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 1 hour 45 minutes

Paper reference **WEC11/01**

Economics

International Advanced Subsidiary
UNIT 1: Markets in action

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, B and C.
- Answer **ONE** question in Section D.
- 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.

Turn over ▶

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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 Which **one** of the following is a role of financial markets?

- ☐ **A** To collect tax revenues
- ☐ **B** To enable consumers to minimise their utility
- ☒ **C** To make funds available for individuals and businesses
- ☐ **D** To provide public goods

(Total for Question 1 = 1 mark)

2 In the UK, new consumers paid an average of £130 for home insurance in 2020. Consumers who had remained with the same insurance company since 2015 paid £238 for the same annual home insurance cover. Despite this, many consumers stay loyal to their insurance company.

Which **one** of the following is the most likely reason why consumers stay loyal to their insurance company?

- ☐ **A** Consumers feel undervalued
- ☐ **B** Consumers have good computational skills
- ☐ **C** The free-rider problem
- ☒ **D** Habitual behaviour

(Total for Question 2 = 1 mark)

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3 The table shows the estimated price elasticity of demand for railway tickets for use on underground trains in selected Mexican cities in 2020.

City	Price elasticity of demand
Guadalajara	–0.32
Mexico City	–0.25
Monterrey	–0.23

(Source adapted from: https://www.nber.org/system/files/working_papers/w28244/w28244.pdf)

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

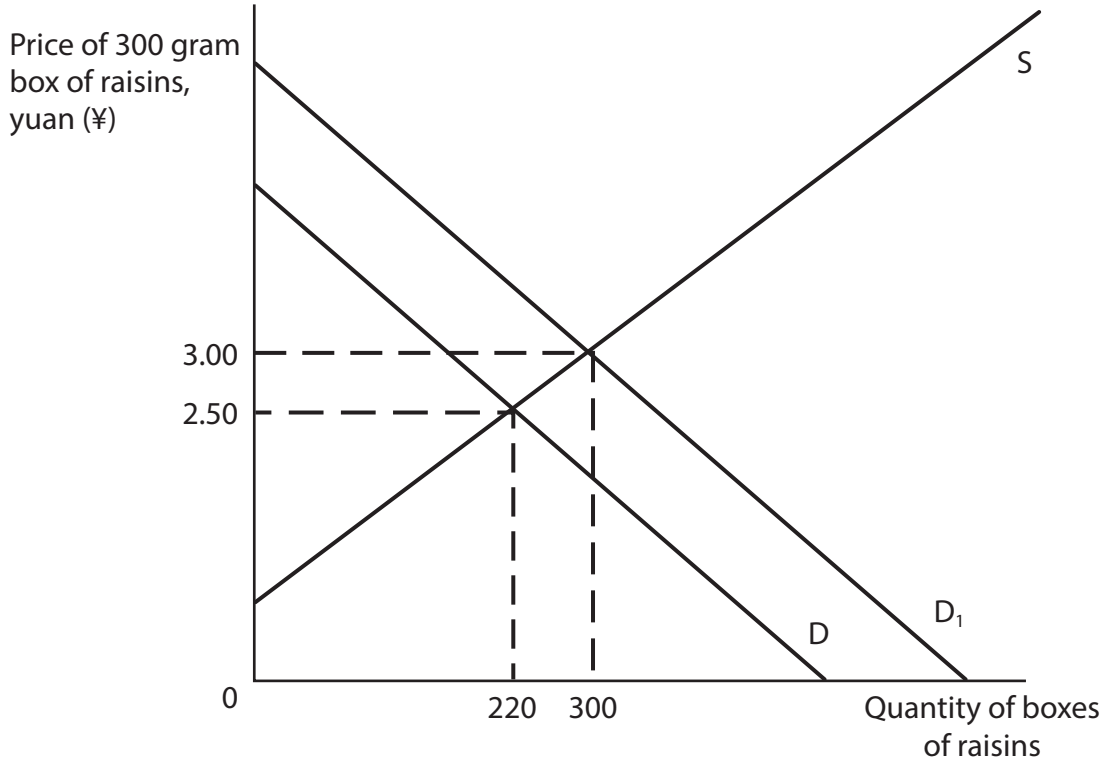
- ☒ **A** The demand for railway tickets in Guadalajara is price elastic
- ☒ **B** A decrease in the price of railway tickets in Mexico City will decrease total revenue
- ☒ **C** An increase in the price of railway tickets in Monterrey will decrease total revenue
- ☒ **D** The demand for the railway tickets in all three cities will decrease in response to an increase in income

(Total for Question 3 = 1 mark)

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4 The diagram shows the market for 300 gram boxes of raisins in China.



Which **one** of the following is the price elasticity of supply for boxes of raisins when the demand curve shifts from D to D_1?

