

Please check the examination details below before entering your candidate information

Candidate surname <i>StemUp Model Solution</i>		Other names											
Pearson Edexcel Level 3 GCE		Centre Number <table border="1"><tr><td></td><td></td><td></td><td></td><td></td></tr></table>						Candidate Number <table border="1"><tr><td></td><td></td><td></td><td></td><td></td></tr></table>					
Thursday 16 May 2019													
Morning (Time: 1 hour 30 minutes)		Paper Reference 8EB0/02											
Economics B Advanced Subsidiary Paper 2: The wider economic environment													
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 80.
- 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.

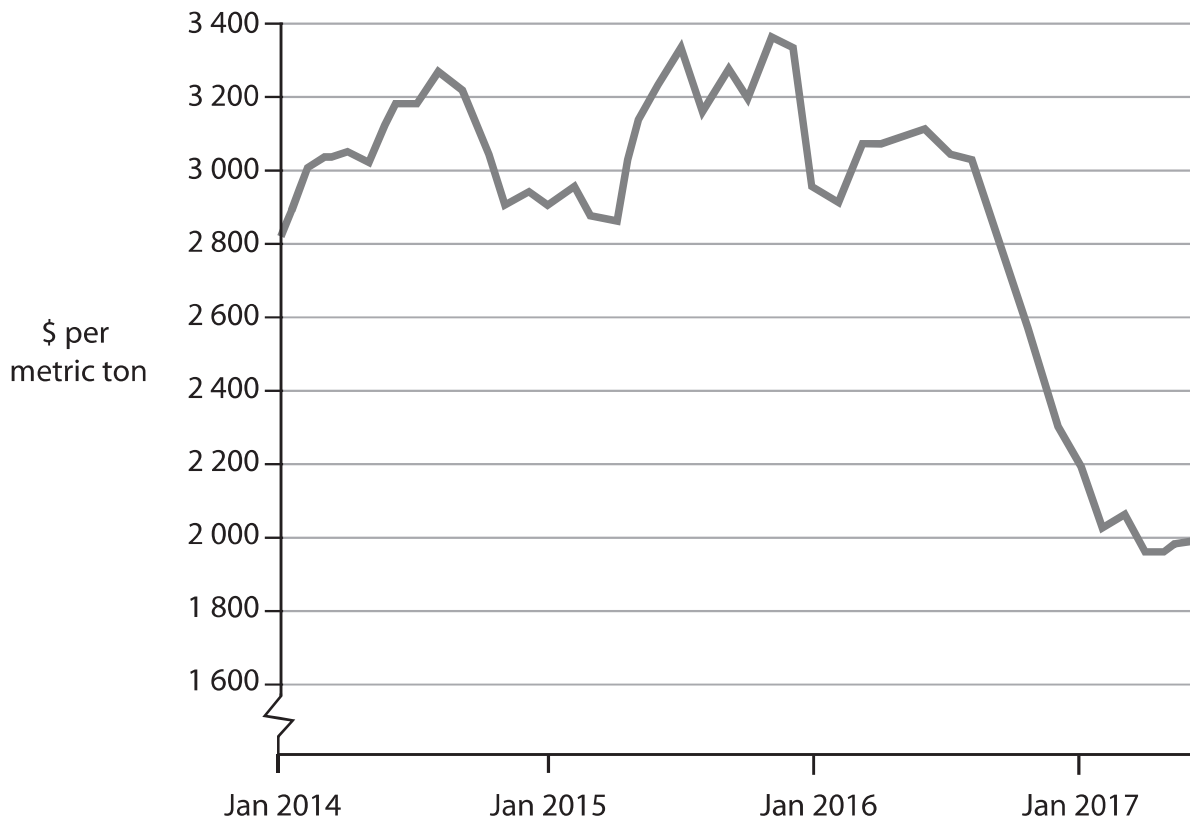
SECTION A

Read the following extracts (A and B) before answering Question 1.

Write your answers in the spaces provided.

