



GCE A LEVEL

A520U30-1



THURSDAY, 5 JUNE 2025 – MORNING

ECONOMICS – A level component 3
Evaluating Economic Models and Policies

2 hours 30 minutes

ADDITIONAL MATERIALS

A WJEC pink 16-page answer booklet.

INSTRUCTIONS TO CANDIDATES

Use black ink or black ball-point pen. Do not use gel pen or correction fluid.

You may use a pencil for graphs and diagrams only.

Answer **both** parts of **one** question from Section A.

Answer **both** parts of **one** question from Section B.

Answer **both** parts of **one** question from Section C.

Write your answers in the separate answer booklet provided, following the instructions on the front of the answer booklet.

Use both sides of the paper. Write only within the white areas of the booklet.

Write the question number in the two boxes in the left-hand margin at the start of each answer, for example

1	1
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Leave at least two line spaces between each answer.

INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question or part-question.

You are reminded of the necessity for good English and orderly, clear presentation in your answers.

SECTION A

Answer **both** parts of **one** question from this section.

Either,

**“Our goal is long-term growth in revenue and absolute profit”
Larry Page, Google, 2012**

1	1
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Using diagrams, explain how both an increase in the scale of a firm **and** an increase in the scale of an industry could lead to a rise in a firm's average costs. [10]

and

1	2
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Discuss whether all firms should aim to maximise their profits. [20]

Or,

Increased contestability in UK energy market had unintended consequences

2	1
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Explain the main factors that determine the level of contestability in a market. [10]

and

2	2
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To what extent is it desirable that all markets should become more contestable? [20]

SECTION B

Answer **both** parts of **one** question from this section.

Either,

UK consumers continue to cut spending

3	1
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Explain the factors that might cause consumption in an economy to rise. [10]

and

3	2
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Discuss whether an increase in consumption is likely to be good for the UK economy. [20]

Or,

Bank of England struggles to reduce UK inflation to target rate

4	1
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Explain how a price index to measure the rate of inflation is constructed. [10]

and

4	2
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Discuss whether a reversal of quantitative easing could be effective in bringing inflation down to its target level. [20]

SECTION C

Answer **both** parts of **one** question from this section.

Either,

Covid and rising debt levels cause collapse in foreign direct investment (FDI)

5	1
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Explain why high levels of public sector debt can be an obstacle to economic development in low-income countries (LEDs). [10]

and

5	2
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Discuss whether an increase in FDI into low-income countries (LEDs) is likely to lead to an increase in economic development. [20]

Or,

LEDs face a deteriorating terms of trade as dollar surges

6	1
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Explain what is meant by a country's terms of trade and explain two factors that could cause it to worsen. [10]

and

6	2
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Evaluate the view that a worsening in a country's terms of trade is good for its economy. [20]

END OF PAPER

Question
number

1 1

An increase in the scale of a firm means that the firm increases all of its factors of production, so its whole capacity grows (for example a new factory, more managers and more workers), rather than just producing more output from a fixed plant. This is a long run change, shown by a movement along the long run average cost (LRAC) curve. An increase in the scale of an industry means the whole industry grows, with more firms and more total output, often concentrated in one area.

