

# Economics A-level

## **Microeconomics**

### **Contextual Analysis**

(Please note: This contextual analysis document is not exam-board specific)

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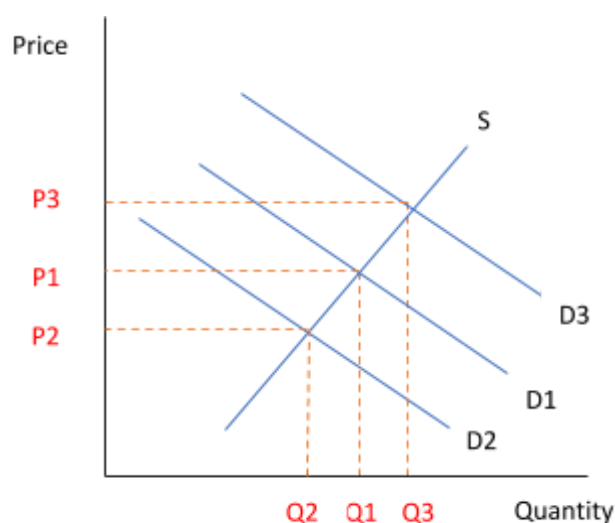
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# 1. Price Determination in Competitive Markets

## Factors Shifting the Demand Curve

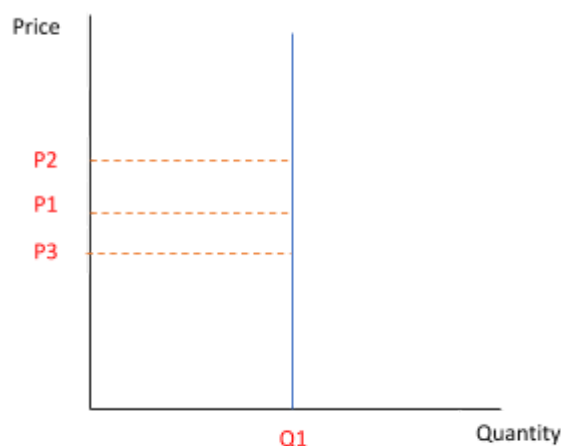
- Decrease - due to **technological advances** in the food industry, **restaurant dining** is on the decline due to the introduction of apps such as UberEats and Just Eat that allow food to be delivered directly to your house. These apps save consumers the time of travelling to restaurants and the inconvenience of having to leave the comfort of their home, hence why 'take outs' are becoming a perfect **substitute** to traditional 'dining out'.
- Decrease - an alternative industry that is on the decline due to innovation in technology is **print journalism**. Newspapers have been substituted by online articles, as setting up **e-commerce** businesses require less costs and so consumers are charged with lower prices as a result. Another reason online news sources have gained popularity is because consumers have access to it from their mobile devices that they carry around daily, and so are much more convenient than newspapers.
- Decrease - the **coronavirus** pandemic has forced countries to close their borders to foreigners (regardless of whether they were travelling for business or pleasure) in order to slow the spread of the virus. This has arguably had the largest impact on the **aviation industry**, as consumers can't fly anywhere so the demand for plane tickets has dropped, hence the price of them has fallen to P2 following a shift left of the demand curve on the graph. This has forced airlines to put workers on **furlough schemes** or even make some redundant.
- Increase - as a result of national lockdowns in many countries to mitigate the impact of **covid-19**, e-commerce businesses have seen sales soaring as consumers are physically unable to buy from **brick-and-mortar** stores so must turn to the internet. For example, **Amazon** announced a 200% increase in profits to \$6.3 billion relative to the previous quarter in 2020.
- Increase - another beneficiary of the national lockdowns in 2020 was **Peloton**, an American firm that produces exercise equipment. In the UK, gyms were one of the several establishments in the **hospitality sector** that had to shut their doors to customers. With most people now stuck at home, alternatives had to be found in order to keep fit, and so consumers turned to Peloton. With online classes and workout sessions, demand for the



firm's services skyrocketed, and prices with it. This is represented by an outward shift to D3, triggering a price increase of P3 on the graph above. Peloton's **revenues** rose by 172% to \$607 million during this period, and with lockdowns to be extended indefinitely in 2021, their **profits** will only rise further.

