



Sample Papers – Set 2

EDEXCEL A Level – Paper 1 (Markets and Business Behaviour)

Answer Guide

This document is intended to support paper 1 of the second set of the EzyEconomics sample exam papers.

The answer guide provides a commentary on possible effective approaches to answer the sample exam

Contents

Section A

- Short Response Questions - Pg 3 - 4

Section B

- Question 6a – Pg 5 – 8
- Question 6b – Pg 9 – 13
- Question 6c – Pg 14 – 19
- Question 6d – Pg 20 – 24
- Question 6e – Pg 25 – 39

Section C

- Question 7 – Pg 40 – 52
- Question 8 – Pg 53 – 67

Section A:

Question 1:

- a) PED Value = -1.2
- b) B - Inelastic Demand
- c) When the demand for a firm's product is inelastic it means that an increase in the price of the product will result a less than proportionate increase in the quantity demanded. This means that when firms increase their prices, the gain in revenue from a higher price exceeds the loss in revenue from a fall in the quantity sold.

Question 2:

- a) D - A price control
- b) The minimum wage forces the wage rate to increase to W_{MW} . This means for all firms in the industry, the higher wage rate has to at least be paid to all workers. The higher wage rate creates a divergence between the supply of labour and the demand for labour. The supply of labour rises, as more workers are encouraged to supply their labour at a higher wage rate. The demand for labour falls as firms wish to hire less labour the more expensive labour is to the firms. This creates excess supply in the labour market and results in higher unemployment, but remaining workers get paid a higher wage rate.

Question 3:

- a) C – Third-degree Price Discrimination
- b) Price Discrimination Revenue = $(£6.00 \times 112) + (£12.00 \times 243) + (£8.00 \times 64)$
 $= £4,100$

$$\begin{aligned} \text{Uniform Pricing Revenue} &= (£8.00 \times 90) + (£8.00 \times 275) + (£8.00 \times 64) \\ &= £3,432 \end{aligned}$$

As the cinema chain receives more revenue by charging customers based on their elasticity of demand, the chain is likely to engage in price discrimination.

- c) Price discrimination is a differentiated pricing strategy which aims to convert any consumer surplus in the market into producer surplus. This is done by firms attempting to charge consumers their maximum willingness to pay. Therefore, some consumers will have to pay higher prices than under a

uniform pricing strategy. The higher prices result in a loss of consumer surplus.

Question 4:

- a) C – All firms in the market produce homogeneous products.
- b) The firm will make supernormal profits, as the price the firm is able to charge is above the average cost curve at the profit maximising level of output. The firm is able to charge a price above the marginal cost because of the market power the firm has established from differentiating its products.
- c) Despite some of the inefficiencies that are created under a monopolistically competitive market compared to a perfectly competitive outcome, the outcome in this type of market structure can be beneficial for consumers. This is because firms engage in product differentiation and therefore increase the quality and quantity of goods available to the market. Even though consumers may have to pay a higher price. Consumers may be willing to do so if the quality of the product has improved in this market structure.

Question 5:

- a) D – Organisational slack which results in the firm operating at a point above their LRAC curve at the level of output produced.
- b) A monopoly is when one firm dominates the market. The lack of competition that the monopolist faces can often result in the firm failing to control its costs. This is because they are not under any intense competitive pressure to commit to costly investment projects to ensure that costs remain low. The likelihood is that if the costs of the monopolist rise then this will be passed onto the consumer via higher prices. This results in a market outcome where welfare and efficiency is lower.

Question 6a

Using a demand and supply diagram, explain why in the UK ‘on average, house prices have increased by 7% per year since 1980’.

[5 marks]

There are two key elements required within this answer:



A good (but not the only) approach to this question is:

Market Forces

Begin by establishing the context and highlight that the story of rising house prices in the UK is down to both changes in demand and supply. For example:

“Extract A makes it clear that house prices have been increasing because of the forces behind demand and supply, “House prices reflect both demand and supply, and, as in all markets, the equilibrium price of a house will occur at the price that matches current demand to available supply”.

Therefore, this provides you with immediate evidence that you should be looking for demand and supply curve shifts.

Demand Change

Establishing the context and highlighting the shift in demand both introduces the diagram and squeezes in some application. For example:

“Extract A makes it clear that demand for homes in the UK has significantly increased across all regions, “demand for housing, has increased, partly as a result of an increasing population together with decreasing average household size in the midst of a low interest rate environment.”.

This provides you with firm evidence of expanding demand for homes in the UK over time.

Supply Change

You can then highlight the shift in supply in this market. For example:

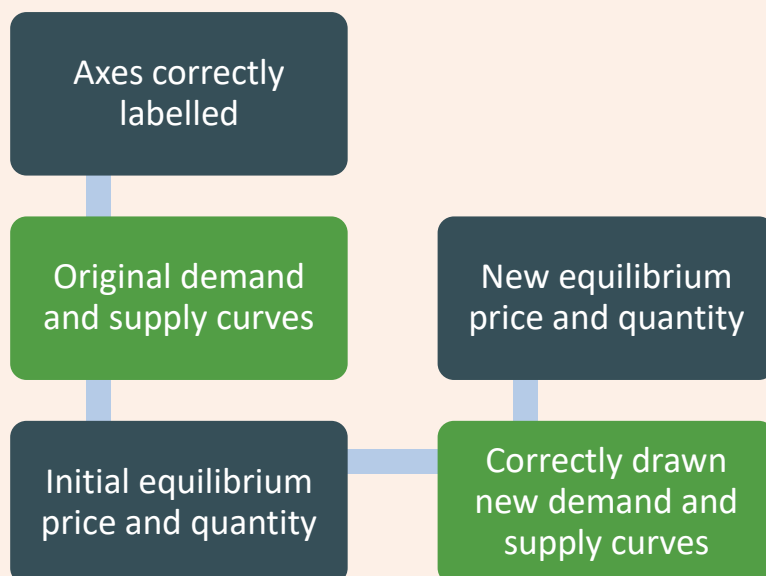
“Extract A also provides evidence that there has been limited growth in the supply of homes in the UK in the last two decades, which has resulted in supply lagging behind demand, “The overall level of house building in the UK has declined since 1980, with approximately 150,000 houses built in 2015 – a fall of 40% from the 250,000 homes built in 1980”.

This provides you with firm evidence that the growth in the supply of homes in the UK has slowed down.

Diagram

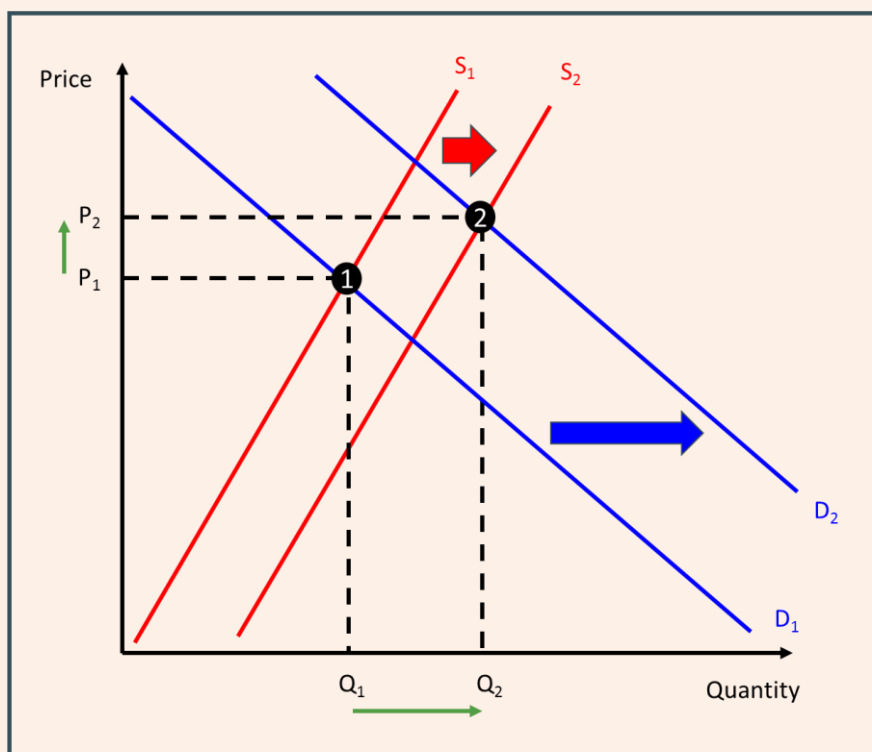
Here the question revolves around a change in both demand and supply. Therefore, the appropriate diagram is a demand/supply diagram.

In this case, for the diagram to be completed accurately, the following features have to be present:



Use a ruler and ensure the diagram is neat and tidy.

UK Housing Market



Excess Demand

Rise in UK House Prices

Brief Written Explanation

The first thing your written explanation needs to do is to clearly explain what your diagram shows. To assist clarity, it helps to refer to the labels you have given on your diagram. Where possible, the results of the diagram should be applied to the context of the question. For example:

“In the diagram above, the UK housing market is depicted at an initial equilibrium of (Q_1, P_1) formed at the intersection of the original demand curve (D_1) and the supply curve (S). The supply curve is relatively inelastic to reflect the fact that the supply of homes cannot react as flexibly to changes in house prices as other goods.

The increase in demand of UK homes is represented by an outwards shift in the demand curve from D_1 to D_2 mainly due to demographic factors.

At the same time the supply curve also expands from S_1 to S_2 . This is because despite the growth in the supply of homes slowing down, the quantity of homes being supplied to the market is overall still increasing. Therefore, the shift in the supply curve is smaller than the demand curve shift.

As a result, the market price increases until the market reaches a new equilibrium at (Q_2, P_2) .

This new equilibrium results in more houses being sold on the market as represented by the quantity increasing from Q_1 to Q_2 , but price of a house in the UK increasing from P_1 to P_2 ."

Note: You could draw the diagram with the supply curve shifting inwards if you explain the logic behind this.

You should be careful to make you get straight to the point of what this question is asking for: an accurately drawn demand and supply diagram. Your answer should take you no longer than **6 minutes**.

Within this question, marks are awarded for displaying the following skills:

Knowledge – 1 Mark

Application – 1 Mark

Analysis – 3 Marks

Question 6b

Examine two reasons why demand for homes in the UK have increased in the last three decades.

[8 marks]

There are four key elements required within this answer:



Reasons:

This question only requires you to explain the reasons **why** demand for homes in the UK have increased and does not require you to add in a diagram to show the impact of this increase in demand on house prices as this was shown in **Q6a**.

You should use the extracts and your own knowledge to identify only **two** reasons for increasing demand over time. Some examples are:

Population Growth

One of the main reasons put forward in extract A is that the UK has experienced a persistent increase in the population over time. As having access to a home is a basic human right and need for human beings, the more people there are in a country, the greater the number of people will be looking for a home at any given point in time. This will therefore put pressure on the housing market to supply more homes as demand grows.

Single Ownership Households

Extract A explains that there has been a growth in the number of individuals deciding to live on their own since the 1980s. This could be own to many different cultural, social or educational reasons. However, if individuals are

looking to buy a house as a single occupant rather than a group the demand for homes in the UK will increase.

Low Interest Rates

Since the Financial Crisis of 2008, the UK central bank has maintained low interest rates to ensure that the economy continues to grow despite economic uncertainty. However, this has contributed to a boom in the housing market. If the main base rate is lowered by the central bank it reduces interest rates across the entire economy. If banks offer lower interest rates, the number of people willing to take out a mortgage to buy a home will increase as the respective rate on a mortgage will fall.

Second Homes

The rise in house prices over the last three decades has contributed to the housing market being a very lucrative market for investors. Individuals have taken advantage of low interest rates to build up a property portfolio across the UK which they can then rent out to individuals struggling to afford to buy a house. The surge of individuals buying more homes to add to their property portfolio has added to the increase in demand.

