost if the shirt manufacturer is producing 10 000 shirts?

☒ **A** $5

☒ **B** $6.67

☒ **C** $10

☒ **D** $20

(Total for Question 5 = 1 mark)

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6 In 2022 the average price of a standard cinema ticket in Johannesburg, South Africa, was R60 in the daytime and R105 in the evening.

Which **one** of the following is the most likely reason for this price difference?

- ☒ **A** The demand for cinema tickets is more price inelastic in the daytime than in the evening
- ☒ **B** The demand for cinema tickets is more price elastic in the daytime than in the evening
- ☒ **C** The supply of cinema tickets is perfectly price elastic
- ☒ **D** The supply of cinema tickets is more price elastic in the evening than in the daytime

(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 2, calculate the percentage change in the price of the Model 3 Rear Wheel Drive vehicle between January and October 2022.

(2)

(b) With reference to Extract A, analyse **two** reasons why sales of electric vehicles in China increased.

Illustrate your answer with a supply and demand diagram.

(6)

(c) With reference to Figure 1 and Extract B, explain the market structure that best describes the electric vehicle market in China.

(4)

(d) With reference to the first two paragraphs of Extract B, examine the impact of Tesla producing its electric vehicles in China on its costs and profits.

Illustrate your answer with a costs and revenues diagram.

(8)

(e) With reference to the information provided and your own knowledge, discuss the impact of Tesla reducing its prices on the behaviour of other electric vehicle manufacturers.

(14)

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7 (a) With reference to Figure 2, calculate the percentage change in the price of the Model 3 Rear Wheel Drive vehicle between January and October 2022.

(2)

Change in price = 266 − 280 = −14 thousand yuan

Percentage change = (−14 ÷ 280) × 100

= −5%, so the price fell by 5%

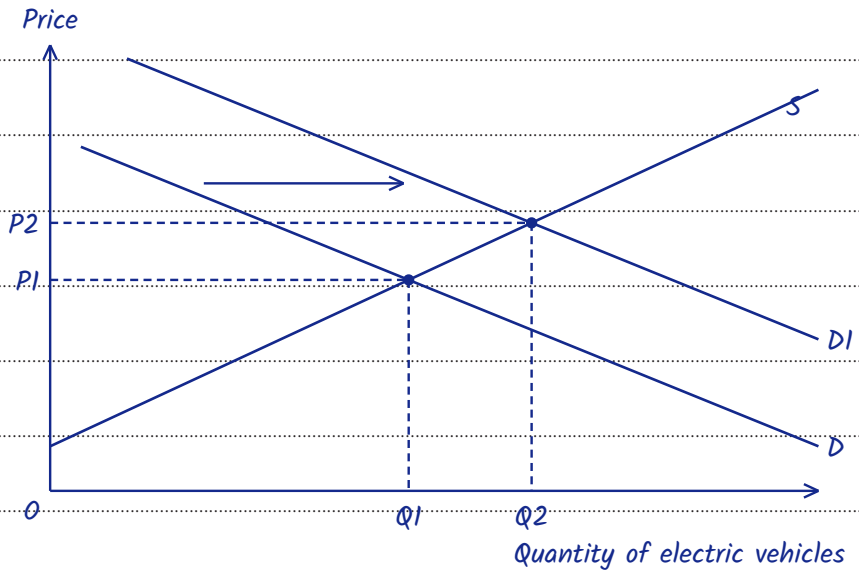
(b) With reference to Extract A, analyse **two** reasons why sales of electric vehicles in China increased.

Illustrate your answer with a supply and demand diagram.

(6)

1. Government measures to cut CO2 emissions. To meet its climate change goals by 2030 the Chinese Government increased the number of charging points, which makes electric vehicles more convenient to own, and raised the tax on non-electric vehicles, which raises the price of the main substitute. Both increase the demand for electric vehicles at every price, so demand shifts right from D to D1.

2. The global increase in the price of fuel. Petrol is a complement to non-electric cars, so a higher fuel price raises their running costs. Consumers switch to electric vehicles, which are a substitute, again shifting demand to the right.