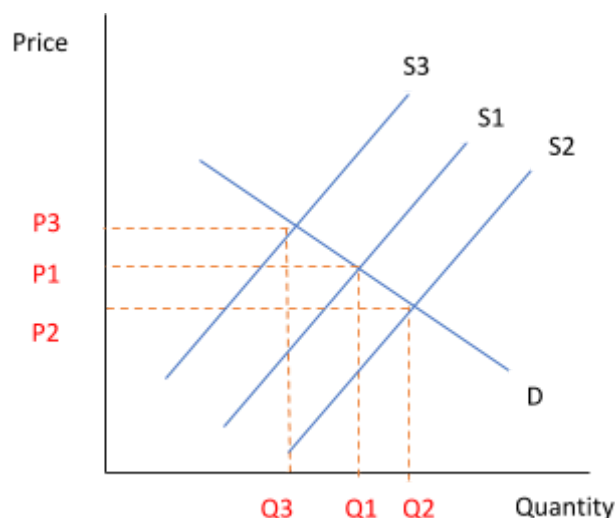
## Price Elasticity of Demand

- **Price elastic:** **furniture** stores and **motor vehicle** providers have many competitors and therefore many substitutes for consumers, therefore a rise in price will trigger a proportionally larger fall in demand, as there is an abundance of alternatives available so no **rational economic agent** would choose to pay more for the good/service.
- **Price inelastic:** the **electricity** and **water** industries are regarded as **natural monopolies** (see notes), and so very few substitutes are available. These goods/services are also necessities, and so when the price rises, there is a much smaller fall in demand.
- **Perfectly elastic:** although the idea of perfectly elastic goods can be seen as unrealistic, one of the closest examples of firms that provide these goods are **book stores**. These firms are set up as **e-commerce** and brick-and-mortar stores, and if one book store was to raise their prices, the demand for their goods would theoretically fall to zero, as consumers simply buy from alternative stores. However in reality this may not be the case, as that particular book store that raised their prices may be situated at a convenient location for some consumers, and so they would be willing to pay the extra price as opposed to commuting to a different store. This is why perfectly elastic goods do not exist in the minds of many economists.
- **Perfectly inelastic:** similar to the example above, a perfectly inelastic good is more of a theoretical concept, but there are a few examples that come close. For instance, **lifesaving drugs** would be bought by consumers regardless of the price (depending on the severity of their health conditions), which therefore yields a vertical demand curve. As shown, even if the firm in question decides to raise prices to P2 or reduce prices to P3, the quantity demanded for the drug remains at Q1.
- **Unitary price elastic:** this is when the quantity of a good/service changes in proportion to its price, and an example of this is **clothing**.



## Factors Shifting the Supply Curve

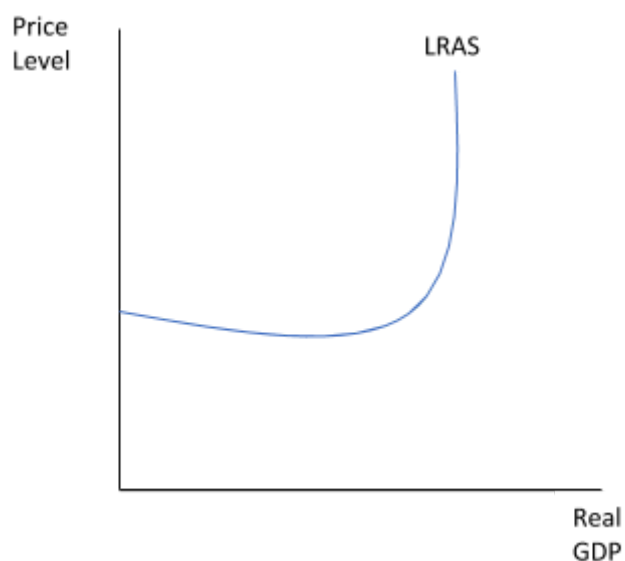
- Decrease - following the end of the transition period on December 31st 2020, the UK reached a **trade deal** with the EU, however it still means **tariffs** on both UK imports and exports. This may significantly impact the supermarket industry, as tariffs would reduce the supply of fruits and veg, for example, which boosts their prices to P3. This is because tariffs increase the cost of production for firms, which they then pass onto consumers.