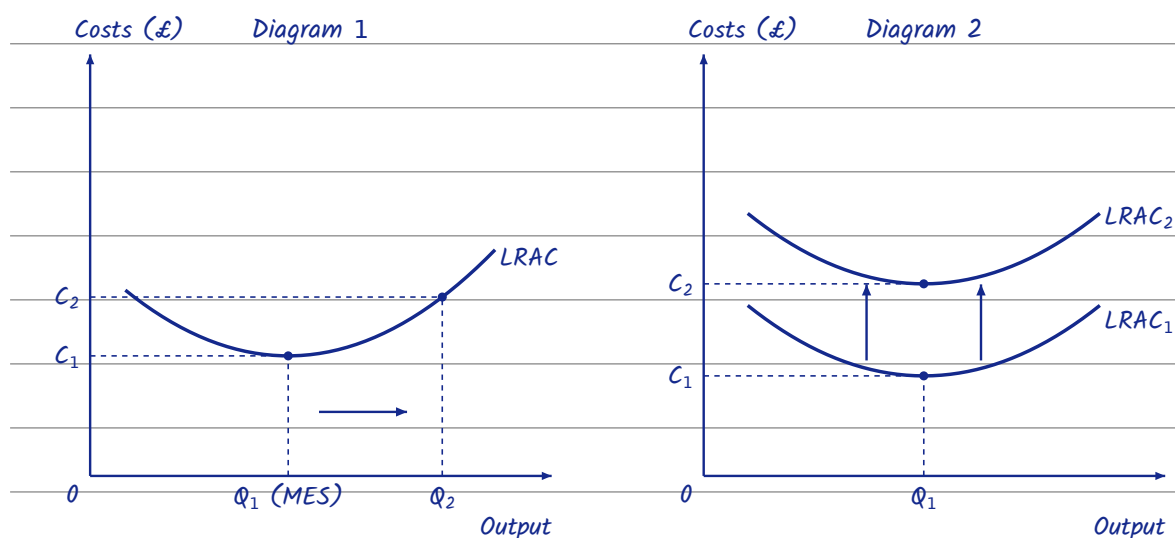


Diagram 1 shows internal diseconomies of scale. Up to the minimum efficient scale (MES) at Q_1 , economies of scale lower average cost to C_1 . If the firm expands beyond this to Q_2 , average cost rises from C_1 to C_2 as it moves up the rising part of its LRAC. The causes come from inside the firm:

Communication: a larger firm has more layers of management (a longer chain of command) and relies more on written messages and emails, so instructions are slower and distorted. Decisions are taken more slowly, possibly across different time zones, which lowers productivity and so raises unit costs.

Coordination: a bigger organisation is more complex, so it is harder to make sure resources are in the right place at the right time. If components do not arrive, workers and machines sit idle, and if a branch over-orders supplies they are wasted, so the cost per unit rises.

Control: with more staff it is harder for managers to monitor workers, so effort and focus fall. Output per worker falls while wage costs do not, pushing up average costs.

Demotivation: workers in a giant firm may feel like small cogs in a machine and lose their connection to their work. Lower motivation leads to higher absenteeism, higher labour turnover (with extra recruitment and training costs) and lower productivity, all of which increase unit costs.

Diagram 2 shows external diseconomies of scale. When the industry grows, the firm's whole LRAC curve shifts upwards from $LRAC_1$ to $LRAC_2$, so even at the same output Q_1 its average cost rises from C_1 to C_2 . This is caused by factors outside the firm:

Competition for scarce factors of production: more firms competing for a limited supply of skilled workers bids up wage rates, and more demand for land in the area drives up rents, so every firm's costs rise.

Pressure on local resources: if the industry is agglomerated, roads and transport links become congested, so deliveries take longer and transport costs rise. More regulation is also possible as the industry attracts government attention, increasing red tape and compliance costs.

Therefore both growth of the firm beyond its MES and growth of the whole industry can raise the firm's average costs, one through a movement along the LRAC and the other through an upward shift of the LRAC.

1 2

Profit maximisation is where a firm produces the output at which marginal cost equals marginal revenue ($MC = MR$), so that the gap between total revenue and total cost is as large as possible. Traditional theory assumes all firms aim for this, but in practice many firms have other objectives such as growth, survival,

sales or social aims.

There are strong reasons why firms should aim to maximise profits. Higher profits mean higher retained profits, which are a cheap source of finance compared with borrowing or issuing shares. These funds can be used to expand the scale of the business through organic growth or mergers and acquisitions, which may lower costs through economies of scale and create even larger profits in the long run. Retained profit can also be reinvested in research and development. Better processes drive costs down (dynamic efficiency), allowing lower prices and greater competitiveness, while new or improved products raise quality and widen the firm's product range. Google, quoted by Larry Page, has used huge profits from search advertising to fund innovations such as Android and cloud computing, which in turn generate more revenue.

Profit maximisation also allows a firm to pay higher dividends to shareholders. This supports the share price, attracts further investment, reduces shareholder activism and makes a hostile takeover less likely, since a firm with a low share price relative to its potential profits is an easy target. Profits also allow a firm to pay off debts and build up liquid reserves, such as Apple's large cash pile, giving a buffer in a downturn and the flexibility to take advantage of opportunities. For a small owner-run firm, profit is the owner's reward for effort and risk, so maximising it raises their income and standard of living. In a competitive market, a firm that does not seek maximum profit may also be unable to survive, because only firms covering at least normal profit stay in the market in the long run.

However, there are good reasons why not all firms should aim to maximise profits, at least not in the short run. Raising prices or cutting costs to boost short term returns can damage a firm's reputation and reduce its long term profit stream, for example if quality falls and customers switch to rivals. Cutting wages or forcing higher productivity may increase labour turnover and lower motivation, which is counterproductive. High short term supernormal profits also signal to potential entrants that the market is attractive. In a contestable

market it may make more sense to use limit pricing, setting a price below the profit maximising level to deter entry and protect long run profits. So the answer depends on the firm's time horizon.