Extract A

Cocoa beans: International Cocoa Organization cash price 2014–2017



(Source based on: www.ons.gov.uk/economy/inflationandpriceindices/articles/shrinkflationandthechangingcostofchocolate/2017-07-24)



Extract B***Hotel Chocolat* full of beans after doubling profits**

Hotel Chocolat's recipe of opening combined shop and café stores and expanding online appears to be working as the British chocolatier doubled its profits last year. In 2017, *Hotel Chocolat's* pre-tax profit had increased by 100% to £11.2m, up from £5.6m in 2016. The revenue was £105.2m with a 12% year-on-year growth.

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Angus Thirlwell, co-founder and chief executive, said that the results showed the strength of the brand, which is known for the high cocoa content in its premium chocolates. After an expansion drive, the retailer has 94 stores in the UK and abroad. Its combined shop and café stores, where customers can buy boxes of chocolates and consume hot chocolate drinks, have proved popular.

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"There is no sign of people trading down," he said. "The average order value is creeping up. Once you get a taste for *Hotel Chocolat* with more cocoa and less sugar, you don't want to buy cheaper chocolate again. You may defer a big extension to your home or a new car, but our security is we offer affordable luxury."

Mr Thirlwell said that despite an environment where commodity prices were rising and consumer demand was volatile, *Hotel Chocolat* had made 'excellent progress' with its three strategic priorities: to invest further in its manufacturing operations, increase its number of stores and develop its digital business.

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Hotel Chocolat said it has also arranged six commercial wholesale deals so its chocolates could be sold more widely. These include gaining contracts with the internet groups *Amazon* and *Ocado*, as well as the department store *Fenwick*.

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"Despite the challenges and uncertainties in the wider economy, trading since the end of the financial period has been encouraging," said Mr Thirlwell.

(Source adapted from: © Times Newspapers Limited 2018)



1 (a) What is meant by the term 'brand'?

(2)

A brand is a unique name, design, sign or symbol that identifies a product or firm and differentiates it from the products of its competitors, so that consumers recognise it.

Estimates indicate that a 2.3% rise in incomes in the UK would result in an 8% increase in demand for premium chocolate.

(b) Calculate, to 2 decimal places, the income elasticity of demand (YED) for premium chocolate. You are advised to show your working.

(4)

$YED = \% \text{ change in quantity demanded} \div \% \text{ change in income}$

$YED = +8\% \div +2.3\%$

$YED = 3.478...$

$YED = 3.48 \text{ (to 2 d.p.)}$

Positive and greater than 1, so premium chocolate is an income elastic, normal luxury good.



Hotel Chocolat imports all its cocoa from Saint Lucia.

- (c) Using the trend shown in Extract A for the period 2016–2017, explain **one** possible impact on chocolate manufacturers, such as *Hotel Chocolat*.

(4)

One impact is lower costs of production for chocolate manufacturers. Cocoa beans are the main raw material used in the production of chocolate, and Extract A shows the ICCO cash price fell steeply from about \$3,100 per metric ton in mid 2016 to around \$2,000 per ton by early 2017, a fall of roughly one third.

As Hotel Chocolat imports all its cocoa from Saint Lucia, its unit costs should fall if Saint Lucian prices follow the world price. If it does not pass these cost savings on to consumers through lower prices, it can increase its profit margins, helping to explain how its pre-tax profit doubled to £11.2m.



- (d) Discuss how the economic cycle might affect manufacturers of premium chocolate, such as *Hotel Chocolat*.

(8)

The economic cycle is the fluctuation of national or global economic activity (real GDP) around its trend, moving between boom, downturn, recession and recovery.

During recovery and boom, real incomes rise and unemployment falls. Premium chocolate is likely to be a normal luxury good with YED greater than +1: the estimate of 3.48 means a 1% rise in incomes raises demand by about 3.5%. As incomes rise, the proportion of income spent on it rises and consumers switch from cheaper brands to Hotel Chocolat, so its sales and profits grow faster than the economy, as seen in revenue of £105.2m, up 12% year-on-year.

However, in a downturn or recession incomes fall and unemployment rises. Customers cut back first on income elastic non-essentials, so with a YED of 3.48 a 2% fall in incomes could cut demand by about 7%. Businesses making premium and luxury goods are often hit hard and may have to cut prices, delay opening stores or reduce output.

