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Candidate surname

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Pearson Edexcel
Level 3 GCE

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Thursday 23 May 2019

Morning (Time: 2 hours)

Paper Reference **9EB0/02**

Economics B

Advanced

Paper 2: Competing in the global economy

You do not need any other materials.

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- Answer **all** questions.
- Answer the questions in the spaces provided
– *there may be more space than you need.*

Information

- The total mark for this paper is 100.
- The marks for **each** question are shown in brackets
– *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Try to answer every question.
- Check your answers if you have time at the end.

Turn over ►

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Answer ALL questions.

SECTION A

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

Write your answers in the spaces provided.

Extract A

Food bank use in UK reaches highest rate on record

The UK's national food bank provider has warned that food bank use has soared at a higher rate than ever in the past year, as welfare benefits fail to cover basic living costs. Figures from the Trussell Trust show that in the year to March 2018 1.3 million, three-day emergency food supplies were delivered to people in crisis across the UK – a 13% increase on 2017. This marks a considerably higher increase than the previous financial year, when it rose by 6%.

5

Low income is the biggest single – and fastest growing – reason for referral to food banks, accounting for 28% of referrals in 2018, compared to 26% in 2017. The Trussell Trust is calling for benefit levels to be increased in line with inflation, particularly for disabled people and families with dependent children who are more at risk of needing a food bank.

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(Source adapted from: Food bank use in UK reaches highest rate on record as benefits fail to cover basic costs, by May Bulman © Independent - April 2018)

Extract B

The gender pay gap in the UK

While women hold 45% of full-time 'professional occupations' – including scientists, engineers and health professionals – their hourly earnings are still 11% lower than men. However, on average, women earn 18% less per hour than men in all occupation groups. The number of women working part-time is one of the possible reasons for this gender pay gap.

5

Men are more likely than women to work in highly-paid occupations such as managers, directors and senior officials. Women in these occupations earn, on average, 16% less than men. In skilled trades, for example farmers, mechanics, electricians and chefs, there is a higher proportion of men than women and they earn 25% more. However, for full-time primary and nursery school teachers, where five out of six are women, there is still a pay gap.

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(Source from: Contains public sector information licensed under the Open Government Licence v3.0)

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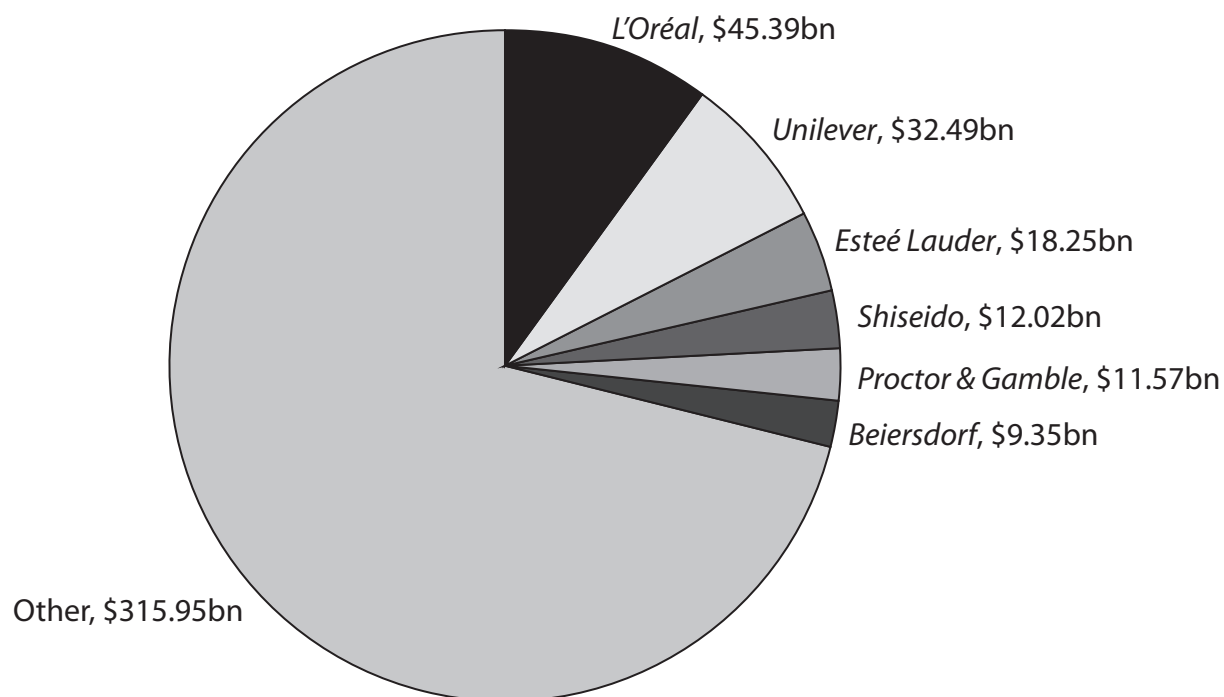
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Extract C