High Rent Rates

When house prices start to rise often individuals turn to renting as the only affordable option to fall back on. However, the UK housing market is one which has experienced such rapidly increasing prices, that too many people have turned to renting a home. This has contributed to the growth in rent rates in certain regions in the UK to outstrip the growth in house prices. This almost encourages people to look at buying a house rather than get stuck in a vicious cycle of renting.

Government Intervention

The government has introduced various schemes to help encourage first-time buyers save and establish themselves in the market. The Help-to-Buy scheme is probably the best example of this. As these schemes increase the value of

savings that first-time buyers have available to purchase a home, it creates an increase in the number of people looking to buy a home in the UK.

Foreign Investment

Demand may be increasing because foreign investors forecast high long-term returns of investing in the UK housing market. This has long been the case in the city of London, where investors see putting their money into UK property as a safe haven.

You only need to identify and explain **two** reasons for rising demand in the UK housing market. Do not try and explain each of these reasons as you will not be rewarded with higher marks.

Evaluation

This question also requires you to briefly evaluate the reasons that you have put forward. Therefore, the best approach to take here is to develop a brief evaluative comment for each of the two reasons you have mentioned.

Ageing Population

As much as the UK population has increased over the last three decades, this rate has been slowing down and it raises fears that the UK will experience a slowdown from an ageing population. If the population ages this is likely to neutralise the effect of a growing population. This is because an ageing population represents the percentage of the population that is least mobile and therefore is least likely to purchase a new home.

However, an argument could also be made regarding the high wealth levels of the elderly. The fact that house prices have been rising could contribute to a positive wealth effect and encourage these individuals to buy a second home.

Mortgage Availability

Despite the central bank reducing interest rates, this does not guarantee that the rate on mortgages will fall as banks may not pass the lower interest rates

on. You could argue this happened on the back of the financial crisis where mortgage availability shrunk due to banks wanting to shy away from engaging in risky banking activities.

Demand and Supply

The housing market is an example of a market where supply brings its own demand. Therefore, the increase in demand may come from the fact that recent housebuilding projects in certain areas have come to fruition and this has exacerbated some of the reasons you may have mentioned.

Housing Type

There are lots of different types of residential property which are bought and sold on the UK housing market. Therefore, when discussing factors which have led to an increase in demand, it would be useful to make mention of the type of residential property considered as the strength of the demand increase will depend on this.

Regional Variations

The extent of the increase in demand depends on the regional performance of the area. For example, London is one of the most attractive cities in the world to live in. Therefore demand for a home in London has surged compared to other regions in the UK, as it attracts not only domestic demand for homes, but also demand from the rest of the world for homes. The surge in house prices in major cities such as London has boosted the average price of a home in the UK.

This is just a brief summary of just some of the evaluative comments that you could make within your essay. You should not aim to include all of these points as there is simply not enough time.

You should be careful to make you get straight to the point of what this question is asking for: clearly explaining 2 reasons why demand for homes in the UK has increased. Your answer should take no more than **10 minutes**.

Within this question, marks are awarded for displaying the following skills:

Knowledge – 2 Marks

Application – 2 Marks

Analysis – 2 Marks

Evaluation – 2 Marks

Question 6c

With reference to Figure 1, discuss the impact of higher house prices on different age groups of consumers in the UK.

[12 marks]

The key to answering this 12-mark question effectively is to realise that an answer which covers all of the main exam skills is required. This question is predominantly focused upon examining your ability to present structured and coherent analysis, relying heavily upon well-written chains of reasoning all in the context of the UK housing market. But, at the end of your response you should include some evaluative comments to recognise different viewpoints to those supported in the evidence. It is important to ensure that your response answers the question and provides a relevant and technically correct explanation.

Be careful to read the question carefully – here the question is prompting you to discuss the **impact** that higher house prices have had on different age groups across the UK. An easy mistake to make would be to focus your answer on the impact that high house prices has had on the UK economy. Whilst not completely irrelevant to the topic being discussed, this kind of response would not be effectively answering this specific question.

A good (but not the only) approach to this question is:

Step 1: Introduction

The introduction provides an opportunity to demonstrate that you understand the topic the question is asking about and structure your response. It is also a good opportunity to demonstrate some knowledge (AO1) by providing definitions of the key terms and some application (AO2) by making a clear link with the context of figure 1.

The example below makes a clear reference to the context (UK housing market), and sets up the rest of the answer by describing what we are trying analyse (rising house prices on consumers):

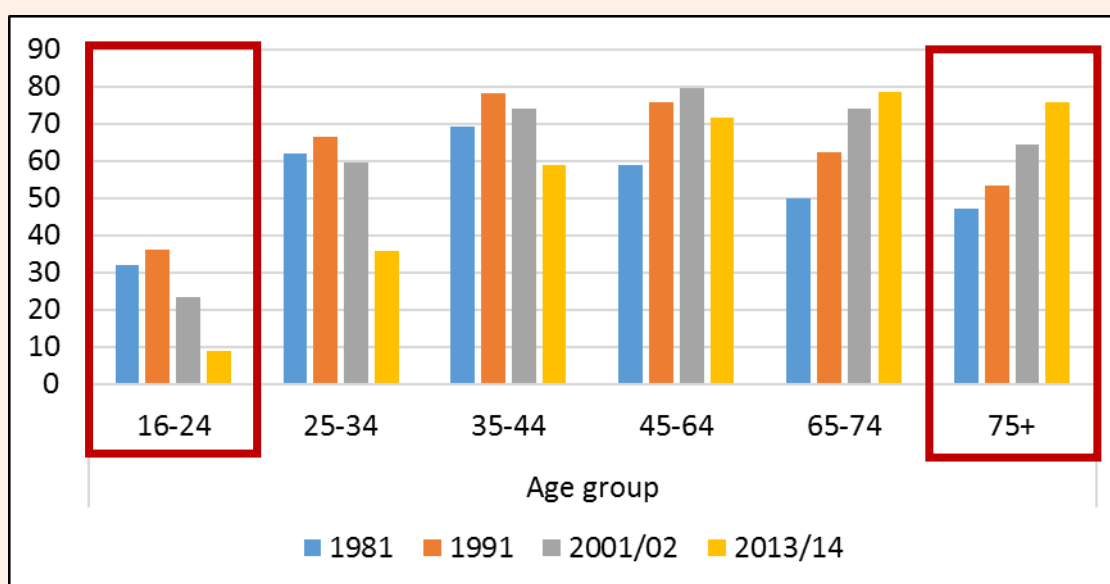
“The average price of a home in the UK provides an indicator of how strong the UK economy is performing and how attractive the proposition of living in the UK is. As a house represents the biggest consumption item that a consumer can

purchase it also holds strong links to the confidence and wealth levels of individuals. In the UK, house prices have been moving in an upwards trajectory due to a combination of demographic factors and complexities in the production process of building a home. This has created a toxic mix of expanding demand and limited supply growth. The increase in house prices has simultaneously constricted the affordability of homes to certain groups of the population, whilst providing financial opportunities to other groups of the population.”

Step 2: Analysis

As the question is asking you to make reference to figure 1, your analysis should stem from the trends shown in this data.

Figure 1: Percentage of each age group that are home owners, UK, 1981-2014



As you are being asked to analyse the impact of rising house prices on different age groups in the UK housing market, it is best to analyse the declining home ownership rates in the youngest age bracket and the increasing home ownership rates in the oldest age bracket.

Home Ownership (16-24s)

A striking trend in the UK housing market is the sharp fall in the home ownership rates amongst the youngest parts of the population. This is important as these people often represent first-time buyers:

“Figure 1 shows that the home ownership rates amongst 16 to 24 year olds has fallen dramatically in the last three decades, from a peak of approximately 35% to less than 10%. This provides economists and the UK government with a stark reminder of the damaging impact that the housing market price bubble is having on the parts of the population which will shape the future prospects of the UK economy.”

The fact that many young people cannot afford to get onto the housing ladder is damaging not only for those young people, but the economy in general. If young people cannot afford to buy a house it firstly reduces the mobility of the labour and skills set they can provide the economy with. This is because if individuals cannot afford to move to the area, the type of jobs that they are willing to take up will be reduced to local ones, which do not involve long and disruptive commutes. This may lead to the incomes of some of these individuals to be lower than what they would have earned if they were more mobile.

The lack of affordability in homes encourages individuals to turn to renting as the only viable option available to them. As house prices have increased, so have rent rates. This means there is a growing number of young people locked into renting an apartment and paying extortionate rent rates. Those individuals are paying a large percentage of the income they earn on paying for rents. This reduces the capacity for individuals to save to afford to buy a house.

Finally, ever-growing house prices have resulted in a growing divide between the wealth levels of home owners and non-homeowners. This has resulted in increased intergenerational inequality between the youngest parts of the population and the oldest.

Home Ownership (75+)

If we now contrast the declining trend in home ownership in the youngest parts of the population with that of the oldest parts of the population, it will provide a significant comparison point to help support your answer:

“Figure 1 shows that the home ownership rates amongst 75 year olds has simultaneously risen rapidly in the last three decades, from approximately 45% in the 1980s to nearly 75% in 2014. This shows that the biggest beneficiaries of rising house prices are the retired parts of the population, as these individuals receive a positive wealth effect from rising house prices.”

The rise in home ownership rates in these age groups could also be partly explained by an improvement in the living conditions and life expectancy of the nation and therefore individuals are living in more stable conditions into their 70s, contributing to more people owning a house in this age bracket.

Older age groups represent groups of people in society that are likely to already own a house, therefore the persistent rise in house prices nationwide, boosts the value of their wealth.

Improvements in the wealth of the oldest age groups, allow individuals standard of living to improve and ensure that individuals can afford the best care services available to them.

There is no need to include a diagram in this question as you are analysing the impact of rising house prices on home ownership and wealth rather than what has caused the increase.

Step 3: Evaluation

The explanation in your analysis should have put forward some of the implications of rising house prices on different age groups. However, in this question you also need to consider some of the factors which will either increase or decrease the importance of this effects. These comments will represent evaluative comments and provide examples of why some of the theoretical implications of rising house prices on individuals may not come into fruition. Some examples of these may include:

Improvement in Educational Attainment

You might argue that home ownership has fallen as a greater number of young people decide to further their education at University. This results in individuals renting accommodation rather than purchasing a home. This results in home ownership rates continuing to fall, but you could argue the long-term benefits of the greater educational attainment achieved may outweigh the short-term burden of renting. Therefore, the fall in home ownership rates in this age group may not tell the full story.

Skills Degradation

If young people are priced out of buying a house in the area they wish to work in, then it may result in them moving into a job or industry which does not best match their skills. This may result in the individuals settling into a job, where they do not effectively use the skills that they have and this results in the skills of that person eroding over time. This can result in an individual loss, but also a loss in output and productivity for the economy as well.

Property Portfolios

The increase in house prices raises the return that investors get from owning a large property portfolio. The rise in house prices may benefit them to such an extent, that it encourages them to sit on properties and land holdings to maintain high house prices. This amplifies the negative implications for young first-time buyers and the positive implications for older parts of the population.

Government Assistance

Government assistance through policies aimed at increasing the ability of first-time buyers to afford a house can mitigate and neutralise the negative effects of rising house prices on the youngest parts of the population.

As always, you are not expected to talk about every single one of these evaluative points, you just need to make reference to a couple to ensure that you have effectively discussed the impact of high house prices on different age groups.

Within this question, marks are awarded for displaying the following skills:

Knowledge – 2 Marks

Application – 2 Marks

Analysis – 4 Marks

Evaluation – 4 Marks

Question 6d

Assess one positive and one negative externality from the introduction of national house building projects in the UK housing market.

[10 marks]

The key to answering this 10-mark question effectively is to realise that an answer which covers all of the main exam skills is required. This question is predominantly focused upon examining your ability to present structured and coherent analysis, relying heavily upon well-written chains of reasoning all in the context of the UK housing market. But, at the end of your response you should include some evaluative comments to recognise different viewpoints to those supported in the evidence. It is important to ensure that your response answers the question and provides a relevant and technically correct explanation.