- ☒ **A** –1.82
- ☒ **B** –0.55
- ☒ **C** +0.55
- ☒ **D** +1.82

(Total for Question 4 = 1 mark)

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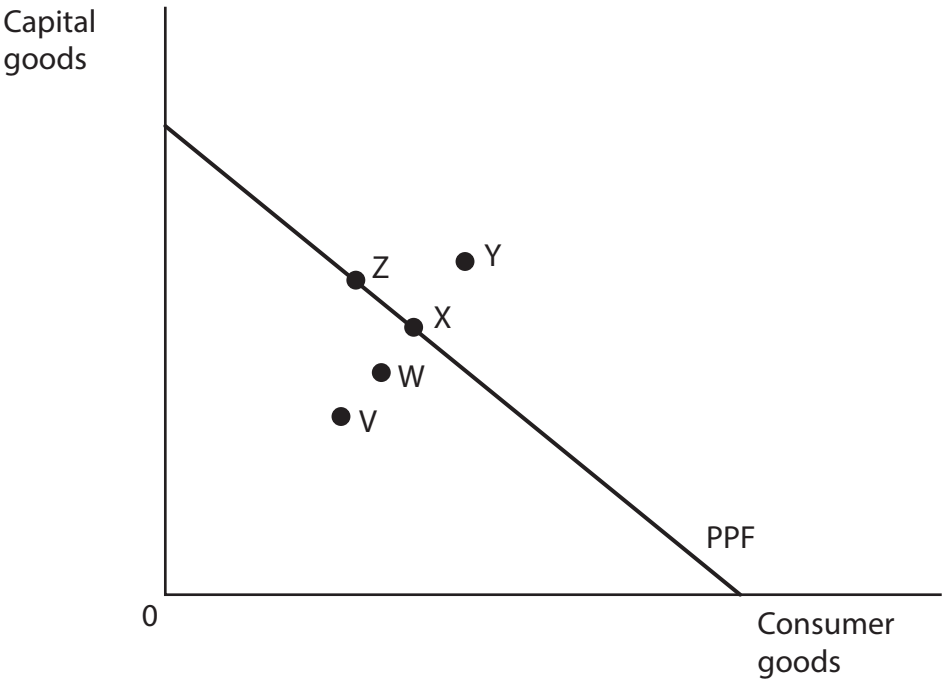
5 A relatively high rate of indirect taxation on fuel in the Philippines leads to the smuggling of fuel from neighbouring countries. This results in the Philippine Government losing $750 million of tax revenue a year.

Smuggling is an example of which **one** of the following concepts?

- ☒ **A** Government failure
- ☒ **B** Market failure
- ☒ **C** Unobtainable production
- ☒ **D** Consumer inertia

(Total for Question 5 = 1 mark)

6 The diagram shows the production possibility frontier (PPF) for a small country.



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

- ☒ **A** The movement from X to Y is obtainable using current available resources
- ☒ **B** The movement from X to Z has an opportunity cost in terms of capital goods
- ☒ **C** The movement from V to W results in an increase in unemployed resources
- ☒ **D** The movement from W to X results from improved efficiency

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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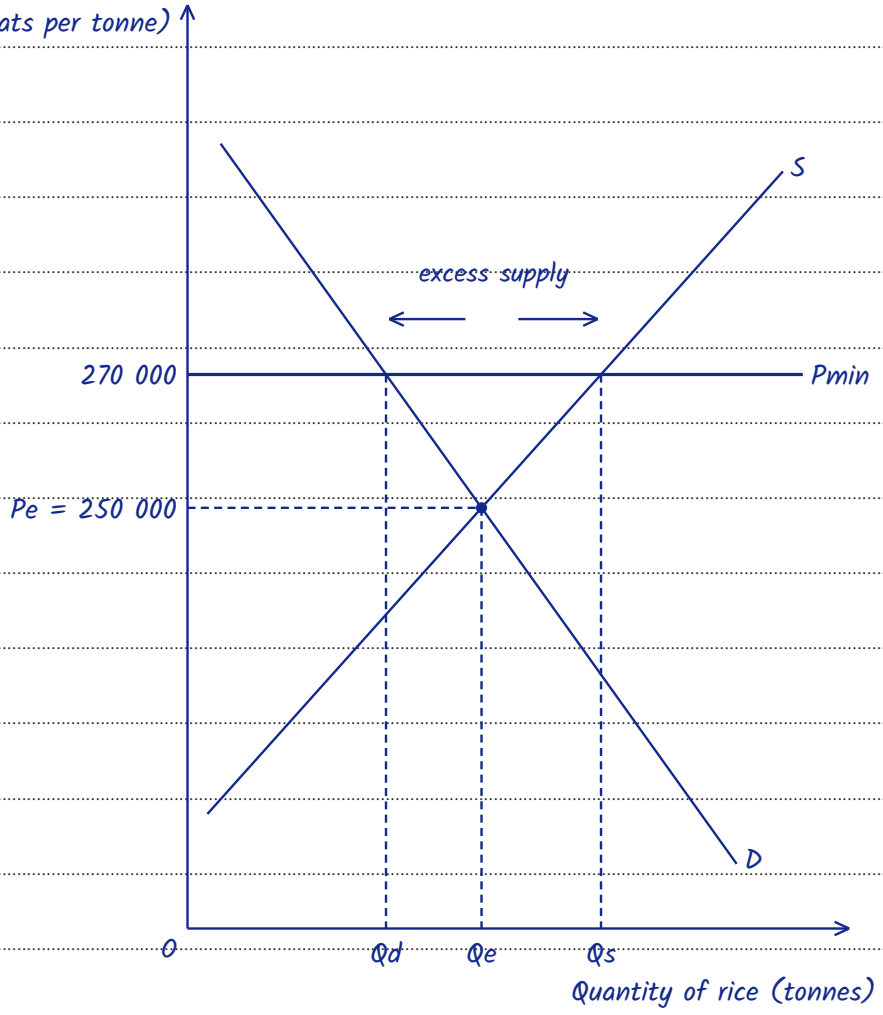
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SECTION B

Answer ALL questions in this section in the space provided.