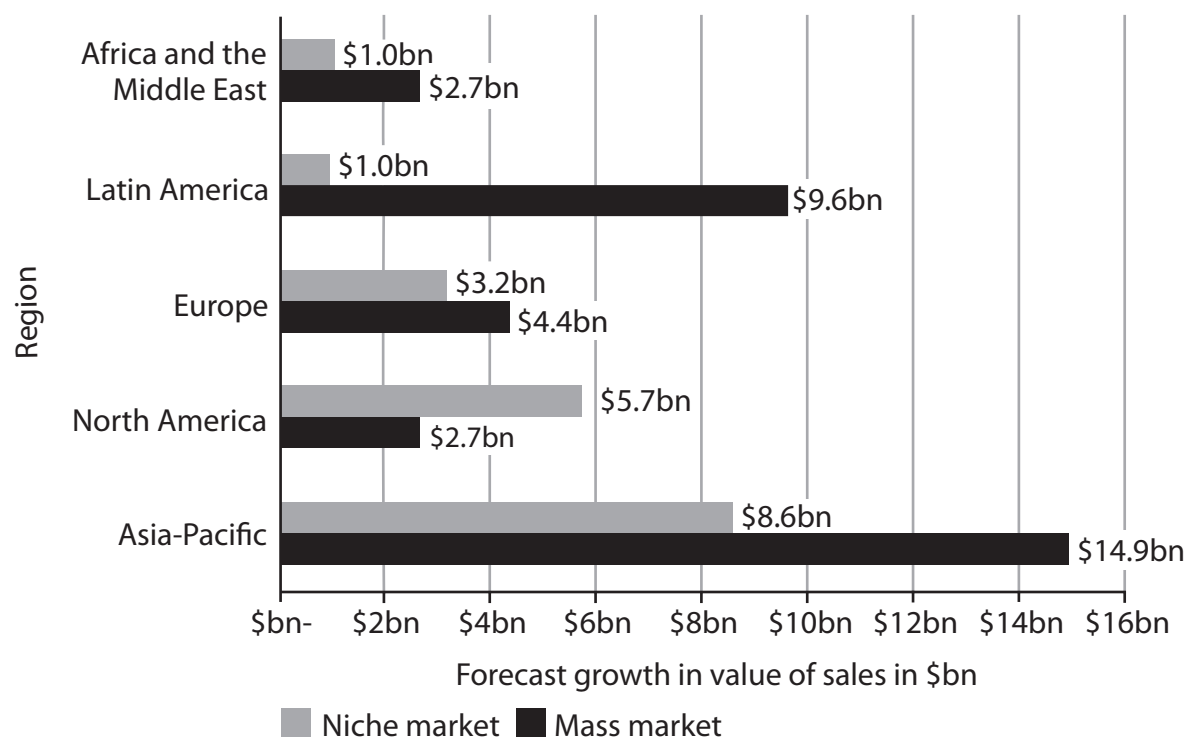
Estimated global market share of top 6 cosmetics firms in 2016 (in \$bn)



(Source adapted from: © 2018 Cloudinary)

Extract D

Forecast sales growth between 2016 and 2021 for niche and mass market cosmetic products



(Source adapted from: © 2018 Cloudinary)



Extract E

Natura buys The Body Shop from L'Oréal for €1bn (£877m)

The Body Shop, an ethical British cosmetics firm, operates in 66 countries and has more than 3,000 outlets, 133 of them in Brazil. Its turnover makes it about half the size of *Natura*. Together they would have net sales of about €3.15bn with 3,200 stores worldwide.

