



Oxford Cambridge and RSA

Thursday 18 May 2023 – Morning

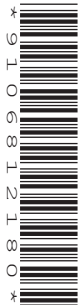
A Level Economics

H460/01 Microeconomics

Time allowed: 2 hours

You can use:

- a scientific or graphical calculator



Please write clearly in black ink. **Do not write in the barcodes.**

Centre number

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Candidate number

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First name(s)

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Last name

StemUp Model Solution

INSTRUCTIONS

- Use black ink. You can use an HB pencil, but only for graphs and diagrams.
- Write your answer to each question in the space provided. If you need extra space use the lined pages at the end of this booklet. The question numbers must be clearly shown.
- Answer **all** the questions in Section A, **one** question in Section B and **one** question in Section C.

INFORMATION

- The total mark for this paper is **80**.
- The marks for each question are shown in brackets [].
- Quality of extended response will be assessed in questions marked with an asterisk (*).
- This document has **20** pages.

ADVICE

- Read each question carefully before you start your answer.

SECTION A

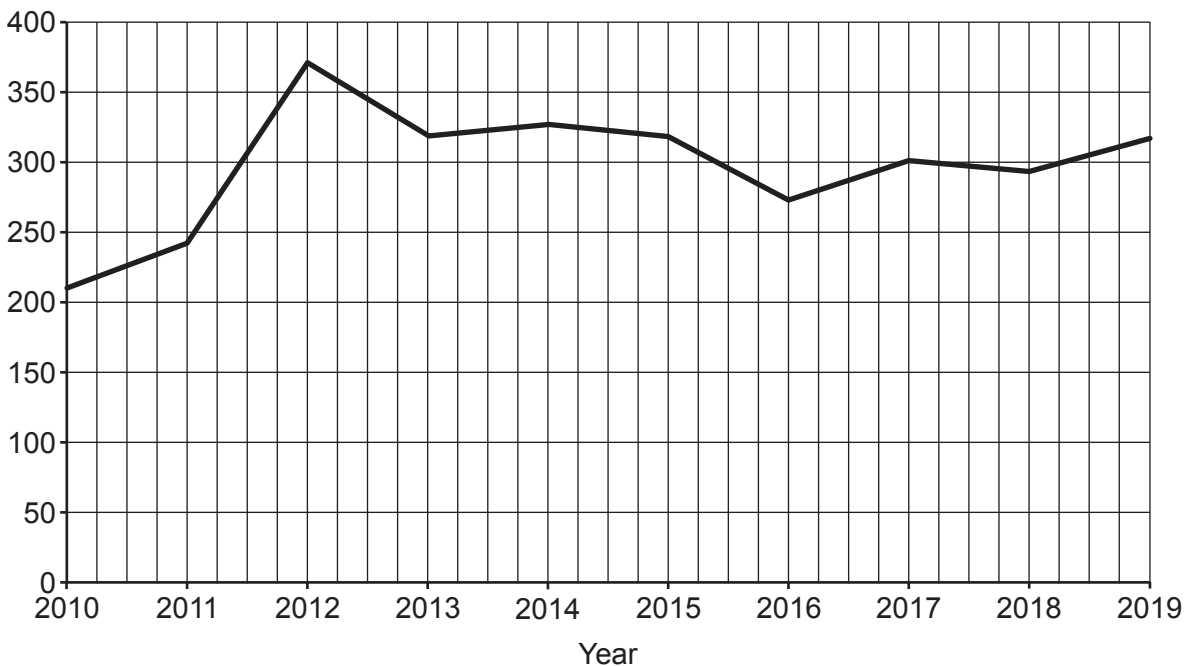
Read the stimulus material and answer **all** the parts of Question 1.

Wage differentials in the USA

Research shows the ratio of Chief Executive pay ('remuneration') to employee remuneration in the USA has increased significantly since 2010 (see **Fig. 1**). In 2019, Chief Executives at the largest 350 firms in the USA earned 320 times more than a typical employee.