- Decrease - the supply of housing can suffer as a result of **natural disasters** (floods, tsunamis, etc), as these demolish houses or deem them inhabitable. With the supply falling, the price of houses in the area rises according to traditional economic theory.
- Increase - **innovation** is one of the major causes of a supply curve shift. For example, in the early 2000's firms started getting the most out of the '**digital revolution**' which increased the efficiency of their supply chains and lowered the cost of production, so therefore lowers prices to P2 according to traditional economic theory.

## Price Elasticity of Supply

- **(Perfectly) elastic**: if a firm has plenty of **spare capacity**, then the goods they supply will be PES elastic, as the firm can afford to offer more of the good/service if its price rises without operating too close to their **production possibility frontier (PPF)** (see notes). This can also be illustrated on the **Keynesian LRAS curve**. Although this falls under macroeconomics, initially the LRAS curve is horizontal, as the economy has a lot of spare capacity and can therefore allocate resources elsewhere. However, as the economy moves towards its PPF, the amount of spare capacity decreases, and firms find it



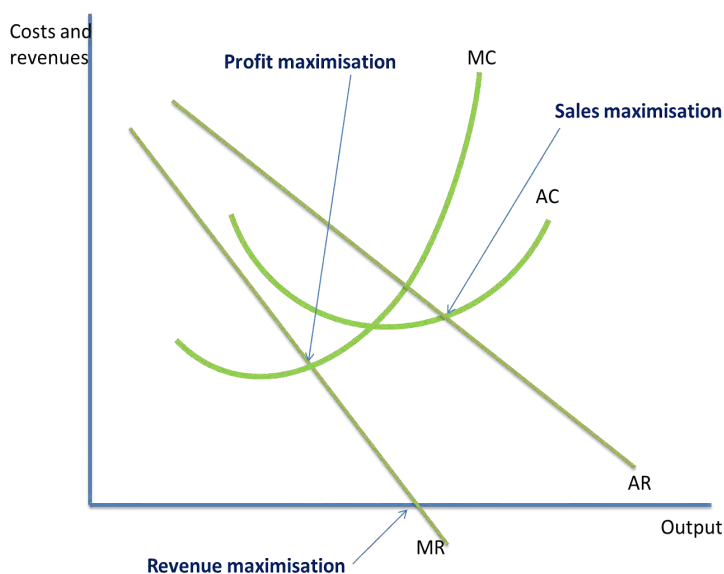
harder to find resources that aren't currently being exhausted, and so the LRAS curve becomes inelastic.

- **(Perfectly) inelastic: housing in prime locations** (i.e. major cities) can be considered perfectly inelastic goods. For example, in London the government has implemented a **Green Belt** policy which prevents houses being built in certain areas in order to maintain the local environment. This effectively keeps the supply of housing in these areas fixed as it would be against the law to build any new houses, and so the quantity supplied remains constant regardless of the price offered for the houses.

## 2. Market Structures

### The Objectives of Firms

- Following the covid-19 pandemic, several **biotechnology** firms set out to discover a vaccine, and several succeeded near to the end of 2020, however it was clear each firm had different intentions when distributing their vaccines. **Moderna** sold their vaccines for the highest price out of all the firms, and so their objective was arguably to **profit maximise**, as the coronavirus vaccine was a discovery of a lifetime as it had the potential to bring several nations out of lockdown and therefore boost the economy. On the other hand **Pfizer** distributed their vaccines to the public free of charge, which suggests they had purely had **ethical objectives** to curb the number of covid-related deaths.