5

Natura, founded in 1969 in São Paulo, is the largest Brazilian cosmetics company. In 2014, it became the first publicly traded company to be certified as meeting certain standards of social and environmental performance and transparency.

The co-chair of *Natura's* board said, "*Natura* and *The Body Shop* have always walked in parallel, and today their paths meet. The sustainable use of biodiversity in our products, a belief in ethics in management and fair relations with communities and a high degree of innovation constitute the pillars of the journey on which we are now embarking."

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(Source adapted from: L'Oréal to sell Body Shop to Brazil's Natura in €1bn deal, by Sarah Butler © The Guardian 2017)

1 Estimated global sales revenue in the cosmetics industry in 2016 was \$445bn.

(a) Using the data from Extract C, calculate the total global market share of *L'Oréal*.

(4)

Market share = sales of L'Oréal ÷ total market sales × 100

= \$45.39bn ÷ \$445bn × 100

= 0.1020 × 100

L'Oréal's total global market share = 10.2%



(b) Using Extract D, explain **one** possible reason why the growth forecast for the niche market in North America is greater than for the mass market.

(4)

One reason is that North America is a high income, developed economy, so the mass market for cosmetics may already be saturated: most consumers already buy basic mass market products, so there is little room for further growth.

Extract D shows forecast growth in the niche market of \$5.7bn compared with only \$2.7bn in the mass market, so niche growth exceeds mass market growth by \$3bn.

Because incomes are high, consumers can afford to trade up to more expensive, differentiated niche cosmetics such as organic or ethical brands, so spending grows in the niche segment rather than in mass market products.



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(c) Using Extract A, explain the difference between absolute and relative poverty.

(4)

Absolute poverty is when people cannot meet their basic needs such as food, shelter and warmth, whereas relative poverty is when income is low compared with others in society (below 60% of median income), so people can meet only some needs and cannot enjoy the normal standard of living.

Extract A shows 1.3 million three-day emergency food supplies were delivered to people in crisis, a 13% increase on 2017, because welfare benefits fail to cover basic living costs such as food.

So even people receiving state benefits would be in absolute, not just relative, poverty without food banks, as they could not afford to eat.

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(d) With reference to Extract B, analyse how underemployment might contribute to the gender pay gap.

(6)

Underemployment is when workers are employed below their capacity: either highly skilled workers doing low skilled, lower paid jobs, or part-time workers who would prefer to work full-time.

Extract B states that the number of women working part-time is a possible reason for the gender pay gap, and more women than men have childcare commitments. Many of these women would prefer full-time work, so they are underemployed. Part-time jobs tend to be lower paid per hour and offer fewer chances of training and promotion, so women's hourly earnings fall behind men's, contributing to women earning 18% less per hour across all occupation groups.

Extract B also shows men are more likely than women to work in highly paid occupations such as managers, directors and senior officials. Because these posts are usually held by men, equally qualified women often do not get the opportunity to hold them and instead work in jobs below their skill level. They are underemployed and so earn less pay, which widens the gap: even in professional occupations, where women hold 45% of full-time jobs, their hourly earnings are still 11% lower than men's.



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By 2021, total sales of cosmetic products in the Asia Pacific region are forecast to increase by \$23.5bn.

(e) Discuss the likely effects on a firm such as L'Oréal of this projected rise in sales.

(8)

The forecast \$23.5bn rise in Asia-Pacific sales means L'Oréal's sales of all its products are likely to increase. Extract D shows the mass market is forecast to grow by \$14.9bn and the niche market by \$8.6bn, so L'Oréal, the largest firm with sales of \$45.39bn, has an opportunity to increase revenue and its global market share.

