‘A’ level: Economics B

Paper 1 practice papers

Markets and how they work

By Gerald Wood

Contents

These three Paper 1 practice papers have the following key features:

1. They are laid out in the general format of the Paper 1 examination, and so help students to become familiar with the approach which they will face when they sit the Paper.

2. Accompanying each test is a mark scheme, based around Edexcel’s own mark schemes. These both assist the teacher in marking students’ work, and helps students understand what they need to do to improve their mark.

3. Also accompanying each test is a set of suggested answers. These are rather longer than most students would have time to produce in an examination setting, and also contain more analysis and detail than students would be expected to know. They inevitably contain some points of view personal to the author. They should therefore be seen as an example of how the questions might be tackled rather than as definitive responses.

4. Pagination has been organised so that Question 1 can easily be photocopied separately from Questions 2 and 3. This is also true of the mark schemes and suggested answers.

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November 2017

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Write your name here

Surname	Other names

Centre Number	Candidate Number

Economics B

Advanced

Paper 1: markets and how they work

Time: 2 hours

You do not need any other materials

ECONOMICS B, PAPER 1: FIRST PRACTICE PAPER

Instructions

Write in black

Fill in the boxes at the top of this page

Answer all questions in the spaces provided

Information

Total marks: 100

This gives you one minute per mark plus 20 minutes reading time

Use this to time your answers

Calculators are permitted

Advice

Read each question very carefully

Try to answer every question

Check over your answers if you have time at the end

Answer ALL questions

SECTION A

Read the following extracts (A to D) before answering Question 1.

Extract A

Everything we thought we knew about supermarkets has turned out to be wrong

It used to be the case that the more expensive the supermarket the better the food was. So Waitrose was for rich people, Sainsbury's came next, then Tesco – with Asda bringing up the rear. This view of supermarket shopping has been changed by the new German discount stores, Aldi and Lidl. In just five years Aldi has raised its supermarket share from 2.6% to 7%, while Lidl has increased its market share from 2.5% to 5.2%.

Their relentless focus on cost reduction and quality produce has proved a winning formula. "UK consumers used to think you had to pay more for better products", says Aldi's UK managing director Roman Heini. "We have shown that this doesn't have to be the case". Average costs have been reduced by choosing cheap locations away from high streets and by offering a reduced product range. Customers do their own packing, and paid for plastic bags long before the UK government made this compulsory. Expensive credit cards, which charge the retailer a percentage of sales, are not accepted.

Meanwhile a relatively small store size makes it quicker to shop, and there is less emphasis on 'big name' brands, whose prices reflect substantial marketing expenditure. Professor Evanschitzky of Aston Business School has said, "Supermarkets have to get used to this 'new normal' of low profit margins. The Big Four – Tesco, Morrison's, Asda and Sainsbury's – must accept their falling market share. The best option for them now is to shrink their business gracefully."

Extract B

Supermarket	**UK market share 2017**
Tesco	27.8
Sainsbury	15.8
Asda	15.3
Morrisons	10.4
Aldi	7
Co-Op	6.3
Lidl	5.2
Waitrose	5.1
Other	7.1

Extract C

Online grocery sales as a percentage of all grocery sales		
Country	**2015**	**2016**
South Korea	14.6%	19.7%
UK	6.7%	7.3%
China	4.0%	5.7%
France	5.1%	5.5%
Spain	1.3%	1.7%

Extract D

Amazon launches an online supermarket service in the UK

From June 2016, Amazon customers in parts of London have been able to order a weekly shop from Amazon and get it delivered the same day. Known as Amazon Fresh, it will be the last thing the Big Four grocers wanted to hear. Offering convenience, competitive pricing and one-stop shopping Amazon is rightly feared by its rivals. Amazon has built its success on going after market share with cheap prices, rather than maximising immediate profits.

Morrison's has felt unable to resist the Amazon giant and has struck a deal whereby, in return for a percentage of sales revenues, Morrison's groceries are available on their rival's website where they compete with Amazon's own offerings.

