Unit 1 Business and the business environment

Unit code	**T/618/5032**
Unit type	**Core**
Unit level	**4**
Credit value	**15**

Introduction

Business activity is fundamental and universal to our everyday lives. Business organisations may differ in many ways, depending on the industry in which they operate globally, but they do share one common feature: the transformation of inputs into outputs. This transformation process takes place against a background of external influences that impact on business activity. The external environment in which business organisations operate is dynamic, complex, volatile and interactive.

The aim of this unit is to give students background knowledge and understanding of business, of the functions of an organisation and of the wider business environments in which organisations operate. Students will examine the different types of organisations (including for profit and not for profit), their size and scope (for instance micro, SME, transnational and global) and how they operate. Students will explore the relationships that organisations have with their various stakeholders and how the wider external environments influence and shape business decision making.

The knowledge, understanding and skill sets that students gain in this unit will help them to have an insight into different business functions, which will support them with further study, support the development of analytical thinking and the application of key analytical tools used throughout business planning, and enable them to choose their preferred areas of specialism in future studies and in their professional career.

Learning outcomes

By the end of this unit a student will be able to:

LO1 Explain the different types, size and scope of organisations

LO2 Demonstrate the interrelationship of the various functions within an organisation and how they link to organisational structure

LO3 Use contemporary examples to demonstrate both the positive and negative influence/ impact the macro environment has on business operations

LO4 Determine the internal strengths and weaknesses of specific businesses and their interrelationship with external macro factors.

Essential content

LO1 Explain the different types, size and scope of organisations

Different types of organisations:

Differences between for profit and not for profit and non-government organisations (NGOs).

Micro-, small-, medium-sized enterprises (SMEs). Different business purposes, objectives and supply of goods and services.

The range of legal structures associated with different forms of business: sole traders, partnerships, limited companies.

Size and scope of organisations:

Differences between large-, medium-sized and small organisations, including objectives and goals, market share, profit share, growth and sustainability.

Global growth and developments of transnational, international and global organisations.

Differences between franchising, joint ventures and licensing.

Industrial structures and competitive analysis.

Market forces and economic operations, e.g. scarcity and choice, supply and demand, income elasticity.

Stakeholders and responsibilities of organisations to meet different stakeholder interests and expectations.

LO2 Demonstrate the interrelationship of the various functions within an organisation and how they link to organisational structure

The various functions within an organisation:

The role of marketing, finance, human resource management and operations within an organisational context and the interrelationships.

Functions in relation to overall organisation mission and objectives.

Organisational structure:

Different structures depending on the size and scope of the organisation, including bureaucratic and post-bureaucratic, parent, strategic business units (SBUs), matrix and functional levels.

The virtual organisation and flexible, fluid structures that are geographically dispersed.

Organisation structures and complexities of transnational, international and global organisations.

LO3 Use contemporary examples to demonstrate both the positive and negative influence/impact the macro environment has on business operations

The context of the macro environment:

The different political, economic, social, technological, legal and environmental factors that influence and impact the business environment.

The PESTLE framework as an analytical tool to monitor and forecast external influences.

Different spatial levels of external influences, e.g. local, regional, national, international

The macro factors that influence and impact on business activities:

The transformation of the work environment, the changing and emerging markets, the global shift in economic and social power due to international global crisis.

The impact of emerging digital technologies on production and consumption of products and services including:

- social and mobile technologies to engage and extend customer reach
- cloud technologies for making business more agile, collaborative and efficient
- Artificial Intelligence (AI) to sustain competitive advantage.
- Blockchain for e-commerce

Emerging new sectors creating new career opportunities due to new technologies e.g. data and analytics, digital advertising

The impacts of increased innovation and disruptive innovation.

The growth of data analytics and business intelligence using Big Data, to inform decision making, the rise of cybersecurity and data protection.

The impact of globalisation, e.g. changing workforce, cultural diversity.

The growth of ethical considerations and sustainable business, e.g. equality and diversity and corporate social responsibility.

Organisation operations:

Organisations' responses to transformation and managing resistance to change in response to a highly volatile and changing market environment.

Dealing with unexpected crises that affect business operations and activities, e.g. crisis management and recovery.

LO4 Determine the internal strengths and weaknesses of specific businesses and their interrelationship with external macro factors

Frameworks for analysis:

Introduction to SWOT and/or TOWS analysis and how they can assist in the decision-making process and feed into business planning in organisations.

Different applications of SWOT analysis, e.g. for market positioning, commercial viability, launching a new product, methods of sales distribution.

Internal vs external factors:

Internal factors relating to products, pricing, costs, profitability, performance quality, people, skills, adaptability, brands, services, reputation, processes, infrastructure.

Key external factors that inform opportunities and threats, including the competitive environment and government intervention, that influence organisations and business.

1 Business organisations: the external environment

Business organisations differ in many ways, but they also have a common feature: the transformation of inputs into output. This transformation process takes place against a background of external influences which affect the firm and its activities. This external environment is complex, volatile and interactive, but it cannot be ignored in any meaningful analysis of business activity.

Learning outcomes

Having read this chapter you should be able to:

- indicate the basic features of business activity
- portray the business organisation as a system interacting with its environment
- demonstrate the range and complexity of the external influences on business activity
- identify the central themes inherent in the study of the business environment

Key terms

Environmental change
External environment
General (or contextual) environment
Immediate (or operational) environment
Inputs
Open system
Outputs
PESTLE analysis
Transformation system

Introduction

Business activity is a fundamental and universal feature of human existence and yet the concept of 'business' is difficult to define with any degree of precision. Dictionary definitions tend to describe it as being concerned with buying and selling, or with trade and commerce, or the concern of profit-making organisations, and clearly all of these would come within the accepted view of business. Such a restricted view, however, would exclude large parts of the work of government and its agencies and the activities of non-profit-making organisations – a perspective it would be hard to sustain in a climate in which business methods, skills, attitudes and objectives are being increasingly adopted by these organisations. It is this broader view of business and its activities that is adopted below and that forms the focus of an investigation into the business environment.