Be careful to read the question carefully – here the question is prompting you to discuss just **one** positive and **one** negative externality of national housebuilding projects in the UK housing market. An easy mistake to make would be to focus your answer on the advantages and disadvantages of government intervention in this market. Whilst not completely irrelevant to the topic being discussed, this kind of response would not be effectively answering this specific question.

Introduction

A good (but not the only) way to start this question is to focus on the phrase ‘externality’ and explain what is meant by that term in the context of the UK housing market. A good example of how to introduce this into your answer is:

“Economists often regard a house as being an example of a merit good. This is because the provision of good quality housing in the UK can contribute to lots of positive externalities for society. An externality is an external cost/benefit imposed on society from the production/consumption of a good or service. In the case of the UK housing market, the provision and supply of homes to the population, provides society with a series of positive consumption externalities, which improves the welfare of society.”

However, it is important to stress that housing has to be of the right quality, build and form in order to generate the expected positive externalities, otherwise it may amplify some of the social problems in a particular area.”

This is an effective way to start your response as it showcases your knowledge and understanding of the externalities that are produced when talking about increasing the supply of homes in the UK.

Positive Externalities

The most persuasive and powerful argument for an increase in the provision of homes in the UK is that it can provide society with a series of positive externalities. This is because the social benefit received from housing exceeds the private benefit that individual property developers gain. Some examples are:

Reduced Inequality

The provision of good quality and affordable housing can help reduce the level of intergenerational inequality that exists between the youngest and oldest parts of the population. This is because a house is a store of wealth and therefore provides individuals with the financial platform to progress. An accumulated effect of the provision of housing is the fact that it can help reduce economic deprivation and poverty in an area by giving humans access to shelter.

Reduces Environmental Costs

Modern day homes that are sufficiently insulated can reduce the need for individuals to heat their homes during the winter months and therefore this can not only reduce the private costs of heating their own homes, but reduce the environmental costs of homes being heated during the winter months.

From a seller’s point of view, a more efficient heating bill also increases the chance of being able to resell the property in the future.

Protection against Pollution

Modern day homes that are built can help reduce the exposure of individuals to certain environmental problems such as noise and air pollution. For instance, homes built with double or triple glazing insulate the house better and prevent individuals from being exposed to outside influences which could reduce their welfare of living in the area.

Community Spirit

By providing individuals with access to good quality homes it can help reduce some of the social conflicts that may exist in an area where individuals have an inability to be able to get onto the housing ladder such as crime and vandalism.

Improvement in Mobility of Labour

An improvement in the provision of housing across the UK will lead to a substantial improvement in the geographical mobility of workers across the UK. This provides an external benefit to firms across the UK as it enables them to be able to recruit the most skilled and enthusiastic people to fill their vacancy.

Negative Externalities

However, if the quality and/or quantity of houses being provided is inadequate it is likely to produce some negative externalities for society. Some examples are:

Social Problems

Bad housing that is unaffordable to many can lead to significant social problems in the area. If individuals have no access to a home it is likely to increase the crime rate in that area, as well as the prevalence of social problems such as vandalism. The building of sub-standard housing may

actually reduce the welfare of the area despite increasing the supply of homes on the market.

Health Problems

If individuals do not have a home to be able to take shelter in it can increase the number of health problems that persist in the local area. The greatest exponent of this externality is seen in developing countries, where often there is a large community of slum housing, which breeds poor sanitation and therefore contributes to the deterioration of the health of individuals. This contributes to economic deprivation, inequality and poverty.

Environmental Problems

The type of land that houses are built on affects the overall welfare on the local area. If houses are built on developed brownfield sites, then it will not lead to a degradation in the environment. However, often the pressure on housebuilding firms to increase the supply of homes quickly results in these firms building on undeveloped greenfield sites, which can disrupt and destroy the local ecosystem and environment.

As the housing market has such an influential impact on how the economy operates, there are many different examples of externalities you could call upon here. The important thing is that whichever examples you choose, they are clearly explained.

Evaluation

It is vitally important to weave in some evaluative comments into your response. These might include:

Quality of the Build

The provision of homes only represents a merit good if the right type of homes are being built. If homes are being built inadequately without some of the

modern features that all homes should have then it is unlikely to generate the

Affordability

positive externalities expected of increasing the supply of homes in the UK. Houses that are built have to be affordable to the public, otherwise it may result in individuals still not being able to achieve the basic living conditions that any human being should be entitled to.

However, the issue with the design of modern homes is that they can often be expensive to build because of the added features which need to be included. If these costs are passed on to consumers it could be damaging for prospective house buyers.

Size of the Externality

How important a particular externality is depends upon the magnitude of that externality.

Persistence of the Externality

An externality which is likely to still be affecting society's welfare 20 years later is more important to consider than an externality which may impose only a one-off cost or benefit.

There are many other evaluative comments you could introduce. Remember that you should be challenging how important a particular factor is and what may cause its importance to increase or decrease.

Within this question, marks are awarded for displaying the following skills:

Knowledge – 2 Marks

Application – 2 Marks

Analysis – 2 Marks

Evaluation – 4 Marks

Question 6e

Assess the view that the UK government should intervene in the housing market by directly providing financial support to prospective first-time buyers.

[15 marks]

To access top marks in any economics essay, it is important to focus on two key elements:



As essay structure is a more general skill, we will focus on showcasing how to hit the different assessment objectives required for this specific question. However, hopefully the following discourse will provide some assistance with regards to essay structure.

AO1: Knowledge

Being able to display accurate knowledge is judged to be the most basic requirement in an essay. It is still important to be able to demonstrate accurate knowledge throughout your essay. You can signpost this by including accurate definitions. For example, in your introduction you might want to provide a definition of government intervention in the context of the UK housing market as an alternative to ‘market forces’. This can be incorporated into your introductory paragraphs in the following way:

“The price of any good or service is determined by market forces – the interaction of demand and supply. The price mechanism ensures that the market reaches an equilibrium via the rationing, signalling and incentive function. However, often these forces in a market break down and it leaves the market in a position where resources are misallocated. Government intervention refers to the proactive actions that a government takes in a market in order to improve the market outcome and prevent a market from failing.”

The UK housing market is a market that relies on government intervention to ensure that supply of homes on the market manages to keep pace with demand for homes. By propping up the housing market with subsidies and various schemes to help first-time buyers get on the housing market, the balance between demand and supply can be restored. This is important as good quality housing is an example of a merit good, that provides a significant number of positive externalities to the local area upon provision.”

Introducing your essay by showcasing your knowledge and understanding of the subject matter will lay the foundations for your essay. In this section of the essay a detailed demonstration of your understanding of the key economic terms and concepts is required.

AO2: Application

Being able to apply your knowledge to the subject matter of the essay is particularly important in essay questions that contain a data extract, as it showcases to the examiner that you have a detailed and developed understanding of the related economic concepts. You are only expected to use some of these application examples in your essay:

Figure 1

This provides evidence of the main problem in the housing market, that supply cannot keep up with demand and it is creating vast intergenerational inequality between the young and old. The data shows the fact that the percentage of homes owned by the youngest age group has fallen from over 30% in the 1980s to under 10% in 2014.

Extract A

This explains that the current housing crisis in the UK is not just down to supply side factors but also due to increasing demand. Increasing demand because of a growing population and a low interest rate environment has contributed to more prospective buyers in the UK housing market. This shows that the main issue in the housing market is supply not keeping pace with demand. Potential

policy solutions need to target factors which will increase the rate of supply growth in the UK.

Extract B

This explains that the provision of good quality housing creates positive externalities in the local area and across the economy. Therefore, there is an incentive for the government to intervene in the housing market to ensure that more of this merit good is provided nationwide.

Extract C

This provides some evidence of proactive efforts made by the government to help both demand and supply side factors in the UK housing market. This might provide you with evidence that the government is focusing too much on policies which increase demand rather than supply in the UK housing market.

As well as using the data and the extracts to support your answer, you may also want to demonstrate to the examiner that you have a rounded knowledge of the economic issues at the heart of the context. Some of the issues you might raise is:

Help-to-Buy Scheme

The Help-to-Buy scheme was introduced by the government to help first time buyers make their first move on the housing ladder. It was a scheme that worked by encouraging individuals to save for their first home by the government pledging to top up the amount that individuals save by 25% up to a maximum of £3,000. For example, if an individual pledged £200 to this scheme each month, the government put in an extra £50. Over the course of the year, this would increase savings by £600.

Renting over Home Ownership

As a result of a lack of affordability of UK homes in the most popular urban areas, this has resulted in a simultaneous fall in home ownership rates and a rise in the number of people renting. As a result, this has caused the pace at

which rents have risen by to increase significantly, as people clamour for a limited supply of homes. As renting becomes the only affordable option to prospective buyers, rents are expected to increase at a faster pace than the price of a UK home in the next decade.

Low Housebuilding Rates

The rate of housebuilding by population in the UK is the lowest rate seen in Europe. This is expected to contribute to house prices increasing by 20% up to 2020.

Housing Market White Paper

In 2017, the UK government released a white paper which outlined proposals to fix the UK's 'broken' house market and to eventually increase the housebuilding rates across the economy. The proposals put forward include: encouraging and pressuring local authorities and house building firms to build houses at a rate quicker than currently witnessed, reducing the time taken for planning permission to result in house construction and providing funds/subsidies to struggling housebuilding firms.

Developing Brownfield Sites

Housing is often viewed as a merit good because of the positive spill-over effect that are created by providing good quality houses on the market. However, in order to take advantage of the positive externalities available, the construction of houses should take place on brownfield sites over greenfield sites. Brownfield sites describes land that has already been used for industrial or commercial purposes and therefore building on this type of land will not disrupt and damage the local environment. Greenfield sites describe sites that have not been previously used and therefore to build on these sorts of sites often involve the destruction of the local environment and ecosystem. The negative externalities produced from the destruction of the environment could offset the positive externalities of building houses.

As ever, you only need to include some of these issues. Indeed, some of these application examples are quite high-level and would only be expected of highly sophisticated answers.

AO3: Analysis

The core of top-level essays consists of well-constructed, relevant analysis of the topic. This should be presented using logical chains of reasoning, and where appropriate, clear diagrams.

There are lots of analytical routes you could go down with a question like this. The core analysis will involve an explanation and an evaluation of government intervention in the housing market to improve the fortunes of first-time buyers. A good (but not the only) approach would be to start off with an explanation of the impact that providing direct financial support to first-time buyers will have on the UK housing market. This then leads you onto the arguments for and against government intervention in the housing market via this channel. You can then put forward some alternative policies that might prove more effective in solving the crisis in the UK housing market.

Financial Support for First-Time Buyers

There are lots of different forms and examples of government intervention in the UK housing market. However, in the question you are specifically asked to assess the effectiveness of policies that directly provide financial support for first-time buyers:

“The government of any country is under pressure and scrutiny to ensure that good quality housing is sufficiently provided nationwide to ensure that individuals have access to the basic human right of shelter. This is of particular importance for young people, as this age group represents the future wealth creators of the economy. Therefore, the UK government is consistently trying to provide innovative ways of providing financial support to individuals looking to make their first realistic move onto the housing ladder.”