Not that Amazon is leaving existing bricks-and-mortar stores unchallenged. In the USA it has rolled out trial stores known as Amazon Go. Customers enter the store by swiping their smart phones, put food in their baskets and then walk straight out. Other than a security guard and a shelf-stacker no employees are required. Cameras record what they pick up and customer accounts are then automatically charged for their shopping. Combined with its acquisition of Whole Foods – the American upmarket equivalent of Waitrose - in early 2017, Amazon represents a potential long-term threat to UK grocery stores as well.

Sources: press reports, 2015-2017

1a Using Extract B, calculate to one decimal place the four-firm concentration ratio of the UK grocery market. **(4)**

1b Grocery sales in the UK were £186 billion in 2015. Using Extract C, calculate to two decimal places the value of UK online grocery sales in the same year. **(4)**

1c Using a market map, illustrate how Aldi and Lidl have positioned themselves in the UK grocery market. **(4)**

1d Analyse the impact of new technology, such as that trialled by Amazon Go (Extract D), on the supply curve of the grocery industry. **(6)**

1e Discuss the impact on grocery retailers of increases in unemployment. **(8)**

1f There are still 32,000 small independent grocery retailers but their numbers are falling fast. Assess **two** economies of scale which may be causing their decline. **(10)**

1g Assess the impact of the market structure of UK groceries on pricing strategies and consumers. **(12)**

1h Assess the strategy of 'going after market share' adopted by Amazon (Extract D). **(12)**

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Mark scheme for Economics B, Paper 1: First practice paper

Q	Using Extract B, calculate to one decimal place the four-firm concentration ratio of the UK grocery market.	Mark
1a	**Knowledge/understanding 1, Application 3** **Knowledge:** For formula: 4 firm concentration ratio = sum of 4 largest firms' market share (1) **Application:** up to 3 marks for calculations 27.8+15.8+15.3+10.4 (1) = 69.3% (2) 69.3% on its own scores 4; 69.3 on its own scores 3	**4**

Q	Grocery sales in the UK were £186 billion in 2015. Using Extract C, calculate to two decimal places the value of UK online grocery sales in the same year.	Mark
1b	**Knowledge/understanding 1, Application 3** **Knowledge:** For formula: Total grocery sales times percent of online sales = total online sales (1) **Application:** up to 3 marks for calculations £186 billion x 6.7% (1) £12.46 billion (2) £12.46 billion or £12.46bn on its own scores 4; 12.46 billion or 12.46bn on its own scores 3; 12.46 on its own scores zero	**4**

Q	Using a market map, illustrate how Aldi and Lidl have positioned themselves in the UK grocery market.	Mark
1c	**Knowledge/understanding 2, Application 1, Analysis 1** **Knowledge/understanding:** For each credible axis (1+1) e.g. high price/low price; small stores/large stores; expensive location/cheap location; high level of service/self-service; large product range/small product range; national brand focus/own brand focus **Application:** Aldi & Lidl in correct quadrant e.g. low price/small stores/cheap location/self-service/small product range/own brand focus (1) **Analysis:** For at least one other store placed in its correct quadrant (1)	**4**

Demonstrating application:

1. Where the question specifically stipulates use of an Extract, students
   a) must directly reference or analyse information in the relevant Extract
   b) may, in addition, use their own knowledge provided it is directly relevant to the context of the question.
2. Where the question does not specifically stipulate use of an Extract, students
   a. must use their own knowledge which is relevant to the context
   b. may, in addition, reference an Extract provided it is directly relevant to the context of the question.

Q	Analyse the impact of new technology, such as that trialled by Amazon Go (Extract D), on the supply curve of the grocery industry.	Mark
1d	**Knowledge/understanding 2, Application 2, Analysis 2** **Knowledge/understanding:** Supply curve: quantity supplied at each and every price (or a supply curve drawn with both axes labelled) (2) **Application:** By saving the costs of employing staff, new technology will increase supply (or diagram showing supply curve shifting down and out). (2) Alternatively, may reward less credible argument that new technology costs more than it saves, shifting the supply curve inwards/upwards. (2) **Analysis:** Any extension e.g. costs will only fall when technology is rolled out across a significant proportion of stores e.g. impact may be limited by growth of online shopping. (2) May also reference falling equilibrium price and increased equilibrium quantity, although the question does not require this. (1) Note: the question does not require a diagram so full marks may be obtained without one. A fully-labelled diagram showing an outward shift in the supply curve may score up to 3, with the remaining 3 marks for written explanation.	**6**