Many firms also have different objectives. In a recession, survival is more important, so a firm may focus on cash flow and cost reduction rather than profit. Some firms sacrifice short term profit for growth, sales revenue or market share, as Amazon did for many years, hoping to create larger profits later.

Under the principal-agent problem, managers may prefer sales revenue maximisation ($MR = 0$) or growth because their pay and status depend on firm size. Social enterprises and not-for-profit organisations, such as Wikipedia or Mozilla, pursue social and community objectives instead. Owners of small firms may satisfice, accepting lower profits in exchange for more leisure time and a better quality of life, since literally maximising profits may be more trouble than it is worth.

There is also a practical problem: profit maximisation may be impossible. Firms rarely know their exact MC and MR curves because information about demand and costs is imperfect, so it may make more sense to aim for large or satisfactory profits rather than the maximum. From society's point of view, a monopoly that maximises profits restricts output and charges a price above MC, causing allocative inefficiency and a deadweight loss, which is why regulators may not want all firms to pursue maximum profit.

In conclusion, firms should not all aim to maximise profits in the same way. It depends on the firm's size, ownership, current situation and the external environment. A large shareholder-owned plc in a stable market, like Google, has good reason to pursue long run profit maximisation because this funds innovation and keeps shareholders satisfied. A firm in a recession should prioritise survival, a new firm may prioritise growth and market share, and a social enterprise exists for other goals. Overall, the most sensible aim for most firms is long run rather than short run profit maximisation, balancing profit against reputation, staff and the threat of entry, which is exactly what Larry Page's emphasis on

long-term growth in absolute profit suggests.

4 1

A price index measures the average change in the prices of goods and services compared with a base year, which is given the value of 100. In the UK the main measure of inflation is the Consumer Prices Index (CPI), produced by the Office for National Statistics (ONS). The rate of inflation is the percentage change in the index over twelve months.

Step 1, the basket: the ONS chooses a representative basket of around 700 goods and services that reflects the spending patterns of typical households. The Living Costs and Food Survey records what households actually spend their money on, and the basket is updated every year, adding new items (such as streaming subscriptions) and removing outdated ones.

Step 2, the weights: each item is given a weight to reflect its importance, measured by the proportion of total household spending on it. The weights add up to 1000. Spending on transport is far larger than spending on tea, so a 10% rise in petrol prices has a much bigger effect on the cost of living than a 10% rise in tea prices, and the index must reflect this.

Step 3, price collection: the ONS collects the prices of each item every month from a wide range of outlets across different regions, both shops and online, and averages them.

Step 4, item price indices: the percentage change in each item's price is added to its base value of 100, so a 4% rise gives an index of 104.

Step 5, weighting and combining: each item's price index is multiplied by its weight, the results are added to give the total weighted index, and this is divided by the total of the weights. For example:

Food: weight 300 $\times$ index 104 = 31,200

Housing: weight 500 $\times$ index 106 = 53,000

Transport: weight 200 $\times$ index 110 = 22,000

Total = 106,200 $\div$ 1000 = 106.2

So the price index is 106.2, meaning the price level has risen by 6.2% since

the base year. Comparing the index from one year to the next gives the annual rate of inflation, for example $(106.2 - 100) \div 100 \times 100 = 6.2\%$. Because of the weights, the large rise in transport prices has less effect than the smaller rise in housing costs.

4 2

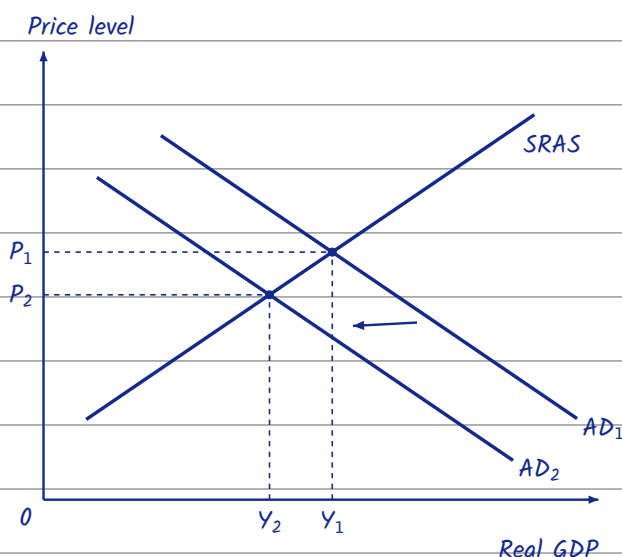
Quantitative easing (QE) is when the central bank creates new money electronically to buy government bonds (gilts) and corporate bonds from financial institutions. Reversing QE is called quantitative tightening (QT), also known as balance sheet normalisation. Under QT the Bank of England shrinks its balance sheet, either by not reinvesting the money from bonds that mature or by actively selling bonds back to the market. Tapering, a slowdown in bond purchases, is a milder form. The Bank built up about £895bn of bonds through QE and began QT in 2022, including active gilt sales from November 2022, as CPI inflation rose to 11.1% compared with the 2% target.