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The rise in demand creates excess demand at P1, so price rises to P2 and the quantity sold rises from Q1 to Q2. This is shown in Extract A: between 2021 and 2022 sales of electric vehicles in China increased by 83% to 5.92 million.

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(c) With reference to Figure 1 and Extract B, explain the market structure that best describes the electric vehicle market in China.

(4)

The electric vehicle market in China is best described as an oligopoly, a market dominated by a few large firms, with a high concentration ratio, high barriers to entry and interdependence.

Using Figure 1, the three-firm concentration ratio is SAIC 25% + BYD 16% + Tesla 12% = 53%, and the four-firm concentration ratio is 53% + GAC 6% = 59%. The firms are interdependent: Extract B says that when Tesla cut its prices, domestic and other international manufacturers responded by reducing their prices as they competed for market share.

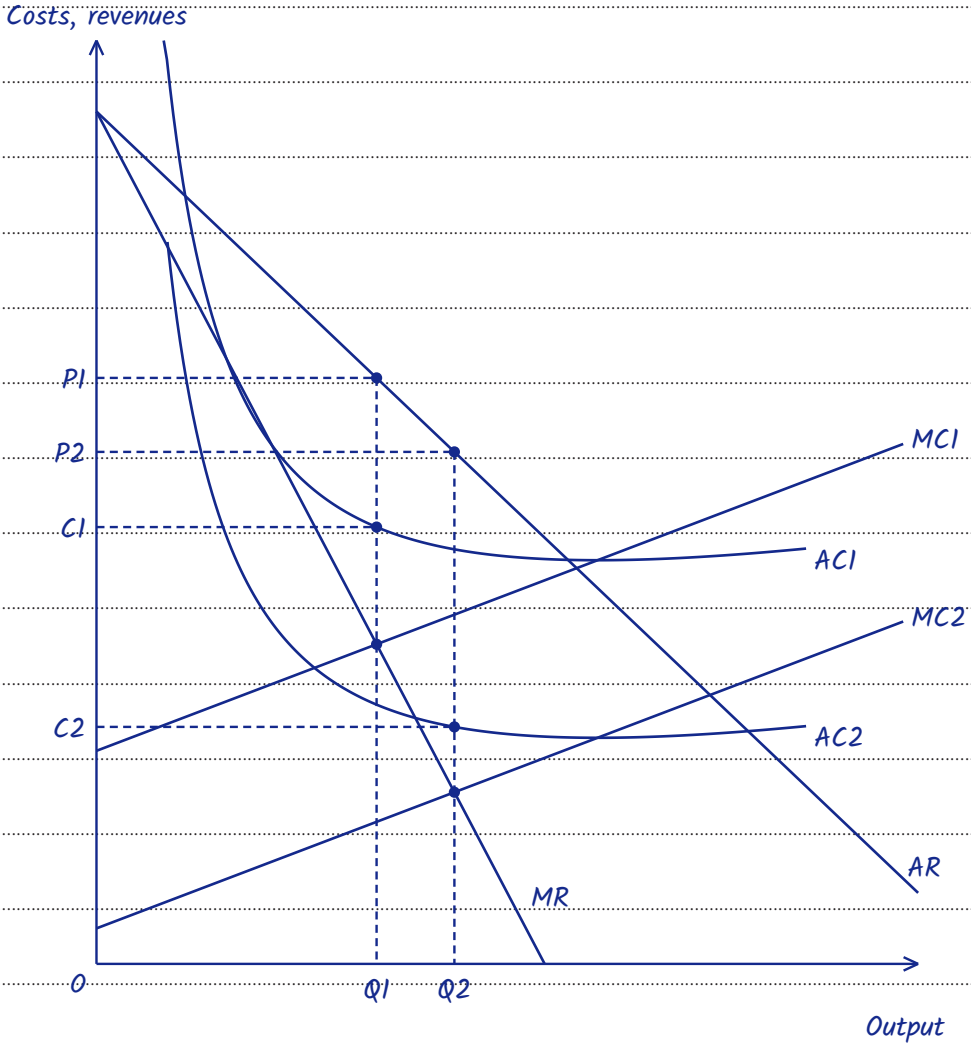
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(d) With reference to the first two paragraphs of Extract B, examine the impact of Tesla producing its electric vehicles in China on its costs and profits.