The business organisation and its environment

A model of business activity

Most business activity takes place within an organisational context and even a cursory investigation of the business world reveals the wide variety of organisations involved, ranging from the small local supplier of a single good or service to the multi-billion-dollar international or multinational corporation producing and trading on a global scale. Given this rich organisational diversity, most observers of the business scene tend to differentiate between organisations in terms of their size, type of product and/or market, methods of finance, scale of operations, legal status and so on. Nissan, for example, would be characterised as a major multinational car producer and distributor trading on world markets, while a local builder is likely to be seen as a small business operating at a local level with a limited market and relatively restricted turnover.

web link

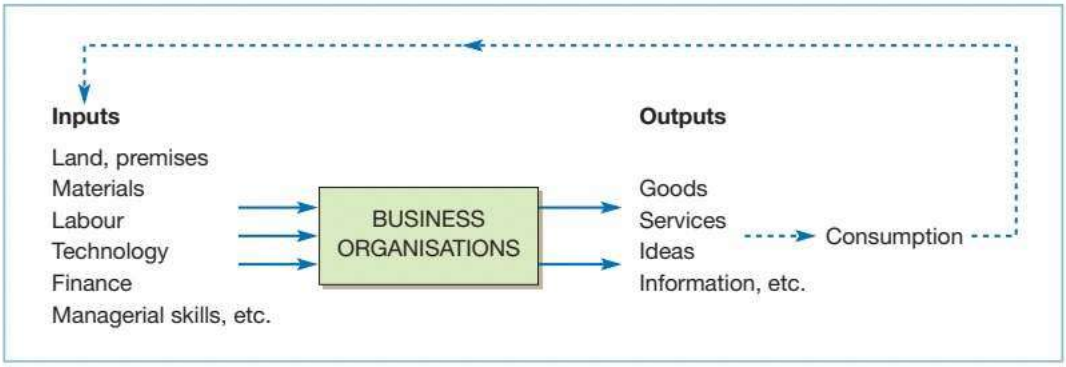
Further information on Nissan is available at *www.nissan-global.com*
The Nissan UK website address is *www.nissan.co.uk*

While such distinctions are both legitimate and informative, they can conceal the fact that all business organisations are ultimately involved in the same basic activity, namely, the transformation of **inputs** (resources) into **outputs** (goods or services). This process is illustrated in Figure 1.

In essence, all organisations acquire resources – including labour, premises, technology, finance, materials – and transform these resources into the goods or services required by their customers. While the type, amount and combination of resources will vary according to the needs of each organisation and may also vary over time, the simple process described above is common to all types of business organisation and provides a useful starting point for investigating business activity and the environment in which it takes place.

A more detailed analysis of business resources and those internal aspects of organisations which help to transform inputs into output can be found in Chapters 2 and 7 below. The need, here, is simply to appreciate the idea of the firm as a **transformation system** and to recognise that in producing and selling output, most organisations hope

Figure 1 The business organisation as a transformation system



to earn sufficient revenue to allow them to maintain and replenish their resources, thus permitting them to produce further output which in turn produces further inputs. In short, inputs help to create output and output creates inputs. Moreover, the output of one organisation may represent an input for another, as in the case of the firm producing capital equipment or basic materials or information or ideas. This interrelationship between business organisations is just one example of the complex and integrated nature of business activity and it helps to highlight the fact that the fortunes of any single business organisation are invariably linked with those of another or others – a point clearly illustrated in many of the examples cited in the text.

The firm in its environment

The simple model of business activity described above is based on the systems approach to management (see Chapter 2). One of the benefits of this approach is that it stresses that organisations are entities made up of interrelated parts which are intertwined with the outside world – the **external environment** in systems language. This environment comprises a wide range of influences – economic, demographic, social, political, legal, technological, etc. – which affects business activity in a variety of ways and which can impinge not only on the transformation process itself but also on the process of resource acquisition and on the creation and consumption of output. This idea of the firm in its environment is illustrated in Figure 2.

Figure 2 The firm in its environment

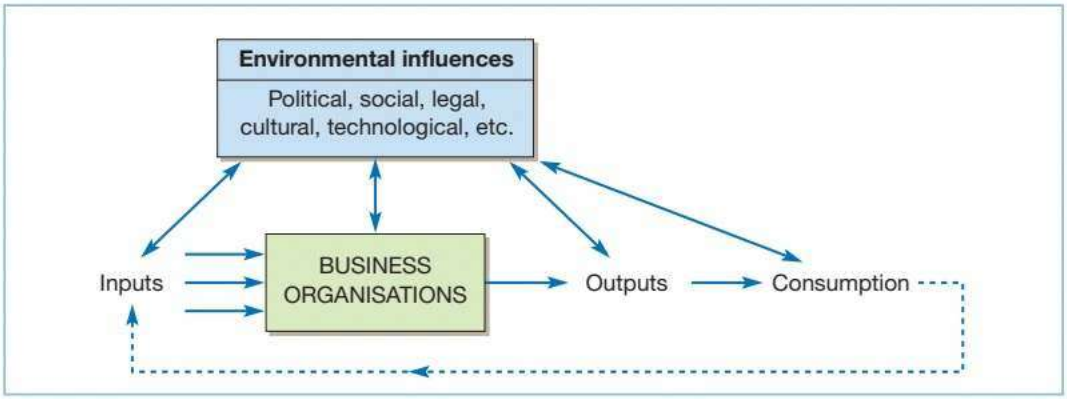
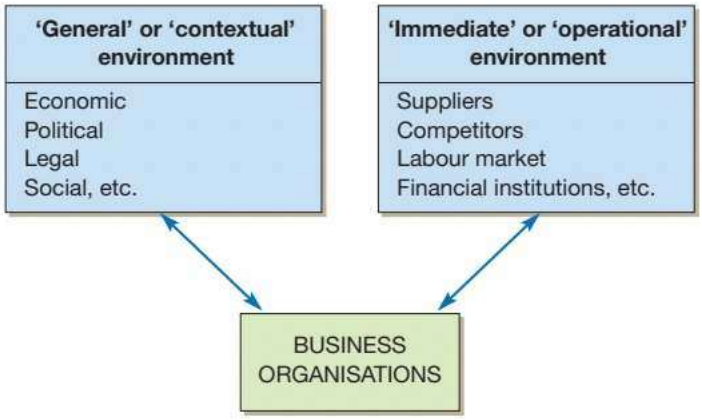


Figure 3 Two levels of environment

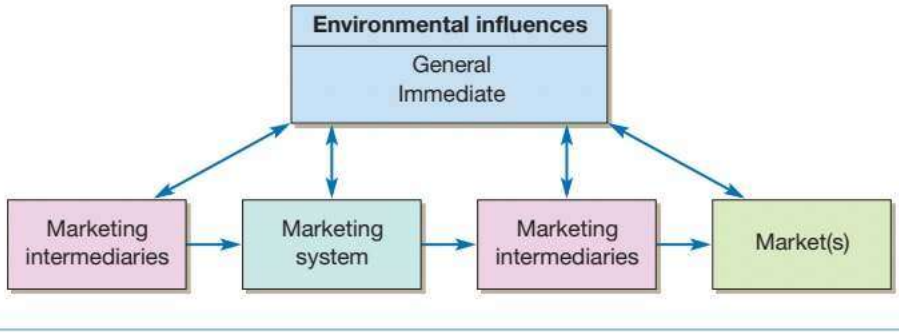


In examining the business environment, a useful distinction can be made between those external factors that tend to have a more immediate effect on the day-to-day operations of a firm and those that tend to have a more general influence. Figure 3 makes this distinction.