7 In Myanmar the price of rice was 250 000 kyats per tonne in October 2021. However, many rice farmers made a loss because of rising costs of production. In response, the Myanmar Government introduced a minimum price for rice of 270 000 kyats per tonne.

Draw a diagram to illustrate the impact of the introduction of this minimum price for rice.



The minimum price of 270 000 kyats is set above the equilibrium price of 250 000 kyats, so quantity demanded contracts to Qd and quantity supplied extends to Qs. This creates an excess supply (surplus) of rice of Qd to Qs.

(Total for Question 7 = 4 marks)

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8 In the USA research found that 68% of those without health insurance and 88% of those with health insurance visited a dentist.

With reference to health insurance, explain what is meant by 'moral hazard'.

Moral hazard is when an individual takes greater risks, or is less careful, because they do not bear the full consequences of their actions: the cost of the risk is transferred to another party, such as an insurance company.

In the USA, 88% of people with health insurance visited a dentist compared with only 68% of those without health insurance, a difference of 20 percentage points.

Once insured, the cost of dental treatment is covered by the insurance policy, so the price of treatment to the patient is close to zero. Insured people therefore have less incentive to look after their teeth, for example they may eat more sugary food or drink more fizzy drinks and brush less carefully, because they know any treatment will be paid for. As a result they are more likely to need dental care and make a claim, which raises costs for the insurer. This change in behaviour caused by being insured is moral hazard.

(Total for Question 8 = 4 marks)

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9 Emiliana Lucas owns a farm in Tanzania on which she grows sunflowers. In 2020 Tania, her neighbour, started a honey bee farm. The honey bees pollinated Emiliana's sunflowers. As a result, seed production on Emiliana's farm increased from 300kg in 2019 to 620kg in 2020.

With reference to the information provided, explain the difference between private benefits and external benefits.

Private benefits are the benefits received by the first or second party directly involved in a transaction, i.e. the buyer or seller of the good. For example, Tania receives revenue and profit from selling the honey her bees produce, and her customers gain utility from consuming the honey.

External benefits are the positive spillover effects on third parties who are not involved in the production or consumption of the good and who do not pay for them, so the marginal social benefit is greater than the marginal private benefit (MSB > MPB).

Emiliana is a third party to Tania's honey farm. Tania's bees pollinated Emiliana's sunflowers, so seed production on Emiliana's farm increased from 300kg in 2019 to 620kg in 2020, an increase of 320kg (more than double). Emiliana pays nothing to Tania for this, so it is an external benefit of Tania's honey production rather than a private benefit.

(Total for Question 9 = 4 marks)

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10 The table shows the average income and car sales in the USA in 2011 and 2021.

	Average income	Car sales
2011	$31 024	12 741 800
2021	$44 225	14 926 900

(Sources adapted from: https://www.statista.com/statistics/199983/us-vehicle-sales-since-1951/ and https://dqydj.com/individual-income-by-year/#:~:text=Average%20Individual%20Income%20by%20Year%20%20%20Year,%20%20%2463%2C214.03%20%2056%20more%20rows%20)

Ceteris paribus, calculate the income elasticity of demand for cars between 2011 and 2021. Show your working.

YED = % change in quantity demanded ÷ % change in income

% change in quantity demanded = (14 926 900 – 12 741 800) ÷ 12 741 800 × 100

= 2 185 100 ÷ 12 741 800 × 100 = 17.15%

% change in income = (44 225 – 31 024) ÷ 31 024 × 100

= 13 201 ÷ 31 024 × 100 = 42.55%

YED = 17.15 ÷ 42.55 = +0.40 (2 d.p.)

YED is positive, so cars are a normal good, and it is between 0 and 1, so demand for cars is income inelastic.

(Total for Question 10 = 4 marks)

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11 The cross elasticity of demand of milk with respect to sugar-sweetened drinks is +0.25.

Explain the likely impact of a 5% increase in the price of sugar-sweetened drinks on the market for milk.

Cross elasticity of demand (XED) measures the responsiveness of quantity demanded of one good to a change in the price of another good: XED = % change in quantity demanded of milk ÷ % change in price of sugar-sweetened drinks.

The XED is positive (+0.25), so milk and sugar-sweetened drinks are substitutes.

% change in quantity demanded of milk = +0.25 × 5% = +1.25%

When sugar-sweetened drinks become 5% more expensive, some consumers switch to milk, so the demand for milk increases (shifts to the right) by 1.25%, raising both the equilibrium price and quantity of milk. However, the XED is low (between 0 and 1), so they are not close substitutes and the increase in demand for milk is less than proportionate to the 5% rise in price, so the impact on the market for milk is small.

(Total for Question 11 = 4 marks)

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SECTION C

Study Figure 1 and Extracts A, B and C in the Source Booklet before answering Question 12.

Write your answers in the space provided on the following pages.