Illustrate your answer with a costs and revenues diagram.

(8)

Producing in China lowers Tesla's costs. It receives government subsidies aimed at promoting the domestic electric vehicle industry and benefits from low-cost labour. The Shanghai factory produced over 710 000 vehicles in 2022, 52% of Tesla's worldwide output, so it gains economies of scale and spreads its fixed costs over more units. Lower costs shift the cost curves down from MC1 and AC1 to MC2 and AC2.



Tesla profit maximises where MR = MC. Originally output is Q1 and price P1, with supernormal profit shown by the rectangle between P1 and C1 up to Q1. After costs fall, MR = MC2 at a higher output Q2, price falls to P2 and average cost falls to C2, so supernormal profit rises to

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the larger rectangle between P2 and C2 up to Q2. Improved efficiency in Shanghai let Tesla cut prices and still raise profit.

However, costs may in fact have risen. Production has been difficult in China: supply chain disruptions from the global health crisis reduced output and increased costs, and Tesla must pay taxes on imported components and finished vehicles. This would shift MC and AC up and reduce profit. The size of the cost saving also depends on how labour intensive production is; car making is capital intensive, so cheap labour matters less. In the long run subsidies may end and wages in China may rise as incomes grow, reducing the cost advantage, while supply chain problems should ease, lowering costs again.

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(e) With reference to the information provided and your own knowledge, discuss the impact of Tesla reducing its prices on the behaviour of other electric vehicle manufacturers.

(14)

By reducing its prices in October 2022, for example cutting the Model 3 Rear Wheel Drive by 5% from 280 to 266 thousand yuan and the Model Y Rear Wheel Drive from 317 to 289 thousand yuan, Tesla engaged in price competition: competing by offering lower prices to win customers. With only a 12% market share, behind SAIC (25%) and BYD (16%), Tesla wants to increase its market share.

Because the market is an oligopoly, firms are interdependent. If rivals kept their prices the same, consumers would switch to the cheaper Tesla vehicles, so rivals would lose sales and market share. Extract B shows that domestic and international manufacturers responded by cutting their own prices. Tesla is acting as a price leader, and the rivals' behaviour can be shown with game theory. The matrix shows illustrative profits (yuan bn) for Tesla and BYD, Tesla's payoff first.

	BYD keeps price	BYD cuts price
Tesla keeps price	10 , 10	5 , 14
Tesla cuts price	14 , 5	7 , 7

Whatever Tesla does, BYD earns more by cutting its price (14 > 10 and 7 > 5), so cutting price is the dominant strategy for both firms. The Nash equilibrium is that both cut, even though both would earn more if both kept prices high. This is a prisoner's dilemma and it can lead to a price war, where firms keep undercutting each other and supernormal profits are competed away.

Rivals may also suspect Tesla of limit pricing, keeping prices low to deter new entrants, or even

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predatory pricing, setting price below average variable cost to force smaller firms such as NIO (4%) and Li Auto (3%) out of the market. Smaller rivals may exit, and competitors could report Tesla to the competition authorities. Others may switch to non-price competition, such as advertising, branding, better batteries or longer warranties, to differentiate their cars instead of matching every price cut.

However, the impact on rivals may be limited. If manufacturers can differentiate their vehicles, or have a strong reputation for reliability, safety and quality, demand for their cars is more price inelastic and they need not cut prices. Domestic producers also receive government subsidies and use low-cost labour, so they can match Tesla's cuts without making losses. SAIC, with a 25% share, more than double Tesla's, is in a strong position to withstand the competition.

A price war also reduces revenue and profit for all firms, so manufacturers have an incentive to stop cutting prices and may tacitly collude. Lower supernormal profits also leave less money for research and development and non-price competition. If Tesla's or its rivals' costs rise in the long run, for example when subsidies end, prices may have to rise again. Predatory pricing is illegal, so Tesla risks fines and lost consumer confidence, which limits how far it will cut prices.