The **immediate** or **operational environment** for most firms includes suppliers, competitors, labour markets, financial institutions and customers, and may also include trade associations, trade unions and possibly a parent company. In contrast, the **general** or **contextual environment** comprises those macroenvironmental factors such as economic, political, socio-cultural, technological, legal and ethical influences on business which affect a wide variety of businesses and which can emanate not only from local and national sources but also from international and supranational developments.

This type of analysis can also be extended to the different functional areas of an organisation's activities such as marketing or personnel or production or finance, as illustrated in Figure 4. Such an analysis can be seen to be useful in at least two ways. First, it emphasises the influence of external factors on specific activities

Figure 4 Environmental influences on a firm's marketing system



within the firm and in doing so underlines the importance of the interface between the internal and external environments. Second, by drawing attention to this interface, it highlights the fact that, while business organisations are often able to exercise some degree of control over their internal activities and processes, it is often very difficult, if not impossible, to control the external environment in which they operate.

The general or contextual environment

While the external factors referred to above form the subject matter of the rest of the book, it is useful at this point to gain an overview of the business environment by highlighting some of the key environmental influences on business activity. In keeping with the distinction made between general and more immediate influences, these are discussed separately below. In this section we examine what are frequently referred to as the 'PESTLE' factors (i.e. political, economic, socio-cultural, technological, legal and ethical influences). A **PESTLE** (or **PEST**) **analysis** can be used to analyse a firm's current and future environment as part of the strategic management process.

The political environment

A number of aspects of the political environment clearly impinge on business activity. These range from general questions concerning the nature of the political system and its institutions and processes to the more specific questions relating to government involvement in the working of the economy and its attempts to influence market structure and behaviour. Government activities, both directly and indirectly, influence business activity and government can be seen as the biggest business enterprise at national or local level. Given the trend towards the globalisation of markets and the existence of international trading organisations and blocs, international politico-economic influences on business activity represent one key feature of the business environment. Another is the influence of public, as well as political, opinion in areas such as environmental policy and corporate responsibility.

The economic environment

The distinction made between the political and economic environment – and, for that matter, the legal environment – is somewhat arbitrary. Government, as indicated above, plays a major role in the economy at both national and local level and its activities help to influence both the demand and supply side. Nevertheless there are a number of other economic aspects related to business activity which are worthy of consideration. These include various structural aspects of both firms and markets and a comparison of economic theory and practice.

Mini case The impact of regional economic conditions

For a company that trades in different markets across the world, macroeconomic conditions in a particular part of its overall market can play a key role in determining its corporate sales and profitability. French carmaker PSA Peugeot Citroën, for instance, experienced a significant decline in sales in 2012 as demand fell in southern Europe on the back of the recession in the Eurozone. In response to the problem, the company announced significant job cuts aimed at reducing costs and looked to the French government for a series of multi-billion-euro loans to keep it afloat until trading conditions improved.

Another company experiencing the impact of the recession in Europe was India's Tata Steel, which was affected by a downturn in the demand from the construction and carmaking industries, culminating in significant losses in the European arm of its business in 2012–13. As with Peugeot Citroën, Tata announced steps to cut its costs and improve its efficiency via a programme of restructuring and redundancies, decisions which will clearly have an impact not only on employees but also on the communities in which they live and on other firms in Tata's supply chain.

Since market conditions can vary substantially in different locations, some businesses can experience significant variations in performance in different parts of their operations. US car giant Ford, for example, announced significant losses in Europe in 2012 alongside 'spectacular' results in its North American division. Like Chrysler and other competitors including GM, Ford was able to offset its European losses with stronger sales in the US. It also posted pre-tax profits in its South American and Asian markets.

web link

Further information on the organisations mentioned in this mini case is available at *www.psa-peugeot-citroen.com*; *www.tatasteel.com*; *www.ford.com*; *www.chrysler.com*; *www.gm.com*

The social, cultural and demographic environment

Both demand and supply are influenced by social, cultural and demographic factors. Cultural factors, for example, may affect the type of products being produced or sold, the markets they are sold in, the price at which they are sold and a range of other variables. People are a key organisational resource and a fundamental part of the market for goods and services. Accordingly, socio-cultural influences and developments have an important effect on business operations, as do demographic changes.

The technological environment

Technology is both an input and an output of business organisations as well as being an environmental influence on them. Investment in technology and innovation is frequently seen as a key to the success of an enterprise and has been used to explain differences in the relative competitiveness of different countries. It has also been responsible for significant developments in the internal organisation of businesses in the markets for economic resources.

The legal environment

Businesses operate within a framework of law, which has a significant impact on various aspects of their existence. Laws usually govern, among other things, the status of the organisation, its relationship with its customers and suppliers and certain internal procedures and activities. They may also influence market structures and behaviour. Since laws emanate from government (including supranational governments) and from the judgments of the courts, some understanding of the relevant institutions and processes is desirable.

The ethical and ecological environment

Ethical considerations have become an increasingly important influence on business behaviour, particularly among the larger, more high-profile companies. One area where this has been manifest is in the demand for firms to act in a more socially responsible way and to consider the impact they might have on people, their communities and the natural environment.

The immediate or operational environment

Resources and resource markets

An organisation's need for resources makes it dependent to a large degree on the suppliers of those resources, some of which operate in markets that are structured to a considerable extent. Some aspects of the operation of resource markets or indeed the activities of an individual supplier can have a fundamental impact on an organisation's success and on the way in which it structures its internal procedures and processes. By the same token, the success of suppliers is often intimately connected with the decisions and/or fortunes of their customers. While some organisations may seek to gain an advantage in price, quality or delivery by purchasing resources from overseas, such a decision can engender a degree of uncertainty, particularly where exchange rates are free rather than fixed. Equally, organisations may face uncertainty and change in the domestic markets for resources as a result of factors as varied as technological change, government intervention or public opinion (e.g. conservation issues).