To meet this demand L'Oréal will need to increase production and investment in new capacity. It may consider moving production to a country within the Asia-Pacific region to reduce distribution costs and import duties, which would lower average costs and could bring economies of scale, raising profit.

However, the marketing mix may need to be adapted to suit local tastes and cultural needs, for example lighter skin products or lower prices for mass market consumers, which raises costs. The effect also depends on L'Oréal's competitiveness and on the reaction of competitors such as Unilever and Shiseido, a Japanese firm with strong local knowledge, which may capture much of the growth.

In addition, Latin America is also expected to grow significantly, by \$10.6bn, and may also require investment, so L'Oréal must prioritise. The figures show growth in sales but not the overall size of the market, so the percentage growth may be smaller than it appears. Overall, the effect is likely to be positive, but the size of the benefit depends on how well L'Oréal adapts to local markets compared with its rivals.

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- (f) Assess the factors that determine the pricing strategy for a cosmetic firm such as L'Oréal when entering an emerging market.

(10)

An emerging market is an economy with rapid growth and rising incomes, although average incomes are still lower than in developed markets. This is a key factor in L'Oréal's pricing strategy, as many consumers cannot yet afford premium priced cosmetics.

Firstly, price may need to be lower in order to gain market share, so L'Oréal may adopt penetration pricing, setting a low price to attract consumers and build a customer base quickly. This is likely when price elasticity of demand is elastic, because there are cheaper local substitutes, so a high price would cause a more than proportionate fall in quantity demanded and lower total revenue. Over time, as consumers become loyal and incomes rise, demand may become more price inelastic, enabling higher prices to be charged.

Secondly, the amount of competition matters. Domestic cosmetic firms, as well as other multinationals such as Estée Lauder and Unilever, may limit the scope for higher prices and result in a competitive pricing strategy, where L'Oréal sets prices close to those of its rivals.

However, L'Oréal has a strong global brand identity. Brand loyalty makes demand more price inelastic, so it could use premium pricing for its luxury brands targeted at the growing high income middle class, as Extract D suggests niche markets are growing quickly in some regions. It can also price differently for different segments, selling cheaper mass market brands alongside premium ones.

Costs and the need to make a profit are also important. Penetration pricing may mean low margins or even losses, so it may only be a short term strategy. For a large firm such as L'Oréal, with sales of \$45.39bn, this may not be a problem, as it can cross-subsidise from profits in developed markets. Costs of distribution, import tariffs



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and adapting products to local tastes may push prices up.

Overall, the most important factor is likely to be the income level and price elasticity of demand of consumers in the emerging market, as this determines whether a low or high price maximises long run revenue. However, pricing strategy will need to change as the emerging market develops and more competitors enter, and it depends on the rest of the marketing mix: if L'Oréal positions a product as premium through promotion and place, a low price could damage its brand image.

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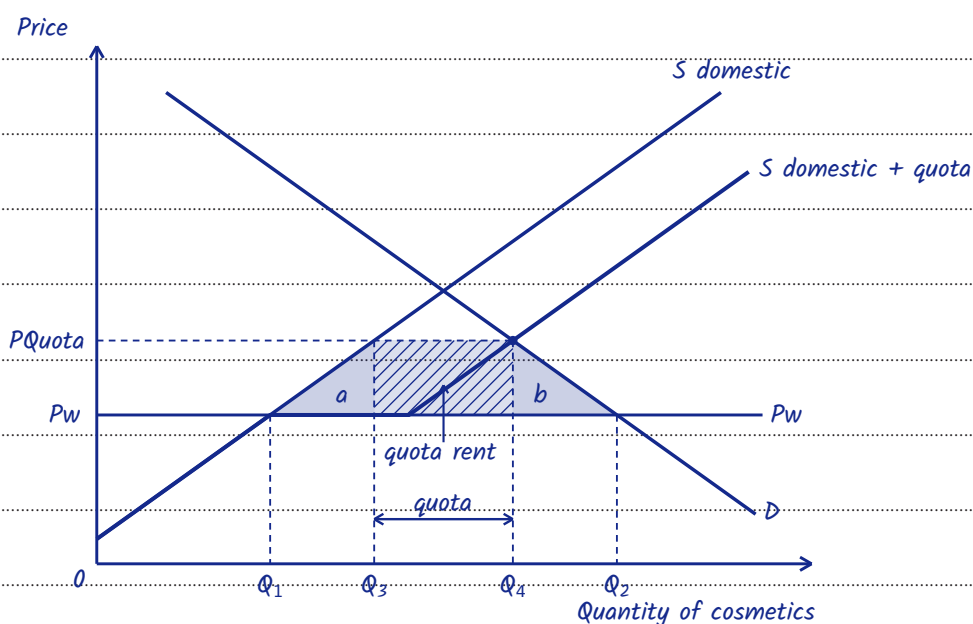
India imposes quotas on imported cosmetics.