Overall, Tesla's price cuts are likely to force rivals to cut prices in the short run, because the firms are interdependent in an oligopoly. The long-run impact depends on how differentiated each rival's vehicles are and on their costs: large subsidised firms like SAIC and BYD can respond, while small firms may exit or rely on non-price competition.

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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 Pakistan, internet services are provided by a monopolist, Pakistan Telecommunication Company Ltd (PTCL). The quality of the service offered is poor and the internet speed is slow resulting in a high level of complaints from consumers.

Evaluate policies that a government could use to control and regulate monopolies, such as PTCL.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 8 = 20 marks)

9 In 2022 Belgium had an unemployment rate of 5.5% and a vacancy rate of 4.8%.

Evaluate policies that a government could use to reduce the geographical immobility of labour **and** the occupational immobility of labour.

Refer to industries of your choice in your answer.

(Total for Question 9 = 20 marks)

10 Nestlé is the largest manufacturer of pre-packaged food and beverages in the world, based on revenue. Its size has enabled it to reduce its average cost of production.

Evaluate the impact that the size of a business has on its efficiency.

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.

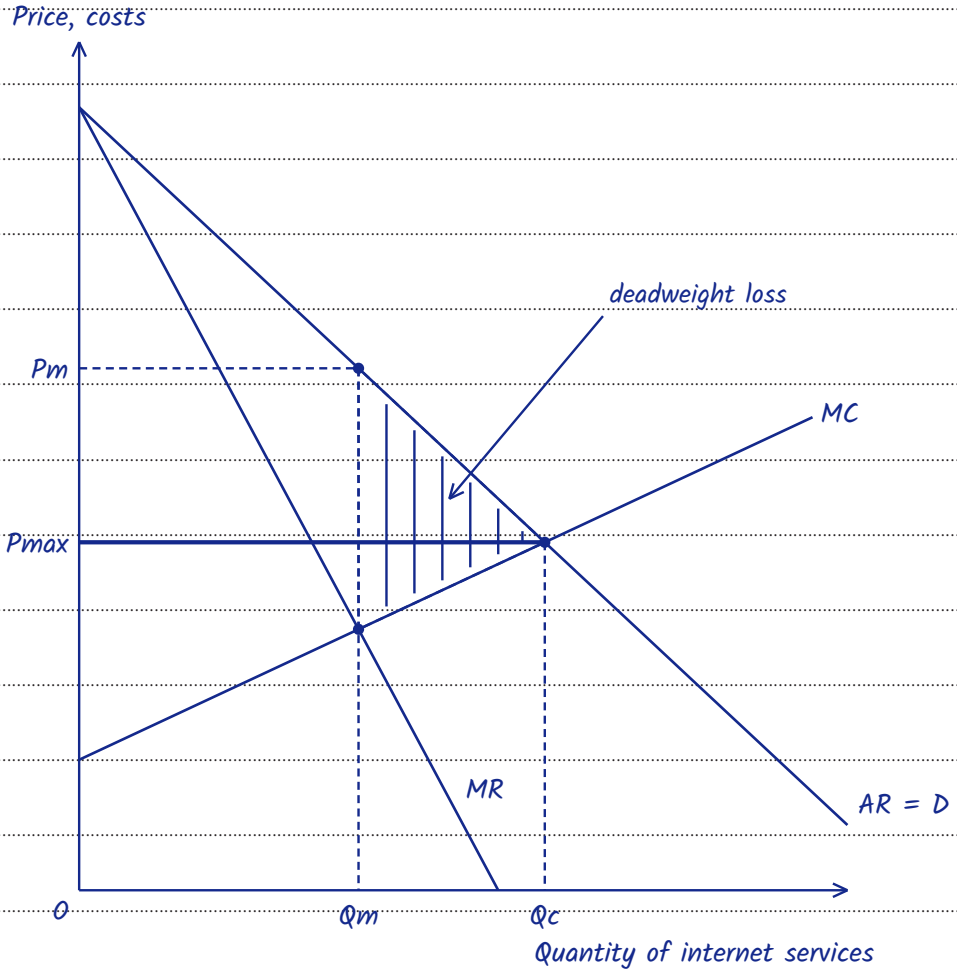
Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

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

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

A pure monopoly is a market with a single seller, so the firm is the industry. As the only provider of internet services in Pakistan, PTCL is a price maker facing no competition. It can restrict output and charge a price above marginal cost, so it is allocatively inefficient, and without competitive pressure it has little incentive to improve its service. This explains the poor quality, slow speeds and high level of consumer complaints.