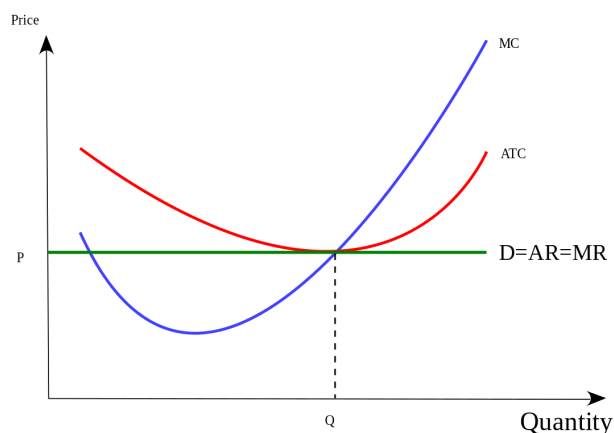
- **Lush**, a cosmetics company, has clear **ethical objectives** as they do not test any of their goods on animals which - at a time when the topic of animal cruelty is facing a lot more backlash - strengthens Lush's brand name. This would also increase Lush's **market share**, which the firm can then use to increase prices and profit maximise in the long run.
- In February 2020, British Gas raised the **minimum price** for their gas meter top-ups, with the intention to maximise profits. However this resulted in major backlash from customers, with reports of some households having to choose between "heating or eating". The firm eventually reversed their policy in order to maintain their **market share** in the energy industry.



- With the covid-19 pandemic and national lockdowns forcing firms to close their doors to consumers and place their employees on **furlough schemes**, the main objective for the majority of these firms is **survival**. This involves reducing costs, i.e. making workers redundant, cutting back on advertising, etc.

## Examples of Market Structures

- **Perfect Competition:** the simplest example of this type of market structure is the **agricultural industry**. For example, in India farming accounts for nearly 55% of all jobs with estimates at around 120 million people in the farming sector. This satisfies the requirement for 'many buyers and sellers'. We can also see there are 'low **barriers to entry**', as farming requires very few start-up costs with most farmers in India already in possession of land they have inherited.



Finally, goods produced by farmers are '**homogenous**' as the overall temperature and humidity levels are the same across India, meaning farmers grow the same types of crops and all harvest in the same seasons. According to traditional economic theory, perfectly competitive firms would set the price of their goods at point P, in order to **profit-maximise** where  $MC=MR$ , and achieve both productive and **allocative efficiency**.

- **Monopolistic Competition:** the **fashion industry** is arguably monopolistically competitive for several reasons. Firstly, due to technological advancements in recent decades the need for conventional **brick-and-mortar** stores has declined as it has become much easier to create clothing stores online for a fraction of the cost. This has allowed 'many sellers' to enter the market, and has significantly lowered 'barriers to entry' as the start-up costs for these firms are much lower, and there is some 'differentiation' amongst the goods offered by these firms. For example, companies such as **Boohoo plc** and **ASOS** are based entirely online and have already taken majority of the market share in the fashion industry as low costs means low consumer prices..

An alternative industry that is monopolistically competitive is the **airline industry**, and there have recently been an influx of 'budget airlines' making the market *more* competitive, e.g. **Ryanair**, **EasyJet** and **Jet2**. These budget airlines are able to offer low prices as they lease their planes as opposed to buying them, which significantly reduces their operating costs.

- **Oligopoly:** the **supermarket industry** in the UK operates as an oligopoly with the Big 4 (Tesco, Morrisons, Asda and Sainsbury's) owning more than 70% of the market share. There are several high barriers to entry that prevent new entrants from seizing any market share. For example, Tesco has been accused of '**land banking**' - when firms buy a plot of land (without any intentions to build on it) so that their competitors have no space to build



stores. The Big 4 supermarkets also boost their market share by contributing to their **corporate social responsibility (CSR)**. For instance, in January 2021 Morrisons became the first supermarket in the UK to pay all staff a minimum of £10 per hour. Tesco have also built several leisure centres in the areas where their stores are based, as this creates several jobs and boosts the local economy.