Q	Discuss the impact on grocery retailers of increases in unemployment.	Mark
1e	**Knowledge/understanding 2, Application 2, Analysis 2, Evaluation 2** • Possibility of falling wages reducing costs. • Reduced costs lead to lower prices and increased sales. • Possibly a reduced industry turnover as the unemployed spend less. • Inward shift in demand curve will reduce prices, sales levels and profits. • Possible gain in market share for discounters like Aldi/Lidl. • Demand will only be marginally reduced due to necessity of buying groceries (low YED). • Fall in demand will affect mid-range grocers more; discount grocers may actually gain sales (if inferior good). • Outcome dependent on extent of increase in unemployment and its duration.	**8**

Level	**Mark**	**Description for 1e**
	0	Completely inaccurate
L1	1-2	Elements of knowledge, little or no relevant evidence, limited attempt to address the question.
L2	3-5	Elements of knowledge, limited relevant evidence, developed chains of reasoning, judgements may be attempted.
L3	6-8	Accurate knowledge, well-chosen relevant evidence, developed arguments with balanced awareness of competing arguments.

Q	There are still 32,000 small independent grocery retailers but their numbers are falling fast. Assess **two** economies of scale which may be causing their decline.	Mark
1f	**Knowledge/understanding 2, Application 2, Analysis 3, Evaluation 3** • Purchasing economies – but many small grocers band together to buy e.g. Nisa, Londis. • Marketing economies – but small grocers rely more on word-of-mouth and repeat custom. • Financial economies – but are less relevant to long-established no-growth businesses which are unlikely to have major financing needs. • Managerial economies – but many small business owners have decades of experience. • Technical economies e.g. average costs of transporting supplies by van rather than by lorry. • Risk-bearing economies – but increased customer loyalty may give some protection e.g. against a recession. • Increased specialisation – but customers often prefer dealing with one known person on successive shopping trips.	**10**

Level	**Mark**	**Description for 1f**
	0	Completely inaccurate.
L1	1-2	Isolated elements of knowledge, little or no relevant evidence, limited attempt to address the question.
L2	3-4	Elements of knowledge, limited relevant evidence, limited chains of reasoning, judgements may be attempted.
L3	5-7	Accurate knowledge, well-chosen relevant evidence, developed arguments with awareness of competing arguments though this may lack balance.
L4	8-10	Accurate knowledge, substantial well-chosen relevant evidence, developed arguments showing a full understanding of the question. Arguments are fully evaluated and demonstrate balance.

Q	Assess the impact of the market structure of UK groceries on pricing strategies and consumers.	Mark
1g	**Knowledge/understanding 2, Application 2, Analysis 4, Evaluation 4** • Oligopoly or imperfect competition? Possibility that 'big four' could wield some market power with 69.3% of market. • But little sign of cartel-like behaviour. Entry of Aldi/Lidl (and Amazon, and other online) suggests a competitive market. Contestable with relatively low entry barriers. • Market structure possibly moving in a more competitive direction. • Competition leads to innovation e.g. home delivery (Amazon Fresh as well as major supermarkets), no queues (Amazon Go), discounters (Aldi, Lidl). • Competition leads to low prices ('new normal' of low profit margins). Hence greater consumer surplus and higher standard of living. • Competition leads to differentiation: wide range of price points, levels of service, 'bricks or clicks' channels of distribution.	**12**

Level	Mark	Description for 1g and 1h
	0	Completely inaccurate.
L1	1-2	Isolated elements of knowledge, little or no relevant evidence, limited attempt to address the question.
L2	3-5	Elements of knowledge, limited relevant evidence, limited chains of reasoning, judgements may be attempted.
L3	6-9	Accurate knowledge, well-chosen relevant evidence, developed arguments with awareness of competing arguments though this may lack balance.
L4	10-12	Accurate knowledge, well-chosen relevant evidence, developed arguments showing a full understanding of the question. Arguments are fully evaluated and demonstrate balance.