1. Price regulation. The government or a regulator can set a maximum price below the monopoly price.



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Unregulated, PTCL produces where MR = MC at Qm and charges Pm. If the maximum price is set at Pmax, where AR = MC, PTCL's AR becomes horizontal at Pmax up to Qc, so MR = Pmax and it maximises profit at Qc. Price falls, output rises from Qm to Qc and P = MC, so the shaded deadweight loss is removed and allocative efficiency is achieved. Consumer surplus rises and supernormal profit falls. An RPI – X formula, where price may only rise by inflation minus X%, also forces PTCL to cut costs, improving productive efficiency, and lets it keep any extra savings as profit.

However, the regulator faces information gaps: it does not know PTCL's true costs, and PTCL has an incentive to exaggerate them. If the cap is set too high it has little effect; if it is set too low PTCL may make a loss, so it may cut investment in its network, reducing dynamic efficiency and making the slow internet speeds even worse.

2. Quality standards and performance targets. The regulator can set minimum standards for internet speed, reliability and coverage, monitor PTCL's performance and impose fines if it fails to meet them, or require compensation to consumers for outages. This tackles the main problem in Pakistan directly: poor quality and consumer complaints. The threat of fines raises the cost of poor service, so PTCL has an incentive to invest in faster broadband, improving the experience of consumers. However, this only works if the fines are large enough; if they are smaller than the cost of upgrading the network, PTCL will simply pay them. Monitoring is also costly, and PTCL may meet the measured targets while quality falls in areas that are not measured.

3. Profit regulation. The government can limit the rate of return PTCL may earn to the level a firm would make in a competitive market. This reduces supernormal profit, but it removes the incentive to cut costs, because any savings must be passed on, so X-inefficiency may rise and

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PTCL may inflate its costs, for example with high managers' pay, to hide its profits. Less retained profit also means less to invest in improving the network.

4. Promoting competition. The government can reduce barriers to entry by issuing licences to new internet providers, subsidising new entrants, and forcing PTCL to give rivals access to its network at a fair price. Competition authorities can also block mergers and fine anti-competitive practices such as predatory pricing. More competition makes the market contestable, so PTCL must improve quality and cut prices or lose customers. However, fixed network infrastructure has very high fixed costs, so internet provision may be a natural monopoly where one firm has the lowest average cost and duplicating the network would be wasteful. New entry also takes time to build, so this is a long-run solution.

5. Nationalisation. Government ownership would change the firm's objective from profit to the public interest. But without a profit motive and competition, a state firm may be X-inefficient and slow to innovate, and it is costly for the government to buy.

A further problem with all regulation is regulatory capture, where the regulator comes to act in the interests of PTCL rather than consumers, and government failure if intervention leads to a net welfare loss.

In conclusion, the most effective approach for PTCL is a combination of policies: an RPI – X price cap to protect consumers from high prices while keeping an incentive to cut costs, together with strict quality targets backed by large fines to deal with the poor service, which is the main source of complaints. In the long run, opening PTCL's network to rival providers would create competition that removes the need for so much regulation. The success of any policy depends on the regulator being independent, well informed and willing to enforce penalties.