12 (a) Define the term 'market failure' (Extract A, line 14).

(2)

(b) With reference to paragraph 1 of Extract A, analyse **two** reasons why house prices increased between March 2020 and March 2021.

Illustrate your answer with a supply and demand diagram.

(6)

(c) With reference to Extract B, explain why the supply of new houses is likely to be price inelastic.

(4)

(d) With reference to Extract C, examine whether national parks in New Zealand are public goods.

(8)

(e) With reference to Figure 1, Extract A and Extract B, discuss the likely microeconomic effects of a housing market bubble in New Zealand.

(14)

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12 (a) Define the term 'market failure' (Extract A, line 14).

(2)

Market failure is when the free market (the price mechanism) leads to an inefficient allocation of resources, so resources are over or under allocated and society's welfare is not maximised, for example the housing bubble and homelessness in New Zealand.

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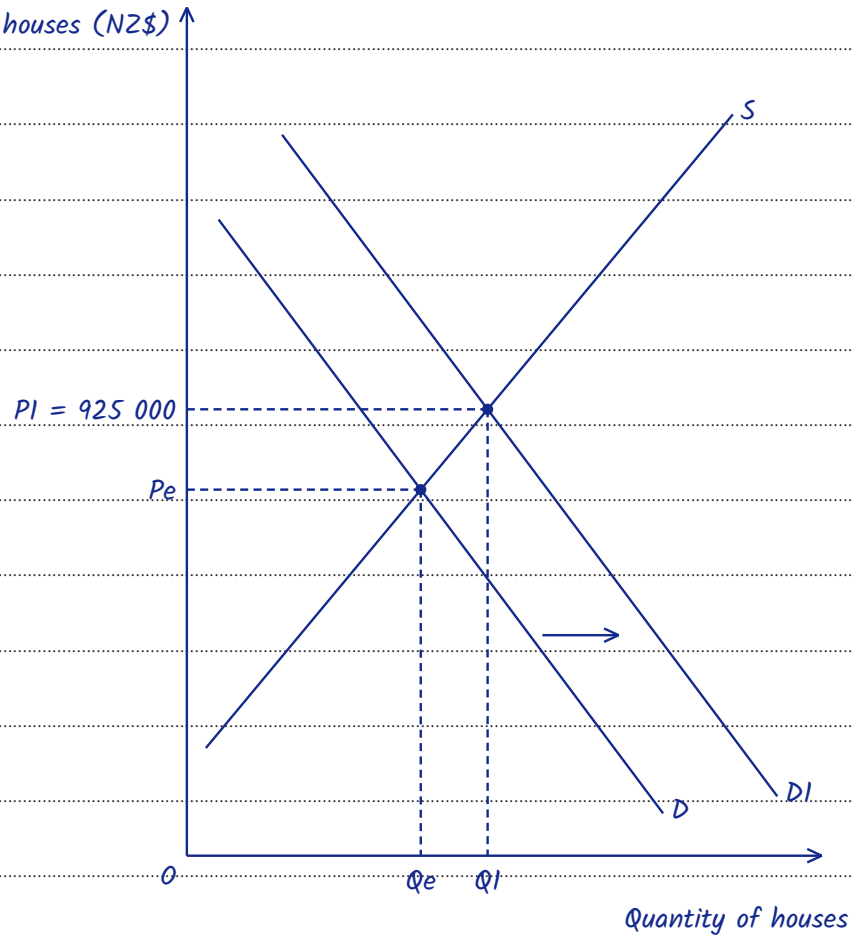
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(b) With reference to paragraph 1 of Extract A, analyse **two** reasons why house prices increased between March 2020 and March 2021.

Illustrate your answer with a supply and demand diagram.

(6)



House prices in New Zealand rose by 15.7% between March 2020 and March 2021, to an average of NZ$925 000. This was caused by an increase in demand, shown by the shift from D to D1, which raises price from Pe to P1 and quantity from Qe to Q1.

First, real incomes increased because of an above average rate of economic growth. Houses are a normal good, so with higher real incomes households can afford to buy houses and borrow more, so demand increases.

Second, the base interest rate was only 0.25%, so it was relatively cheap to borrow to buy a house. Mortgage repayments are lower, which makes buying more affordable and encourages

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buyers and speculators to borrow, so demand shifts right. As the supply of houses is inelastic, the increase in demand mainly raises price rather than quantity.

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(c) With reference to Extract B, explain why the supply of new houses is likely to be price inelastic.

(4)

Price elasticity of supply (PES) measures the responsiveness of quantity supplied to a change in price. Supply is price inelastic when PES is between 0 and 1, so a change in price leads to a less than proportionate change in quantity supplied.

The supply of new houses cannot respond quickly to higher prices. There is much paperwork needed to obtain planning permission, which causes long time lags before building can start, and many local authorities limit the land on which houses can be built to protect the environment, so land is a fixed factor. There is also a shortage of over 55 000 construction workers, so firms cannot easily increase output.

This is shown by the Government building just 6 000 homes between June 2018 and July 2020, despite promising 100 000 in 2017. Even after the significant price rise in 2021, the number of houses under construction increased by only 26%, so quantity supplied responds slowly.

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(d) With reference to Extract C, examine whether national parks in New Zealand are public goods.