- **Duopoly:** Boeing and Airbus, two **aerospace companies** are together regarded as a duopoly as they hold more than 90% of the market share. The two firms are constantly in fierce competition with each other, not only due to **profit-motives** but also because of the **geopolitical** factors at play, as Airbus is European-owned and Boeing is American-owned.
- **Monopoly:** Although there are several examples of monopolies, the one that might be the most obvious is **Google**. Formed in 1998, it has over the years seized control of 70% of the market share for search engine use. Other firms that can be classed as monopolies are **Apple** and **Amazon**. Aside from the market share aspects, we can see just how much **monopoly power** these 2 companies really have following the events in January 2021, when the US Capitol building was stormed by Republicans and advocates of **Trumpism** (as an attempt to stop Joe Biden from becoming president) where 5 people lost their lives. **Parler**, a social networking service, was accused of triggering these events as the app is used by several Trump supporters. Therefore, in response to the event Apple and Amazon banned Parler from their **app stores**, to which these two monopolies have then faced major backlash from President Trump and Parler CEO as “preventing free speech”. Aside from the events in the US, we can clearly see the extent to how much monopoly power these two giants have because by banning Parler from *their* app stores, Trump supporters had no other platform to turn to as Apple and Amazon take up so much of the market share there are no other alternatives.

## Barriers to Entry

- **Government legislation** is arguably the highest barrier to entry, as no one can break the law. For example the **Financial Services Authority (FSA)**, a former regulator of the British financial services industry, used to have to approve firms if they wanted to set up **stock exchanges** or other services. This was a long-winded and costly process and therefore acted as a deterrent to new entrants, which therefore maintained the monopoly power of the **incumbents**.
- As previously mentioned, **Amazon** and **Apple** have monopoly power that they arguably exploit because they operate a market as well as compete in the market. Put simply, Apple has an “app store” that provides a platform for third-party developers to sell their apps. However Apple also creates its own applications, e.g. iMovie, Keynote, GarageBand, etc. Apple has therefore been accused of displaying its own apps at the top of customer search results in order to promote these more over their third-party competitors. Amazon also does the same with its own-branded products. In order to sell goods off Amazon, the company





charges third-party sellers a commission (which is how it makes its profits), and then deals with the storage, packaging and shipment of the product itself. However now that Amazon has risen to become one of the largest firms in the world, it has begun to make its own goods, e.g. Amazon Basics, Amazon Elements and Amazon Fresh. These own-branded products are offered at a lower price to consumers as there are no commissions charged on them, and so third-party sellers are finding it increasingly difficult to compete with the firm.

- **Intellectual Property Rights (IPRs)** can also be regarded as a barrier to entry, and are essentially copyrights that protect creators from other people/firms who try to steal their ideas or designs. **Pharmaceutical** companies are known for using these to maintain their monopoly powers, however in recent years increased government regulation has prevented this from further occurring. For example the United States-Mexico-Canada Agreement (**USMCA**) has made it harder for pharmaceutical firms to impose **patents** on their goods in order to promote competition.
- As the issue of **climate change** has started to become more apparent in the 21st century following increased flooding and temperature changes, households are starting to care more about their environmental impacts and carbon footprints. For example, in the **automotive industry**, cars powered by the internal combustion engine are on the fall and electric cars are on the rise due the environmental benefits associated with the latter. **Tesla**, a producer of electric cars, has risen to become a multi-billion dollar firm and has now been included in the **S&P 500** index, as more countries tackle climate change and promote sustainability. Following this, **Ford** - a producer of petrol cars - witnessed a huge plummet in sales in 2019. In addition, Norway recently became the first country in the world to have more electric-powered cars than cars that run on petrol, with many other countries not far behind. Not only is this **creative destruction** (as Ford and other companies are falling victim to technological advancements), but this also creates barriers to entry for new firms wanting to join the market, because electric cars come with much higher startup costs and require much more **regulation** than cars that run on petrol.

## Contestability

- **Technological advancements** in the gaming industry have lowered barriers to entry and allowed new entrants into the market that has been dominated by Microsoft's **Xbox** and Sony's **Playstation**. One of these new entrants is **Stadia**, a subsidiary of Google, and allows players to download games from their mobile devices with no upfront hardware costs unlike its competitors. Through these **technical economies of scale**, Stadia has minimised its costs and has therefore been able to advertise heavily to increase in market share. However, in order to maintain their monopoly power, Xbox and Playstation have been accused of enforcing **strategic** barriers to entry (i.e. **predatory pricing**), which has significantly stunted Stadia's growth. Other firms that have entered the online gaming industry are Apple, Nintendo's Switch and EA.