Customers

Customers are vital to all organisations and the ability both to identify and to meet consumer needs is seen as one of the keys to organisational survival and prosperity – a point not overlooked by politicians, who are increasingly using business techniques to attract the support of the electorate. This idea of consumer sovereignty – where resources are

allocated to produce output to satisfy customer demands – is a central tenet of the market economy and is part of an ideology whose influence has become all-pervasive in recent years. Understanding the many factors affecting both individual and market demand, and the ways in which firms organise themselves to satisfy that demand, is a vital component of a business environment that is increasingly market led.

Competitors

Competition – both direct and indirect – is an important part of the context in which many firms operate and is a factor equally applicable to the input as well as the output side of business. The effects of competition, whether from domestic organisations or from overseas firms, are significant at the macro as well as the micro level and its influence can be seen in the changing structures of many advanced industrial economies. How firms respond to these competitive challenges and the attitudes of governments to anti-competitive practices is a legitimate area of concern for students of business.

Mini case Fresh but not so easy

A recurring theme in this and previous editions of the book is the need for businesses to monitor and, where necessary, respond to changes in the business environment. Equally important is the requirement for a firm to understand the needs of the customers in the markets in which it currently operates or in which it wishes to expand its operations as a means of growing the organisation. Even some of the world's largest and most sophisticated companies can sometimes get this wrong.

Take the case of Tesco PLC's foray into the US grocery retailing market with the launch of its Fresh & Easy stores in 2007–8. Initially established in a number of states on the west coast of America, the experiment was aimed at providing a low-risk method of entry into a large and lucrative market, with the focus on providing fresh produce at low prices in competition with existing retailers such as Trader Joe's and Walmart. As a preliminary step, the company sent some of its senior executives to the US to live with American families for several months in order to understand their shopping habits and product preferences. It also ran a high-profile promotional campaign to support its plans to open up 1,000 stores in California and neighbouring states before launching the brand on the east coast.

Tesco's hope that it would be able to break even in two years quickly evaporated and the company was forced to pump hundreds of millions of pounds into the venture to keep it afloat. Apart from the rather unfortunate coincidence of the launch of its brand with the sub-prime crisis and subsequent recession in the US, retail analysts have pointed to some fundamental errors in understanding the preferences of US consumers. Mistakes are said to have included an unclear image; cold and antiseptic stores; the introduction of self-pay checkouts; using cling film on fresh products; an over-emphasis on ready meals; an unwillingness to embrace the 'coupon culture' that is an important part of the US shopping experience; and problems in ensuring high-quality produce. Some consumers also apparently complained that the name Fresh & Easy reminded them of a deodorant or a sanitary product.

By the time of its withdrawal from the market in 2013, Tesco had reputedly spent more than £1 billion on the venture and final losses are expected to be considerably higher. Efforts to

break into a number of other overseas markets – particularly India and China – have also run into difficulty for a variety of reasons and underline the challenges that can face a business that embarks on a strategy of international expansion. On the positive side, the company learned in late December 2013 that India's foreign investment regulator had approved a multi-billion-pound investment plan which, if cleared by the Indian government, would allow Tesco to become the first foreign company to establish supermarkets in the country.

web link Tesco's website address is: *www.tesco.com*

Central themes

A number of themes run through the text and it is useful to draw attention to these at this point.

Interaction with the environment

Viewed as an **open system**, the business organisation is in constant interaction with its environment. Changes in the environment can cause changes in inputs, in the transformation process and in outputs, and these in turn may engender further changes in the organisation's environment. The internal and external environments should be seen as interrelated and interdependent, not as separate entities.

Interaction between environmental variables

In addition to the interaction between the internal and external environments, the various external influences affecting business organisations are frequently interrelated. Changes in interest rates, for example, may affect consumer confidence and this can have an important bearing on business activity. Subsequent attempts by government to influence the level of demand could exacerbate the situation and this may lead to changes in general economic conditions, causing further problems for firms. The combined effect of these factors could be to create a turbulent environment which could result in uncertainty in the minds of managers. Failure to respond to the challenges (or opportunities) presented by such changes could signal the demise of the organisation or at best a significant decline in its potential performance.

The complexity of the environment

The environmental factors identified above are only some of the potential variables faced by all organisations. These external influences are almost infinite in number and variety and no study could hope to consider them all. For students of business and for

managers alike, the requirement is to recognise the complexity of the external environment and to pay greater attention to those influences which appear to be the most pertinent and pressing for the organisation in question, rather than to attempt to consider all possible contingencies.

Environmental volatility and change

The organisation's external environment is further complicated by the tendency towards **environmental change**. This volatility may be particularly prevalent in some areas (e.g. technology) or in some markets or in some types of industry or organisation. As indicated above, a highly volatile environment causes uncertainty for the organisation (or for its sub-units) and this makes decision-making more difficult.

Environmental uniqueness

Implicit in the remarks above is the notion that each organisation has to some degree a unique environment in which it operates and which will affect it in a unique way. Thus, while it is possible to make generalisations about the impact of the external environment on the firm, it is necessary to recognise the existence of this uniqueness and where appropriate to take into account exceptions to the general rule.

Different spatial levels of analysis

External influences operate at different spatial levels – local, regional, national, supranational, international/global – exemplified by the concept of LoNGPEST/LoNGPESTLE. There are few businesses, if any, today that could justifiably claim to be unaffected by influences outside their immediate market(s).

Two-way flow of influence

As a final point, it is important to recognise that the flow of influence between the organisation and its environment operates in both directions. The external environment influences firms, but by the same token firms can influence their environment, and this is an acceptable feature of business in a democratic society which is operating through a market-based economic system.

Synopsis

In the process of transforming inputs into output, business organisations operate in a multifaceted environment which affects and is affected by their activities. This environment tends to be complex and volatile and comprises influences which are of both a general and an immediate kind and which operate at different spatial levels. Understanding this environment and its effects on business operations is vital to the study and practice of business.

Summary

- Business activity is essentially concerned with transforming inputs into outputs for consumption purposes.
- All businesses operate within an external environment that shapes their operations and decisions.
- This environment comprises influences that are both operational and general.
- The operational environment of business is concerned with such factors as customers, suppliers, creditors and competitors.
- The general environment focuses on what are known as the PESTLE factors.
- In analysing a firm's external environment attention needs to be paid to the interaction between the different environmental variables, environmental complexity, volatility and change, and to the spatial influences.
- While all firms are affected by the environment in which they exist and operate, at times they help to shape that environment by their activities and behaviour.

Case study — Facing the unexpected

In previous editions of the book we have stressed how the business environment can sometimes change dramatically and unexpectedly for the worse, using the September 11 2001 attack on the World Trade Center in the US as an example of what is known as an exogenous shock to the economic system. Mercifully, events of this kind tend to be relatively rare, but when they occur they present a considerable challenge to the businesses and industries affected.