- (g) Using a suitable diagram, assess the likely impact of quotas on Indian cosmetics producers and consumers.

(12)

A quota is a physical limit on the quantity (or value) of a good that can be imported into a country, here imported cosmetics into India.

In the diagram, before the quota Indian consumers can buy unlimited cosmetics at the world price P_w . Domestic firms supply Q_1 and consumers demand Q_2 , so imports are Q_1 to Q_2 . The quota limits imports to the distance Q_3 to Q_4 , shifting the domestic supply curve outwards by a horizontal distance equal to the quota, from S_{domestic} to $S_{\text{domestic} + \text{quota}}$. With restricted supply, the domestic price rises from P_w to P_{Quota} ,



above the world price.

For Indian cosmetics producers this is beneficial. Imported cosmetics become scarcer and more expensive, so Indian firms become more price competitive. Their output rises from Q_1 to Q_3 and they sell at the higher price P_{Quota} , so sales revenue and producer surplus rise, which could protect jobs and allow investment in the domestic industry.

For Indian consumers the effect is negative. They face higher prices and consume less, as quantity demanded falls from Q_2 to Q_4 , so consumer surplus falls and consumers face increased expenditure per unit and less choice of foreign brands such as L'Oréal.



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Lower income consumers lose the most. Part of the lost consumer surplus becomes the shaded quota rent, which goes to foreign firms that can still sell at P_{Quota} , or to the Indian Government if it sells quota licences; this income could be reinvested in the Indian cosmetics industry.

However, the size of the impact depends on the price elasticity of demand and supply for both domestic and foreign cosmetics. If Indian cosmetics are seen as poor quality substitutes, customer loyalty to foreign brands means demand for imports is price inelastic: consumers simply pay the higher price and Indian producers gain little. If Indian products are close substitutes, domestic firms gain much more. Indian producers may also become inefficient in the long run, since they are protected from foreign competition, so there is a loss of efficiency shared between Indian consumers and foreign firms, shown by the deadweight loss triangles a and b.

Retaliation is also possible, where other countries impose barriers on Indian exports, which would harm Indian producers who export. Overall, quotas are likely to benefit Indian producers in the short run at the expense of consumers, but the net effect depends on elasticities, on who receives the quota rent, and on whether domestic firms use the protection to become more competitive.

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(h) Using Extract E, assess the likely benefits to *Natura* of purchasing *The Body Shop*.

(12)

The purchase of *The Body Shop* by *Natura* is an example of inorganic growth, specifically horizontal integration, as both firms produce cosmetics at the same stage of production. Together they would have net sales of about €3.15bn with 3,200 stores worldwide.

The main benefit is access to new markets. *The Body Shop* operates in 66 countries with more than 3,000 outlets, while *Natura* is mainly a Brazilian firm. Instead of building stores abroad itself, which is slow and risky, *Natura* gains an established global retail network immediately, so sales revenue and market share should rise quickly.

Natura is also buying an already established brand, so it does not have to invest in the development of new products or branding. *The Body Shop* is an 'ethical' brand, which fits *Natura's* own certification for social and environmental performance, and supplements its existing brand, with 133 outlets already in Brazil. This shared ethical image could strengthen customer loyalty and make demand more price inelastic, allowing higher prices.