(8)

A public good is one that is non-excludable and non-rival in consumption. Non-excludable means people who do not pay cannot be prevented from consuming it, so there is a free rider problem. Non-rival means one person's consumption does not reduce the amount available to others.

National parks appear to be non-excludable. New Zealand has 13 national parks covering 30 000 km², which is too large an area to fence off and charge an entry fee, and individuals can walk, run or cycle across the parks without charge. This means people can free ride by using the parks without paying, so a private firm could not make a profit from providing them and they would be underprovided by the market.

National parks also appear to be non-rival. For much of the year there is so much space that an individual will rarely meet another person, so one extra visitor does not reduce the enjoyment of others, and the marginal cost of an extra visitor is close to zero.

However, in the summer season the parks are very popular and become crowded, so there is rivalry: one more visitor reduces the space and enjoyment available to others. Car parking spaces are hard to find, so a car parking space used by one visitor cannot be used by another, and access by car could be made excludable by charging for parking.

In addition, some activities within the parks, such as skiing and kayaking, have to be paid for, so people who do not pay are excluded from these activities. These parts are private goods rather than public goods.

Overall, national parks are not pure public goods. Walking, running and cycling for most of the

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year are close to a public good, but it depends on the season and the activity, so national parks are best described as quasi-public goods.

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(e) With reference to Figure 1, Extract A and Extract B, discuss the likely microeconomic effects of a housing market bubble in New Zealand.

(14)

A housing market bubble is when house prices rise far above their true value, often because of speculation, where buyers purchase houses expecting to sell them later at a higher price. Research showed New Zealand house prices were about 40% overvalued relative to income, and in 2020 approximately 15 000 buyers owned five or more houses.

The first effect is on affordability for households. House prices rose from 8.6 times median income in 2020 to 10 times in 2021, and in Auckland the average price of NZ$1.4 million was 35 times median income. Figure 1 shows prices rose by 23.7% in Manawatu / Wanganui and 20.4% in Marlborough in one year. First-time buyers on average incomes are priced out of the market, and because they cannot buy, demand for rented housing rises, so rents increase and renters have less disposable income. This contributes to 1% of the population being homeless, the highest rate among developed countries, which is a form of market failure.

A second effect is the risk that the bubble bursts. If buyers realise houses are overvalued, speculators sell, supply of houses for sale rises and demand falls, so prices could fall sharply. Households who bought at the peak may end up owing more on their mortgage than their house is worth (negative equity), and speculators who sell late make losses.

There are also effects on house builders. Higher prices create an incentive to build: in 2021 the number of new houses under construction increased by 26%, compared with average growth of 13% a year between 2011 and 2020. Builders earn more revenue and profit, and demand for construction workers rises, which, given the shortage of over 55 000 workers, should raise their wages. In the long run this extra supply would help reduce prices.

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However, the size of these effects depends on whether this really is a bubble. The rise in prices may reflect true value, as it was caused by rising real incomes, a base interest rate of just 0.25% and immigration, together with inelastic supply. If these causes continue, prices may stay high and there is no guarantee the bubble will burst. On the other hand, a 256% rise in prices between 2000 and 2021, compared with 68% in the USA and 110% in the UK, suggests the overvaluation is large in magnitude.

The effects are also not all negative. Existing homeowners gain from higher wealth, and landlords receive higher rental income. The supply response is limited, though: planning paperwork, restricted land and the worker shortage mean the 26% rise in construction may take years to reduce prices. Effects also vary by region, with Auckland prices rising by only 9.8% but from a much higher level.

Overall, the most significant effect is likely to be the fall in affordability and rising homelessness for low-income households, because supply is so price inelastic. The risk of a crash depends mainly on interest rates: if the 0.25% base rate rises, mortgage costs increase, demand falls and the bubble is more likely to burst.

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(Total for Question 12 = 34 marks)

TOTAL FOR SECTION C = 34 MARKS

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SECTION D

Answer ONE question from this section.

Write your answer in the space provided.

EITHER

13 In January 2022 average energy prices increased by 28.6% in the eurozone area. In response:

- the German Government provided subsidies to energy producers
- the Spanish Government reduced indirect taxes on energy bills
- the French Government introduced a maximum price on energy bills.

Evaluate **two** possible measures that could be introduced to reduce the price that consumers pay for energy.

Include at least one diagram in your answer.

(Total for Question 13 = 20 marks)

OR

14 Fertiliser is used by farmers to increase the output of crops per acre of farmland. In 2021 farmers experienced a 400% increase in the cost of fertiliser. Between March 2021 and March 2022 the global food price index increased by 38%.

Evaluate the impact of the 400% increase in the cost of fertiliser on farmers and households.

Include one diagram to show the impact on farmers in your answer.