Fig. 1

Chief Executive-to-employee remuneration ratio (USA), 2010–2019



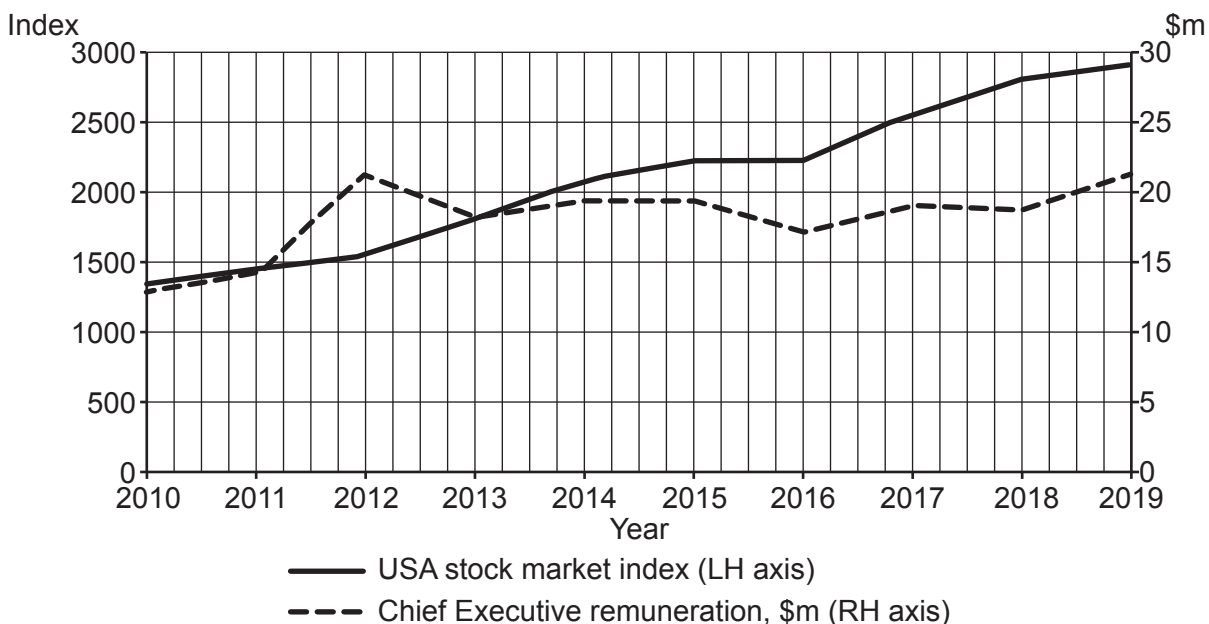
Source: Economic Policy Institute

Chief Executives earned an average of \$21 million in 2019, a 14% increase since 2018. In that year, the US stock market price index, which shows changes in the share prices of US companies also rose (see **Fig. 2**).

5

Fig. 2

Chief Executive remuneration and stock market performance (USA), 2010–2019



Source: Economic Policy Institute

This growth in Chief Executive remuneration has happened while wage growth for most Americans has remained relatively low. To distract attention from their remuneration, some Chief Executives have taken a voluntary cut in salary. However, this approach is criticised as much of their remuneration comes from share options (the right to buy shares at set prices) and bonuses. Other policies that may help reduce the remuneration gap between Chief Executive and employee have been suggested, including: 10

- reinstating a higher marginal income tax rate at the very top income levels;
- setting corporation tax rates higher for firms that have higher ratios of Chief Executive-to-employee remuneration; 15
- allowing greater use of 'say on pay' which allows a firm's shareholders to vote on Chief Executive remuneration.

Society is increasingly recognising who are the essential workers. They harvest our food, stock our grocery shelves and deliver goods all over the country. They look after our children and care for us when we are ill. They are also amongst the lowest-paid workers in the country. Why is this? 20
And, in contrast, why are relatively non-essential jobs, in such areas as entertainment and sport, so well paid?

The answer to these questions is not clear. The traditional economics answer would be to consider the concepts of demand and supply. Many of the essential occupations are easy to enter. For example, a cleaner might not require specialist knowledge or training. 25

A different answer could be 'scalability'. A cleaner, however skilled at their job, can only clean one building at a time. However, an entertainer can provide value to millions of people at the same time, thanks to television or the Internet. In many jobs, such as those in entertainment or sport, it is difficult to measure marginal physical productivity and so pay is set in a seemingly random way, often based on power. 30

This 'power differential' is a new area of research to explain wage differentials. This suggests that skill levels are not good predictors of wage levels, as there are big differences in wage between workers who do the same job.

In the USA, business leaders and politicians have worked together to weaken trade unions, oppose minimum wage legislation and remove labour market restrictions. Marshall Steinbaum, an economist at the University of Utah, suggests that the decline in workers' rights and bargaining power of trade unions alongside the greater power of employers is the main reasons for growing wage differentials. He says that "[The power] American bosses have to dictate take-it-or-leave-it terms to workers is the core reason our 'essential' workforce are underpaid." 35

Source: Adapted from *The Washington Post* (6/4/20) & *Pressenza* (19/8/20)

1 (a) Refer to Fig. 2.

- (i) Describe the relationship between Chief Executive remuneration and stock market performance between 2010 and 2019.

There is a positive (direct) relationship: both rose. Chief Executive remuneration rose from about \$13m to \$21m (around 65%) while the stock market index rose from about 1350 to 2950 (around 120%), so stock market performance increased at a faster rate. [2]

- (ii) Explain why this relationship may exist.