Q	Assess the strategy of 'going after market share' adopted by Amazon (Extract D).	Mark
1h	**Knowledge/understanding 2, Application 2, Analysis 4, Evaluation 4** • Context shows Amazon building market share through a deliberate low price strategy, leading to lower-than-normal 'immediate' profits. • Similar to many internet businesses – where the aim is to grow a community first and monetise it later. • Key point: is this actually different from profit-maximisation – or is Amazon's view that the way to maximise long-term profits is to sacrifice them in the short term? • Difficulty of financing early growth if little internal finance available from retained profits. But like most internet start-ups Amazon relied on equity finance from venture capitalists. • Is the strategy sustainable? Or at some point will shareholders want a higher return on their investment? • Possibility of cross-selling: by building a wide customer base Amazon can then sell more profitable items. • Just because it has worked for Amazon does not follow it will work for every business e.g. in niche markets high mark-ups are necessary as high volumes will never be possible. And venture capital is less likely to be available. • Targeting 'market share' works best in new industries and new business models where early success may translate into long-term market leadership – e.g. Uber, Amazon, Facebook. Elsewhere the potential rewards of this approach are smaller.	**12**

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Suggested answers for Economics B, Paper 1: First practice paper

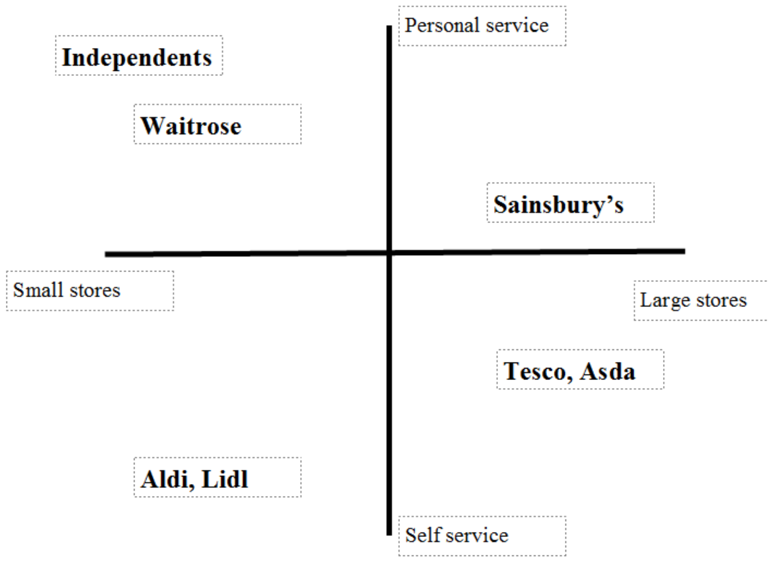
1a *Using Extract B, calculate to one decimal place the four-firm concentration ratio of the UK grocery market.* **(4)**

The four-firm concentration ratio is the sum of the market shares of the four biggest firms in an industry. In this case they are Tesco (27.8%), Sainsbury (15.8%), Asda (15.3%) and Morrison's (10.4%). These sum to give a 4-firm concentration ratio of 69.3%.

1b *Grocery sales in the UK were £186 billion in 2015. Using Extract C, calculate to two decimal places the value of UK online grocery sales in the same year.* **(4)**

From Extract C we know that online sales took a 6.7% share of the UK grocery market in 2015. So the total value of these online sales equals the total UK grocery market in 2015 times 6.7%. This gives a sales revenue of £186 billion times 6.7% = £12.46 billion.

1c *Using a market map, illustrate how Aldi and Lidl have positioned themselves in the UK grocery market.* **(4)**



1d *Analyse the impact of new technology, such as that trialled by Amazon Go (Extract D), on the supply curve of the grocery industry.* **(6)**

New technology usually reduces costs. This will certainly be the case with Amazon Go whose queue-less stores will be able to operate with many fewer staff. As the concept is rolled out across more and more stores so the fixed costs of developing the idea will be spread out over multiple units leading to ever-lower average and marginal costs.
Now supply curves reflect the marginal costs of production. The grocery industry supply curve will therefore shift downwards and to the right, leading to lower prices and increased quantities across the industry. This will not happen overnight: it may well be a few years before shoppers notice lower prices. Indeed lower prices may be concealed behind a rise in the cost of wholesale food globally driven by expanding, wealthy populations in Asia. Nevertheless, the supply curve itself will have shifted to the right, other things equal.