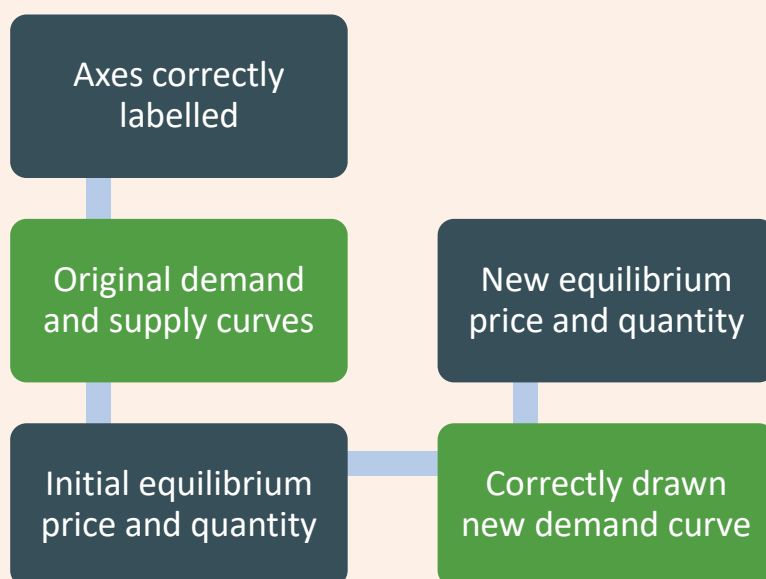
Financial support given by the government to first-time buyers is meant to prevent individuals from being caught up in the vicious cycle of high rent rates.

This prevents individuals from being able to acquire the savings required to put down a deposit on a house.

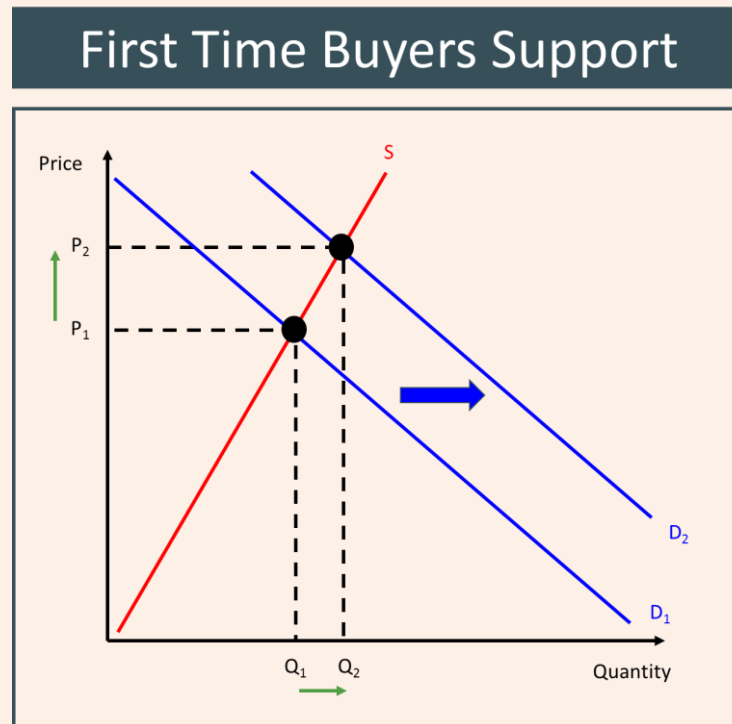
The government can predominantly provide support by launching schemes which encourage individuals to save towards a house. Most recently, the government have introduced Individual Savings Accounts (ISAs) to directly support the savings put aside to afford a deposit on a house. The government makes a fixed commitment to match a percentage of the savings put forward in each period to a maximum level. This increases the value of savings and reduces the time taken for a first-time buyer to be able to afford the deposit.

You can represent the impact of these types of support schemes for first time buyers using a demand and supply diagram. As we are looking at the housing market, the supply curve is going to be relatively inelastic because of the inability of house building firms to change supply significantly in the short-run.

In this case, for the diagram to be completed accurately, the following features have to be present:



Use a ruler and ensure the diagram is neat and tidy.



An explanation of the diagram is required to capture analysis marks:

“Financial support provided to first-time buyers is an example of a scheme that affects mostly the demand side of the housing market. This is because it results in the value of first-time buyer’s savings to increase. Therefore, the confidence that first-time buyers have in being able to afford a house also increases. This encourages more first-time buyers to take up a more active position in the UK housing market. Therefore, the demand for housing increases and the demand curve expands from D_1 to D_2 . Assuming ceteris paribus, this creates excess demand in the market and this puts pressure on house prices in the UK to rise to P_2 .

The scheme may enable a fraction of first-time buyers to be able to afford a deposit for a house, but the long-term effect is it will exacerbate the housing crisis. This is because supply will still fail to keep up with ever increasing demand.”

As schemes that directly provide financial support for first time buyers encourage individuals to save and look for a house to buy in the future, it is going to cause the demand curve for homes to expand. It can be argued that government intervention needs to target the supply side of the market rather than the demand side of the market.

The only supply-side impact that providing financial support to first-time home buyers is likely to have is a movement along the supply curve. However, as supply, in the short-term at least, is inelastic, higher prices do not stimulate much of an increase in supply nor homeownership.

One of the potential benefits of the proposal stems from its targeting. By targeting financial support to first-time homebuyers, the government may be able to improve intergenerational inequality. This is because, it is first-time homebuyers who are mostly impacted by rising house prices. They suffer by having to pay more for the house they purchase, without benefitting by an increase in the price they receive for their current house like existing homeowners do. Furthermore, first-time buyers tend to be young, active members of the labour force often with children to support. There may be positive externalities surrounding the targeting of this support.

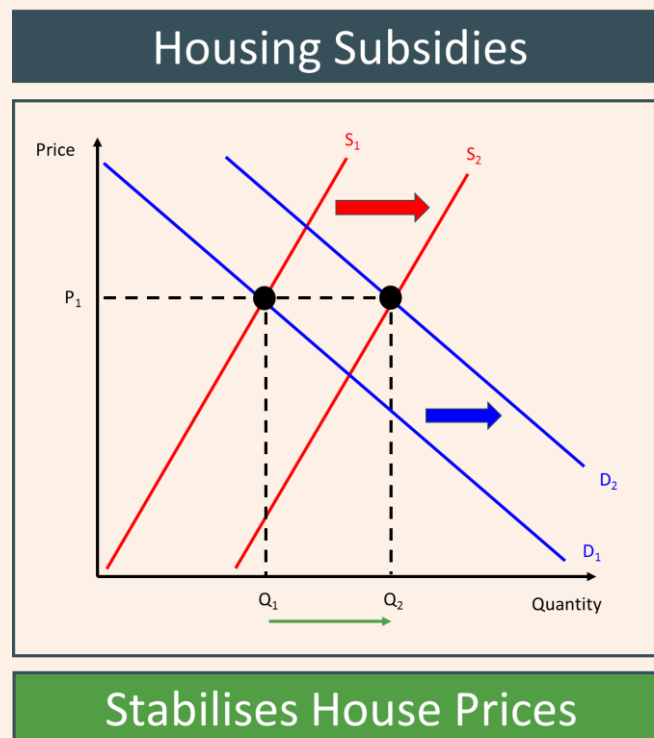
Alternative Housing Policies

As the housing market is suffering from limited supply growth, the most effective government policies and schemes are ones that target the supply side of the market. If you have effectively outlined the problems of providing direct financial support to first-time buyers, this presents you with the opportunity to put forward alternative strategies to tackle the limited supply of UK homes. This makes the case for government intervention in the UK housing market, just not in the format prescribed.

Housing Loans and Subsidies

If the government provide subsidies to house building firms, it provides firms with the incentive to invest and build more homes in the UK. This policy will be at its most effective if the subsidies are channelled towards small but struggling house builders. The effect this will have on the market is to increase the rate at which homes are being built in the UK and therefore will help balance the forces of supply and demand in the UK housing market.

This can be represented in a demand and supply diagram as increasing the size of the supply curve shift, as the increase in houses being built has now increased. Alongside continual demand increases, this will help stabilise the price of a home in the UK.



The effectiveness of this policy will all depend crucially on the size of the subsidy given by the government and to which house building firms they have given the subsidy to. The only limitation of the policy that needs to be considered is that subsidies come at a cost to the government and therefore can be expensive to maintain in the long-run, particularly if house building firms become over reliant on these subsidies. This is a particular poignant point to consider when the government already runs a budget deficit and has a rising national debt.

Provision of Social Housing

There are many different types of homes that can be supplied in the UK. One of those is social housing i.e. homes built by local authorities and councils that is affordable for the residents of the area. This can be done by passing down more power to local councils and removing some of the restrictions in place that prevent councils from readily and easily building new homes.

The UK government has recently made an effort to reduce the frictions that exist in the housing market preventing local councils from building. This has been achieved by reducing the time taken before a house can be built on an

area of land that councils have received planning permission for from three to two years. The building of council houses is an example of direct state provision.

Reduction in Supply Side Frictions

The supply curve for homes is relatively inelastic because of some of the restrictions that exist for house building firms, as well as local councils. These restrictions range from planning permission time lags and skills shortages that exist in the construction sector.

If the government can help reduce some of the restrictions to make the planning process for homes smoother and more efficient, this will enable the supply of homes to keep up with the demand of homes in a cost-effective manner and create less of a disparity between the short-run and long-run outcome in the housing market.

However, there is always a fear that if firms and councils build homes at a faster rate it might lead to a steady decline in the quality of homes being built, as firms cut corners to meet projected demand. Furthermore, land in the UK is limited and increased building may have negative environmental externalities.

Skills Training

One factor that results in the supply curve for homes being relatively inelastic is that firms have a restricted ability to increase supply as they lack spare capacity and suffer from a shortage in skilled labour.

The government can help firms overcome this problem by funding training programs which aim to increase the quality of human capital in the economy and the construction sector in particular.

The main limitation with this policy is it is a supply side policy which is more than likely to take a long period of time to feed through to the desired supply benefits.

Removal of Affordable Housing Requirements

Affordable housing requirements are requirements put forward by local councils and imposed on private house building firms. This prevents firms from being able to charge high prices for houses built on small scale development projects i.e. the construction of a new estate.

However, if the price of a good sold increases, the profit motive for firms increases and therefore they wish to supply more at the higher price. It has often been argued that these restricting requirements reduce the incentive that firms have to invest in building more houses.

Therefore, these requirements could be removed to increase the profit motive that firms have to produce more houses on the market. In the UK in 2014, some affordable housing requirements imposed on the construction of small-scale housing projects were overturned to ensure that these projects do not get delayed.

However, this may eliminate the benefits of the affordable housing requirements. That is that low-income households may be given the opportunity to own their own homes, even in the face of high house prices generally.

Reasons for Government Intervention

As with all of these supply side policies they have their downsides, most notably regarding financial cost and question marks over their short-term effectiveness. However, each of the policies aim to solve the fundamental problem of the housing market which is limited supply growth. Therefore, these types of policies provide evidence of reasons for government intervention:

Corrects Market Failure

The encouragement from the government to private house building firms helps increase the supply of homes being built in the UK and therefore moves the UK housing market towards the social optimum, increasing welfare and efficiency along the way.

House Price Stability

By ensuring that supply can keep up with demand in the housing market, it means that the price of the average home in the UK is likely to stabilise. This is important as a house represents a big store of household wealth and therefore by stabilising house prices, wealth and confidence of individuals is also stabilised.

Improves Labour Mobility

The greater the availability of housing in the UK, the fewer frictions that will exist in the UK labour market. This is because if individuals struggle to afford a house within close proximity of their workplace they will have to commute to work. Some individuals will be discouraged by the extra time and effort that a long commute requires and therefore this may reduce their incentive to take or continue to work in a job in certain areas.

Improves Wealth Distribution

As the purchase of a house represents the biggest consumption item that an individual will purchase in their lifetime, the value of the house owned represents a large proportion of that individual's wealth. Therefore, if house prices rise, it increases the wealth of existing home owners, whilst reducing the affordability of homes for first-time buyers. Therefore, the wealth gap between home owners and non-home owners increases, worsening the distribution of wealth.

If house prices stabilise because of government intervention, then the distribution of wealth will also be more equitable.

AO4: Evaluation

Including accurate and relevant evaluation in your essay is the most important thing to ensure you achieve top marks. Evaluation is the art of making supported judgements, of deciding which factors are most important and of explaining the circumstances in which factors assume importance or otherwise.

