

## January 2003 Unit 4 past paper

### Question 1

- (a) (i) Using the information provided define what is meant by vertical integration.**

When firms at different stages of the production line merge, for example a tour operator merging with an airline, travel agent or hotelier.

- (ii) Explain one motive for a firm such as Airtours to become more vertically integrated.**

Airtours may be motivated to pursue vertical integration to control the supply in their market, such as tickets for airlines. This will lead to an increase in profitability as the firm will then be able to overcharge its competitors for use of their services.

The firm will also lower the costs of production by reducing duplication and taking advantage of economies of scale, again leading to an increase in profits. The firm may also be able to increase its market share by offering lower prices to consumers and overcharging rivals for use of their services attracting more customers to the firm and so increasing profits.

- (b) (i) State two features an economist would consider to classify the market structure of any industry.**

*Two from...*

- The number of firms in a market.
- Existence and size of barriers to entry.
- The size of firms.
- The number of firms.
- The ability of firms to control their price.

- (ii) Comment on the extent to which the tour operators' industry is an oligopoly.**

Four large firms dominate the market with a four-firm market share of 74%. There are high barriers to entry in the form of brand loyalty and that the larger firms are able to take advantage of economies of scale.

There is lots of product differentiation and firms aim to attract customers through non-price competition. In the market there are also a large number of small firms supplying to niche markets.

However there have been price wars in the past where large firms have competed on price and there is good information in the market, neither of which are characteristics of an oligopoly.

To conclude the market is an oligopoly to a greater extent demonstrating many of the qualities of an oligopoly with only minor characteristics not typical of an oligopoly.

**(c) Using examples from the article, explain two ways in which large tour operators prevent their industry from becoming more contestable.**

A contestable market is a market with low/no barriers to entry and from which there is costless exit, there are no sunk costs associated with a perfectly contestable market.

Vertical integration can be used by large tour operators to control the supply to the market and overcharge rival firms for using this supply. In the package holiday market this may include a tour operator buying hotels or buying an airline as a form of backward integration and buying a travel agent to ensure their holidays are sold at travel agents. This makes the market less contestable as it increases smaller firms sunk costs.

Large firms can also take advantage of economies of scale to lower their costs of production and so offer consumers the same product at a lower price forcing smaller firms who are unable to lower their costs to the same level out of the market.

**(d) Discuss the implications for consumer of this industry becoming increasingly dominated by a small number of large firms.**

Large firms can benefit from economies of scale and so have lower average costs of production. The firm can choose to benefit consumer by lowering their price. Alternatively the firm may choose to invest the supernormal profits they make to fund research and development projects and so improve choice for the consumer.

Firms may have promotions such as children for free or at a reduced rate to gain a greater market share which will benefit the consumer in the short run as they get the same product for a lower price, however in the long run firms may be able to exploit the consumer from the dominant position they obtain.

However large firms can abuse their position by offering consumers less choice and less specialised holidays. There is the possibility that the larger firms may take over the smaller firms supplying to a niche market and the niche market may be supplied a generic product, which is not beneficial to the consumer.

Large firms can also use economies of scale as a barrier to entry so fewer firms will enter the market leading to a reduced consumer surplus, which is not beneficial to the consumer.

In order to avoid price competition with the few firms left in the industry there is a high possibility of collusion, possibly forming a cartel. This would allow the firms to set high prices for consumers and reduce the quality of holidays made available to consumers.

In reality an informal collusion is made in the holiday market with Airtours being the price leader (with 23% market share, according to the case study). In a market like this much non-price competition will lead to firms spending money on advertising to affect consumer tastes and preferences so the consumer may end up with a holiday they did not want.

For questions in the style of part d, aim to comment on prices/price setting/quality of goods/variety of holidays. Talk about how dominance may be beneficial as firms invest their supernormal profits, obtained by taking advantage of economies of scale, into research and development.

Also mention how dominance can be harmful to the consumer through exploitation in the form of a higher price and reduced consumer surplus.

## Question 2

**(a) Explain how the concept of opportunity cost can be used to analyse an individual's choice both between work and leisure and between different uses of leisure time.**

Opportunity cost is the real value of the next best option forgone. When a worker works, they cannot spend that time on leisure, and when a worker spends time on one leisure activity they cannot spend time on any other leisure activity.

An individual chooses to spend a proportion of their time on working to gain an income to live from and can choose to spend their remaining time working or participating in leisure activities.

At a low wage rate the opportunity cost of choosing not to work is low and, as we assume individuals are aiming to minimise their opportunity cost, workers will choose to spend their time on an activity that yields the highest total gains to them.

The net advantages of an occupation consist of non-pecuniary and pecuniary factors. The pecuniary factors are easy to quantify, by definition, in monetary terms. Non-pecuniary factors such as working environment, the dangers of work, feeling of helping the community and other characteristics of the nature of the work are not so easily quantifiable but are likely to be higher in occupations such as being a doctor than being a shop assistant. So for doctors the wage rate is likely to have a smaller effect on the choice between work and leisure than for supermarket assistants.