1e *Discuss the impact on grocery retailers of increases in unemployment.* **(8)**

The unemployment rate measures the proportion of the labour force which is looking for a job. Rising unemployment indicates a surplus of labour, and – like any surplus – it will tend to force down prices. In this case real wages will be reduced leading to higher sales and potentially increased profits. However, the impact of falling wages will be minimised as automation though the spread of self-service checkouts reduces the proportion of retailing costs which is accounted for by wages.
However, increases in unemployment will also have an impact on the demand-side of grocery retailing as workers becoming unemployed experience lower incomes. That said, groceries are a necessity so are likely to have a low income elasticity of demand (YED) resulting in a relatively small reduction in demand compared to most industries. Indeed, the new discounters Aldi and Lidl experienced rapid growth as unemployment rose following the 2008-09 recession as they took market share from the more expensive market leaders. In other words, they may have been inferior goods. At the other end of the market, Waitrose may also escape, particularly if the unemployment is technology-driven. In this case, most of the newly-unemployed will be relatively low-skilled and therefore unlikely to have been shopping at Waitrose in the first place.

1f *There are still 32,000 small independent grocery retailers but their numbers are falling fast. Assess* ***two*** *economies of scale which may be causing their decline.* **(10)**

Economies of scale are factors which reduce average costs as an enterprise grows in size. In the case of retailing, purchasing economies of scale are substantial. The bigger the order you wish to place the greater your market power and the lower the price you can negotiate. So Tesco, for example, can negotiate directly with farmers to take (for example) all their supply of broccoli, while the small independent would have to go to a wholesale market where prices for relatively small quantities sold to restaurants and local shops would be higher. However, small grocery retailers have been fighting back on this front for some years now by forming consortia to buy in bulk on behalf of many members. So shops badged as 'Spar' or 'Nisa' or 'Londis' are all independently-owned but have joined an umbrella group which provides its many members with both branding and bulk-purchased groceries.
Another significant economy of scale is labour specialisation. This is evident in the growing areas of online sales and home delivery. A small grocery retailer would never get enough customers for it to be worthwhile to employ a full-time driver with a van to deliver online orders. By contrast, the major supermarkets all have teams dedicated to improving their websites and to delivering their groceries within ever-tighter time frames. It is this second economy of scale which is likely to be most significant in accelerating the decline of the local convenience store. As the ability of large companies to promise delivery within the hour grows the key strategic advantage of the local store – convenience – is in danger of withering away.

1g *Assess the impact of the market structure of UK groceries on pricing strategies and consumers.* **(12)**

In 2008 the Competition Commission (now the Competition and Markets Authority) concluded its third market investigation into supermarkets in response to fears that the Big Four – and market leader Tesco in particular – had too much market power and were, in effect, an oligopoly. In their defence they said that competition was fierce both on price and non-price competition. Having a relatively high 4-firm concentration ratio, they said, was entirely compatible with fierce competition, and that the market was open to new entrants. In other words, it was contestable.
Developments over the next ten years have proved the supermarkets right. Aggressive new competitors from Germany, Aldi and Lidl, have seized market share from the Big Four and they now enjoy the fifth and seventh largest share (see Extract B). Then Extract D shows that Amazon is entering the market too. We may therefore

conclude that grocery retailing in the UK is currently fiercely competitive. It is indeed a clear example of imperfect competition due to the scope for differentiation within the market.

The impact on pricing strategies has been to compel most firms most of the time to follow a low price strategy. This is always the effect of competition. If rivals offer broadly similar products, and potential customers are aware of this, then each firm's demand curve becomes very elastic. Small decreases in price pay dividends as customers are attracted from rivals. Equally, any increases in price are likely to be penalised as customers desert the store for a lower-price alternative. Hence Extract A tells us that supermarkets have to "get used to this 'new normal' of low profit margins". Nevertheless, grocery retailers may find niches where high prices and profit margins may be maintained. So Waitrose has successfully differentiated itself as an upmarket brand with prices to match. And petrol stations enjoy very high margins in their attached grocery stores where customers make impulse purchases in a context where there is no immediate competition.