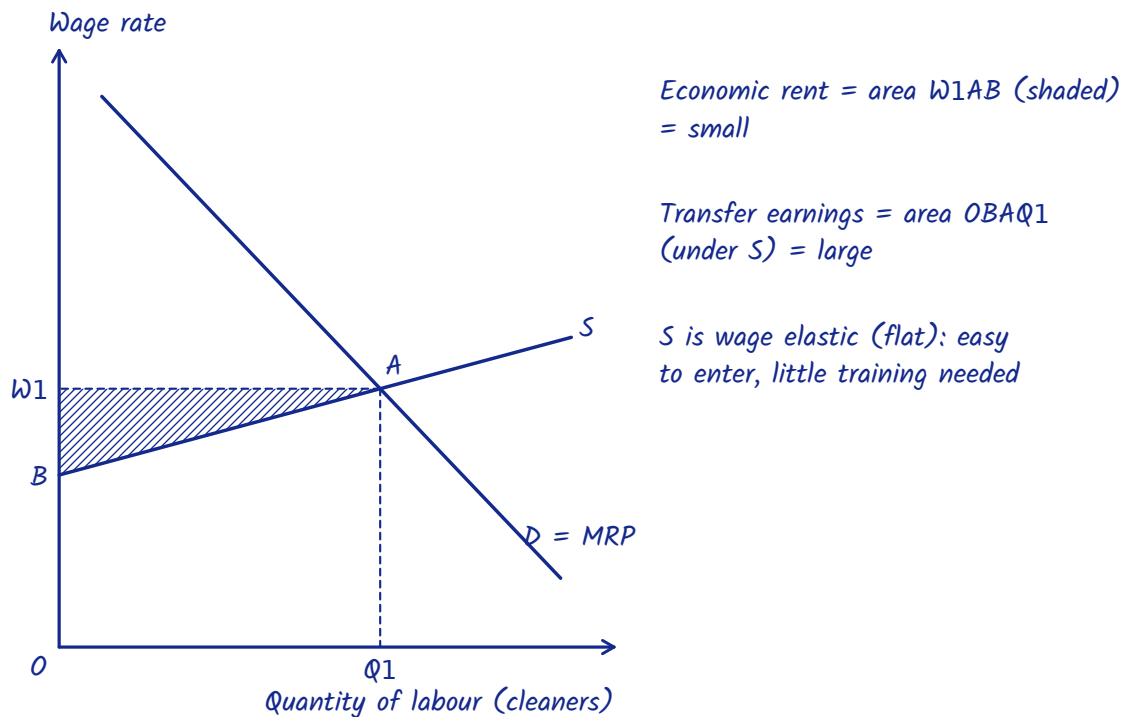
Much of a Chief Executive's remuneration is linked to the firm's share price through share options and bonuses, so when the stock market rises the value of these options rises, which increases their remuneration. [2]

- (b) A marginal income tax rate is one example of the marginal principle used by economists.

Explain what is meant by the economic concept of 'the margin'.

The margin is the effect of one more (an extra) unit. For example, marginal cost is the change in total cost of producing one more unit, and the marginal income tax rate is the tax paid on an extra £1 of income. [2]

- (c) Explain, using an appropriate diagram, the size of economic rent relative to transfer earnings for essential workers such as cleaners. **Lines 23–25.**



Economic rent (area W_1AB) is small relative to transfer earnings (area $OBAQ_1$).....

Cleaning is easy to enter and needs little specialist knowledge or training, so supply.....

is very wage elastic: if the wage fell slightly many cleaners would leave, so almost.....

all of W_1 is transfer earnings..... [4]

- (d) A number of policies have been suggested to affect Chief Executive remuneration including 'Allowing greater use of 'say on pay' which allows a firm's shareholders to vote on Chief Executive remuneration,' **Lines 16–17**.

Evaluate, using evidence from the stimulus material, the extent to which greater use of 'say on pay' alone may help reduce the remuneration gap between Chief Executive and employee in the US.

[8]

Remuneration is the total reward to a Chief Executive, including salary, share options and bonuses; the remuneration gap is the difference between this and the pay of a typical employee. In 2019 Chief Executives at the largest 350 US firms earned 320 times more than a typical employee, and Fig. 1 shows the ratio rose from about 210 in 2010. In large public companies there is a divorce of ownership and control. Shareholders (principals) are a large and diverse group, while Chief Executives (agents) may pursue their own interests. Asymmetric information means accountability is weak, so executives can influence their own pay: a principal-agent problem and a market failure. Greater 'say on pay' lets shareholders vote against excessive packages, which increases accountability and could limit the growth in Chief Executive remuneration, narrowing the gap. However, say on pay is only an indirect way of reducing the gap. Fig. 2 shows remuneration rises with the stock market, from about \$13m to \$21m as the index rose around 120%. If shareholders are satisfied with growth in share prices, profits and dividends they have little reason to vote against pay, and they may fear that limiting pay means they cannot recruit or retain the best Chief Executives. It also does nothing to raise employees' pay, whose growth has stayed low because of weaker trade unions and greater employer power. Say on pay alone is therefore unlikely to be enough. It would be more effective combined with higher corporation tax for firms with high pay ratios, which gives shareholders an incentive to limit pay, while a higher top marginal income tax rate would reduce the gap more directly. Its impact depends on the size of the firm, how many shareholders there are and how involved they are, and how Chief Executives

are paid: votes may restrain salaries and bonuses, but share options tied to rising
share prices would still widen the gap, so on its own it would reduce it only slightly.