Within leisure time rationally thinking individuals are likely to choose the activity with the highest net value. The cost of the activity is likely to act against the activity's favour so might make walking seem more attractive than going to a football match in a foreign country, but there are many other factors influencing the choice of how individuals spend their leisure time. The ability to see people individuals known and socialise, the feeling of loyalty to a sports team, the physical ability of an individual and many other factors influence these non-pecuniary net advantages to a given choice of leisure activity. The choice of how leisure time is spent is a very personal decision and depends on the individual's tastes, preferences and enjoyment of an activity.

**(b) A firm is considering a significant increase in its hourly wage rate. Discuss the possible consequences for the hours worked and the output produced by its labour force.**

- Explain the effect of an increased wage rate on the individual worker (with backward-bending supply curve), how workers individually may choose to work fewer hours.
- Explain the effect of an increased wage rate in the industry market.
- Mention the significance of the price elasticity of supply/demand and what factors affect this.
- Increased wage rate causes demand to increase and that improved motivation could increase MPP further so move the  $MRP = D$  curve outward again.

- Discuss motivations for jobs like shop assistants, where a change in wage rate is more likely to have an effect on output produced by labour in comparison to occupations to doctors where pay is not a dominant factor.
- Mention the concept of economic rent and transfer earnings, the effect higher wage rates in this industry may have on this and other similarly skilled occupations with similar working conditions.
- Consider other measures to alter the hours worked. It has been found that shorter working hours tends to lead to higher productivity, so UK law has limited workers to 48 hours work a week.
- Other ways to increase the output produced by the labour force including use of technology and improving education/skills of workers to increase MPP.
- Improvement in skills improves flexible labour market which can increase total output as demand changes to different sectors of the economy over time.

### Question 3

**(a) Explain how the earnings of a worker can be divided between transfer earnings and economic rent.**

- Transfer earnings are the earnings required to keep a worker in their current occupation. They are the opportunity cost – the real value (net advantages) of the next best option forgone – of the job.
- Economic rent is pay over and above this rate of pay. This is high in occupations such as the priesthood or footballers. Supply for these workers is highly inelastic and a large cut in wages would be unlikely to result in the workers leaving their industry. Shop assistants have low economic rent and if their wages were cut substantially they would be likely to move to another occupation.
- Three diagrams showing a perfectly elastic supply curve, a perfectly inelastic supply curve and a supply curve with PED of  $\sim 1$ .

**(b) Discuss the extent to which the concept of economic rent explains the difference in earnings between airline pilots and in-flight attendants.**

- Airline pilots are likely to have a higher economic rent than in-flight attendants as the net advantages of their occupation have a higher non-pecuniary component than the net advantages for in-flight attendants.
- This explains the elasticity of supply for pilots and in-flight attendants, but this does not explain the higher wages in the pilot market.
- For this we also need to explain the level of supply. The skills and qualifications necessary to become a pilot but not to become an in-flight attendant act as barriers to entry and prevent entrants to the market.
- We also need to consider the demand for workers in the two industries.
- Pilots are likely to have a high MPP, output per worker, and the output to be of high value so have high demand as  $D = MRP = MPP \times P$ . Demand is also very inelastic as pilots are essential for planes to fly.
- In-flight attendants are likely to have a lower MPP and value of output, so a lower more elastic demand.
- Diagram to explain the higher wages of pilots compared to in-flight attendants.

### Question 4

**(a) Explain the likely effects of introducing a minimum wage on the levels of income and employment in a low-paid occupation, such as the hotel and catering industry.**

- Define the minimum wage as a government policy to ensure all workers receive a 'fair' wage for their work.
- The minimum wage rate is set at a higher rate than the equilibrium wage rate to have an effect.
- Explain the unemployment created diagrammatically as of two components – the workers who have lost a job and those who are now willing to work but cannot find work.
- Relate to the low-paid industries and consider the elasticities of supply and demand.
- Demand is likely to be low and elastic as the MPP of workers is low and the value of output is also low, and  $D = MRP = MPP \times P$ .
- Supply is likely to be elastic and low as there are many low-skilled occupations and workers are mobile between the occupations due to the low barriers to entry.
- Depending on the chosen level of the minimum wage the effect of putting people out of work may be worse than giving those who remain in work a higher wage.

**(b) Discuss whether a national minimum wage is the best way of reducing poverty in the UK.**

- Absolute poverty is where an individual does not have enough income to afford basic necessities for life such as food, clothing and shelter. Government policies aim to eradicate this.
- Relative poverty
- The national minimum wage ensures all workers receive a rate of pay that allows for subsistence living.
- The higher pay rate for those left in employment may cause them to be more motivated, which is likely due the high proportion of the net advantages of low-skilled occupations that are pecuniary, which should increase their output per worker.
- A higher MPP will cause the  $MRP = D$  to increase so move cause demand to shift outwards.
- Explain diagrammatically how this might eliminate the problem of the national minimum wage.
- The limitations of this are that the supply and demand are price inelastic so there would need to be a very large increase in MPP which is unrealistic.
- There are other ways the government can reduce poverty in the UK such as benefits.
- Three types of benefits: Universal, means-tested, in kind. Explain each, give an example and talk about how it can reduce poverty.
- Education and training as part of the flexible labour market increasing occupational mobility, flexible working hours, short term contracts
- National minimum wage rate causes unemployment and does not resolve the issue of unemployment but can be useful in achieving a more flexible labour market.