(Total for Question 14 = 20 marks)

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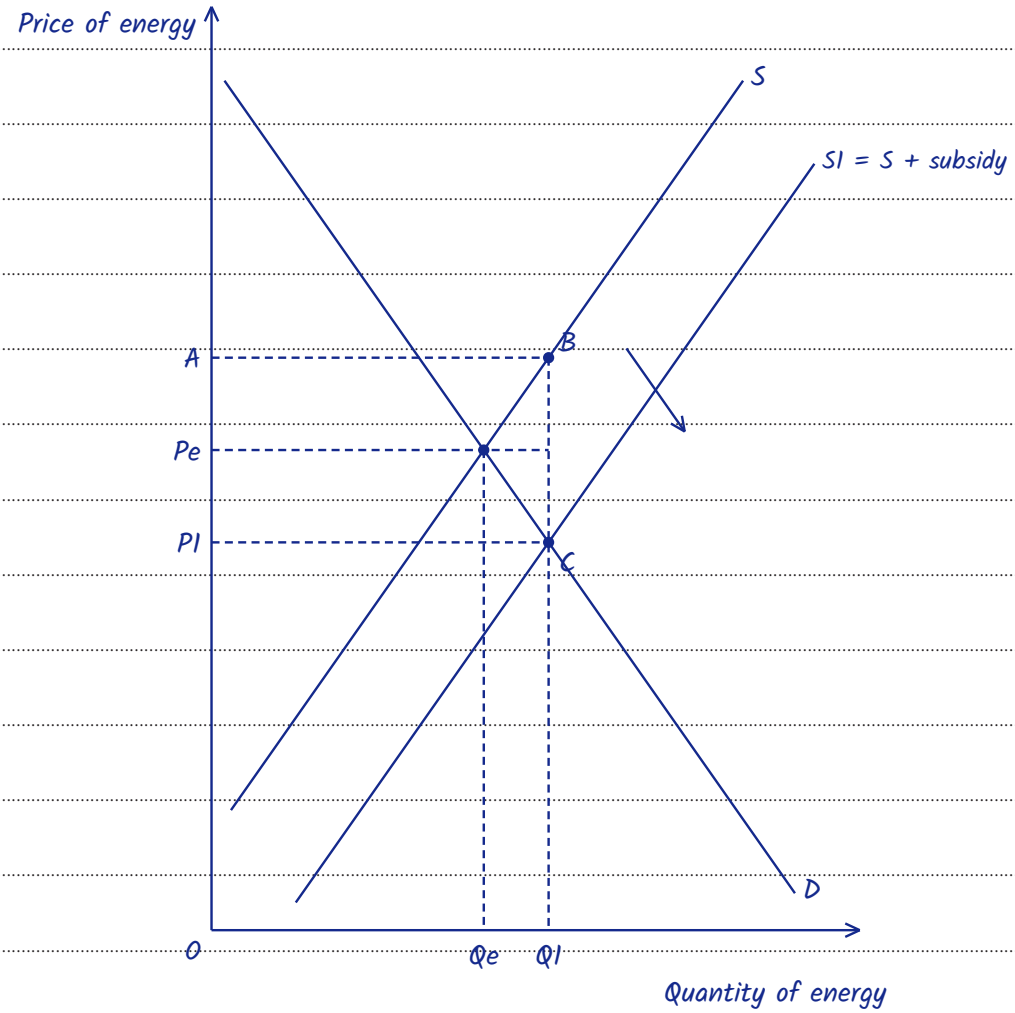
Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 13** ☒ **Question 14** ☐

Write your answer here:

Energy prices increased by 28.6% in the eurozone in January 2022. Two measures to reduce the price consumers pay are a subsidy to energy producers, as used in Germany, and a reduction in indirect taxes on energy, as used in Spain.

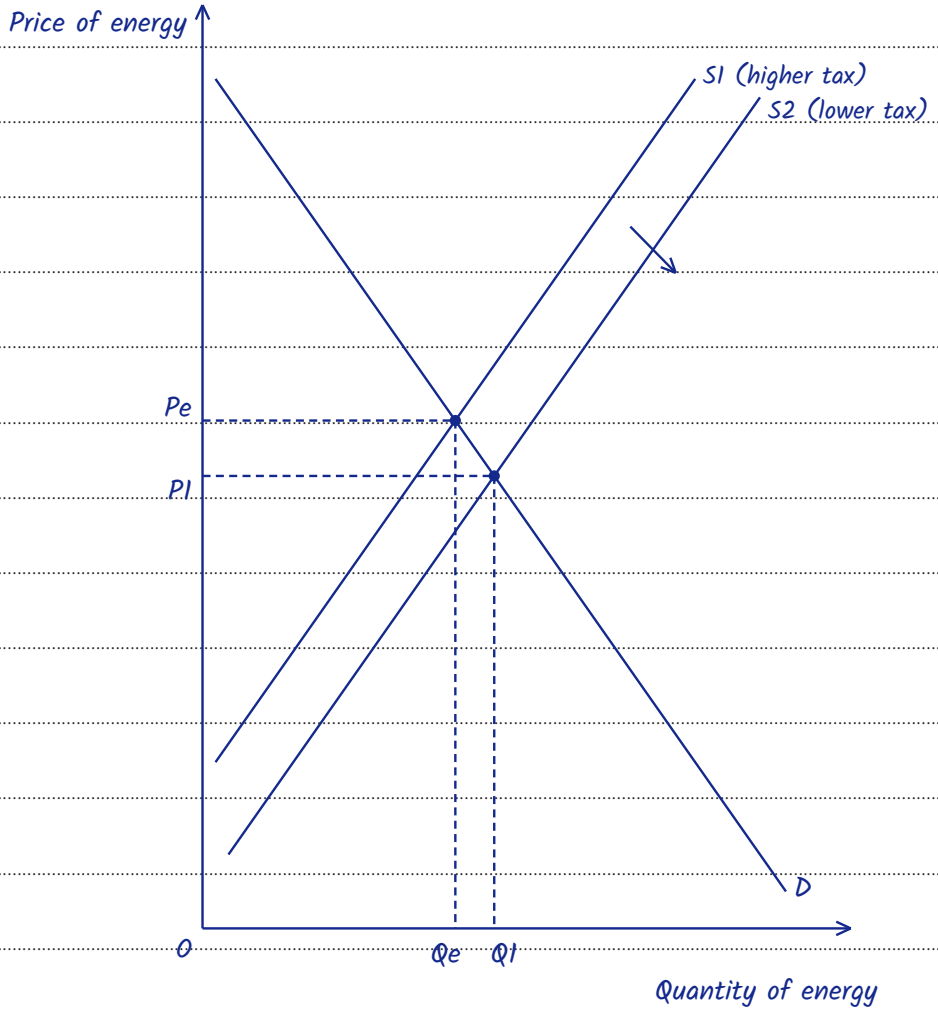
A subsidy is a payment from the government to producers that lowers their costs of production. In the diagram, supply shifts right from S to S1 (S + subsidy) by the amount of the subsidy per unit, the vertical distance BC.