The same is true when natural disasters occur, as the following recent examples illustrate.

2010 – the eruption of an Icelandic volcano sent a cloud of volcanic ash over large parts of Europe, resulting in the grounding of planes and weeks of disruption of air travel. Airlines in particular were badly affected and faced additional costs because of stranded passengers and cancelled flights. Beneficiaries included hoteliers who had to accommodate people unable to travel and alternative transport businesses (e.g. ferry operators).

2011 – an earthquake in Chile devastated the Chilean wine industry by destroying storage tanks and infrastructure. Another earthquake and a tsunami in Japan destroyed a major nuclear facility and led to damage and the temporary closure of major factories, including those of Nissan and Toyota. The negative impact on the Japanese economy resulted in a reduction in oil imports as industrial production declined and shortages of electricity occurred. To support the economy the Japanese government pumped billions of yen into the economic system.

2013 – sudden and devastating storms in the Burgundy and Bordeaux regions of France destroyed swathes of the French wine industry, resulting in a loss of jobs and income in the affected local communities, with a knock-on impact on local businesses. In China, a heatwave across the central and eastern parts of the country badly affected the farming industry and tempted the government to

spend millions on artificial steps to trigger rain. In some areas power failures occurred as the demand for electricity soared as individuals and organisations turned on the air conditioning. Much warmer conditions were also experienced in parts of northern Europe, including the UK, resulting in increased sales of certain items (e.g. barbecues, sunscreen) and tempting many people to holiday at home. Other adverse natural events in 2013–14 included a super typhoon in the Philippines, extensive fires in parts of Australia, a major drought in California and severe storms and flooding in southern Britain, all of which had major effects on businesses and communities in the affected areas.

While there is little a business can do to protect itself totally against events of this kind, many larger firms, especially multinationals, tend to put in place contingency plans to manage unexpected crises, whether they are caused by human or natural events. A business continuity plan (BCP) can help an organisation to respond quickly and effectively to a negative situation and hopefully to survive the experience and learn from it. Smaller firms on the whole tend to lack the financial and human resources needed to adopt such resilience measures and some may not survive an adverse change in the external environment. For other organisations such a change may bring with it business opportunities, an unexpected though possibly welcome gain from an event that has a negative impact on other firms.

Case study questions

1 Can you think of any other examples of major unanticipated events in your own country (or areas of your own country) that have had a serious adverse effect on its firms and/or industries?

2 Can you think of any businesses that may have benefited commercially from this event or these events?

Review and discussion questions

1 In what senses could a college or university be described as a business organisation? How would you characterise its 'inputs' and 'outputs'?

2 Taking examples from a range of quality newspapers, illustrate ways in which business organisations are affected by their external environment.

3 Give examples of the ways in which business organisations can affect the external environment in which they operate.

Assignments

1 Assume you are a trainee in a firm of management consultants. As part of your induction process you have been asked to collect a file of information on an organisation of your choice. This file should contain information not only on the structure of the organisation and its products but also on the key external influences that have affected its operations in recent years.

2 For a firm or industry of your choice, undertake a PESTLE analysis indicating the likely major environmental influences to be faced by the firm/industry in the next five to ten years.

Further reading

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2 Business organisations: the internal environment

The systems approach to the study of business organisations stresses the interaction between a firm's internal and external environments. Key aspects of the internal context of business include the organisation's structure and functions and the way they are configured in pursuit of specified organisational objectives. If the enterprise is to remain successful, constant attention needs to be paid to balancing the different influences on the organisation and to the requirement to adapt to new external circumstances. This responsibility lies essentially with the organisation's management, which has the task of blending people, technologies, structures and environments.

Learning outcomes

Having read this chapter you should be able to:

- outline the broad approaches to organisation and management, paying particular attention to the systems approach
- identify alternative organisational structures used by business organisations
- discuss major aspects of the functional management of firms
- illustrate the interaction between a firm's internal and external environments

Key terms

Bureaucracy
Classical theories of organisation
Contingency approach
Divisional structure
Downsizing
Formal structures
Functional organisation
Functional specialisation
Hierarchy of needs
Holding company
Human relations approach
Human resource management
Management
Marketing
Marketing concept
Marketing mix
Matrix structure
Organisation by product
Organisation chart
Private sector
Profit centre
Project team
Public sector
Re-engineering
Scientific management
Sub-systems
Systems approach
Theory X and Theory Y
Theory Z
Virtual organisation
Voluntary (or third) sector

Introduction

Under the systems approach to understanding business activity presented in Chapter 1, the organisation lies at the heart of the transformation process and tends to be seen as a kind of 'black box' which contains a multitude of elements – including structures, processes, people, resources and technologies – that brings about the transformation of inputs into outputs (see below). While the study of the business environment rightly focuses on the external context of business organisations, it is important to recognise that firms also have an internal environment that both shapes and is shaped by the external context in which they operate and make decisions. This notion of the interplay between an organisation's internal and external environments is a theme that runs through many of the chapters in this book.

As students of business and management will be aware, the internal features of business organisations have received considerable attention from scholars researching these fields, and a large number of texts have been devoted to this aspect of business studies.[1] In the discussion below, the aim is to focus on three areas of the internal organisation that relate directly to a study of the business environment: approaches to understanding organisations, organisational structures, and key functions within the enterprise. Further insight into these aspects and into management and organisational behaviour generally can be gained by consulting the many specialist books in this field, a number of which are mentioned at the end of this chapter.

A central theme running through any analysis of the internal environment is the idea of **management**, which has been subjected to a wide variety of definitions. As used in this context, management is seen both as a system of roles fulfilled by individuals who manage the organisation (e.g. entrepreneur, resource manager, coordinator, leader, motivator, organiser) and as a process that enables an organisation to achieve its objectives. The essential point is that management should be seen as a function of organisations, rather than as a controlling element, and its task is to enable the organisation to identify and achieve its objectives and to adapt to change. Managers need to integrate the various influences on the organisation – including people, technology, systems and the environment – in a manner best designed to meet the needs of the enterprise at the time in question and be prepared to institute change as and when circumstances dictate.

The concept of the organisation: an initial comment

According to Stoner and Freeman (1992: 4), an organisation can be defined as two or more people who work together in a structured way to achieve a specific goal or set of goals. Defined in this way, the term covers a vast array of structures in the:

- **private sector** – that part of the economy where ownership and control of the organisation is in the hands of private individuals or groups and where profit-seeking is a central goal;
- **public sector** – that part of the economy under the control of government and its agencies and where the state establishes and runs the different types of organisation on behalf of its citizens and for their general well-being;

- **voluntary (or third) sector** – comprising those organisations, including charities, voluntary bodies and community businesses, that are not-for-profit enterprises and non-governmental.