- (e)* Evaluate, using evidence from the stimulus material, whether weaker trade unions is the main reason for increased wage differentials in the USA. [12]

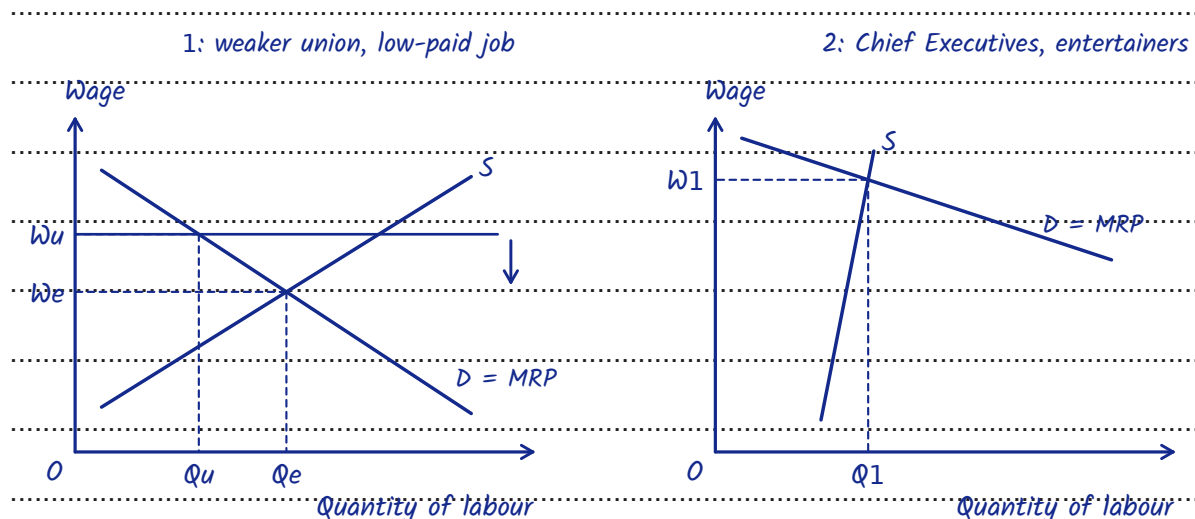
Wage differentials are differences in wage rates between workers or occupations.

Trade unions are organisations that represent the interests of their members by negotiating with employers on pay and conditions and large-scale redundancies, and by representing them in disciplinary and grievance meetings.

Strong unions use collective bargaining to raise wages above the free market equilibrium, or restrict the supply of labour. In Diagram 1 a union sets the wage W_u above the equilibrium W_e for low-paid workers. The extract says business leaders and politicians have worked together to weaken unions and remove labour market restrictions, so bargaining power has fallen and the wage falls from W_u towards W_e , lowering pay at the bottom of the income distribution. At the same time employers have more power to 'dictate take-it-or-leave-it terms', acting like monopsonists that pay below MRP, so wage growth for most Americans has stayed relatively low and differentials widen. Marshall Steinbaum argues this is the main reason.

However, the traditional explanation is demand and supply. Essential jobs such as cleaning are easy to enter and need little specialist knowledge or training, so supply is large and wage elastic, keeping wages low whatever the strength of unions. In Diagram 2, Chief Executives and entertainers face high demand (high MRP) and inelastic supply, giving a much higher wage W_1 . Scalability adds to this: an entertainer can provide value to millions at once through television and the Internet, so their MRP will always be far higher than a cleaner's, who can only clean one building at a time.

Other factors matter too. Opposition to minimum wage legislation means the US minimum wage has not been raised, so low pay falls behind, while cuts in marginal tax rates for top earners raise net incomes at the top. Chief Executive pay rose 14% in 2019 to \$21 million, linked to share options and the stock market, and the ratio rose from about 210 in 2010 to 320 in 2019 (Fig. 1).



On balance, weaker unions are probably not the main reason. Many low-paid jobs, such as cleaning and care, already had low union density, so weaker unions would have only a small effect there. Most of the increase in differentials has come from the growth of pay at the top of the income distribution, which is better explained by share options, scalability and the power of executives to set their own pay. Weaker unions and greater employer power explain why low pay has stagnated, but rising top pay is more significant, although the importance of each factor differs between groups of workers.

SECTION B

Answer Question 2 or Question 3.

- 2* In 2020, the Competition and Markets Authority (CMA) found that three pharmaceutical companies had taken part in an illegal agreement resulting in the price of a life-saving medicine supplied to the NHS increasing by up to 1800%. This was one of many examples investigated by the CMA where consumers were being disadvantaged by collusion and the actions of monopolies.

Evaluate, using an appropriate diagram(s), whether collusion and monopoly would always disadvantage consumers.

[25]