### 3. The Labour Market

- In August 2020, the **UK** unemployment rate rose to **4.9%**, following huge drops in consumer demand and investment.
- Prior to the covid-19 pandemic, the US was experiencing its longest ever economic expansion on record, but then entered a deep recession with unemployment rates last seen during the **Great Depression** at **14.7%** once the virus spread rapidly across states. Most of the impact has been seen in the **gig economy**, i.e. across workers with temporary jobs and who work on an ad-hoc basis, e.g. freelancers.

#### Trade Unions and Discrimination

- Due to cultural differences, men and women used to get paid significantly different amounts for performing the same job. However, the **Equal Pay Act** was introduced in 1970 in the UK, which prohibited **discrimination** regarding the salaries of men and women.
- **Milton Friedman**, a prominent economist, and **Margaret Thatcher**, the British prime minister from 1979 to 1990, both frowned upon the idea of trade unions. This is because they can, through **collective bargaining power**, push to increase their wages, which raises a firm's **cost of production** (as they must pay more for labour). This can lead to **real-wage unemployment**, as firms are forced to lay off workers they cannot afford, as well as **cost-push inflation**, as firms incur higher costs with higher wages that they then pass onto consumers in the form of higher prices. For example, in 1979 the UK experienced an inflation rate of 27%, and several economists argued that trade unions were one of the main triggers of this.
- In addition, if workers are unhappy with work conditions or have any other issues that are not resolved through discussions with managers, they are more likely to go on **strike** - whereby they seize working until their demands are met. If this occurs across several industries, the lost economic activity during the strikes can translate to a severe slump in the overall GDP of an economy. As well as strikes, employees can also **work to rule**, whereby they only do the bare minimum that is required by them, and decide not to work any extra hours with no pay which is what they may have done if their salaries were raised.
- **Friedman** also argued that by pushing for higher wage rates, workers exposed themselves to a lot more **discrimination**. He argued that employers would discriminate against those who they believed didn't have the skills and qualifications to match the higher wage rate and therefore justify their **Marginal Revenue Product**. So for example black and brown youth unemployment was arguably triggered by the bargaining power of trade unions. This



is why **Thatcher** passed several acts and laws which gradually diminished the power and influence trade unions had over employers.

## Monopsony Power

- **Product Market:** the **National Health Service (NHS)** has significant monopsony power over pharmaceutical goods, which it uses to lower the cost of purchasing drugs - and can therefore offer patients the same drugs at much lower prices. This also explains why the prices of pharmaceutical drugs are much higher in the US than in the UK, as American hospitals are private and own smaller portions of the market share - so have less **bargaining power** over their suppliers.
- **Product Market:** the **Big 4** supermarket chains occupy more than 70% of the market share, and are the sole supplier of food from farmers. This means they can negotiate much lower prices for goods (milk, eggs, etc.), however this has sparked a number of protests by farmers, complaining that they have been exploited by these supermarkets.
- **Labour Market:** the **NHS** is the largest employer of doctors and nurses in the UK. **Walmart** is the third largest employer in the world, with approximately 2.3 million employees. According to traditional economic theory, these two firms have the power to reduce **wages** without losing too many workers, as there are few or no alternative employers to turn to. However in reality, most firms that can afford to pay workers high wages will remain doing so in order to maintain their reputation and brand strength, even though the higher wages translate to higher **costs of production**. For example, in November 2020 **Pretty Little Thing** - a fashion company - slashed prices by up to 99% in preparation for **Black Friday**. So for example, items that were £10 were reduced to as little as 10p. But this sparked major concerns as to how the company could afford to reduce their prices so much whilst still making a profit, especially considering the global pandemic that hurt nearly every single business in the UK in some form. However it was then clear that PLT were only able to offer 10p clothing items because they paid their workers in **'sweatshops'** so little. The company witnessed a 40% drop in sales following this promotion, as their reputation was tarnished and they lost several loyal customers. So regardless of the costs they were able to save by paying their workers so little, it was clear PLT had no **ethical objectives** (see notes), and so lost customers as a result.