Leaving aside the blurring of definitions of these three generic sectors that has occurred over recent years (e.g. where third-sector organisations deliver public services), the concept of the 'business organisation' as used in this text covers enterprises of all types and in all sectors. It also encapsulates those organisations where the objectives are set by one individual who both owns and controls the business and has no other employees (i.e. sole traders with zero staff).

Despite coming in a wide variety of shapes, forms and sizes, business organisations share a number of common features. Mullins (2010) identifies four such features:

- people (i.e. employees);
- objectives (i.e. what the organisation is set up to achieve);
- structure (i.e. the organisational framework through which the objectives are pursued and efforts are coordinated);
- management (i.e. the directing and controlling aspect of the enterprise).

To these we could add the idea of resources (including finance) and technologies. We also need to recognise the existence of an external environment that faces all types of enterprise. This is, after all, a fundamental feature of the systems approach to understanding business organisations and how they operate.

Understanding the nature of organisations: theories of organisation and management

To gain an insight into the principles that are felt to underlie the process of management, it is useful to undertake a brief examination of organisational theories. These theories or approaches – some of which date back to the late nineteenth century – represent the views of both practising managers and academics as to the factors that determine organisational effectiveness and the influences on individuals and groups within the work environment. Broadly speaking, these approaches can be broken down into three main categories: the classical approach, the human relations approach and the systems approach.[2] Since the last of these encompasses the model presented in Chapter 1, particular attention is paid to this perspective.

The classical approach

Classical theories of organisation and management mostly date from the first half of the twentieth century and are associated with the work of writers such as Taylor, Fayol, Urwick and Brech. In essence, the classicists viewed organisations as **formal structures** established to achieve a particular number of objectives under the direction of management, the emphasis being on purpose, structure, hierarchy and common principles. By identifying a set of guidelines to assist managers in the design of the organisational structure, the proponents of the classical view believed that organisations would be

able to achieve their objectives more effectively. Fayol, for example, identified fourteen principles which included the division of work, the scalar chain, centralisation and the unity of command – features which also found expression in Weber's notion of 'bureaucracy'. Urwick's rules or principles similarly emphasised aspects of organisation structure and operations – such as specialisation, coordination, authority, responsibility and the span of control – and were presented essentially as a code of good management practice.

Within the classical approach special attention is often given to two important sub-groupings, known as **scientific management** and **bureaucracy**. The former is associated with the pioneering work of F. W. Taylor (1856–1915), who believed that scientific methods could be attached to the design of work so that productivity could be increased. For Taylor, the systematic analysis of jobs (e.g. using some form of work study technique) was seen as the key to finding the best way to perform a particular task and thereby achieving significant productivity gains from individuals, which would earn them increased financial rewards. In Taylor's view, the responsibility for the institution of a scientific approach lay with management, under whose control and direction the workers would operate to the mutual benefit of all concerned.

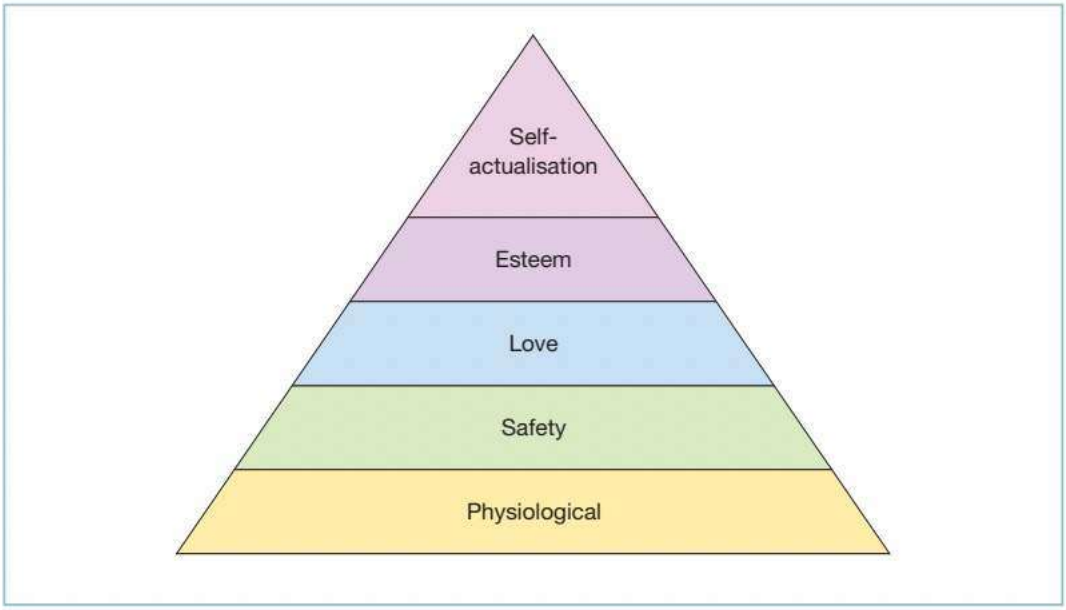
The second sub-group, bureaucracy, draws heavily on the work of Max Weber (1864–1920), whose studies of authority structures highlighted the importance of 'office' and 'rules' in the operation of organisations. According to Weber, bureaucracy – with its system of rules and procedures, specified spheres of competence, hierarchical organisation of offices, appointment based on merit, high level of specialisation and impersonality – possessed a degree of technical superiority over other forms of organisation, and this explained why an increasing number of enterprises were becoming bureaucratic in structure. Despite Weber's analysis appearing somewhat dated nowadays, bureaucratic organisation remains a key feature of many enterprises throughout the world and is clearly linked to increasing organisational size and complexity. Notwithstanding the many valid criticisms of Weber's work, it is difficult to imagine how it could be otherwise.

The human relations approach

Whereas the classical approach focuses largely on structure and on the formal organisation, the **human relations approach** to management emphasises the importance of people in the work situation and the influence of social and psychological factors in shaping organisational behaviour. Human relations theorists have primarily been concerned with issues such as individual motivation, leadership, communications and group dynamics, and have stressed the significance of the informal pattern of relationships that exists within the formal structure. The factors influencing human behaviour have accordingly been portrayed as a key to achieving greater organisational effectiveness, thus elevating the 'management of people' to a prime position in the determination of managerial strategies.