OR

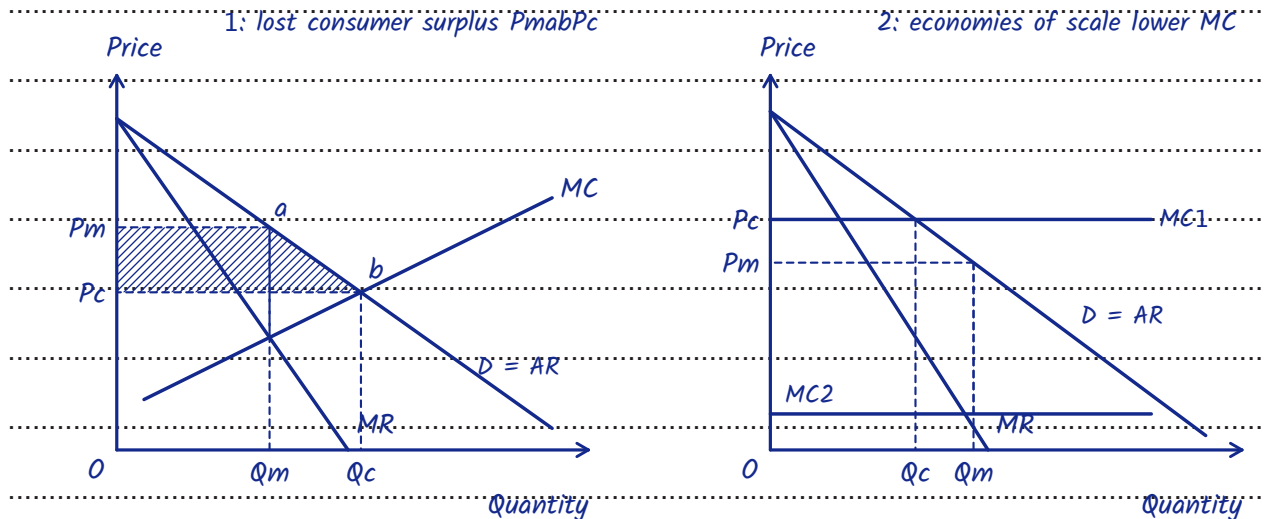
- 3* A report for the charity Action on Smoking and Health (ASH) in January 2022 estimated that smoking in England imposed costs on the NHS totalling £2.4 billion and costs on businesses, from lost productivity, of £17.2 billion.

Evaluate, using an appropriate diagram(s), the most effective method of government intervention to reduce the negative externalities from smoking in England.

[25]

Question No. 2.....

A pure monopoly exists when a firm is the sole seller in a market, although UK competition policy assumes monopoly power can arise with a market share of 25%. Collusion occurs when two or more firms agree to work together to reduce open competition, for example by agreeing to set high prices to make greater profits, as with the three pharmaceutical companies found by the CMA in 2020 to have raised the price of a life-saving medicine to the NHS by up to 1800%. Colluding firms agree not to compete on price and instead act as if they were a monopoly, maximising joint profit. In Diagram 1 the monopoly (or cartel) faces the downward sloping market demand curve $D = AR$. Profit is maximised where $MR = MC$, at output Q_m and a price of P_m is charged. This is higher than the price that would be charged in a competitive market, P_c , where $P = MC$, and output is lower than Q_c . Consumers therefore pay higher prices and buy less, and consumer surplus falls by the shaded area $P_m ab P_c$, some of which becomes supernormal profit for the firms and the rest a deadweight welfare loss. As $P > MC$ there is allocative inefficiency. Consumers also face reduced choice, and with no competitive pressure a monopolist may become x-inefficient, so costs and prices are higher still. For a life-saving medicine demand is



very price inelastic, as patients have no substitute, so the price rise of up to 1800%.

hugely transferred surplus from the NHS and taxpayers to the firms. The CMA also

investigated unfair pricing of hand sanitiser in 2020 and the merger of the ticket

websites StubHub and Viagogo in 2021, as reduced competition could raise fees for

consumers.

However, monopoly is not always a disadvantage to consumers. A monopolist can exploit

economies of scale, such as purchasing, technical and financial economies, which lower

its average and marginal costs. In Diagram 2, if MC falls from MC_1 to MC_2 and some

of this is passed on to consumers, the profit maximising monopoly price P_m can be

below the competitive price P_c and output higher than Q_c . This is especially likely in

natural monopolies, where one firm can supply the whole market at lower cost than

several.

Secondly, the supernormal profit earned by a monopolist can be used for research and

development, resulting in new and better products for consumers, giving dynamic

efficiency. In pharmaceuticals, monopoly arises from patents, which give firms the

incentive to fund the very expensive and risky research needed to develop new medicines;

without the prospect of monopoly profit many life-saving drugs would never be developed.

A monopoly may also face competition from substitutes or from new entrants in a

contestable market, which keeps prices close to costs.