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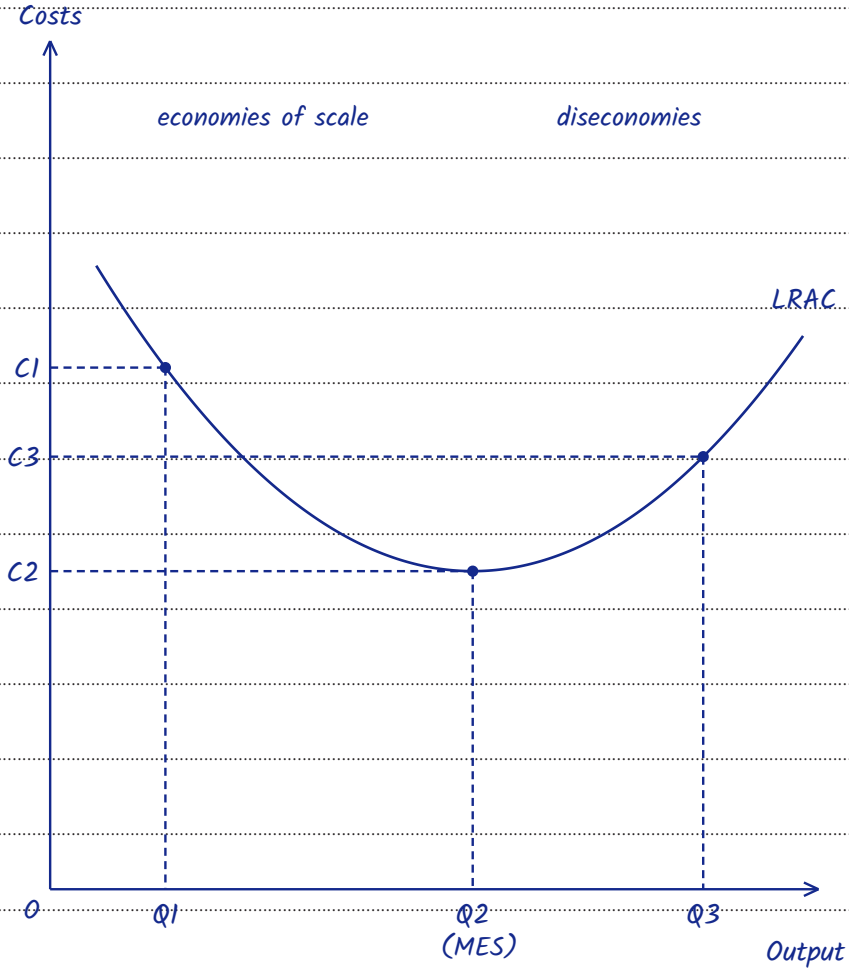
Write the answer to your SECOND chosen question here.

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 ☒.

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

Efficiency can be productive (producing at the lowest point of the average cost curve), allocative (where price equals marginal cost), dynamic (innovation and improvement over time) or X-efficiency (no wasted resources at a given output). Nestlé is the largest manufacturer of pre-packaged food and beverages in the world by revenue, and its size has let it reduce its average cost.

Productive efficiency. A large firm benefits from internal economies of scale, so long-run average cost falls as output rises, shown below.



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A small food producer at Q1 has average cost C1, while a large firm such as Nestlé producing at Q2, the minimum efficient scale, has a lower average cost C2. Nestlé gains purchasing economies by buying coffee, cocoa, milk and packaging in bulk at a discount; technical economies from long production runs and specialist capital, such as automated packaging machines, which spread high fixed costs over a huge output; marketing economies, since an advertising campaign for a global brand is spread over billions of units; and financial economies from borrowing at lower interest rates. Specialisation and the division of labour also raise labour productivity. So size can make a firm more productively efficient.

Dynamic efficiency. Large firms often have price-setting power and earn supernormal profits in the long run. These can be reinvested in research and development, for example healthier recipes, new products and more efficient production processes, lowering costs in the future. Small firms in perfect or monopolistic competition earn only normal profit in the long run, so they have less finance to innovate. Large firms can also cross-subsidise, using profits from some products to keep prices of essential goods low.

However, size can also reduce efficiency. If a firm grows beyond the minimum efficient scale, to Q3, it suffers diseconomies of scale and average cost rises to C3. A firm employing many thousands of workers in many countries faces communication and coordination problems, slow decision making and poor staff motivation, so it becomes less productively efficient. Large firms with market power may also suffer X-inefficiency: without strong competitive pressure, managers allow costs to rise above the lowest possible level, so the firm produces above its LRAC curve.