The early work in this field is associated with Elton Mayo (1880–1949) and with the famous Hawthorne Experiments, conducted at the Western Electric Company (USA) between 1924 and 1932. What these experiments basically showed was that individuals at work were members of informal (i.e. unofficial) as well as formal groups and that group influences were fundamental to explaining individual behaviour. Later

Figure 1 A hierarchy of needs



work by writers such as Maslow, McGregor, Argyris, Likert and Herzberg continued to stress the importance of the human factor in determining organisational effectiveness, but tended to adopt a more psychological orientation, as exemplified by Maslow's '**hierarchy of needs**' and McGregor's '**Theory X and Theory Y**'. Maslow's central proposition was that individuals seek to satisfy specific groups of needs, ranging from basic physiological requirements (e.g. food, sleep, sex), through safety, love and esteem, to self-actualisation (i.e. self-fulfilment), progressing systematically up the hierarchy as each lower-level need is satisfied (see Figure 1). To McGregor, individuals at work were seen by management as either inherently lazy (Theory X) or committed to the organisation's objectives and often actively seeking responsibility (Theory Y). These perceptions consequently provided the basis for different styles of management, which ranged from the coercive to the supportive.

McGregor's concern with management styles is reflected in later studies, including Ouichi's notion of **Theory Z**.[3] According to Ouichi, one of the key factors in the success of Japanese manufacturing industries was their approach to the management of people. Theory Z organisations were those that offered workers long-term (often lifetime) employment, a share in decision-making, opportunities for training, development and promotion, and a number of other advantages which gave them a positive orientation towards the organisation. For Ouichi, the key to organisational effectiveness lay in the development of a Japanese-style Theory Z environment, adapted to western requirements.

The systems approach

More recent approaches to organisation and management have helped to integrate previous work on structures, people and technology, by portraying organisations as socio-technical systems interacting with their environment. Under this approach – which

became popular in the 1960s – organisations were seen as complex systems of people, tasks and technologies that were part of and interacted with a larger environment, comprising a wide range of influences (see Chapter 1). This environment was frequently subject to fluctuations, which on occasions could become turbulent (i.e. involving rapid and often unpredictable change). For organisations to survive and prosper, adaptation to environmental demands was seen as a necessary requirement and one that was central to the process of management.

The essence of the **systems approach** has been described in Chapter 1 but is worth repeating here. Organisations, including those involved in business, are open systems, interacting with their environment as they convert inputs into output. Inputs include people, finance, materials and information, provided by the environment in which the organisation exists and operates. Output comprises such items as goods and services, information, ideas and waste, discharged into the environment for consumption by 'end' or 'intermediate' users and in some cases representing inputs used by other organisations.

Systems invariably comprise a number of **sub-systems** through which the process of conversion or transformation occurs. Business organisations, for example, usually have sub-systems that deal with activities such as production, marketing, accounting and human resource management, and each of these in turn may involve smaller sub-systems (e.g. sales, quality control, training) which collectively constitute the whole. Just as the organisation as a system interacts with its environment, so do the sub-systems and their component elements, which also interact with each other. In the case of the latter, the boundary between sub-systems is usually known as an 'interface'.

While the obvious complexities of the systems approach need not be discussed, it is important to emphasise that most modern views of organisations draw heavily on the work in this area, paying particular attention to the interactions between people, technology, structure and environment and to the key role of management in directing the organisation's activities towards the achievement of its goals. Broadly speaking, management is seen as a critical sub-system within the total organisation, responsible for the coordination of the other sub-systems and for ensuring that internal and external relationships are managed effectively. As changes occur in one part of the system, these will induce changes elsewhere and this will require a management response that will have implications for the organisation and for its sub-systems. Such changes may be either the cause or effect of changes in the relationship between the organisation and its environment, and the requirement for managers is to adapt to the new conditions without reducing the organisation's effectiveness.

Given the complex nature of organisations and the environments in which they operate, a number of writers have suggested a **contingency approach** to organisational design and management (e.g. Lawrence and Lorsch, Woodward, Perrow, Burns and Stalker).[4] In essence, this approach argues that there is no single form of organisation best suited to all situations and that the most appropriate organisational structure and system of management is dependent upon the contingencies of the situation (e.g. size, technology, environment) for each organisation. In some cases a bureaucratic structure might be the best way to operate, while in others much looser and more organic methods of organisation might be more effective. In short, issues of organisational design and management depend on choosing the best combination in the light of the relevant situational variables; this might mean different structures and styles coexisting within an organisation.

Other theoretical approaches

To complement these traditional approaches to understanding the nature of organisations, Mullins (2010) highlights the contribution of theories of decision-making and social action. Decision-making theory, he suggests, can be seen as a sub-division of the systems approach in which the focus of attention is on the process of managerial decision-making and how information is gathered, processed and used in deciding how to act. The organisation in effect is seen as an information-processing network and successful management is concerned with making choices and resolving conflicts, often against a background of a changing internal and external environment.

Social action approaches emphasise the need to view the organisation from the standpoint of the individual employees or actors, each of whom has their own goals and interpretation of their work situation and whose behaviour is guided by their view of what work means to them and the satisfaction they are seeking. Organisations are portrayed as arenas in which individuals with different views and expectations interact. Conflicts of interest are regarded as a normal feature of human behaviour and an inevitable part of organisational life.

Organisational structures

Apart from the very simplest form of enterprise in which one individual carries out all tasks and responsibilities, business organisations are characterised by a division of labour which allows employees to specialise in particular roles and to occupy designated positions in pursuit of the organisation's objectives. The resulting pattern of relationships between individuals and roles constitutes what is known as the organisation's structure and represents the means by which the purpose and work of the enterprise are carried out. It also provides a framework through which communications can occur and within which the processes of management can be applied.

Responsibility for establishing the formal structure of the organisation lies with management and a variety of options is available. Whatever form is chosen, the basic need is to identify a structure that will best sustain the success of the enterprise and will permit the achievement of a number of important objectives. Through its structure an organisation should be able to:

- achieve efficiency in the utilisation of resources;
- provide opportunities for monitoring organisational performance;
- ensure the accountability of individuals;
- guarantee coordination between the different parts of the enterprise;
- provide an efficient and effective means of organisational communication;
- create job satisfaction, including opportunities for progression;
- adapt to changing circumstances brought about by internal or external developments.

In short, structure is not an end in itself but a means to an end and should ideally reflect the needs of the organisation within its existing context and taking into account its future requirements.

Mini case 'Into the Dragon's Den'

As the chapter illustrates, the structure of an organisation is a means by which an enterprise can achieve its objectives. As the environment in which a business operates changes, a firm should be willing to adapt the structure to meet the new circumstances. This might mean moving beyond the traditional models discussed below, in an effort to improve performance.