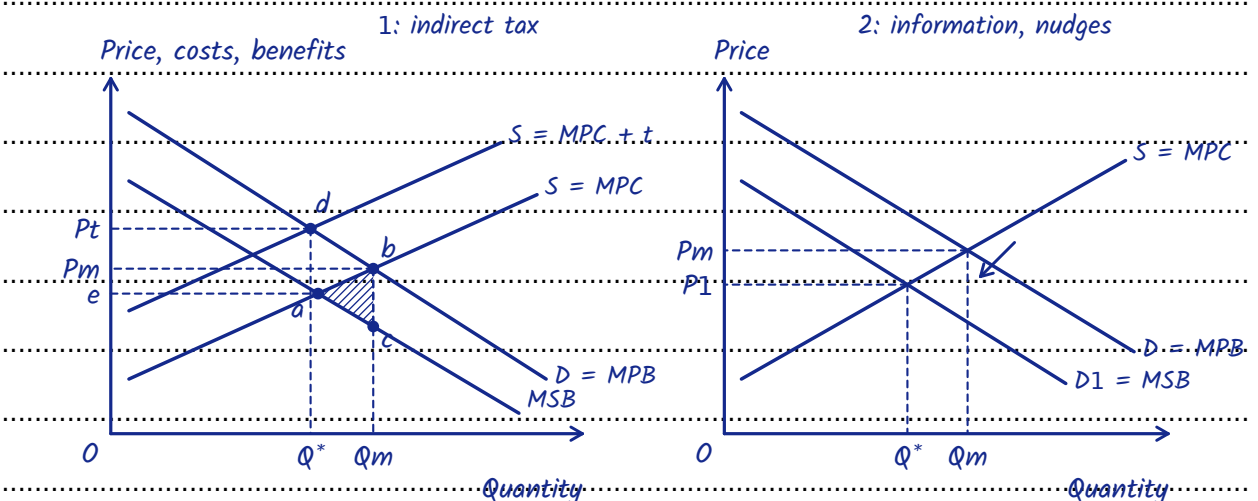
Collusion, however, is different. It is a deliberate attempt to reduce competition in a market, while the actions of a monopoly may not reduce competition. A cartel does not gain the economies of scale of a single large firm, because each member still produces separately, so costs do not fall and the higher price is simply a transfer from consumers to producers. The case found by the CMA involved an old medicine, so there was no research benefit to justify the price rise. Some cooperation, such as joint research agreements, can benefit consumers, but these are allowed by regulators rather than secret price fixing.

Whether monopoly disadvantages consumers depends on several factors. It depends on whether profits are reinvested in research and development or distributed to shareholders as dividends; on whether cost savings are passed on as lower prices, which a profit maximiser may not do if demand is inelastic; on the height of barriers to entry and contestability; and on regulation, such as price caps and the CMA's power to fine firms and block mergers. Monopoly is more likely to benefit consumers in industries where research and development costs and economies of scale are significant, such as pharmaceuticals.

In conclusion, collusion and monopoly do not always disadvantage consumers. There are no advantages to consumers from collusion, which raises prices and restricts output without lowering costs, so it is right that it is illegal. In contrast, monopoly could be an advantage for consumers through economies of scale and innovation, so there is no presumption that monopoly is harmful and the CMA examines each case on its merits. Monopoly is most likely to benefit consumers when profits fund research and when it is regulated so that lower costs are passed on in lower prices.

Question No. 3.....

Negative externalities are spill-over costs imposed on third parties who are not part of a transaction. Smoking creates negative consumption externalities: the ASH report estimated that smoking in England imposed costs on the NHS of £2.4 billion from treating smoking-related diseases, and costs on businesses from lost productivity, absenteeism and reduced ability to work, of £17.2 billion. Second-hand smoke and smoking during pregnancy also harm children's health. Because smokers consider only their marginal private benefit (MPB), and the marginal social benefit is lower ($MSB < MPB$), the free market over-consumes. In Diagram 1 the market equilibrium is at Q_m , where $MPB = MPC$, but the socially optimal output is Q^* , where $MSB = MPC$. Over-consumption of $Q_m - Q^*$ causes a welfare loss of area abc (shaded). Smokers may also suffer from information failure, underestimating the damage to their own health, and addiction.



The first method is an indirect tax on tobacco. The tax raises production costs from MPC to $MPC + t$, so supply shifts left and the market price of cigarettes rises from P_m to P_t . There is a contraction in demand and consumption falls from Q_m to Q^* , so the negative externalities are reduced: the marginal external cost ($MEC = MPB - MSB$) falls from bc to da . If the tax equals the MEC at Q^* , the externality is internalised and the

welfare loss is removed. The government also raises tax revenue of P_{tdae} , which could contribute towards the £2.4 billion cost of treating smoking-related diseases in the NHS. However, the reduction in smoking depends on the price elasticity of demand (PED) for cigarettes. Because smoking is habit-forming and addictive, and there are few close substitutes, demand is likely to be highly price inelastic, so a tax may be successful in raising revenue but not in reducing the negative externalities. The tax is also regressive, as smoking rates are higher among low-income households, who spend a larger share of their income on it, and very high taxes encourage smuggling and illegal cigarettes, which escape the tax. It is also difficult to measure the MEC accurately, so the tax may be set at the wrong level, causing government failure.

The second method is the provision of information and the promotion of alternatives. This may take the form of education and health campaigns, plain packaging and graphic health warnings, and nicotine replacement products and stop smoking medication, which can be subsidised or prescribed on the NHS. These work by reducing the demand for cigarettes: in Diagram 2 demand falls from $D = MPB$ towards $D_1 = MSB$, so the quantity consumed falls from Q_m to Q^* and the MEC falls from bc to da . Unlike a tax, this corrects the information failure at its source and is not regressive. Behavioural economics suggests that smokers may respond more to nudges, such as warnings on packets and default smoke-free spaces, than to price.

However, information campaigns involve a cost for the government and taxpayer on top of the external costs, and they have an opportunity cost. Their effectiveness depends on the degree of information failure: many smokers already know the costs to themselves but choose to ignore them because they are addicted or focus on the present rather than the future. The effect is also slow and uncertain, as it can take years for health campaigns to change behaviour.