Large firms also tend to be allocatively inefficient. A firm with price-setting power maximises profit where MR = MC and sets price above marginal cost, so output is restricted and there is a

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deadweight loss. By contrast, small firms in perfect competition are price takers and in long-run equilibrium P = MC = AC, so they are both allocatively and productively efficient.

Being large does not guarantee dynamic efficiency either. A dominant firm may have little incentive to innovate because its position is secure, and it may suffer inertia, being slow to respond to changes in tastes because of its investment in existing operations. Small firms are often more flexible, with lower overheads and less bureaucracy, so they can quickly change their products. A small firm in a niche market, such as organic or vegan foods, can charge high prices, earn supernormal profit and reinvest it in innovation.

The impact of size also depends on the industry. In food manufacturing fixed costs and the minimum efficient scale are high relative to the market, so only large firms can reach the lowest average cost. In industries with a low minimum efficient scale, such as restaurants, a small firm can be just as productively efficient as a large one.

In conclusion, the large size of a firm like Nestlé is likely to increase productive and dynamic efficiency, because economies of scale are significant in food production and supernormal profits fund research and development. However, this holds only up to the minimum efficient scale and only if the firm avoids diseconomies of scale and X-inefficiency, and large firms are usually less allocatively efficient than small competitive firms. The overall effect depends on the size of the firm relative to the minimum efficient scale and on the degree of competition it faces.

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TOTAL FOR PAPER = 80 MARKS

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Friday 20 October 2023

Morning (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 electric vehicle market in China

Figure 1 Market share for electric vehicle passenger sales, based on sales revenue, 2021

