

Edexcel (A) Economics A-level

AS-level Paper 1: Markets and Market Failure

Example answers

June 2016



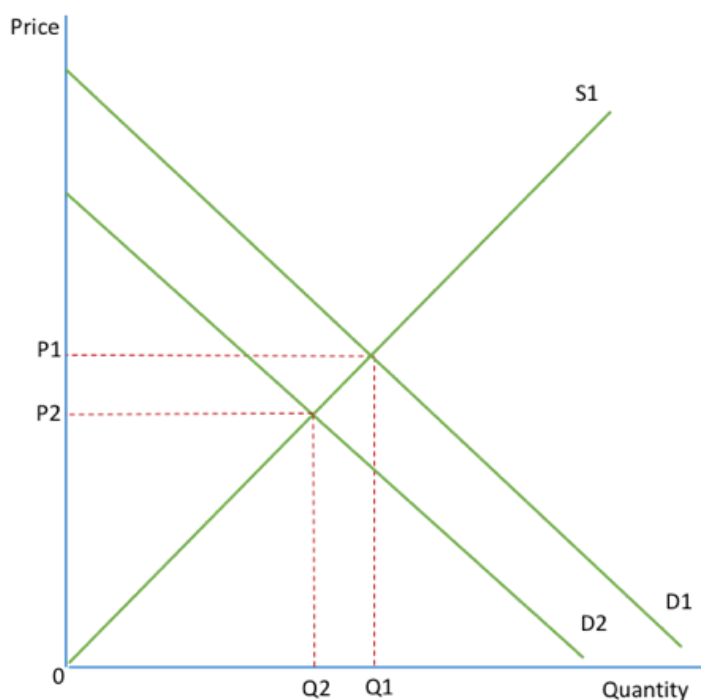
6a) With reference to Figure 1, explain one possible reason for the differences in price elasticity of supply of new housing between countries. (5)

Price elasticity of supply is the responsive of supply to a change in price. In the USA supply is very price elastic, so there is a large increase in houses when prices rise, as it is 2.0 whilst the Netherlands is price inelastic at 0.2. Finland is unitary elastic. One reason for this difference could be the availability of factors of production. In the USA, there may be lots of people trained to build houses who are willing to do so for higher prices and so therefore there is a high availability of labour. However, in the Netherlands there may be little access to labour as there are few trained builders and most of those who are trained are already in jobs so it is difficult to increase supply even when prices go up. There may be better access to bricks, mortar etc. in the USA than the other countries and so therefore it is easier to build more houses when prices rise.

Teacher's comments: 4/5

It is more the lack of land in Netherlands vs lots of land in US?

(b) With reference to Extract A, assess the likely impact of the Help to Buy scheme on the market for rented properties in the UK. (10)



The Help to Buy scheme is likely to increase demand for houses and therefore decrease demand for rented properties as they are substitutes. Demand will fall from D1 to D2 and therefore price will fall from P1 to P2 and output from Q1 to Q2. People will buy houses since it is more accessible as they only need 5% deposit as opposed to 20%, rather than renting out properties and therefore this demand shift will occur. The fact the scheme is specifically going to first time buyers is likely to make the demand shift large as these are the people who are renting in the first place before they can buy a home **(the effect is likely to be smaller- as it is only affecting part of the market)**. If it went to those who already had houses but wanted to move, it would have been a very small



impact on the renting market as people would be unlikely to be renting if they already had a house. There is likely to be a lower producer and consumer surplus. Moreover, the fall in price for rented accommodation is likely to mean that first-time buyers will be able to save quicker, as less is spent on rent and therefore demand for houses will rise even faster and so demand for rented properties will fall even further, causing an even larger effect.

However, the effect will depend on the cross elasticity of demand of rented accommodation and houses. Although they are substitutes, the level of elasticity is unknown. The higher the XED figure, the more elastic so the larger the effect on prices and output.