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Because costs fall, the price paid by consumers falls from Pe to PI and the quantity of energy bought rises from Qe to QI. Consumer surplus increases, households have more disposable income to spend on other goods, and producers receive PI plus the subsidy (A), so their revenue and producer surplus also rise. The total cost to the government is the area ABCPI.

A reduction in indirect taxes lowers the tax firms must pay on each unit sold, which also reduces their costs. Supply shifts right from S1 (higher tax) to S2 (lower tax).



The price paid by consumers falls from Pe to PI and quantity rises from Qe to QI, so consumer surplus increases. Unlike a subsidy, the government does not spend money directly, but it loses tax revenue that could have been used elsewhere.

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The effectiveness of both measures depends on price elasticity. Energy is a necessity with few substitutes, so demand is price inelastic. When demand is inelastic, most of the subsidy or tax cut is passed on to consumers as a lower price rather than a larger quantity, which is exactly what is wanted. However, if supply is also inelastic in the short run, because power stations cannot quickly raise output, a larger share of the benefit goes to producers.

The impact also depends on size. A small subsidy or tax cut will do little to offset a 28.6% rise in prices. A subsidy large enough to do so is very expensive and has an opportunity cost, as the money could be spent on healthcare or education, or may require higher taxes or borrowing. If high energy prices are a long-term problem, for example because of global supply shortages, the subsidy may have to continue for years, and producers who rely on it may become complacent and less efficient.

With a tax cut there is no guarantee that firms pass the saving on to consumers. Energy markets are often dominated by a few large firms, which may keep the lower tax as higher profit, so the fall in price is smaller than expected. The government may also lack the information to know the right size of subsidy or tax cut, which risks government failure.

Both measures also lower the price of energy and so encourage consumption. As much energy comes from fossil fuels, this increases carbon emissions and the external costs of pollution, moving output further from the social optimum. In addition, both measures help all consumers, including high-income households who use the most energy, rather than targeting low-income households who spend the largest share of income on energy.

In conclusion, a cut in indirect tax is probably the better short-run measure because it is quick to introduce and reduces prices immediately without direct government spending, but its effect

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depends on firms passing it on. A subsidy can have a bigger impact on price but is costly. Since demand for energy is inelastic, both will reduce prices significantly in the short run, but they should be temporary and targeted to limit their cost and environmental damage.

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TOTAL FOR SECTION D = 20 MARKS
TOTAL FOR PAPER = 80 MARKS

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Pearson Edexcel International Advanced Level