In addition, *Natura* may benefit from economies of scale as its output increases, for example purchasing economies from buying ingredients in bulk, so average costs fall and profit margins rise. It may acquire a new supply chain that can be used across the firm, and synergies, such as the sharing of technology and the 'high degree of innovation' mentioned in Extract E, could improve products for both brands.

Diversification of its product range and of the countries it sells in would also spread risk, for example if the Brazilian economy slows.

However, the benefits may not be achieved. There is a risk of an unsuccessful takeover, as differences in corporate culture between a Brazilian firm and a British firm could cause conflict, and *The Body Shop* could lose its brand identity. As *Natura* grows it may



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suffer diseconomies of scale, with rising average total costs because the firm becomes too big to manage and communicate efficiently across 66 countries.

There must also be a reason why L'Oréal sold The Body Shop, such as falling revenues, so Natura may need to invest further in the product line or brand image to maintain or increase revenues. The cost of the deal, €1bn (£877m), is very high, as The Body Shop is only about half the size of Natura; the impact on Natura will depend on how this has been financed, as heavy borrowing would raise interest costs.

Overall, the greatest benefit is likely to be rapid access to new global markets with an ethical brand that matches Natura's values. However, the benefits are long term and uncertain, and depend on Natura integrating the two businesses successfully and turning The Body Shop's sales around.

(Total for Question 1 = 60 marks)

TOTAL FOR SECTION A = 60 MARKS



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QUESTION 2 BEGINS ON THE NEXT PAGE.



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SECTION B

Read the following extract (F) before answering Question 2.

Write your answer in the space provided.

Extract F

Call for 'latte tax' of 25p to cut disposable coffee cup waste

The UK throws away 2.5 billion paper cups every year, with many consumers believing they are being recycled when less than 1% actually are. The rest are incinerated or buried in landfill sites because they have an inner-lining made of plastic which paper mills struggle to remove.

5

Estimated at 22,845 outlets, the total UK coffee shop market grew by 6% in outlets and 12% in turnover to reach £8.9bn in 2016. For example, between 2008 and 2017, the multinational *Starbucks* went from operating a total of 666 company-operated stores in the UK to 606 company-operated and 345 franchised stores.

However, according to a committee of MPs, a 25p 'latte tax' should be introduced on disposable coffee cups to cut waste. The plan is being considered by ministers amid calls for a complete ban on all disposable cups by 2023, unless manufacturers can make them recyclable. The Environmental Audit Committee is calling on the Government to introduce a minimum 25p charge to cut waste in the same way as the plastic bag tax has done in supermarkets. The money raised should be spent on improving "binrastructure", MPs said, including better recycling points around the country and in workplaces.

10

15

(Sources adapted from: <http://www.telegraph.co.uk/news/2018/01/05/call-latte-levy-cut-disposable-coffee-cup-waste/> and <http://www.ukcoffeeleadersummit.com/yet-growth-uk-coffee-shop-market-coffee-shops-become-new-local/> and <https://www.statista.com/statistics/266465/number-of-starbucks-stores-worldwide/>)

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- 2 Evaluate the extent to which the environmental impact of multinational firms, such as Starbucks, can be controlled by governments.

(20)

A multinational firm is one which produces and/or sells in more than one country.

Starbucks is an example, operating 606 company-operated and 345 franchised stores in the UK alone, as well as stores around the world. One of the costs of rising consumption and the pursuit of economic growth has been environmental damage, such as the 2.5 billion paper cups thrown away in the UK every year, less than 1% of which are recycled.

These cups create a negative externality: the costs of landfill and incineration are paid by third parties, not by Starbucks or its customers, so the social cost of disposable cups is greater than the private cost and the cups are over-consumed. Governments therefore have a reason to intervene.

One way is a tax on consumption, such as the proposed 25p 'latte tax'. This raises the price of drinks in disposable cups, so consumers switch to reusable cups and fewer disposable cups are used, internalising the externality. The plastic bag charge in UK supermarkets shows this can work, as bag use fell sharply after it was introduced. The money raised could be spent on 'binrastructure', such as better recycling points, further reducing waste. Governments can also use regulation, such as the proposed complete ban on disposable cups by 2023 unless manufacturers make them recyclable, which forces firms to change their behaviour regardless of price.