Regulation, such as the ban on smoking in enclosed public places, the minimum age of 18 and bans on advertising, directly reduces harm to third parties from second-hand

smoke and is cheap to enforce. However, it does not reduce smoking at home and can be hard to police.

In conclusion, the most effective method depends on the PED for cigarettes and the type of smoker. Because demand is likely to be highly price inelastic for existing addicted smokers, taxation alone is not effective in reducing their smoking, although it raises revenue to pay for the external costs. Indirect taxation may, however, be very effective in discouraging people from starting to smoke, especially young people, whose demand is more price elastic as they have lower incomes and are not yet addicted. For existing smokers, alternatives to taxation, such as subsidised nicotine replacement and stop smoking services and nudges, are likely to be more effective. Therefore a combination is best: a high tax to deter new smokers and fund the NHS, alongside information and alternatives to help current smokers quit.

SECTION C

Answer Question 4 or Question 5.

- 4* Flood defences are considered by economists to be public goods. The £67.4 million Ipswich tidal flood barrier is just one of the many flood defence schemes which has been completed during the government's current capital investment programme. The scheme protects 1600 homes and 400 businesses from tidal flooding.

Evaluate the case for government provision of goods and services such as the Ipswich flood defence scheme. [25]

OR

- 5* Aldi, a discount supermarket, entered the UK market for the first time in 1990. Since then it has expanded its operation and, in 2022, its market share was 9.3% making it the fourth largest supermarket in the UK.

Evaluate the importance of economies of scale to a large retailer when deciding whether to increase the size of its firm. [25]

Question No. 4.....

Public goods are goods and services that have two key characteristics. They are non-excludable: it is not possible to provide the good to one consumer without it also being available for others to consume. If flood defences are built in an area, such as the £67.4 million Ipswich tidal flood barrier, everyone in the area benefits, including all 1600 homes and 400 businesses it protects, whether they pay or not. They are also non-rival (non-diminishable): consumption by one consumer does not reduce the amount available for others. One more house being protected does not reduce the protection given to the others. Other examples are street lighting, national defence, and to a lesser extent roads and parks. Because of non-excludability, the private sector would not provide public goods. Consumers have no incentive to pay as they can free ride on others' payments, so there is no effective demand for public goods, and firms cannot charge a price to make a profit. This is a complete market failure, or a missing market. Even though the social benefit of the Ipswich barrier is very large, avoiding flood damage to homes and businesses and lost output, a private firm could not collect revenue from the people who

benefit.....

Non-rivalry also means that once the good is supplied, the marginal cost of supplying another individual is zero. Allocative efficiency occurs where $P = MC$, so the efficient price is zero, which a private firm could not charge and cover its costs. Therefore pure public goods need to be provided by the government, financed through taxation, so that everyone who benefits contributes. Flood defences also produce positive externalities, protecting local infrastructure and jobs, so the government can take these wider benefits into account through cost-benefit analysis.

However, there are arguments against direct government provision. The government faces information problems: without a price mechanism it is difficult to know how much people value a public good, so it may over- or under-provide, and decisions may be influenced by political pressure rather than need, which is government failure. Government provision has an opportunity cost: the £67.4 million could have been spent on health or education, and raising taxes may create disincentives. State providers may also be x-inefficient as they lack the profit motive, leading to cost overruns and delays in large capital projects. It may be that the most appropriate role of the government is to decide the output of public goods and provide the finance, rather than to produce them itself. The private sector can still provide the goods and services by bidding to supply, with the government then 'demanding' the good. Many flood defence schemes are built by private construction firms under contract, so the government contracts out provision to the private sector. Competitive tendering can reduce costs and improve efficiency, while government finance overcomes the free rider problem.

There are also cases where groups of individuals club together to provide public goods, such as private security in gated communities, or communities clubbing together to keep local schools open. Quasi-public goods, which are only partly non-excludable or non-rival, may be provided by the private sector: the M6 Toll road is financed and operated entirely by the private sector, as it can exclude non-payers with a toll. In the past

public parks were provided by philanthropists. Behavioural economics suggests that individuals can have motivations other than private benefit: enough people may contribute to a public good even if it is rational to avoid paying, as a sense of community overrides maximisation of private benefit.

However, these private alternatives work best for small, local or excludable goods. A tidal flood barrier protecting a whole town is a pure public good: it is impossible to exclude a household that refuses to pay, the cost is very large, and the benefits last for decades, so voluntary contributions would be too small and the barrier would be under-provided or not built at all. A business might pay towards protection, but households would have a strong incentive to free ride.