On the other hand, Extract B suggests Hotel Chocolat has been relatively unaffected by difficult conditions, with sales and profits rising in 2017. Thirlwell says there is "no sign of people trading down" because it offers "affordable luxury": consumers who defer a big purchase such as an extension may still treat themselves to chocolate. If consumers see chocolate as an ordinary normal good with low YED, the cycle will matter much less, and 3.48 is only an estimate.

Overall, the impact depends on the depth and length of the downturn and on brand loyalty: a strong brand reduces, but does not remove, a premium manufacturer's exposure to the cycle.



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(e) Assess the benefits of organic growth for a firm such as *Hotel Chocolat*.

(12)

Organic growth means a firm expands by extending its own operations, for example opening new stores or increasing capacity, rather than through a merger with or takeover of another firm (inorganic growth).

A key benefit is lower risk. *Hotel Chocolat*'s combined shop and café model is clearly working: pre-tax profit doubled from £5.6m to £11.2m and revenue grew 12% to £105.2m.

Opening more of the same stores relies on a tried and trusted business model and builds on existing strengths, such as a strong brand known for high cocoa content, so growth is more sustainable than buying a business it does not understand.

Second, organic growth can be financed through internal sources such as its £11.2m profit, rather than using external finance to fund the takeover of a rival chocolate firm. This avoids interest costs and dilution of ownership, keeping founders such as Angus Thirlwell in control of strategy.

Third, it avoids the problems of integration. Takeovers often cause culture clashes between managers and staff, and job losses in shops and cafés where resources are duplicated.

Growing step by step through its three priorities (investing in manufacturing, more stores and its digital business) lets *Hotel Chocolat* keep its culture and quality control.

However, organic growth is often slow, and shareholders may prefer the more rapid growth of revenue and profits that an acquisition could deliver. Growth also depends on the growth of the overall niche premium chocolate market: as *Hotel Chocolat* already seems to be a market leader with 94 stores, it may be hard to build further market share. It may also suffer a lack of new ideas, skills and economies of scale from outside the business that inorganic growth brings.

Overall, the benefits of organic growth are significant for *Hotel Chocolat* because its existing model is profitable and self-financing, and its six wholesale deals with Amazon, Ocado and



Fenwick show it can widen its reach without the risks of a takeover. The benefits are greatest in the short to medium term; if the premium market becomes saturated, it may need inorganic growth, such as acquiring an overseas chain, to keep growing quickly.

(Total for Question 1 = 30 marks)

TOTAL FOR SECTION A = 30 MARKS



SECTION B

Read the following extracts (C, D and E) before answering Question 2.

Write your answers in the spaces provided.

Extract C

Selected data for Brazil 2014–2017

	2014	2015	2016	2017
Real GDP growth	0.5%	–3.8%	–3.6%	0.4%
Unemployment	6.8%	8.3%	11.3%	13.2%
Foreign Direct Investment (FDI)	\$96.9bn	\$74.7bn	\$78.9bn	\$84.6bn
Exports	\$225bn	\$191bn	\$185bn	\$197bn

(Source based on: <http://www.investexportbrasil.gov.br/investment-guide-brasil-2014-07-1-en>)

Extract D

Trade Talks between EU and Mercosur Trade Blocs

The members of the Mercosur trade bloc are Brazil, Argentina, Paraguay and Uruguay. Trade talks between Mercosur and the European Union (EU) on a trade deal are close to agreement at a World Trade Organisation conference in Buenos Aires.

Brazilian Foreign Minister Aloysio Nunes told reporters that Mercosur and the EU have exchanged notes on how far each side is willing to compromise to reach a free trade deal. Nunes said Mercosur is committed to removing tariffs from 90% of its trade with the EU. This is a positive move for the EU as Brazil imposes relatively high tariffs with an average of 8.8% compared to just 0.6% by Chile and 1.6% by the US.

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Resistance to agricultural imports by some EU member states, such as Ireland and France, has delayed negotiation of the trade deal that seeks to liberalise trade and investment.

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Mercosur members have pushed for an improvement on the EU offer of tariff-free imports for 70,000 tonnes of beef and 600,000 tonnes of ethanol a year.