QT can reduce inflation through several channels. First, selling bonds increases their supply, so bond prices fall. Because there is an inverse relationship between bond prices and yields, yields rise. Higher gilt yields feed into higher long term interest rates, such as fixed rate mortgages and corporate borrowing costs. Higher mortgage payments reduce households' discretionary income, so consumption falls, and higher borrowing costs reduce firms' investment, as fewer projects have an expected return above the cost of borrowing. Since C and I are components of AD, AD shifts left.

Second, higher bond yields cause investors to switch out of shares and property into higher yielding bonds, so asset prices fall. This negative wealth effect makes households feel poorer and lowers confidence, again reducing consumption and AD.

Third, QT should reduce the money supply. When commercial banks and other institutions buy bonds from the central bank, their reserves and liquidity fall, so they are less able to lend. According to the quantity theory of money ($MV = PY$), if the velocity of circulation (V) and real output (Y) are fairly stable, a

fall in the money supply (M) leads to a fall in the price level (P), or at least a slower rise.



As the diagram shows, the fall in AD from AD_1 to AD_2 lowers the price level from P_1 to P_2 , reducing inflation, although real GDP also falls from Y_1 to Y_2 . Lower AD also increases spare capacity in product and labour markets. As unemployment rises, workers find it harder to bargain for pay rises and firms find it harder to raise prices, which helps to break the wage-price spiral and bring inflation back towards 2%.

However, QT may not be very effective. QT is only one of many influences on inflation and could be offset by other pressures, such as expansionary fiscal policy or rising world energy prices. In 2022 UK inflation was largely cost-push, caused by higher gas and food prices after the Russian invasion of Ukraine. QT reduces demand but does nothing to lower these costs, so it would mainly reduce output and jobs rather than prices. Its effect also depends on inflationary expectations: if workers and firms expect high inflation to persist, they will keep pushing up wages and prices even with lower AD.

The transmission mechanism of QT is also uncertain because it is a relatively new policy, so the Bank cannot be sure how large or how quick the effect will be, and time lags of 18 months to 2 years are likely. QT also risks making financial markets more volatile by reducing liquidity, as shown by the gilt

market turmoil in September 2022 when the Bank had to delay its sales and buy gilts temporarily. Because of this risk, QT has to be gradual and predictable, so its effect on inflation may be negligible. Furthermore, many economists are sceptical about the link between the money supply and inflation in $MV = PY$, as V has been unstable and QE itself did not cause high inflation for over a decade.

QT may also be limited by the government, because selling gilts at the same time as the Treasury is issuing large amounts of new debt raises the government's borrowing costs. The Bank also makes losses when it sells gilts below the price it paid, which are covered by the Treasury, adding to the public finances pressure.

In conclusion, QT can help to reduce inflation by raising long term interest rates, lowering asset prices and reducing AD, but on its own it is unlikely to bring inflation down to the 2% target. Its effectiveness depends on the cause of inflation (it works better against demand-pull than cost-push inflation), on the scale and speed of bond sales, on expectations and on whether fiscal policy is pulling in the same direction. The Bank of England itself treats QT as a background process and uses Bank Rate, which rose to 5.25% in 2023, as its main tool. Inflation fell close to target in 2024 mainly because energy prices fell and Bank Rate was high, so QT is best seen as a supporting rather than a main policy for meeting the inflation target.

5 1

Public sector debt is the total amount owed by the government as a result of past borrowing to finance budget deficits. Economic development is a broader improvement in living standards, including health, education, income and freedom of choice, measured for example by the HDI. Many LEDCs, such as Zambia, Ghana and Sri Lanka, have had debt crises in recent years.