The impact on consumers is almost wholly positive. Lower prices translate into higher real incomes and an increased consumer surplus. Given that food is, as a whole, a necessity with inelastic demand it follows that lower prices are particularly important. Everyone has to eat. In particular, the market penetration of Aldi and Lidl has reduced prices in the less-well-off areas where they tend to locate – and where savings on grocery shopping are most important in alleviating poverty. That said, consumers still need to keep their wits about them. The benefits to well-informed consumers who plan ahead will always be greater than those who rely on impulse purchases at motorway service stations and the like to get fed. In these contexts, localised monopolies fully exploit their position to charge two or three times more than normal.

1h *Assess the strategy of 'going after market share' adopted by Amazon (Extract D).* **(12)**

Extract D says that Amazon has launched 'Amazon Fresh', offering same-day delivery on food in parts of London. Should this market research give Amazon the results it wants then there will be nothing to stop it rolling out the model across the towns and cities of the UK. But what are 'the results it wants'? Extract D says Amazon is 'going after market share' rather than 'immediate profits'. So as far as Amazon is concerned the only thing that matters is that Amazon Fresh is popular. Profits can come later.

Since Jeff Bezos, the founder of Amazon, is now the richest man in the world this strategy deserves serious consideration. For one thing, it makes cross-selling very easy. Once you buy anything from Amazon they have your email address and will constantly offer you new services. Ask for books and before long they will offer you films. Ask for food and before long they will offer you kitchen equipment. Of course the lowest price compatible with breaking even makes zero profits, so the question then arises as to how Amazon finances its expansion. The answer is that the long-term business model is so compelling that there has never been any shortage of venture capitalists willing to fund them. And as the behemoth grows ever larger eventually opportunities for profits will arise, even from areas not necessarily thought of by its management. For example, its recently increased profits have come mainly from selling spare cloud storage space on its vast computer servers.

Nevertheless, just because the strategy of targeting market share has worked for Amazon it does not follow it will work for every business. Most businesses operate in much more tightly-defined markets where the potential for expansion is significantly less. In such markets, low prices and wafer-thin profit margins may make sense during an initial phase of penetration pricing – providing finance is available externally or internally to cover start-up costs and possible early losses. But much beyond that, the business needs to move into profit. The exception is purely web-based businesses where marginal costs are often close to zero. Here, prices can be set at zero and market share is everything. Revenues and profits can eventually be made by selling advertising or by offering paid-for additional services on top of the basic, free offering – the so-called 'freemium' model.

*************** EXTRACT FROM PRACTICE PAPER 3 *************

2. *Evaluate the likely benefits of market research to a new start-up like Coffee Republic.* **(20)**

Market research is the process of finding out about an industry, its customers, potential customers, suppliers and competitors. If a new start-up is founded by people who know virtually nothing about that market it is obvious that market research will be absolutely essential. In Extract C we read that neither Sahar nor Bobby "knew anything about coffee or retailing". So even the basics like making a good cup of coffee or renting a shop space would be things they would have to find out about – to research. Of course, if one of them was already an experienced professional in the industry – a common route into a new start-up – then very little market research might be needed as they would already have most of the requisite knowledge as well as a feel for what they were doing.

Research into competitors will tell you if there is the all-important 'gap in the market'. For if your proposed good or service is no better than what is already available then you will find it difficult to penetrate the market. In this case, market research was very encouraging in that it both established that there was an enormous demand for a coffee experience but also that the available experience at the moment was very much less good than it could be. Of course, competitors will not want to give you information. They cannot stop you visiting their premises while posing as a customer, but they will almost certainly keep quiet about their future plans. In this case, their business never achieved its early promise because the American-based Starbucks joined the party "a couple of years later". Market research will never tell you everything you would like to know.

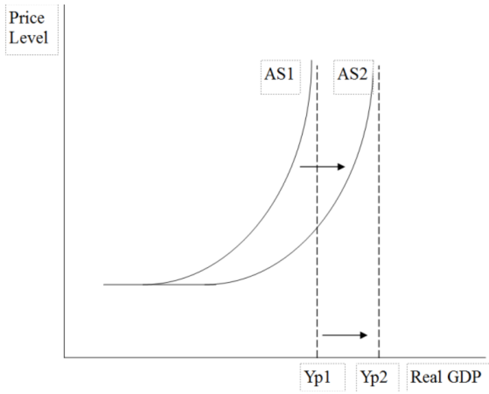
Research into suppliers is also essential. Particularly when – as in this case – the customer proposition is based on the superior quality of the experience your suppliers will have to be very good. Both the coffee and the coffee-making equipment will need to be the very best. However, all market research takes precious time, time when rivals and potential rivals will also be moving. The value of market research has to be weighed up against the need to get moving. Entrepreneurs have to avoid 'analysis paralysis'; rather they need to have a 'bias for action'.