There are a huge number of evaluative angles you could take within this essay. Here we will showcase some useful examples. You would not be expected to include all of these examples – there simply is not enough time!

It is particularly crucial in this type of essay question as you need to evaluate some of the fundamentals of the policies that you have mentioned so far.

Government Failure

As all of the policies mentioned thus far require the government to intervene in the housing market to correct the market failure, there is always the danger that the government may intervene in the market and make the market outcome worse compared to the initial equilibrium. This is particularly the case in the UK housing market given that it is a volatile and uncertain market. Therefore, it has to be discussed whether the outcome under market failure is better or worse than the outcome under government failure.

Financial Costs

A lot of the effective supply side reforms in the UK housing market come at a cost to the UK government and therefore have to be funded by the taxpayer via higher tax contributions increased borrowing by the government. If it does not come from greater tax revenue, then the government may channel spending from another area of the economy into the housing market and this potentially involves large opportunity costs which may go unaccounted for.

However, this has to be weighed up against the costs of the government not intervening into the market. Unaffordable housing results in individuals renting and their ability to afford their basic wants and needs is reduced over a long period of time.

Unintended Consequences

Some of the policies put forward by the government may create unintended consequences which result in the market outcome failing to improve. For

instance, by removing affordable housing requirements it may lead to the expansion in the number of luxury homes built, hurting first-time buyers more.

Effectiveness

The effectiveness of some policies may be low even if they are policies which do correctly target the supply of homes in the UK. The stability of the UK housing market is determined by the forces of demand and supply. The existing supply of 28 million residential properties in the UK represents the stock of houses in the UK. The increase in the supply of houses built each year represents an insignificant flow of houses built each year which prop up the existing stock of houses in the UK. Therefore, even proactive movements to increase the rate of housebuilding are unlikely to significantly affect house prices.

You could also argue that this effect is exacerbated by the fact that an increase in the supply of housing may bring its own accompanying demand and therefore the policies may just continue to inflate the housing market price bubble.

Conclusion

Overall, it is important to provide in your essay, a reasoned judgement; an argument which decides whether government intervention in the form of financial support for first-time buyers is a good idea or not.

The concluding paragraph of your essay is often a very good place to make clear what your overall reasoned judgement of the question is. Some people also like to include a similar judgement in their introduction, to signpost clearly to the examiner that they will be making an evaluative judgement in their essay.

Here is a good example of an attempt to, in one paragraph, argue that government intervention into the housing market via direct financial support for first-time buyers is ineffective:

“Overall, the proposal for government intervention in the housing market by providing financial support to first-time buyers is a poor one. Whilst there are understandable benefits for the first-time buyers who access such a scheme, it

does nothing to solve the long-term problems of the market. In fact, even in the short-term, one of the effects is to exacerbate rising house prices rather than soothe them. Government intervention in this market could be successful, but only if it focused on the supply side of the market rather than encouraging demand.”

Alternatively, it would be just as valid to argue that government provision of financial support for first-time buyers is a good idea:

“In conclusion, the government should provide financial support for first-time buyers. Whilst this would clearly not solve all of the problems faced by the UK housing market, the solutions to the lack of supply are likely to be long-term. In the here and now, an entire generation of prospective house buyers need assistance to get their foot on the ladder and achieve security for their families. Tackling intergenerational inequality should be one of the foremost priorities for the government and in the short-term, this intervention helps to address it.”

Note: Remember that this essay is worth only 15 marks. In this answer guide, we err on the side of comprehensiveness. You should be selective about the points you introduce and be wary about time constraints.

Essays are marked on a levels basis. The overall quality of your essay will be considered when deciding upon which level the answer is. There are 9 marks available for knowledge, application and analysis.

Level 1 [1 – 3 Marks] – Weak knowledge and understanding which includes generic or irrelevant information.

Level 2 [4 – 6 Marks] – A reasonable but narrow response.

Level 3 [7 – 9 Marks] – Accurate knowledge and application with coherent chains of reasoning.

There are a further 6 marks available for evaluation.

Level 1 [1 – 2 Marks] – Generic evaluative comments without relevant evidence.

Level 2 [3 – 4 Marks] – Reasonable evaluation which may be sometimes unbalanced or not fully supported.

Level 3 [5-6 Marks] – Strong levels of well-supported evaluation.

Question 7

Evaluate the view that mergers, such as the one proposed between the mobile networks Three and O2, always results in a lessening of competition within an industry.

[25 marks]

To access top marks in any economics essay, it is important to focus on two key elements:



As essay structure is a more general skill, we will focus on showcasing how to hit the different assessment objectives required for this specific question. However, hopefully the following discourse will provide some assistance with regards to essay structure.

AO1: Knowledge

Being able to display accurate knowledge is judged to be the most basic requirement in an essay. It is still important to be able to demonstrate accurate knowledge throughout your essay. You can signpost this by including accurate definitions. For example, in your introduction you might want to provide a definition of a merger– the main economic concept of the essay. This can be incorporated into your introductory paragraphs in the following way:

“The amount of competition within a given market is the extent to which there are rival suppliers of the same good, each attempting to attract consumers in the face of each other’s presence. A merger describes the process of at least two firms joining together to go forward under common ownership and combined operations. As the process of merging causes the number of firms in the industry to be reduced, any proposed merger in an industry attracts the attention of competition authorities. A merger has to provide evidence that it

will not lead to a substantial lessening in competition and the possible negative consequences this can have for rival firms and consumers in the market.”

Introducing your essay by showcasing your knowledge and understanding of the subject matter will lay the foundations for your essay. In this section of the essay a detailed demonstration of your understanding of the key economic terms and concepts is required.

Other relevant definitions here **MAY** include defining the specific types of mergers that exist between at least two firms:

- **Horizontal Merger** - This is when firms in the same industry at the same stage of the production process decide to combine their operations. For instance, two supermarkets merging is a prime example of this.
- **Vertical Merger** - This is when firms in the same industry but at different stages of the production process merge. For instance, a supplier and buyer merging. If the supplier merges with the buyer this is an example of forward vertical integration. However, if the buyer merges with the supplier this is an example of backward vertical integration.
- **Conglomerate Merger** - This is when firms from different industries merge together. For instance, a drinks company buying a clothing chain.

Be careful in your essay not to worry too much about spending significant time explaining the differences and divergences between the different forms of mergers. This essay focuses upon assessing the competition impact of two firms from the same industry merging together. You may, however, wish to use the distinction as an evaluative tool (see later on).

AO2: Application

Being able to apply your knowledge to the subject matter of the essay is still important in essay questions without a data extract, as it showcases to the examiner that you have a detailed and developed understanding of the related economic concepts in the essay. You are only expected to use some of these application examples in your essay:

Merger Examples

- Even though you are given an example of a proposed merger which was rejected, your answer would be well supported by having some recent examples of mergers. This will aid your analysis when talking about the theorised impact of mergers on the competition of the industry.
- **Horizontal Merger** - The supermarket chains Safeways and Morrisons merged in 2005, creating the fourth largest supermarket chain in the UK. The name carried forward by the merged firm was Morrisons. This increased the concentration ratio of the supermarket industry, with four firms responsible for three quarters of the output and sales in the industry.
- **Vertical Merger** - In 2006, Disney bought Pixar and instead of outsourcing the production of 3D animated films, Pixar became part of the Walt Disney brand. The merger is an example of vertical integration, as the buyer (Disney) bought the supplier of 3D animated films (Pixar). This has led to Disney producing some of the highest grossing films in the film industry.

UK Telecommunications Market

- As the question relates to a merger within the UK telecoms market, it might be helpful to be able to provide some knowledge of the composition of this industry to strengthen your answer if you are going to carry forward this example in your answer. The UK currently has four major mobile phone operators: O2, Three, Vodafone and EE. EE represents an amalgamation of BT and Orange made in 2014. Therefore, this is an example of an industry that is highly concentrated. Proposed mergers are often scrutinised due to concerns of the impact that a lower number of firms existing in the market may have on consumers. This market is a prime example of one where any mergers are likely to have a large impact upon the composition of the market.

Competition and Markets Authority (CMA)

- The CMA oversees, monitors and scrutinises any business practice that may result in a lessening of competition in the market. It has been established to ensure that consumers and rival firms are protected and therefore the market outcome is desirable and efficient.

As ever, you only need to include some of these issues.

AO3: Analysis

The core of top-level essays consists of well-constructed, relevant analysis of the topic. This should be presented using logical chains of reasoning, and where appropriate, clear diagrams.

There are lots of analytical routes you could go down with a question like this. The core analysis will involve you discussing the impact on the market of fewer firms operating in the market because of the merger. A good (but not the only) approach would be to put forward the intuitive reasons for and against mergers, before discussing the net effect that this has on firms and other economic agents.

Theoretical Impact of a Merger

As a merger involves two or more companies joining together, it is going to result in a reduction in the number of firms that operate in the industry. This in general terms, will result in a lessening of competition in the market.

“Under some situations, firms may not be able to achieve organic growth easily due to the lack of sufficient profit reserves. This form of growth may be too slow to satisfy shareholders’ demand for higher returns. This means the only viable option for the firm to grow is an external one. If two firms mutually agree to combine their business operations, it enables them to benefit from the available economies of scale and increase their market power and share.”

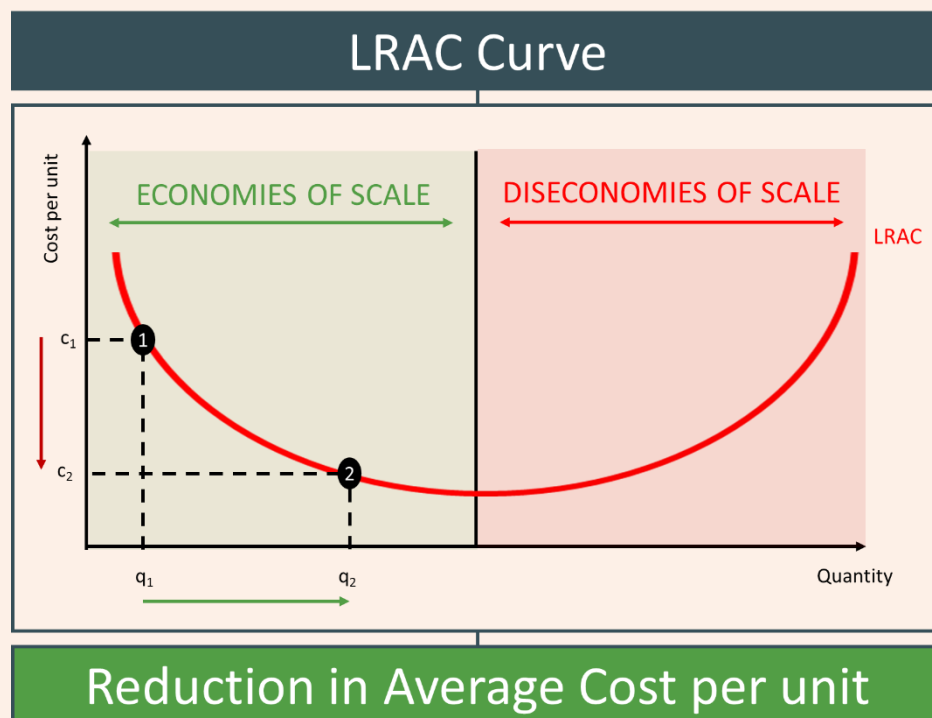
Because a merger is a mutual agreement for two companies to combine their operations, it is perceived that firms will receive large benefits from merging. Here are just some of the traditional benefits that the merged firm might enjoy:

Benefits to Merged Firm

Economies of Scale

The most powerful reason for firms merging is so that their operations can be combined and the merged firm is in a better position to capture all the

economies of scale that exist in the market. Economies of scale are enjoyed when the average costs of production fall as output increases over time. If the two firms merge from a position of strength, the likelihood is that the firm will experience of economies of scale such as marketing and technology economies. This can be represented by the movement down the firm's downward sloping section of the LRAC curve.