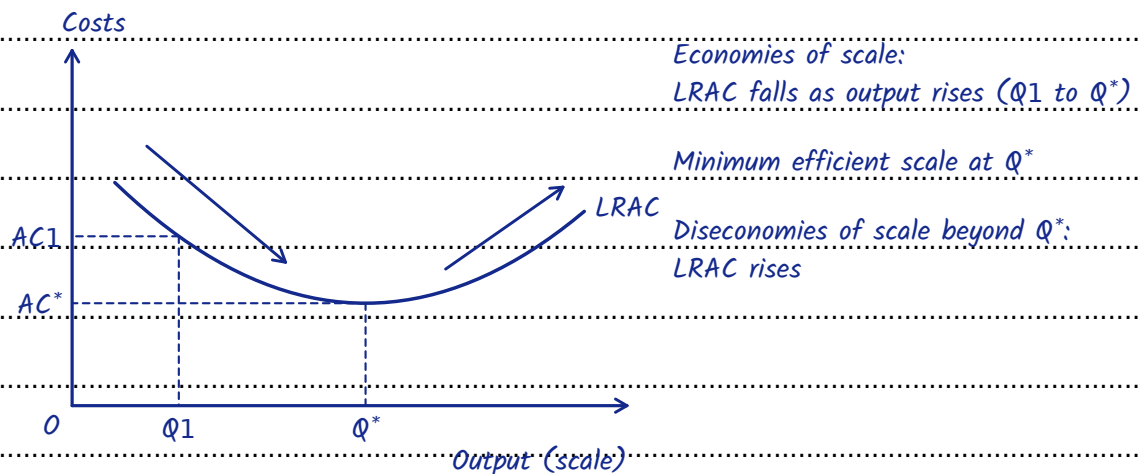
In conclusion, there is a strong case for government provision of pure public goods such as the Ipswich flood defence scheme, because without government provision they would not be provided by the market at all. However, the case is mainly for government finance and decisions about output, not necessarily for government production. Using private firms through contracting out, with careful cost-benefit analysis to avoid government failure, is likely to be the best approach. For quasi-public goods such as toll roads and parks, the case for government provision is weaker, as the private sector and voluntary groups can provide them.

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Question No. 5.....

Economies of scale arise when a larger scale of production leads to a fall in long-run average costs (LRAC). As my diagram shows, as a retailer increases its size from Q_1 towards the minimum efficient scale Q^* , its average cost falls from AC_1 to AC^* . For a large retailer such as Aldi, which has grown since entering the UK in 1990 to a 9.3% market share in 2022 as the fourth largest supermarket, there are several types.

Purchasing economies are probably the most important for a supermarket. Larger firms buy in bulk and get a better deal on the unit cost of the stock they sell, and they have more bargaining power in negotiations with suppliers such as farmers and food manufacturers. Technical economies also matter: a large retailer can invest in stock control and checkout technology to improve efficiency, and a delivery vehicle that is twice as big is not twice the cost to operate, so distribution costs per unit fall.



Managerial economies arise because a larger firm can afford to employ specialist managers, such as store, regional, purchasing, distribution and HR managers, which should result in more efficient management, higher productivity and lower average costs.

Marketing economies occur because national advertising is expensive, but for a large retailer the cost is spread over a greater volume of sales, so the cost per unit is lower.

Financial and risk-bearing economies mean larger firms can borrow more cheaply and

spread risk across many stores and products.

Economies of scale are important because they determine the cost per unit for retailers.

The supermarket market is an oligopoly with a small number of large firms selling similar products, so demand facing each firm may be price elastic and the ability to lower prices

is important. Discount grocers like Aldi face a high degree of price competition, and their

whole strategy depends on low prices. Lower LRAC allows a large retailer to cut prices

and compete more effectively, gaining market share, or to keep prices the same and earn

higher profit margins. Lower costs also act as a barrier to entry for smaller rivals.

However, large retailers must also consider diseconomies of scale, to make sure average

costs do not rise as the firm grows beyond Q^* . A very large firm can suffer from

communication and coordination problems between head office and hundreds of stores,

and from poor staff motivation, which raise LRAC. Aldi's model of smaller stores with a

limited range of products may help it avoid some of these, but it shows that growth will

not always lower costs.

Economies of scale are also not the only factor in deciding whether to grow. Retailers

consider the impact of size on revenue and market share, and their objectives: a firm

aiming for sales maximisation or market share may grow even if costs do not fall,

whereas a profit maximiser grows only if marginal revenue exceeds marginal cost. Where

there is a divorce of ownership from control, managers may expand the firm for status

and higher salaries rather than for lower costs. The firm must also decide how growth is

achieved, through organic growth by opening new stores or inorganic growth through

mergers, and how growth is to be financed, through retained profit or borrowing. A

merger between large supermarkets may also face a response from the competition

authorities, as the CMA blocked the proposed Sainsbury's and Asda merger in 2019.

The importance of economies of scale depends on the nature of the market and the

importance of price. In grocery retailing, where consumers are very price conscious,

especially in a cost of living crisis, lower unit costs are vital. However, where product

differentiation is more important, such as for premium retailers that compete on quality and service, consumers are less price sensitive and economies of scale are a less important reason for growth.

In conclusion, economies of scale are very important to a large discount retailer such as Aldi when deciding whether to grow, because its competitive advantage comes from low prices, which depend on low unit costs from purchasing power and efficient distribution. However, they are not the only factor: the firm must weigh them against diseconomies of scale and consider its objectives, the extent to which shareholders' profit maximisation objective is dominant, how growth is financed and possible action by the competition authorities. For retailers that compete on quality rather than price, economies of scale will be less significant in decisions to increase the size of the firm.

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