Time 1 hour 45 minutes

Paper reference **WEC11/01**

Economics

International Advanced Subsidiary
UNIT 1: Markets in action

Source Booklet

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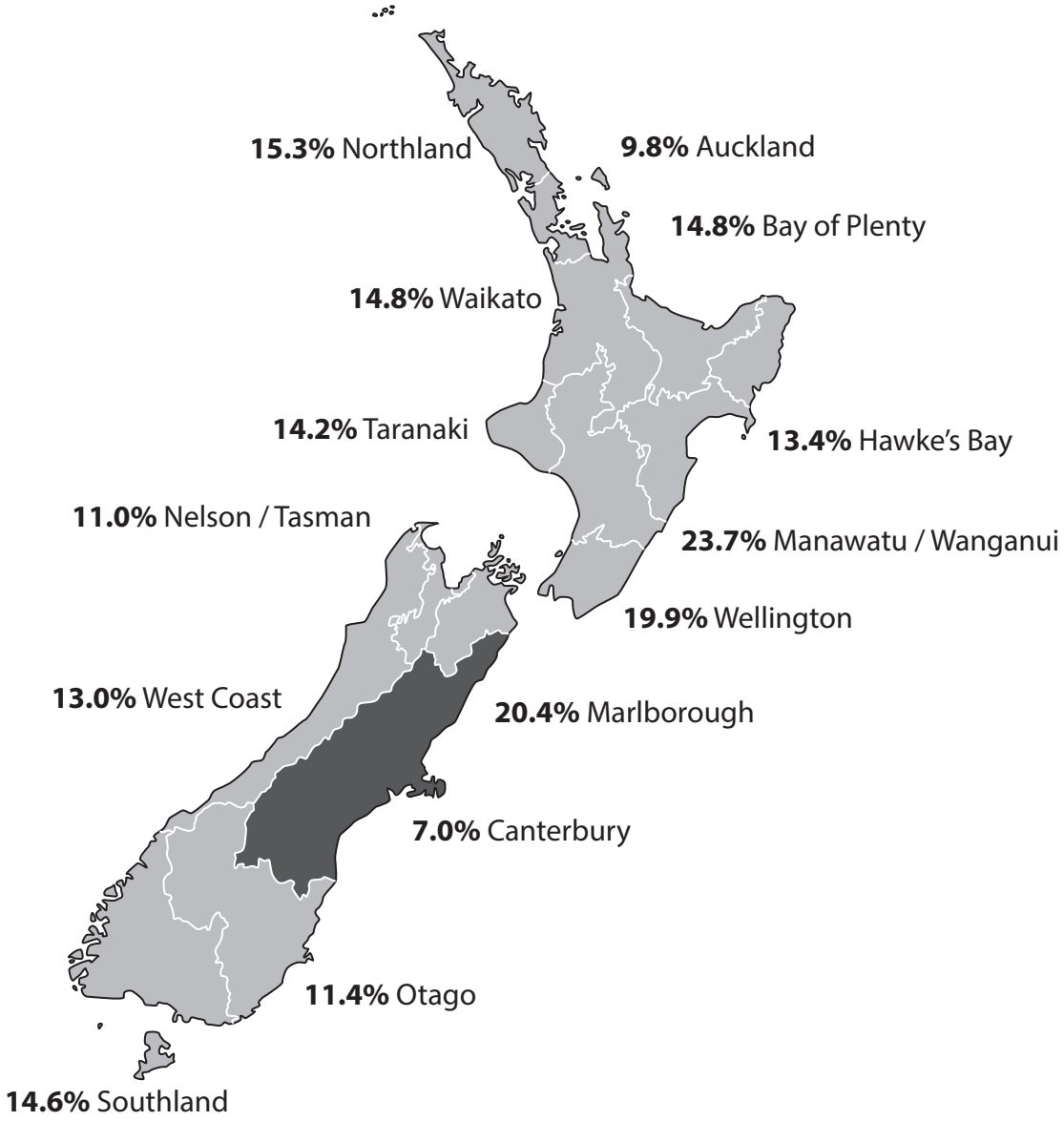
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Sources for use with Section C

New Zealand's housing market and national parks

Figure 1 Percentage change in house prices between March 2020 and March 2021, by region



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Extract A Rapid increase in house prices

House prices in New Zealand increased by 15.7% between March 2020 and March 2021. The average house price had risen to NZ$925 000. This increase in house prices was caused by increasing real incomes, low interest rates and a rise in immigration following the global health crisis. Real incomes increased as a result of an above average rate of economic growth. Between March 2020 and March 2021 the base interest rate in New Zealand was just 0.25%, making it relatively cheap to borrow to purchase houses.

Research showed that house prices in New Zealand were about 40% overvalued relative to income. House prices were rising faster than real incomes and were 8.6 times median income in 2020 and 10 times median income in 2021. In Auckland, the average property price increased to NZ$1.4 million in 2021. This was 35 times median income.

According to New Zealand's Prime Minister, Jacinda Ardern, many buyers are speculators. In 2020 approximately 15 000 people buying houses owned five or more. She is worried that the speculators could cause a dangerous housing bubble and market failure. She is also concerned that 1% of the population are homeless, the highest rate of homelessness amongst developed countries.

Between 2000 and 2021 house prices increased by 256% in New Zealand. By comparison, house prices in the USA increased by 68% and in the UK by 110%.

Extract B House building in New Zealand

In 2017 the Government promised to build 100 000 new homes. Between June 2018 and July 2020 the Government built just 6 000 homes. It is expensive to build houses and there is much paperwork needed to obtain planning permission. Many local authorities limit the land on which houses can be built in order to protect the environment. There is a shortage of over 55 000 construction workers.

Between 2011 and 2020 the average annual growth rate in housebuilding was 13%. However, in 2021, the significant increase in house prices created an incentive to build new houses. Consequently, the number of new houses under construction increased by 26%.

Extract C New Zealand's national parks

New Zealand has 13 national parks covering 30 000 km^2 that the public can explore on foot, by boat, car or air. For much of the year there is so much space that an individual will rarely meet another person. However, in the summer season the national parks are very popular. This means that the national parks become more crowded and car parking spaces are hard to find.

Some activities within the national parks, such as skiing and kayaking, have to be paid for. However, individuals can walk, run or cycle across the national parks without charge.

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Acknowledgements

Figure 1 adapted from: https://wiseplanning.co.nz/market-and-economic-update-may-2021/

Extract A adapted from:

https://www.globalpropertyguide.com/Pacific/New-Zealand/Price-History

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Extract C adapted from: https://www.newzealand.com/int/national-parks/