(Source adapted from: EU, Mercosur approach a deal on sidelines of WTO meeting © REUTERS December 2017)

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Extract E**Brazil: A source of investment**

Brazil is the largest recipient of FDI in Latin America and the eighth largest recipient in the world. The main investors in Brazil are the United States, Spain and Belgium.

Brazil is attractive for international investors due to several factors.

- Tax exemptions and infrastructure support. 5
- A domestic market of nearly 210 million inhabitants representing 3% of global consumers.
- Easy access to raw materials.
- A large pool of workers at all levels of education.
- A member of the Mercosur trade bloc. 10

Key sectors attracting FDI include finance, agriculture, tobacco, mining, pharmaceutical products, automobile, telecommunications, oil and gas.

The main foreign companies who have already heavily invested in Brazil include *Renault*, *General Motors*, *Carrefour*, *McDonalds* and *Zara*. The largest MNC in Brazil is *Shell*.

(Source adapted from: © Banco Santander, S.A - 2018)



2 (a) What is meant by the term 'exports'?

(2)

Exports are goods or services produced in one country and then sold to buyers in another country, bringing money into the domestic economy.

(b) Using Extract C, calculate, to 2 decimal places, the percentage change in the amount of foreign direct investment (FDI) for Brazil from 2014 to 2017. You are advised to show your working.

(4)

% change = (new value - original value) ÷ original value × 100

= (\$84.6bn - \$96.9bn) ÷ \$96.9bn × 100

= -12.3 ÷ 96.9 × 100

= -12.69%

FDI into Brazil fell by 12.69% between 2014 and 2017.



- (c) Using Extract C, explain **one** impact these unemployment rates may have on the Brazilian government.

(4)

One impact is that the Brazilian government receives less tax revenue. Extract C shows the unemployment rate increased every year, from 6.8% in 2014 to 13.2% in 2017, almost doubling.

With fewer people in work, less income tax is collected, and lower household spending reduces indirect tax revenue. At the same time the government must spend more on unemployment benefits, so its budget deficit is likely to widen, leaving less revenue to spend on public services such as health and education, or forcing it to borrow more.



(d) Discuss the possible advantages for Brazil of being a member of a trading bloc.

(8)

A trading bloc is a group of countries with preferential trading agreements between its members, such as reduced or zero tariffs. Brazil is in Mercosur with Argentina, Paraguay and Uruguay.

First, membership makes trading easier and cheaper for Brazil due to lower tariffs and less bureaucracy, giving Brazilian firms easier access to the other three members' markets. Exports can rise, which is much needed: exports fell from \$225bn in 2014 to \$197bn in 2017, and real GDP fell by 3.8% in 2015 and 3.6% in 2016. Higher exports raise AD, real GDP and employment, helping to reduce unemployment of 13.2%.

Second, countries outside the bloc, such as the US or Spain, are more likely to invest in Brazil to access the whole Mercosur market; Extract E lists membership as a reason for FDI. This creates jobs and raises GDP. As a bloc, Mercosur also has more bargaining power, for example in the EU free trade talks that could remove tariffs on 90% of trade. Brazilian consumers also gain access to more, cheaper products and services.

However, reduced trade barriers also mean extra competition for Brazilian producers from cheaper imports from Argentina. This may lead to a decline in Brazilian output and an increase in unemployment in less efficient industries, and trade diversion may occur if Brazil buys from members instead of cheaper producers outside the bloc.

Overall, the advantages are likely to outweigh the costs for a large economy with 210 million consumers, but the size of the gains depends on how competitive Brazilian firms are and whether deals such as the EU agreement are completed.



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- (e) Assess the benefits of inward foreign direct investment (FDI) flows to a country such as Brazil.

(12)

Inward FDI is investment by firms from other countries in productive assets in the host country, such as factories, offices or stakes in local businesses. Brazil is the largest recipient of FDI in Latin America, receiving \$84.6bn in 2017.

First, FDI brings capital investment, as MNCs need buildings, equipment and infrastructure to operate. Investment is a component of AD, so through the multiplier real GDP rises, which matters after GDP fell by 3.8% in 2015 and 3.6% in 2016. It also increases productive capacity, shifting LRAS to the right.