The main problem is the opportunity cost of debt servicing. A government with high debt must spend a large share of its revenue on interest and repayments, so there is less to spend on infrastructure, healthcare and education. Some

LEDCs spend more on debt interest than on health. Without schools, hospitals, clean water and roads, human capital and productivity stay low, life expectancy and literacy do not improve and so development is held back.

High debt also limits fiscal policy. The government has little scope for tax cuts or extra spending to stimulate growth, so it may even need austerity, cutting public services, which directly lowers living standards.

Much LEDC debt is owed in foreign currency, usually US dollars. If the dollar strengthens or the local currency depreciates, the cost of servicing the debt rises in local currency terms, so even more revenue is diverted, and scarce foreign exchange is used for repayments rather than importing capital goods.

High debt reduces creditworthiness, so credit ratings fall and bond yields rise.

This makes it more expensive to refinance existing debt, increasing debt service costs further in a vicious circle, and may stop the country accessing international capital markets, so it cannot borrow for long term development projects.

Government borrowing may also crowd out private investment, as competition for limited domestic savings drives up interest rates and reduces the funds available to firms. Finally, foreign investors may fear future tax rises, spending cuts, default or instability, so FDI falls, reducing jobs, technology transfer and growth. All of these limit the growth in incomes and public services that is needed for economic development.

5 2

Foreign direct investment (FDI) is investment by a multinational company (MNC) in productive assets in another country, such as building a factory or buying a controlling stake in a local firm. Economic development is a broad improvement in living standards, including higher real incomes, better health and education and reduced poverty, measured by the HDI.

FDI can increase economic development in several ways. FDI is an injection of investment, so it increases AD and, through the multiplier, causes a larger rise in GDP. In many LEDCs domestic savings are low (the savings gap in the

Harrod-Domar model), so FDI fills this gap, increasing the capital stock and productive capacity, shifting LRAS to the right. Higher GDP widens the tax base, giving the government more revenue to spend on schools, healthcare and sanitation, which directly raises living standards.

FDI creates jobs directly in the MNC and indirectly in local suppliers. Formal employment raises incomes and GDP per capita, reduces poverty and allows families to spend more on food, health and education. For example, foreign garment and textile firms in Ethiopia's Hawassa Industrial Park have created tens of thousands of jobs.

FDI can also bring skills, technology and management know-how. Workers are trained and may later move to local firms or start their own businesses, spreading knowledge. This raises productivity and helps sectoral shift away from low productivity agriculture into manufacturing and services. FDI can allow primary product dependent economies to add value to commodities, for example by processing cocoa or minerals locally rather than exporting them raw, improving the trade balance and reducing exposure to volatile commodity prices.

Some FDI comes with infrastructure, such as Chinese investment in roads, railways and ports in Africa. Better infrastructure lowers business costs and helps people access markets, schools and hospitals. Increased competition from MNCs can also force local firms to become more efficient.

However, an increase in FDI may not lead to development. FDI raises GDP but not necessarily GNI, because MNCs repatriate profits to their home country, so much of the income leaves the LEDC. MNCs may also use transfer pricing and other tax avoidance schemes, or be offered tax holidays to attract them, so the tax base benefit is small.

Jobs may not be created for local people if MNCs bring in their own skilled workforce, leaving local people with low wage, low skill jobs. Competition from MNCs may drive local firms out of business, destroying jobs. Because MNCs are less accountable, they may exploit the workforce with poor conditions, or damage the environment, as with oil pollution in the Niger Delta. Resource-seeking FDI

may extract natural resources until they run out, with few linkages to the rest of the economy.

FDI may also increase income inequality, since only a small number of workers in a few sectors or regions benefit. Rapid FDI into a newly discovered natural resource may cause Dutch disease, as the currency appreciates and other export industries, such as agriculture and manufacturing, become uncompetitive. MNCs can be footloose: once wages rise they may relocate to cheaper countries, leaving the economy at risk of the middle income trap. Large MNCs may also exert undue influence over governments whose economies depend on them.

In conclusion, whether more FDI leads to development depends on the nature of the FDI and the initial level of development of the economy. FDI into manufacturing or services that diversifies the economic base, trains local workers and links with local suppliers is much more likely to improve development than FDI into resource extraction, which creates few jobs and risks Dutch disease. It also depends on institutions: if the country has strong infrastructure, low corruption and effective regulation of labour, environment and tax, it can capture the benefits and reduce the threats. Where governance is weak and GDP is very low, the gains are more likely to flow abroad. Overall, FDI is likely to increase development only when governments use the extra tax revenue and skills it brings to invest in health, education and infrastructure.