The result of a firm experiencing economies of scale is that the firm develops cost savings and this enables them to produce higher profits in the future.

Market Power

If two established firms in the market merge, it will result in the merged firm having a higher market share than either of the individual firms had before the merger. The higher market share enables the firm to have more market power.

This in turn may allow them to exercise greater control over pricing.

Profit Increase

By benefitting from economies of scale and enjoying increased market power, the firm may be able to increase its profit margins and enjoy higher overall profits.

Risk Reduction

Larger firms created by mergers may be more able to robustly survive economic shocks or take more risks without endangering their existence. A good example of might be domestic firms looking to merge in order to compete against international competitors.

Costs of Merging

From the perspective of the firm, two firms merging does not always lead to universal benefits. To provide a more rounded response, it is a good idea to introduce some of the costs of merging:

Diseconomies of Scale

Theoretically it is assumed that firms will always generate economies of scale from a merger, but, this may not always be the case. The merged firm may experience diseconomies of scale (movement along the upward sloping section of the LRAC curve). This can be because the merged firm may not always be able to generate the expected cost synergies forecast. The combination of two firms' factors of production may result in added complexities and therefore pose a challenge to the management structure of the company. This will increase average costs in the long-run and will contribute to lower profits.

Reputational Damage

As mergers lead to a change in the composition of the market, the merger is likely to attract the attention of competition authorities. This can lead to negative headlines about the conduct and motives of the new firm. This may encourage consumers to avoid the products provided by the firm, reducing the value and benefit derived from the process of merging.

Culture Clash

There is often a lot of emphasis placed on the possible cost synergies that firms can experience when they merge together. However, it may be the case that there is a culture clash between the shareholders and employees of the two

companies merging together. This may result in the wrong decisions being made and ultimately, the merged company going down the wrong route.

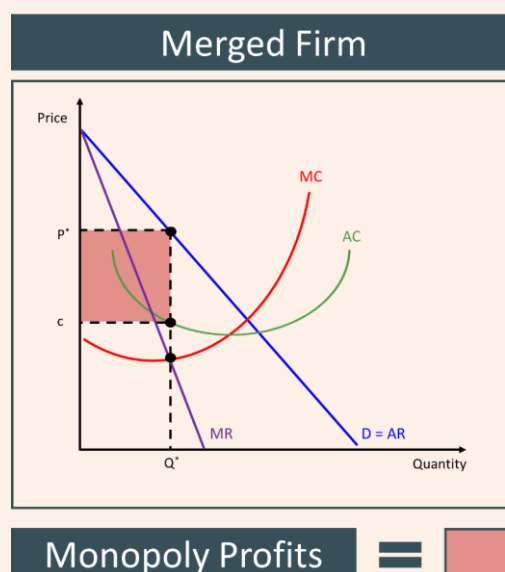
Impact on Market

In the UK telecommunications market both Three and O2 are large network providers that operate in the market. Therefore, these two firms already have a significant amount of market power at their disposal. The proposed merger between these firms would have created even greater market power and could have resulted in the newly merged firm acting like a monopolist for their customers.

Reduction in Competition

Mergers reduce the number of firms in the market. The number of firms in the market is one of the key components for determining how competitive a market is. One way of analysing the impact of a merger is to explain that reducing the number of firms moves the market along the sliding scale away from a perfectly competitive market towards a monopoly. By examining the results of a monopoly market, you can explain the effects that a reduction in competition via a merger might have.

A monopoly diagram representing a merged firm utilising monopoly power might be useful here:



This analysis does depend on the nature of the market before and after the merger. It is likely to be more appropriate for highly concentrated markets like

the telecommunications industry. See the evaluation section for more discussion.

Higher Prices

Firms with monopoly power are able to act as price makers. This allows them to increase the price charged to consumers in order to maximise profits.

Reduction in Output

Firms with monopoly power increase prices but this comes by restricting the output sold. Fewer units are therefore produced and sold.

Reduction in Consumer Choice

If there are fewer firms competing in the market, then this will result in a reduction in the breadth of products available for consumers to choose from. Economists believe that consumers value choice and therefore suffer when choice is restricted.

Reduction in Consumer Surplus

If a merger results in firms with increased market power, some consumers in the market will be priced out of consuming the good altogether, whilst any consumer that still purchases the product will do so at a price closer to their maximum willingness to pay. Together, this results in a reduction in consumer surplus (but an increase in producer surplus).

Assessing Efficiency Changes

There might be a temptation to think that if the market becomes less competitive and more concentrated because of a merger, then this will create a loss of efficiency in the market. However, when assessing the efficiency implications of a merger, it is not always straightforward to analyse.

Productive Efficiency

If firms experience economies of scale and this results in a fall in the average costs of the merged firm, then this can move the firm closer to achieving productive efficiency. This is because it results in a movement down the LRAC curve. Productive efficiency is when the firm is producing at the minimum of its average cost curve. Therefore, mergers which allow firms to exploit economies of scale may increase productive efficiency.

This may benefit consumers if there are mechanisms in place to force the merged firm to pass on these cost savings to consumers.

Allocative Efficiency

The impact on allocative efficiency largely depends on how competitive the market is after the merger. In the traditional analytical framework of the market moving towards a monopoly due to the smaller number of firms, the market will not be producing at $P = MC$ and therefore will be allocatively inefficient.

Dynamic Efficiency

Another form of efficiency you could talk about is dynamic efficiency.

You could argue that if a merger leads to lower average costs and an increase in market power, the market will therefore exhibit less competition and larger barriers to entry. This could make firms complacent, enjoying supernormal profits whilst benefitting from a lack of actual and potential competition. These are unlikely conditions to promote innovation and invention which drives dynamic efficiency. Some economists would describe this as an example of X-inefficiency.

You could also, however, argue that increasing the scale of firms through mergers provides those firms with the chance to earn supernormal profits. The mere presence of these supernormal profits affords the opportunity for firms to invest in research and development, spurring on innovation and invention. In fact, another virtue of mergers may be that increased scale may allow firms to take on risky research and development projects.

Barriers to Entry

The economies of scale and scope opportunities that a merged firm experience may increase the concentration ratio of the industry in the short-run but also act as a barrier to entry in the long-run and therefore reduce the contestability of the market.

If it is a horizontal merger the likelihood for cost synergies is high and therefore this may give the merged firm an unfair cost advantage over new entrants. This reduces the incentive for new firms to enter.

If it is a vertical merger, it may be the case that the merged firm can prevent other firms in the industry from gaining access to some important suppliers in the market or possibly a resource which is required to compete efficiently and effectively in the market.

AO4: Evaluation

Including accurate and relevant evaluation in your essay is the most important thing to ensure you achieve top marks. Evaluation is the art of making supported judgements, of deciding which factors are most important and of explaining in the circumstances in which factors assume importance or otherwise.

There are a huge number of evaluative angles you could take within this essay. Here we will showcase some useful examples. You would not be expected to include all of these examples – there simply is not enough time!

One way, for this question, to demonstrate strong evaluative skills is to hone in on the phrasing of the question: “Evaluate the view that mergers ... **always** result in a lessening of competition within an industry”. The word ‘always’ provides an obvious critique: if there are factors on which it depends on then it is unlikely that it is always the case.

Composition of the Industry

The impact of the merged firm on the competitiveness of the industry all depends on how many firms compete in the industry before the merger. If

there are lots of firms competing in the industry, a merger between two firms is unlikely to significantly affect the competitiveness of the industry.

Market Share of Merging Firms

If the market share of the firms merging is large, then the market share of the merged firm will be significant and that could have significant implications upon the competitiveness of the industry. On the other hand, a merger between firms with insignificant market share is likely to improve competition as it allows the merged firm to reduce their average fixed costs and potentially survive in the market.

Product Differentiation

You could argue that even if the merger takes place in an industry which still remains competitive after the merger has taken place, it could still result in damaging consequences in the long-run for consumers. This is because if the merged firm can generate cost efficiencies, it provides them with the profit reserves to be able to invest back into the production process and differentiate their products from their rivals. The more differentiated products become, the closer the firm gets to distancing itself from its rivals and almost competing in a separate market. If the firms can uniquely differentiate their products, they effectively act as a monopolist in their own market of differentiated products. This may lead to a similar outcome for consumers as under a monopolistically competitive market structure.

Economies of Scale

A lot of the analysis about mergers revolve around the opportunity to exploit economies of scale. The impact on firms and consumers, therefore, is likely to depend upon whether there are indeed economies of scale available to exploit.

Many industries may be characterised by having no economies of scale, or even diseconomies of scale. When this is the case, does a merger really impact the competitiveness of the market? There may be one less firm but it is not at any cost advantage over its rivals.

International Competition

Lots of analysis of mergers focus upon the impact of the merger upon competition between domestic firms. In markets, however, which are sufficiently exposed to international competition, this may make domestic competition concerns less significant.

In fact, it may be the case that a merger between domestic firms is the only way for those firms to survive in the face of international competition and therefore the merger is a way of preserving competition rather than diminishing it.

Conclusion

Overall, it is important to provide in your essay, a reasoned judgement; an argument which summarises the overall impact of the merger on the competitiveness of the industry.

The concluding paragraph of your essay is often a very good place to make clear what your overall reasoned judgement of the question is. Some people also like to include a similar judgement in their introduction, to signpost clearly to the examiner that they will be making an evaluative judgement in their essay.

Here is a good example of an attempt to, in one paragraph, argue that mergers do not always lead to less competition:

“In conclusion, whilst mergers may cause a reduction in competition in many markets, it would not be fair to say that it is always the case. Markets which are not highly concentrated and have no significant economies of scale to exploit may suffer little as a result of a merger. Of course, competition authorities need to be alert to more problematic examples in already highly concentrated markets, but that is not the case of all markets.”

Alternatively, you could argue that mergers do generally lead to a reduction in competition:

“Overall, whilst there may be some notable exceptions, the merger between two firms in a market has the simple impact of reducing the number of firms in the market. This generally reduces competition in that market. Policy-makers should be aware of the dangers of uncompetitive markets and scrutinise proposed mergers carefully.”

Essays are marked on a levels basis. The overall quality of your essay will be considered when deciding upon which level the answer is. There are up to 16 marks available for knowledge, application and analysis:

Level 1 [1 – 4 Marks] – Weak knowledge and understanding which included generic or irrelevant information.

Level 2 [5 – 8 Marks] – A narrow response which contains some knowledge and understanding but under-developed chains of reasoning.

Level 3 [9 – 12 Marks] – Accurate knowledge and understanding with clear analysis but the answer may lack balance.

Level 4 [13 – 16 Marks] – Precise knowledge and understanding with relevant and coherent analysis.

There are up to 9 marks available for evaluation:

Level 1 [1 – 3 Marks] – Generic evaluative comments without relevant evidence.

Level 2 [4 – 6 Marks] – Reasonable evaluation which may be sometimes unbalanced or not fully supported.

Level 3 [7 – 9 Marks] – Strong levels of well-supported evaluation.

Question 8

Evaluate the impact of increasing the national minimum wage upon firms and workers.

[25 marks]

To access top marks in any economics essay, it is important to focus on two key elements:



As essay structure is a more general skill, we will focus on showcasing how to hit the different assessment objectives required for this specific question. However, hopefully the following discourse will provide some assistance with regards to essay structure.

AO1: Knowledge

Being able to display accurate knowledge is judged to be the most basic requirement in an essay. It is still important to be able to demonstrate accurate knowledge throughout your essay. You can signpost this by including accurate definitions. For example, in your introduction you might want to focus upon defining a minimum wage in the context of the labour market

“A minimum wage is a form of government intervention in the labour market which aims to protect workers in the lowest paid occupations. It works by preventing employers from paying workers a wage rate below the stipulated level. It is a policy that is designed to ensure workers are not financially exploited by their employers in occupations that are low-skilled, as well as increasing equity in the labour market.”