Second, jobs are created by MNCs such as Renault, General Motors and Zara, reducing unemployment, which reached 13.2% in 2017, and increasing disposable income and consumer spending. There may also be increased demand for local Brazilian firms that supply MNCs, such as component makers for Renault's car factories.

Third, MNCs may train the local workforce, who acquire useful skills in car production, and bring new technologies, techniques and methods that raise productivity. Higher employment and wages increase tax revenue for the government, and if MNCs export from Brazil, exports rise and the balance of payments improves.

However, the benefits may be smaller than they appear. Many MNCs locate in Brazil due to lower costs of production or a lack of regulation, so wages can be low and working conditions poor. MNCs such as Renault may bring their own management rather than training local workers, and profits may be repatriated to the US, Spain or Belgium. Many key sectors attracting FDI, such as mining, oil and gas and tobacco, can damage the environment and create significant negative externalities. Tax exemptions used to attract FDI also reduce the revenue gained.

Overall, inward FDI brings substantial benefits to Brazil, especially the jobs and investment needed at a time of rising unemployment and weak growth. The size of the benefit depends



on the type of FDI: long-term investment in manufacturing with local suppliers and training is far more beneficial than extractive investment that repatriates profits. As FDI fell by 12.69% from 2014 to 2017, Brazil must protect its attractions to keep these benefits.

(Total for Question 2 = 30 marks)

TOTAL FOR SECTION B = 30 MARKS



SECTION C

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

Write your answer in the space provided.

Extract F

Tax cuts for firms and the rich as President Donald Trump wins major victory in US Senate

America has taken a dramatic step towards becoming more attractive to firms as it has cut corporation tax. US corporation tax will drop from 35% to 20% under Donald Trump's overhaul. The move puts pressure on Britain to increase its competitiveness as the country seeks business and investment after Brexit. America will have a corporation tax rate just 1% higher than Britain's 19% once the change is adopted. Britain's corporation tax is set to drop to 17% in April 2020.

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Mr Trump predicted companies would continue to return to America as he heralded his 'historic' tax cuts. "We're going to grow the country, we're going to grow jobs, we're going to be growing everything," Mr Trump said. Other new tax changes include a reduction in top rates of income tax.

10

Supporters of the cuts argue the boost in growth will outweigh the increase to the US budget deficit from lost tax revenue and the changes have mainly benefited middle-income earners. However, the Joint Committee on Taxation estimated \$1 trillion will be added to the US budget deficit, even with extra growth, and analysis suggests corporations and high-earners will benefit most from the changes.

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(Source adapted from: Tax cuts for businesses and rich as Donald Trump wins major 11th-hour victory in US Senate by Ben Riley-Smith © Telegraph December 2017)

Extract G

UK personal income tax allowances 2014–2019

The personal allowance is the amount of income a person can earn before they start to pay income tax at 20%.

	2014–15	2015–16	2016–17	2017–18	2018–19
Personal income tax allowance (£)	10 000	10 600	11 000	11 500	11 850

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- 3 Evaluate the extent to which a reduction in taxation will increase a country's rate of economic growth.

(20)

Economic growth is an increase in real GDP (actual growth) or in the productive potential of an economy (potential growth). Taxation is a compulsory payment to the government: direct taxes on income and profits, such as income tax and corporation tax, or indirect taxes on spending, such as VAT. A reduction in taxation can affect both aggregate demand (AD) and aggregate supply (AS).

First, a cut in income tax increases the disposable income of households, which may raise consumer spending, the largest component of AD. In the UK the personal allowance rose from £10,000 in 2014-15 to £11,850 in 2018-19 (Extract G), an increase of £1,850, saving a basic-rate taxpayer £370 a year. As AD shifts from AD1 to AD2 in the diagram, real GDP rises from Y1 to Y2, boosted further by the multiplier effect, giving actual economic growth.

Second, a cut in corporation tax raises firms' post-tax profits, increasing both their ability and willingness to invest. Extract F shows US corporation tax dropping from 35% to 20%, while the UK rate falls from 19% to 17% in April 2020. Higher investment increases AD, and new capital also raises productive capacity, shifting LRAS from LRAS1 to LRAS2. Lower corporation tax can also attract FDI, as Mr Trump expects companies to "return to America", adding to potential growth.