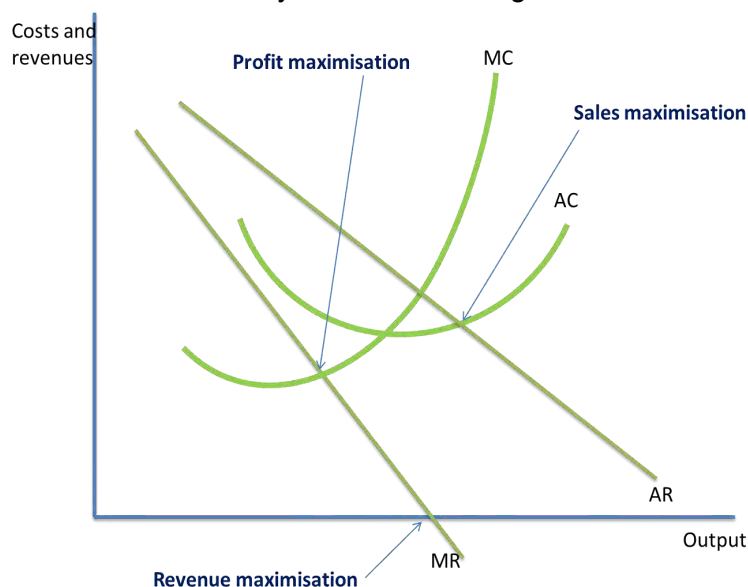


## 4. The Distribution of Income and Wealth

- The **covid-19** pandemic is said to have ‘wiped out’ decades worth of poverty alleviation, as tourism came to a halt for most of 2020, and nearly all countries temporarily shut their borders to outsiders to prevent the spread of the virus. In addition, students have been forced to learn from home and take exams from their laptops, which has proved ineffective. This means students are equipped with less skills and fewer qualifications, thus stunting their ability to earn high-paying jobs, which further widens the gap between high and low-income families.
- The coronavirus has also exacerbated the **North-South divide** in the UK, as most people in London work in the services sector, and so can manage to work from home with a laptop and internet connection. In contrast, many households in the North of England have jobs in the manufacturing industry, so find it much harder to be able to work from home and have therefore been made redundant as a result - this is referred to as **structural unemployment**. The UK currently has the most regionally unbalanced economy in Europe.

## 5. Market Failure and Government Intervention

- In the European Union, firms are regulated by the **European Competition Commission**. In the UK, we have the **Competition and Markets Authority (CMA)**, which oversees the regulatory bodies for specific industries. For example, **OFGEM** regulates the electricity industry, **OFCOM** regulates the telecommunications industry and **OFSTED** regulates the education industry.
- For example, **British Telecommunications (BT)** used to own the majority of the fibre-optic cable network, which allowed the firm to exploit its **monopoly power** by charging households and firms high prices to use the service (i.e. at the point where marginal revenue equals marginal cost on the graph). As a result, **OFGEM** announced in 2015 that it would be forcing BT to open up the cable network to competitors (i.e. TalkTalk, Sky, Virgin Media, etc.) in order to promote competition. Despite BT’s several attempts to argue against the policy, it came into effect in April 2017, and households saw prices for



fibre-optics fall dramatically, as BT no longer enjoyed its monopoly power and was forced to compete with other firms to obtain the most market share.

- In 2018, the **CMA** blocked the merger of **Sainsburys** and **Asda**, believing it wouldn't act in the public's best interest due to the monopoly power the two firms could gain from it.

## Regulation

- The UK government announced a new regulatory body within the Competition and Markets Authority, called the **Digital Markets Unit (DMU)**. This unit will regulate firms that have a "strategic market status" and are funded by digital advertising, so namely Facebook and Google. This particular approach is called "**ex ante**" regulation, as opposed to the conventional "**ex post**" regulation. Ex post is when the government intervene in the market following the evidence of market power abuse, e.g. if Google exploits consumer data the government will then set rules banning them from collecting data. Ex ante regulation refers to government intervention prior to any market power abuse, so the government will essentially tell firms how to behave rather than punishing them after they have misbehaved. The DMU will arguably strengthen ties with the EU, who share the same view on tech regulation as the UK. However, the UK must make sure not to impose too much regulation on these firms, else it will deter them from investing in the country.
- As previously mentioned, following the attacks on the US Capitol building in January 2021, tech firms including **Apple** and **Facebook** have banned **Parler** (a social media app) from their app stores as Parler is used by several right-wing extremists and was therefore blamed for providing a platform for the event to be planned. As well as this, **Twitter** and **Youtube** also banned Donald Trump's accounts on their platforms, as the president violated their guidelines. This has opened up these tech firms to more regulatory and political scrutiny, as several world leaders have expressed their concerns regarding how much power these firms have over free speech.
- However, there are growing concerns that bodies such as the CMA and ECC are falling victim to **regulatory capture** - a theory arguing that regulatory agencies can become dominated by regulatees which leads to them acting in the best interest of the industry rather than the general public. For example, in 2016 there was a public outcry when energy companies stopped showing consumers how much profit they make off each household. Even though this action meant that firms could increase prices to exploit their **monopoly power** and households wouldn't necessarily be aware, OFGEM sided with the energy companies without sufficient justification.