Governments can also influence education, so that consumers are more likely to make an informed choice about what and how much to buy, taking environmental factors into account. Since many consumers wrongly believe cups are being recycled, information campaigns could reduce demand for disposable cups and pressure firms like Starbucks to offer alternatives.

However, controlling multinationals is difficult. Because they produce and sell in more



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than one country, it is very difficult for individual national governments to control their behaviour. If the UK taxes or regulates heavily, a multinational can move production, or the most polluting activities, to countries with weaker environmental laws, so pollution is simply relocated. Multinationals are often very large and powerful, and may lobby governments to resist taxes, as their objectives may simply be profit, share price and dividend maximisation.

There may also be conflicts between government objectives. Strict environmental controls on firms like Starbucks could reduce economic growth and employment, especially as the UK coffee shop market grew by 12% in turnover to £8.9bn in 2016. A government aiming for sustained growth, low unemployment and rising living standards may therefore be unwilling to impose strong controls.

Multilateral government action is often more effective in reducing the environmental impact of multinationals, because firms cannot avoid rules by moving country. The Kyoto Protocol, an international treaty extending the 1992 United Nations Framework Convention on Climate Change, set binding targets for many countries. However, its success depends on the willingness of other governments to cooperate internationally, and Canada withdrew from the Kyoto Protocol in 2012, which shows the limits of this approach.

Governments are not the only influence. Non-governmental organisations such as Friends of the Earth and Greenpeace play an important role in informing consumers about the impact of their purchasing decisions, and bad publicity can force multinationals to act to protect their brand image. Starbucks, for example, has incentives to offer discounts on reusable cups to protect its reputation.

The success of government action also depends on how effective policies are in reducing consumption. If demand for coffee on the go is price inelastic, a 25p tax may lead to only a small fall in disposable cup use, although it would raise revenue for recycling.

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The effect is likely to be greater in the long run as habits change and recyclable cups are developed.

In conclusion, governments can control the environmental impact of multinationals such as Starbucks to a significant extent where the damage happens within their own borders, as with disposable cups in the UK, using taxes, regulation and education.

However, their control is limited for global issues such as carbon emissions, because multinationals can relocate and governments may put growth first. A more effective long term solution would be to replace the pursuit of economic growth with the pursuit of sustainable growth, supported by multilateral agreements and consumer pressure, so the extent of control depends mainly on international cooperation.

(Total for Question 2 = 20 marks)

TOTAL FOR SECTION B = 20 MARKS



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SECTION C

Read the following extracts (G and H) before answering Question 3.

Write your answer in the space provided.

Extract G

Production at *Toyota*

The fourth-generation *Toyota* Prius has two large production lines that stretch away into the distance. Some buildings house the trim workshop. In other buildings, completed body shells roll in, have their doors removed (which make their way in pairs along a separate line) and the interior, hybrid system, dashboard and seats are installed. The factory, which has been making the Prius since 2003, produces 430,000 cars a year. From 6.30am to 1am, it can turn out a Prius every minute.

5

This is the Toyota Production System (TPS) at work, turning the immense complexity of car-making into a series of simple stages. Each step is serviced using the just-in-time manufacturing process by the relevant parts supplier. The system is controlled by the workers themselves, who have autonomy over stopping and starting the line to resolve issues.

10

The system is about efficiency in all its forms. The process utilises the Kaizen system. *Toyota* has this down to a fine art, employing teams to roam the factory and scout for potential problems and possible efficiencies. On posters and shirts the plant's official mascot preaches health and safety.

15

(Source adapted from: © Condé Nast Britain 2018)

Extract H

Problems with production at *Tesla*

In 2010, *Tesla* acquired a large factory, previously owned jointly by *General Motors* (GM) and *Toyota*, for the low price of \$42m. What it did not get as part of the deal was knowledge of and experience in lean production.

Increasing output of a car manufacturing line is difficult. For a new firm, reaching efficient and lean operation at the level of *Toyota* and GM is extremely challenging. Consumer blogs reveal an increasing number of faults, many having to do with quality control of interior fit and finish. *Tesla* appears to be struggling with fundamental quality control issues and manufacturing tolerances that are not as strict as consumers expect from luxury cars.