Finally, market research is useful in that it might tell you whether customers will actually buy the product. Every business stands or falls on its sales levels, and just because an idea seems good to you does not mean it will seem equally good to your potential customers. However, the quotations from both Henry Ford and Yves St Laurent make clear that customers will not be able to tell you what they think of a good or service that they have not yet experienced. Any entrepreneur will reach a point of decision when they have to decide whether to launch, and they cannot expect to have perfect information at that point – or indeed at any other.

In conclusion, market research is absolutely vital for a new start-up, particularly when the entrepreneurs have no previous industry experience. However, market research by itself is not enough. Also required is sufficient finance to scale up your idea before someone else does. We are told that the 'financial firepower' of Starbucks explains why Coffee Republic declined. Starbucks had the money to roll out their format nation-wide before Coffee Republic could do the same. Market research is just one essential requirement for a new start-up. So is finance, and so, for that matter, is operational effectiveness.

3. *Evaluate the most effective supply-side policies the UK government could adopt to accelerate economic growth.* **(20)**

Supply-side policies are any government activity designed to increase the productive capacity of the economy, in other words its ability to provide goods and services. Successful supply-side policies may be illustrated by an outward shift in full-capacity output on the AS/AD diagram as illustrated below:



Supply-side policies normally take some time to be effective. Increasing productive capacity is much harder than increasing aggregate demand. Demand-management requires demand-side policies to shift AD and so control inflation and output in the short-run.

The only way to increase output is either to increase the number employed or to increase their productivity i.e. the output per employed person. As Extract D makes clear, the UK has, over the past ten years, experienced no productivity increase at all. Of course, the supply-side could still be enhanced by increasing employment and indeed this has been done. However, insofar as increased employment is achieved by increased immigration this will not increase GDP per head. And if – as has been the case with immigration from much of Eastern Europe – it is predominantly low-skilled then this will be one explanation of why productivity has not risen.
Of course, it is also possible to increase employment by reducing unemployment and in this the UK government has been remarkably successful with unemployment falling from above 8% to just above 4% since 2010. Real cuts in benefits have encouraged the unemployed into work as this has reduced the opportunity cost of taking a job. Equally, the increase in the tax-free personal allowance has enabled low-paid workers in particular to keep a higher proportion of their gross pay. Indeed, since the real cut in benefits saves the government money the two policies combined are self-financing. However, the cost of this approach has been to reduce the standard of living of those who, for whatever reason, cannot find a job at all.

However, they key issue identified in Extract D is the lack of productivity growth. Given that the employed labour force has expanded due to immigration and workers moving out of unemployment it is not surprising that these new workers have a relatively low skill base and that this will have hampered productivity growth. Supply-side policy must, therefore, be aimed at raising their skill levels. This is best achieved through on-the-job training and firms – their employers – are in the best position to know what skills they need. The government should, therefore, provide incentives for firms to up-skill their staff without seeking to dictate what these skills might be. An expansion of the apprenticeship program might be one way to achieve this, although of course the government will have to increase their overall expenditure to achieve this.

A cheaper option would be to encourage the banking sector to increase lending so that firms could invest more in training. One way of achieving this would be for the Financial Policy Committee to relax its capital requirements on banks. But these requirements were put into effect in the first place to guard against a repeat of the banking crisis of 2007-2008, so the very real benefits of this policy would have to be balanced against a very small risk of creating another banking crisis. However, there might be a case for considering whether the capital requirements on banks could be relaxed slightly without materially increasing the risks they were taking.

In conclusion, there are no easy answers to improving supply-side performance for Britain in 2017. Unemployment is already very low and with the government committed to reducing net migration there is little possibility of increasing the labour supply from overseas. Then our record low interest rates should be encouraging investment and training already. That leaves an expansion of apprenticeships as the most likely success story but even so there will be a limit to the number of apprenticeships that UK companies can absorb.