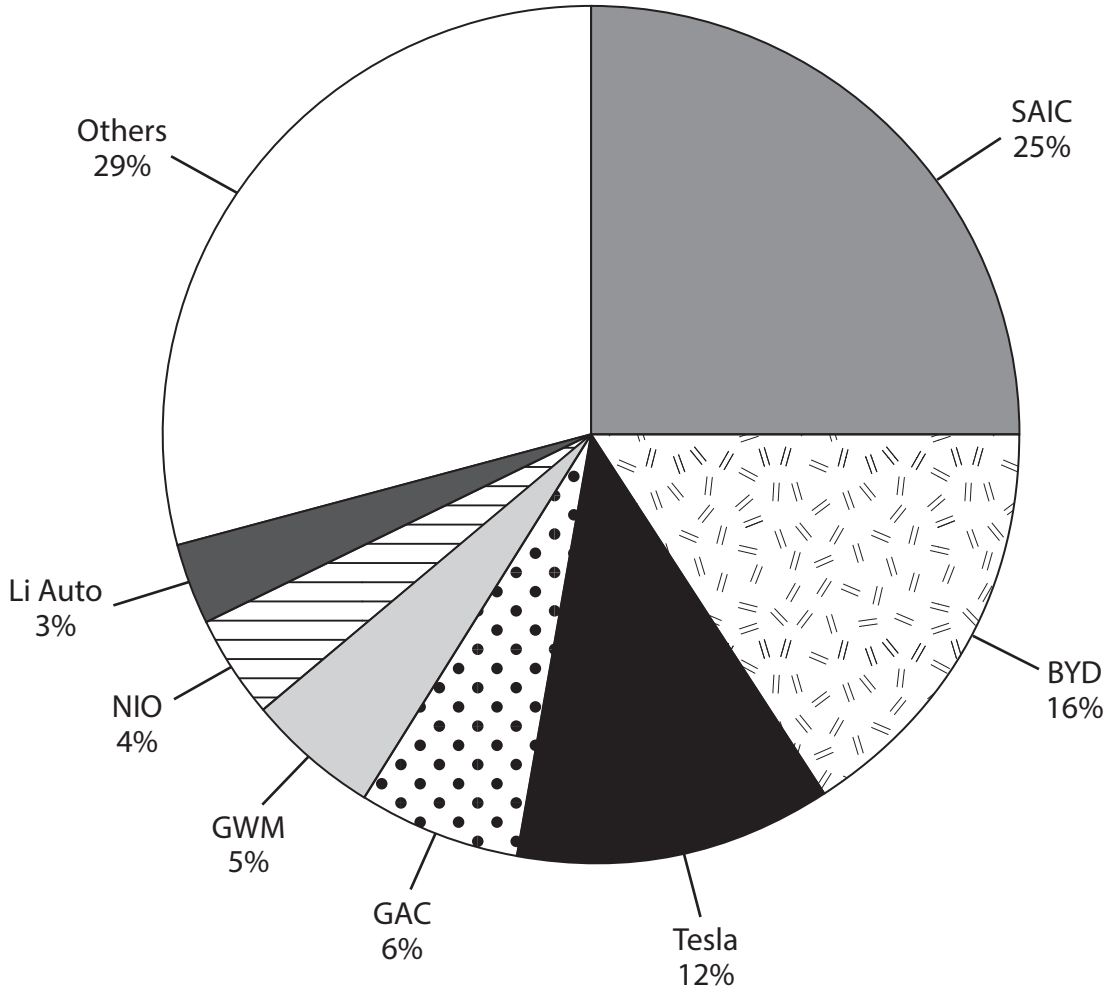


Figure 2 Tesla electric vehicle prices, 2022 (Yuan, 000s)

Model of vehicle	January 2022	October 2022
Model 3 Rear Wheel Drive	280	266
Model 3 Performance	368	350
Model Y Rear Wheel Drive	317	289
Model Y Performance	418	398

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Extract A Changes in the Chinese electric vehicle market

In 2020 the Chinese Government adopted many new measures to reduce CO_2 emissions, in order to meet its climate change goals by 2030. For example, the Government has increased the number of charging points and raised the tax on non-electric vehicles. The global increase in the price of fuel has also led to an increase in demand for electric vehicles. Between 2021 and 2022 the sales of electric vehicles in China increased by 83% to 5.92 million.

Extract B Tesla in China

Tesla, a US-owned vehicle company, has attempted to increase its sales in China to take advantage of the increasing demand for electric vehicles. In 2019 the company opened a factory in Shanghai. It became the first fully foreign-owned vehicle manufacturer in the country. By producing vehicles in China, Tesla was able to take advantage of government incentives, such as subsidies, aimed at promoting the domestic electric vehicle industry, as well as benefiting from low-cost labour. This new factory was expected to increase Tesla's competitiveness in the Chinese market by making its vehicles more affordable for consumers. China has become a key manufacturing centre for Tesla. Its factory in Shanghai produced over 710 000 vehicles in 2022. This represented 52% of the company's worldwide output.

However, production has been difficult in China. Tesla faced supply chain disruptions as a result of the global health crisis of 2020 to 2022. This resulted in a reduction in output and an increase in its costs of production. Tesla also had to pay taxes on imported components and finished vehicles.

In October 2022 Tesla reduced the price of several of its electric vehicles. The two main reasons for these price reductions were:

- a fall in its production costs arising from government subsidies to electric car manufacturers
- improved efficiency from manufacturing in Shanghai.

The lower prices of Tesla's electric vehicles had a significant impact on its competitors. Domestic and other international manufacturers responded by reducing their prices for electric vehicles as they competed for market share.

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Acknowledgements

Figure 1: https://www.schroders.com/en/insights/economics/why-chinas-electric-vehicle-market-is-at-full-throttle/
Figure 2: https://www.bloomberg.com/news/articles/2022-10-24/tesla-cuts-china-prices-partly-reversing-previous-increases

Extract A:

https://www.statista.com/outlook/mmo/electric-vehicles/china
https://www.bbc.co.uk/news/business-62825830

Extract B:

https://www.ft.com/stream/35edec46-ef7b-4f9b-b85a-25174e6e07fa
https://www.ft.com/content/d5781c37-ee16-4ef5-94a9-b77a251aaadb
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