5

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A recent report from California-based 'Worksafe', claims *Tesla's* employee injury and illness rates are significantly higher than the average for the car industry. There are long-standing, carefully-followed practices at any established assembly manufacturing plant but they were not purchased with the factory. Indeed, becoming a world-class volume car manufacturer is not easy. Decades of perfecting supply chains and manufacturing methods, monitoring the smallest details, all those intangible assets that *Tesla* did not purchase with the factory, are critical.

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(Source adapted from: Tesla Will Have a Tough Time Ramping up Production. Here's Why', © Joe Barkai Jun 28, 2017, Industry Week)

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- 3 Evaluate the extent to which quality is important for car manufacturers such as Toyota and Tesla.

(20)

Quality means meeting customer expectations, in terms of reliability, finish and value for money. It also involves firms ensuring that they minimise waste through faulty production, for example through total quality management (TQM), where every worker is responsible for quality, and Kaizen, which is continuous improvement through small, frequent changes.

Quality is important because it leads to productive efficiency and the minimisation of cost. Producing right first time minimises the waste of capital and labour that can exist in many areas across the business, for example unused or wasted components and wasted labour time spent reworking faulty cars. Good quality management with just-in-time production also leads to less waste and less damaged stock. This is shown by Toyota, whose use of the Toyota Production System and Kaizen has increased efficiency so that its factory produces 430,000 cars a year and can turn out a Prius every minute. Lower average costs allow Toyota either to cut prices or to earn higher profit margins.

Quality also matters for reputation and sales. Cars are expensive and are bought infrequently, so consumers place great value on reliability and safety, and demand for a reliable brand is more price inelastic. By contrast, Tesla has not matched Toyota's quality: consumer blogs reveal an increasing number of faults with the interior fit and finish, and manufacturing tolerances are not as strict as consumers expect from luxury cars. This is likely to lead to a loss of reputation, warranty costs, product recalls and disappointing sales, and in a market with strong competitors customers may switch to established luxury brands.

Quality also includes the way workers are treated. Toyota's workers have autonomy over stopping and starting the line to resolve issues, and teams scout for problems and



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efficiencies, which suggests better relations with employees, possibly a result of more effective use of total quality management. Tesla's injury and illness rates are significantly higher than the industry average, which could raise absenteeism, labour turnover and costs, and further reduce quality.

However, quality is only one factor in a car firm's success. Innovation and design may be a more significant factor than quality in determining sales. Tesla's electric cars are highly innovative, and many consumers buy them for their technology, performance and environmental image despite the recorded faults. Marketing and branding may also be a significant factor in the eyes of the consumer, and Tesla's strong brand loyalty means many customers are willing to accept some faults.

In addition, Tesla is a relatively new firm, and Extract H points out that reaching lean operation at the level of Toyota and GM is extremely challenging, since decades of perfecting supply chains are intangible assets it could not buy with its factory for \$42m. Tesla's quality may improve as its experience increases, through learning by doing. Maintaining quality can also increase costs, for example through training, inspection and better components, thus reducing profitability in the short run, so firms must balance quality against cost.

The importance of quality also depends on the market segment. For a mass market producer like Toyota, competing on reliability and low cost per car, quality and efficiency are central to its competitive advantage. For Tesla, selling luxury cars at high prices, customers expect high quality, so in the long run poor quality is likely to be very damaging even if innovation matters more at first.

In conclusion, quality is very important for car manufacturers because it lowers costs through less waste, protects reputation and drives repeat sales, as Toyota's success shows. However, it is not the only factor: innovation, design and branding can allow a firm like Tesla to succeed despite quality problems in the short run. In the long run, as

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competitors launch their own electric cars, Tesla will need to match established quality standards to survive, so quality is important, but there are other factors to be considered to be successful in the car manufacturing industry.

(Total for Question 3 = 20 marks)

TOTAL FOR SECTION C = 20 MARKS
TOTAL FOR PAPER = 100 MARKS



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