Introducing your essay by showcasing your knowledge and understanding of the subject matter will lay the foundations for your essay. In this section of the essay a detailed demonstration of your understanding of the key economic terms and concepts is required.

AO2: Application

Being able to apply your knowledge to the subject matter of the essay is still important in essay questions without a data extract, as it showcases to the examiner that you have a detailed and developed understanding of the related economic concepts in the essay. You are only expected to use some of these application examples in your essay:

UK National Minimum Wage

The UK introduced the national minimum wage in 1999 to protect cheap labour from being exploited in the UK labour market. The minimum wage in the UK is set at a different level for different age groups to reflect the skill and experience level of workers in the labour market. The minimum wage has progressively increased since it was introduced to ensure that in real terms the relevance of the minimum wage still holds today.

UK National Living Wage

The UK government introduced the national living wage on the 1st April 2016. It ensures any working person over 25 years of age receives a higher minimum wage than before. In the reforms, the government committed to increasing this rate each year up to at least 2020.

Living Wage Foundation

Is an organisation setup in 2011 that advises the government and persuades employers to pay their estimate of the true living wage to all employees based on their cost of living forecasts in different regions across the UK. They independently calculate the minimum wage for workers, in order for them to achieve their basic life-sustaining needs and wants. In November 2016, the living wage was estimated at £9.75 per hour in London and £8.45 p/h outside of London.

Labour Costs

Labour costs often represent the largest expense for firms as percentage of their total costs. This means that any change to the cost of labour will have significant implications on the cost curves of any firm and therefore impact their production decisions.

Derived Demand

The demand for labour is an example of derived demand. This is because a firm requires labour to produce its products. However, if there is a downturn in the economy and demand for goods and services falls, demand for the firm's products also fall. If the firm needs to produce less products than before, they will demand less labour than before. Therefore, this results in them laying off workers. This explains why the business cycle and unemployment cycle are usually linked to each other.

Low UK Unemployment Levels

Since the rise caused by the financial crisis of 2008, the unemployment rate has consistently been falling. By March 2017, it had fallen to 4.7%, its lowest rate since 1975. Low unemployment suggests a 'tight' labour market where workers are able to find job easily and it is firms who are competing for workers, rather than workers competing for jobs.

AO3: Analysis

The core of top-level essays consists of well-constructed, relevant analysis of the topic. This should be presented using logical chains of reasoning, and where appropriate, clear diagrams.

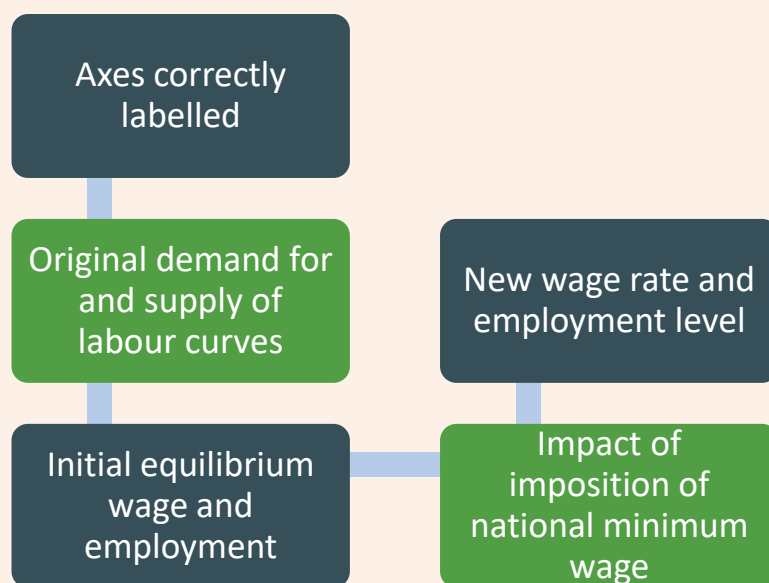
There are lots of analytical routes you could go down with a question like this. The core analysis will involve an explanation and an evaluation of increasing the national minimum wage in the labour market. It is important that you provide a diagram that helps provide you with the logical chain of reasoning of the impact of the minimum wage in an industry. A good (but not the only) approach would be to start off with a brief analysis of the imposition of a binding national minimum wage.

Impact of a Minimum Wage

A minimum wage is a price control applied to the labour market. This is because the wage rate represents the price of labour. It works as a price floor, which means that the wage paid by the employer for the services of a worker cannot fall below the level set by the government. This means that employers have no legal right to be able to undercut this rate set by the government for any part-time or full-time worker.

The best way to analyse the impact of the national minimum wage on the labour market is to represent this in a diagram. As we are looking at labour markets, you will still have a demand and supply curve. However, you will now be looking at the demand for labour and supply of labour curves. The equilibrium wage rate is determined by the interaction of these two curves.

In this case, for the diagram to be completed accurately, the following features have to be present:



Use a ruler and ensure the diagram is neat and tidy.



A description is required alongside the diagram to capture analysis marks:

“Before the imposition of a national minimum wage the industry is in equilibrium with E_1 workers employed, each at a wage rate of W_1 .

The prevailing equilibrium wage rate for labour is determined by the interaction of an upward sloping supply of labour curve and a downward sloping demand for labour curve.

The supply of labour curve represents the number of workers that are willing and able to supply their labour at every given nominal wage rate. It is typically upward sloping as workers have a greater incentive to work the higher the nominal wage rate.

The demand for labour curve represents the number of workers that firms in are willing and able to employ at every given nominal wage rate. It is typically downward sloping as firms wish to hire less labour the more expensive it becomes.”

Now you can analyse the impact of the national minimum wage on labour markets:

“Once the government imposes a national minimum wage on the UK labour market, it forces all firms to employ their workers at a wage rate at the level of W_{MW} . Given that this wage rate is higher than the original wage rate that cleared the labour market in the industry, the labour market policy has two effects on the industry.

Firstly, the supply of labour increases, as workers have a greater incentive to work more hours and take up jobs in the industry if the reward for working is greater. This is depicted by a movement up the supply of labour curve.

However, firms now demand less labour in the industry as the cost of employing labour is now higher. Assuming ceteris paribus, this creates a movement up the demand for labour curve.

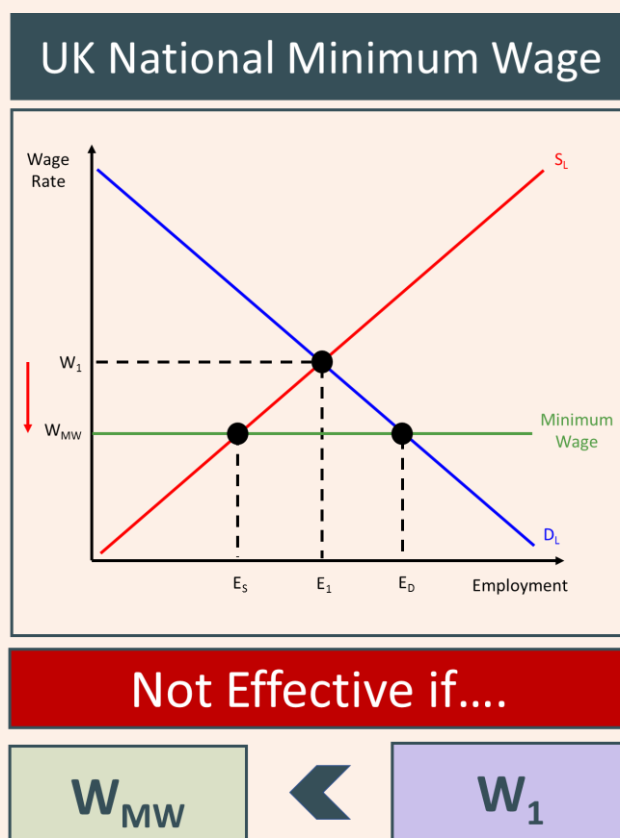
At the higher wage rate, there is now a divergence between the number of workers firms wish to employ and the number of workers willing to work at this rate. When supply exceeds demand in any market this is called excess supply. In this case, there is an excess supply of labour equal to $(E_3 - E_2)$. As employers make the ultimate decision of how many workers to employ, the level of employment in the industry falls from E_1 to E_2 .”

Therefore, for industries where the imposition of the national minimum wage forces the wage rate above the existing equilibrium wage rate, the remaining workers in the industry (E_2) receive a higher wage rate. However, some classical unemployment is created.

An additional point you might make here is that when firms are faced with higher labour costs, they will always lay off the least productive workers. Therefore, not only will these workers be left unemployed in the short-run, but they are likely to face significant labour market frictions in the long-run.

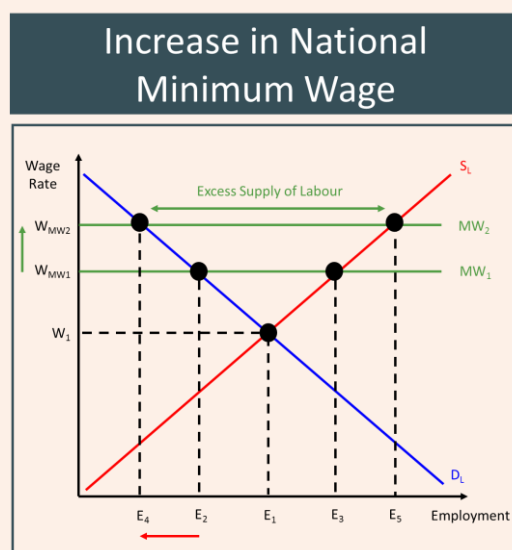
Binding Condition

It is important to stress that the imposition of a national minimum wage will only have the desired effects of increasing the wage rate in the industry if the minimum wage lies above the existing wage rate that prevails in the industry. If the minimum wage is set below the existing wage rate it is unlikely to affect the wage rate or employment levels in that industry.



Increasing the National Minimum Wage

Now that you have set the scene regarding the theoretical impact of the national minimum wage on labour markets, you can then go on to analyse the impact of an increase in the national minimum wage in UK labour markets. The same logic will apply as previously but here you are analysing a change in the NMW, rather than the imposition of a NMW.



Further increases in the national minimum wage are going to create an even further divergence between the supply of and demand for labour. The reward for working goes up, whilst simultaneously the cost of employing goes up. The end result shown in the diagram above is that workers up to E_4 benefit from receiving a pay rise, whilst some workers are made unemployed ($E_2 - E_4$).

Reasons for Increasing NMW

As the question asks you to evaluate the impact of a higher national minimum wage on firms and consumers you need to be able to provide a summary of the microeconomic implications of this labour market policy.

Improvement of Distribution of Income

As the national minimum wage predominantly targets those on the lowest incomes in the least skilled industries, increasing the minimum wage will help close the gap between the richest in society and the poorest. Therefore, this reflects an improvement in the distribution of income.

However, you could argue that this is all conditional on the assumption of ‘all other things being equal’. It might be the case that the government are increasing the minimum wage but not in line with growth and inflation in the economy. This means the minimum wage may only slow the growth in the gap between the richest and the poorest.

Reduces Wage Discrimination

By guaranteeing that the wages of the lowest paid cannot fall below a certain threshold it prevents some employers that may have greater bargaining power i.e. monopsonists from exploiting cheap labour. This can help bring discouraged workers back into the labour market, reducing the overall poverty rate.

Dynamic Efficiency Argument

If the wage that a firm has to pay its workers increases via an increase in the national minimum wage, it could encourage the firms significantly affected to

invest back into productive capital. The logic behind this is that firms always wish to pay workers their marginal revenue product i.e. the monetary value of the output they produce. However, if the minimum wage increases, firms are having to pay workers operating at the same productivity levels a higher wage. Therefore, to justify paying these workers more, the firm may invest in capital to ensure that the productivity of workers increases in line with wages. This can contribute to higher profitability for firms in the long-run, despite an initial damage to profitability in the short-run.