## Deregulation

- By reducing **government intervention** and allowing the **free market** to operate efficiently, several other industries have also seen an increase in contestability. For example, following the **Airline Deregulation Act** in the 1970's, several firms were able to join the market which then triggered the rise of 'low cost'/'budget' airlines. This forced **incumbents** to lower ticket prices to attract customers, which improved **economic welfare** as the lower prices achieved both productive and allocative efficiency.
- Another example of when reduced government regulation resulted in more contestable markets was in the **postal service** industry. Prior to the **Royal Mail** being privatised, this was the only company allowed to send mail and packages in the UK. But now that new entrants have been allowed into the market (i.e. **Hermés**, **Whistl**, etc.), firms have found innovative ways to lower costs and therefore lower consumer prices - which once again improves economic welfare.

## Privatisation

- Prior to the privatisation of the **water industry**, water quality in the UK was very poor, however once these firms were privatised there was an initial investment of £160 billion to improve water quality and reduce pollution - a **positive externality**.
- Privatisation does not necessarily result in productivity improvements, as perfectly illustrated by the **probation industry**. Firms operating in this industry were handed over to private ownership in 2014, with the hopes of improving efficiency. However since then, these firms have been **bailed out** by the government several times, until the government announced plans to **re-nationalise** these firms by 2021. Therefore, we can argue that firms in certain industries operate more efficiently in the hands of the government.

## Government Failure

- In order to tackle the issue of **climate change**, the European Union introduced an **Emissions Trading Scheme** which adopted a 'cap and trade' approach, whereby firms were allocated a limited number of pollution permits that they could use (i.e. pollute) or sell to other firms if they had a surplus of permits. This essentially created a **market** for pollution permits, so if the demand for them was high prices would increase and vice versa. The main aspect of the ETS was that pollution permits were fixed, and so the amount of pollution emitted from firms as a whole was also fixed. Initially, the scheme was a success as the drop in emissions exceeded initial forecasts. However, following the 2008 **Global**



**Financial Crisis** (GFC), there was a huge fall in economic activity and firms no longer needed any more pollution permits than they were given from the EU, so the price for these permits fell dramatically. The whole purpose of the ETS was to reduce carbon emissions, and low prices indicated there was an oversupply of pollution permits so it was cheaper for firms to buy permits and continue polluting rather than finding alternative, 'cleaner' ways to produce goods. Prices remained low for several years following the GFC, until the EU introduced a *Market Stability Reversal* mechanism (MSR), whereby they reduced the supply of excess pollution permits firms had to force an increase in prices. Following the MSR mechanism, prices started to increase again, but the reason this can be classed as 'government failure' is because the EU failed to anticipate the price drop following the GFC, which undermined the whole purpose of the Emissions Trading Scheme in reducing the level of pollution in the environment.

- Another example of government failure can be seen in the US, when the **McCarran-Ferguson Act** was passed in 1945 - involving the regulation of **insurance firms**. Prior to this Act, all insurance firms were subject to the same regulation across the country, but policymakers thought that, by handing back regulation to individual states, it would increase efficiency across the insurance industry. The result was the exact opposite of what was anticipated, because industry firms that operated in several different states had to oblige by different rules, which was time-consuming and more costly to abide by. The **National Association of Insurance Commissioners (NAIC)** was then formed to essentially allow insurance regulators to gather and create rules that all states could follow, to reduce the burden for their regulatees.