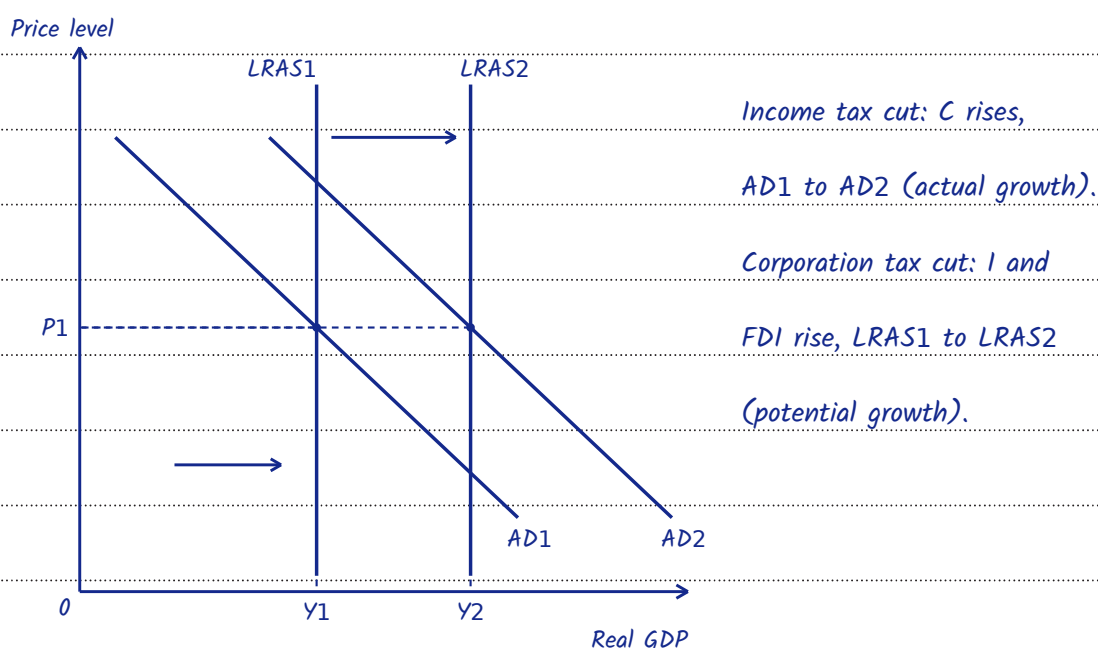
Third, lower income tax rates, such as the US cut in top rates, may increase the incentive to work, as less is taken in income tax. More people may join the labour force or work longer hours, and entrepreneurs have more incentive to take risks. Output rises, unemployment falls and AS shifts right, so growth can occur without inflationary pressure. However, the effect may be limited. If workers are pessimistic about the future, for example due to Brexit uncertainty, they may save the extra disposable income, so consumer spending and AD barely change. Extra spending may also go on imports, a leakage from the circular



flow that reduces the multiplier. Analysis suggests corporations and high earners benefit most from the US changes, and they have a higher propensity to save, so the boost to AD may be small.

Second, lower taxes reduce government revenue: about \$1 trillion will be added to the US budget deficit even with extra growth. If the government cuts spending on public services such as education and health care to compensate, AD may decrease, offsetting the tax cut, and potential growth may be reduced as human capital and infrastructure suffer. Inequality may also increase.

Third, it depends on the state of the economy. Near full capacity, higher AD mainly causes demand-pull inflation rather than higher real GDP. Supply-side effects on incentives and investment are uncertain and slow, as firms invest mainly in response to expected demand and business confidence rather than tax rates alone.



In conclusion, a reduction in taxation is likely to increase the rate of economic growth to some extent, mainly in the short run through higher AD when there is spare capacity. The extent depends on the size of the cut, whether it is to direct or indirect taxation, who benefits and how it is financed: cuts for lower and middle earners and for business investment are more likely to raise actual and potential growth than cuts for high earners.

As the gains may be offset by higher deficits and lower public spending, tax cuts work best in combination with other policies, such as supply-side investment in education and infrastructure.

(Total for Question 3 = 20 marks)

TOTAL FOR SECTION C = 20 MARKS

TOTAL FOR PAPER = 80 MARKS



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