Reasons against Increasing NMW

Despite some of theoretical benefits of increasing the national minimum wage of a country, there are also some significant consequences.

Increases Unemployment

The biggest argument against increasing the national minimum wage is it significantly increase the production costs for firms that predominantly operate in low-skilled sectors of the economy. This creates classical (real-wage) unemployment as the supply of labour increases, whilst the demand for labour decreases.

Increase in Prices

If a firm or an industry is significantly affected by the minimum wage increase, it may result in firms passing the higher costs onto consumers via higher prices. The more inelastic the demand for and supply of labour is in an industry, the more of the minimum wage that firms have to absorb. Therefore, the likelihood of higher prices from this policy is increased in these types of industries.

In essence, the increase in prices could erode the benefit of the higher wages for workers that receive a higher minimum wage.

Inflexible Labour Market

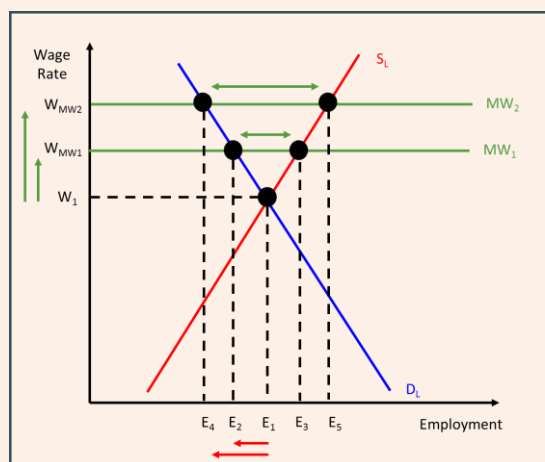
When there is a high minimum wage in the industry, it reduces the ability of firms to be able to respond to industry or economic conditions. The normal process is that a firm will employ more workers during an economic upturn and lay off workers during a downturn. However, a minimum wage prevents firms from being able to flexibly change their employment levels as the wage rate cannot go below a certain level.

Elasticity?

One factor that will have a big impact on the effect of a higher national minimum wage in an industry is the relative elasticities of the demand for labour and supply of labour curves.

If the demand for and supply of labour curves are relatively inelastic the effect of an increase in the national minimum wage upon employment levels in the industry will be reduced. This is because when a curve in the labour market is relatively inelastic it is less sensitive to a change in the nominal wage rate. For instance, an inelastic demand for labour curve means even if the price of labour increases, demand by firms will fall by less proportionately. If the supply of labour curve is relatively inelastic this means workers are less likely to be encouraged to work if the wage rate increases.

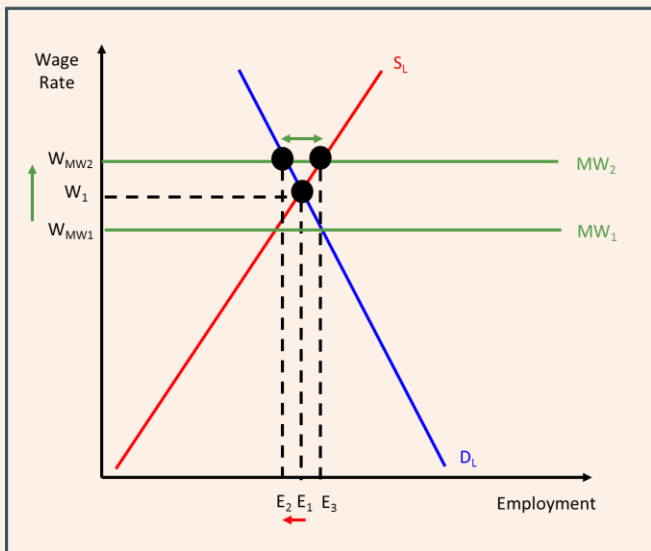
Therefore, the implication is that even if the national minimum wage forces the wage rate above the equilibrium wage rate, it will create a smaller divergence between the supply of and demand for labour at the higher wage because of the relative elasticities of the two curves.



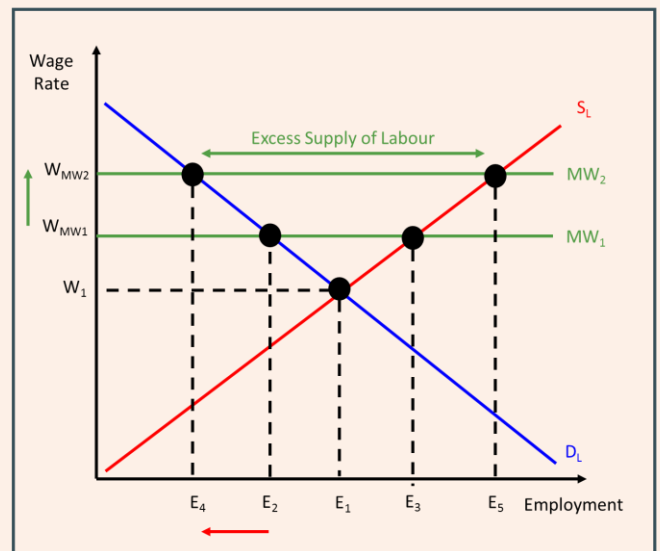
Different Industries

Industries which require different types of labour are likely to be affected in different ways. Firms which require skilled labour, for which they pay relatively high wage rates, are unlikely to be as heavily impacted as firms which employ relatively unskilled labour.

Relatively Skilled Labour



Relatively Unskilled Labour



You could argue that increasing the national minimum wage may result in more industries being affected by the pay legislation. This is because the minimum wage is set to prevent workers in low skill industries from being exploited. However, if the minimum wage increases this means it may start to affect other industries in the economy. This may result in more skilled unemployment.

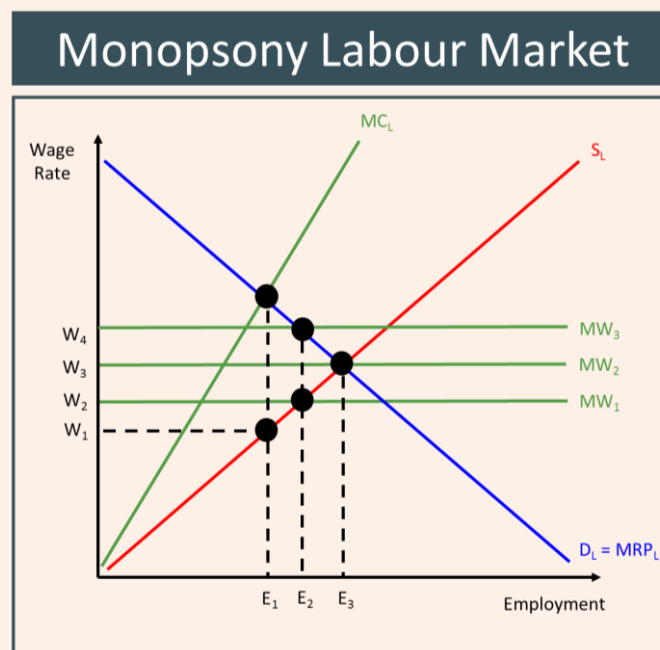
Monopsony Labour Market

The theory shows the impact that increasing the national minimum wage has on a competitive labour market. However, there are lots of industries in the UK where the labour market is a monopsony. This means there is only one buyer of labour. This is the case in the public sector where the government pays for the wages of workers. Do the theoretical results shown so far still hold when looking at a monopsony labour market?

Well because of the unique nature of a monopsony, it will employ labour up to the point where the marginal cost of labour is equal to the marginal revenue product of labour. However, because it is the only buyer of labour it will often

depress wages by exerting its control over the industry. Therefore, a minimum wage will help protect the wages of workers in a monopsony labour market. The impact on employment will depend where the original minimum wage was and to what level it has increased to.

The diagram below describes an example of where both an introduction and subsequent increase in the national minimum wage has contributed to a slight increase in employment and wages of all workers. However, if the minimum wage increases too significantly, then it results in employment falling once again.



AO4: Evaluation

Including accurate and relevant evaluation in your essay is the most important thing to ensure you achieve top marks. Evaluation is the art of making supported judgements, of deciding which factors are most important and of explaining the circumstances in which factors assume importance or otherwise.

There are a huge number of evaluative angles you could take within this essay. Here we will showcase some useful examples. You would not be expected to include all of these examples – there simply is not enough time!

It is particularly crucial in this type of essay question as you need to evaluate some of the fundamentals of the policies that you have mentioned so far.

Critiquing this element of the question phrasing is a sure-fire way to demonstrate some good evaluation skills.

Size of Minimum Wage Increase

The overall impact on the labour market will depend on how significant the national minimum wage increase is. The greater the increase in the minimum wage the more amplified the effects on the labour market.

Original Level of the NMW

The overall impact will depend on what level the national minimum wage increased from. If the national minimum wage was originally at a low level, then an increase may not have much of an effect. However, if the NMW is already high, then an increase may exacerbate the effects and have a significant impact upon agents.

Other Cost Factors

The theorised impact of increasing the national minimum wage may not come to fruition, if there are other changes to the cost conditions of the firm that either amplify the effects of the minimum wage or help firms combat the effect of the minimum wage.

Structure of Labour Market

The structure of the labour market will have an impact on how significantly the employment levels in the industry change as a result of an increase in the national minimum wage. As already shown, if there is just a single buyer of labour then employment could both increase or decrease on the back of an increase in the national minimum wage.

Time Frame

The impact an increase in the NMW would have may depend upon the time frame you consider. Firms may be reluctant to lay off workers in the short-run, preferring to let them go gradually. Similarly, investment in to capital to substitute away from a reliance on labour may only have an impact in the long-run.

Conclusion

Overall, it is important to provide in your essay, a reasoned judgement; an argument which summarises the overall impact of an increase in the national minimum wage on firms and workers alike.

The concluding paragraph of your essay is often a very good place to make clear what your overall reasoned judgement of the question is. Some people also like to include a similar judgement in their introduction, to signpost clearly to the examiner that they will be making an evaluative judgement in their essay.

Here is a good example of an attempt to, in one paragraph, argue that increasing the national minimum wage of a country will be bad for firms and workers that are affected:

“In conclusion, increasing the national minimum wage of a country will result in a series of undesirable consequences for those involved in the industries that are significantly affected. The increase in the price of labour, in the least skilled sectors of the economy, will more than likely produce classical unemployment within those industries. Any positive impact on inequality will be more than offset by the impact felt by those made unemployed and businesses suffering from higher labour costs.”

Alternatively, you could argue that increasing the national minimum wage of a country may positively impact the economy

“Overall, the case for increasing the national minimum wage is a convincing one. This is because the government needs to do more to protect and improve the pay conditions of workers in the lowest skilled industries, but, also firms need an incentive to internally improve the productivity of the production process. If the government finds a balance between an increase in the minimum wage which prevents exploitation, whilst also not harshly affecting

the cost conditions of firms, it can reduce inequality and improve productivity at the same time.”

Essays are marked on a levels basis. The overall quality of your essay will be considered when deciding upon which level the answer is. There are up to 16 marks available for knowledge, application and analysis:

Level 1 [1 – 4 Marks] – Weak knowledge and understanding which included generic or irrelevant information.

Level 2 [5 – 8 Marks] – A narrow response which contains some knowledge and understanding but under-developed chains of reasoning.

Level 3 [9 – 12 Marks] – Accurate knowledge and understanding with clear analysis but the answer may lack balance.

Level 4 [13 – 16 Marks] – Precise knowledge and understanding with relevant and coherent analysis.

There are up to 9 marks available for evaluation:

Level 1 [1 – 3 Marks] – Generic evaluative comments without relevant evidence.

Level 2 [4 – 6 Marks] – Reasonable evaluation which may be sometimes unbalanced or not fully supported.

Level 3 [7 – 9 Marks] – Strong levels of well-supported evaluation.