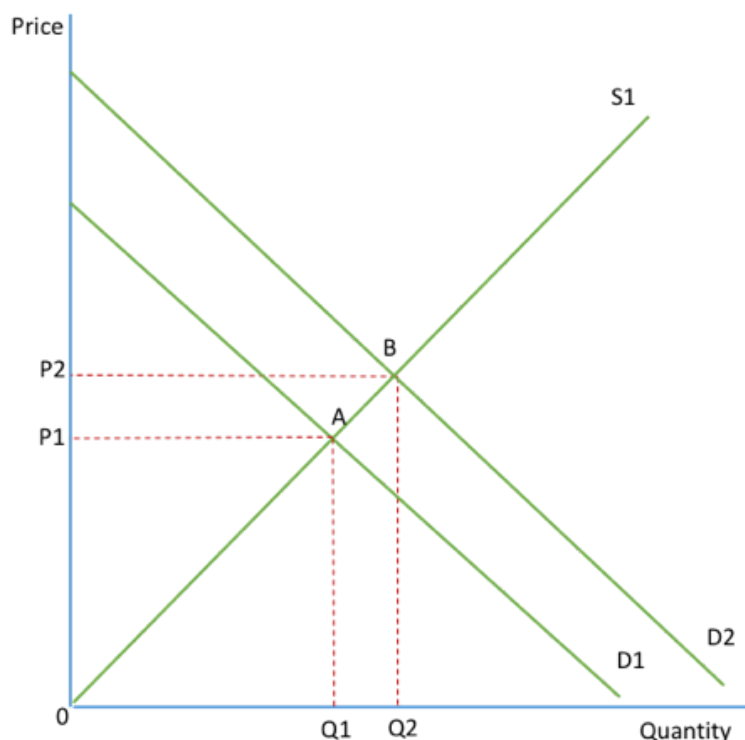
Also, it depends on the success of the Help to Buy scheme. If not many people utilise the scheme, then demand for houses will not change much so demand for rented properties will not be affected much. This will mean the effect on the market is negligible. Similarly, if 5% is still not accessible to many of the first time buyers, there will be little effect on the market for rented properties as demand for houses won't change.

Overall, price and output of rented properties is likely to fall as a result of the scheme, but it will depend on the XED and the success of it.

Teacher's comments: 9/10

Impact will be short term due to scheme ending in 2017

(c) Explain the likely impact on producer surplus of an increase in the demand for housing. Use a diagram to illustrate your answer. (6)



An increase in demand for housing will shift D_1 to D_2 and price from P_1 to P_2 and output from Q_1 to Q_2 . A producer surplus is the difference between what a producer is willing to sell their good for and what they actually sell it for, set by the price mechanism. Therefore, an increase in demand will mean there is increased producer surplus from P_1A_0 to P_2B_0 . This will mean producers will be selling more goods at a higher price and so will mean that they get a higher profit.

Teacher's comments: 5/6

Size of surplus affected by PES

(e) With reference to Figures 1 and 2 and your own knowledge, discuss the functions of the price mechanism in allocating housing. (15)

The price mechanism has three main functions: signalling, incentive and rationing. Firstly, the price mechanism rations housing to only those who can afford it and are willing to pay. When there is excess demand for houses, then the price of these houses will rise and so therefore only those who can afford the price will buy it, meaning demand will contract. This is shown by the rise in prices seen in figure 2 as they had risen by 25% in 2009 to 2015.

Another function of the price mechanism is incentive. When prices rise, it offers an incentive to suppliers to increase their supply as they will be able to make a higher profit. This leads to an expansion in supply. The more elastic the supply of houses, the bigger the increase in the number of houses following a rise in price. Therefore, a country like the USA with a PES of 2, is likely to see a bigger increase in supply than a country like the Netherlands.

Moreover, the price mechanism acts as a signalling mechanism. This means it signals to suppliers that they should switch resources to the production of housing when prices rise. It also signals to the consumer to buy more houses when prices falls, to get rid of excess supply. Therefore, it means that when prices rise, suppliers should produce more of a good and supply expands. However, this will again depend on the price elasticity of supply. Inelastic supply will mean that little more resources are devoted to producing houses as supply will not extend by much.

However, this may not occur properly as externalities and market failure may occur or there may be imperfect information which mean consumers do not know the costs and benefits. In the case of externalities, housing may be seen as a merit good as it is better for society to have people in houses than living on the streets. This may mean there is a social welfare loss due to underprovision of houses. The existence of regulation may cause government failure, where government intervention leads to net welfare loss, as it prevent increases in supply. This will mean supply is price inelastic as it is difficult to build more houses due to the need for planning regulation and people with certain skills. Therefore, the price mechanism may be inefficient at allocating housing.

Overall, the price mechanism is meant to be efficient when allocating houses, as increased demand would push prices up and prevent excess demand/supply. It aims to ensure pareto optimality, where one person can't be made better off without making another person worse off. However, the existence of externalities, imperfect information and government failure may mean it



is not as efficient as it could be. In a free market, the price mechanism is the main method of allocation.

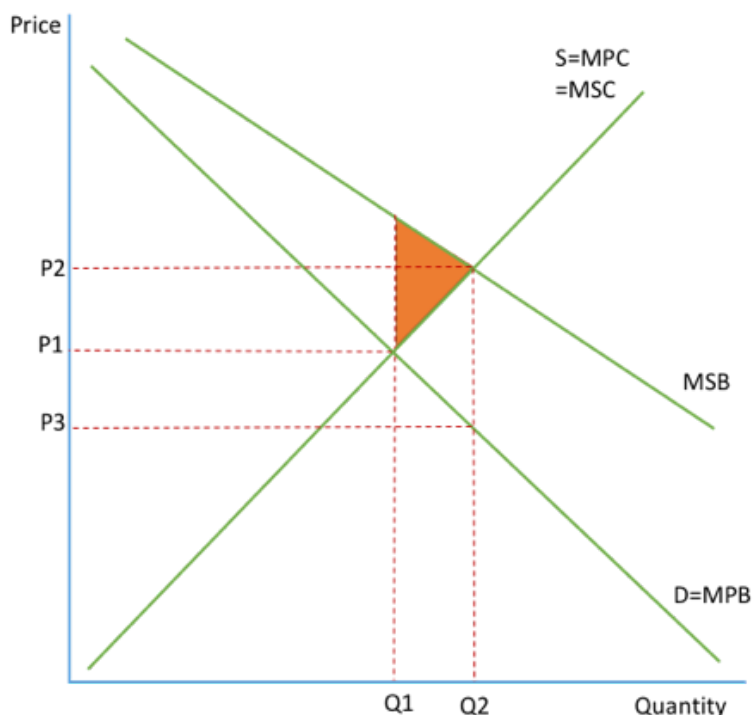
Teacher's comments: 15/15

Excellent answer

(g) Evaluate the case for government provision of goods and services such as flood defence schemes or housing. (20)

In a mixed economy, governments often provide public or merit goods, such as housing and flood defence systems. Other examples include healthcare and education. They provide merit goods, where benefits to society are bigger than benefits to individuals, and public goods, goods which are non-excludable (so a person can't be prevented from accessing them) and non-rivalry (one person's use of a good doesn't prevent someone else from using it).

One reason why governments should provide goods like this is because of the free rider problem. This says that public goods will not be provided by the private sector since they are non-excludable so no one will pay for them. As a result, the government has to provide them because otherwise there will be under provision, leading to net welfare loss and due to the market failure. Flood defence schemes are public as they are non-rivalry and non-excludable so therefore the governments needs to provide them otherwise houses, roads etc. will be severely damaged and this will have negative social impacts.



Moreover, the government should provide a good if it is a merit good, with a positive externality. The diagram shows the effect of a positive externality of consumption. The social benefits are higher than the private benefits, but the price mechanism will ignore the external benefits as



economics assumes individuals are selfish. This will mean there is a social welfare loss of the area shaded, as equilibrium is at P_1Q_1 instead of P_2Q_2 . In order to fix this, the government could intervene and provide all the goods at P_3 so that Q_2 is sold. Therefore, the government should provide merit goods to prevent the welfare loss. On the other hand, the government could simply provide subsidies of P_2 - P_3 to also allow the market to get to the social optimum position.

However, some people argue that the government should not provide these goods as they could result in government failure, where government intervention results in a net welfare loss. Many free market economists argue that government provision of goods leads to inefficiency as they are not aiming for profit and so will not aim to cut costs as low as possible. If the government is the only provider of goods, then they will have no competition and will not have to keep quality high.

Also, some people argue the government shouldn't provide goods as it may have a high opportunity cost. For example, providing flood defences may mean the government can't spend money on the NHS, pensions etc. Free market economists tend to argue that governments aren't good at deciding what to fund/provide and this is also likely to cause the problem of government failure.

Overall, the government should provide them in order to maximise welfare: which is the primary aim of any government.

Teacher's comments: 16/20