The global pharmaceutical giant GlaxoSmithKline (GSK) illustrates this idea of an evolving organisational structure. In July 2008, GSK announced that in future its scientists would have to pitch their ideas for new drugs to a development board, based essentially on the lines of *Dragons' Den*, a popular UK television programme where would-be entrepreneurs seek to gain backing for their ideas from a group of financiers. The board would include two venture capitalists and would be a mixture of executives from inside the company and GSK outsiders, the plan being to stimulate innovation by requiring smaller teams of scientists to pitch three-year business plans to the new drug discovery investment board in an effort to secure funding for new drug treatments.

web link You can access the website for GSK at *www.gsk.com*

The essence of structure is the division of work between individuals and the formal organisational relationships that are created between them. These relationships will be reflected not only in individual job descriptions but also in the overall **organisation chart**, which designates the formal pattern of role relationships, and the interactions between roles and the individuals occupying those roles. Individual authority relationships can be classified as line, staff, functional and lateral and arise from the defined pattern of responsibilities, as follows:

- *Line relationships* occur when authority flows vertically downwards through the structure from superior to subordinate (e.g. managers–section leader–staff).
- *Staff relationships* are created when senior personnel appoint assistants who normally have no authority over other staff but act as an extension of their superior.
- *Functional relationships* are those between specialists (or advisers) and line managers and their subordinates (e.g. when a specialist provides a common service throughout the organisation but has no authority over the users of the service). The personnel or computing function may be one such service that creates a functional relationship. (Note that specialists have line relationships with their own subordinates.)
- *Lateral relationships* exist across the organisation, particularly between individuals occupying equivalent positions within different departments or sections (e.g. committees, heads of departments, section leaders).

With regard to the division of work and the grouping of organisational activities, this can occur in a variety of ways. These include:

- *by function or major purpose*, associated particularly with departmental structures;
- *by product or service*, where individuals responsible for a particular product or service are grouped together;

- *by location*, based on geographical criteria;
- *by common processes* (e.g. particular skills or methods of operation);
- *by client group* (e.g. children, the disabled, the elderly).

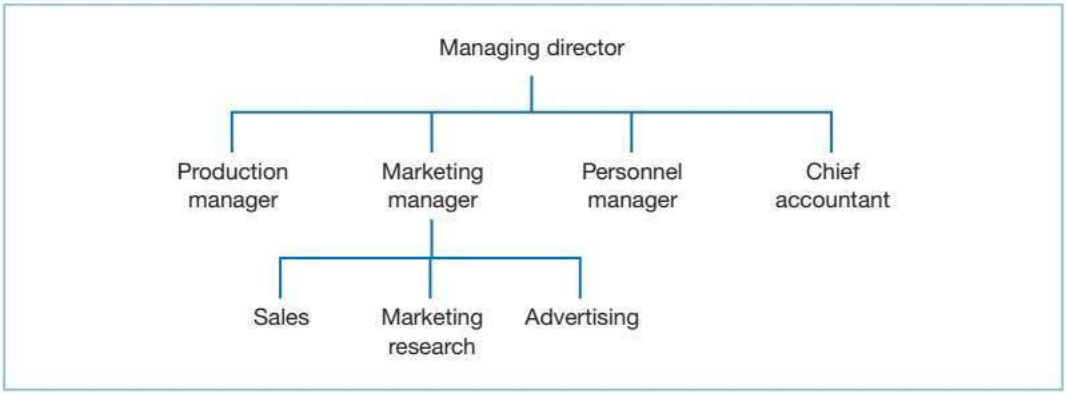
In some organisations a particular method of grouping will predominate, in others there will tend to be a variety of types, and each has its own particular advantages and disadvantages. In the next section, we examine five popular methods of grouping activities in business organisations. Students should attempt to discover what types of structure exist within their own educational institution and the logic (if any) that underlies the choices made.

Functional organisation

The functional approach to organisation is depicted in Figure 2. As its name indicates, in this type of structure activities are clustered together by common purpose or function. All marketing activities, for example, are grouped together as a common function, typically within a marketing department. Similarly, other areas of activity, such as production, finance, personnel and research and development, have their own specialised sections or departments, responsible for all the tasks required of that function.

Apart from its obvious simplicity, the **functional organisation** structure allows individuals to be grouped together on the basis of their specialisms and technical expertise, and this can facilitate the development of the function they offer as well as providing a recognised path for promotion and career development. On the downside, functional specialisation, particularly through departments, is likely to create sectional interests which may operate to the disadvantage of the organisation as a whole, particularly where inequalities in resource allocation between functions become a cause for inter-function rivalry. It could also be argued that this form of structure is most suited to single-product firms and that it becomes less appropriate as organisations diversify their products and/or markets. In such circumstances, the tendency will be for businesses to look for the benefits that can arise from specialisation by product or from the divisionalisation of the enterprise.

Figure 2 A functional organisation structure



Organisation by product or service

In this case the division of work and the grouping of activities are dictated by the product or service provided (see Figure 3), such that each group responsible for a particular part of the output of the organisation may have its own specialist in the different functional areas (e.g. marketing, finance, personnel). One advantage of this type of structure is that it allows an organisation to offer a diversified range of products, as exemplified by the different services available in National Health Service hospitals (e.g. maternity, orthopaedic, geriatric and so forth). Its main disadvantage is the danger that the separate units or divisions within the enterprise may attempt to become too autonomous, even at the expense of other parts of the organisation, and this can present management with problems of coordination and control.

The divisional structure

As firms diversify their products and/or markets – often as a result of merger or takeover – a structure is needed to coordinate and control the different parts of the organisation. This structure is likely to be the divisional (or multi-divisional) company.

A **divisional structure** is formed when an organisation is split up into a number of self-contained business units, each of which operates as a profit centre. This may occur on the basis of product or market or a combination of the two, with each unit tending to operate along functional or product lines, but with certain key functions (e.g. finance, personnel, corporate planning) provided centrally, usually at company headquarters (see Figure 4).

The main benefit of the multi-divisional company is that it allows each part of what can be a very diverse organisation to operate semi-independently in producing and marketing its products, thus permitting each division to design its offering to suit local market conditions – a factor of prime importance where the firm operates on a multinational basis. The dual existence of divisional **profit centres** and a central unit responsible for establishing strategy at a global level can, however, be a source of considerable tension, particularly where the needs and aims of the centre appear to conflict with operations at the local level or to impose burdens seen to be unreasonable by divisional managers (e.g. the allocation of central overhead costs).

Much the same kind of arguments apply to the **holding company**, though this tends to be a much looser structure for managing diverse organisations, favoured by both UK

Figure 3 A product-based structure

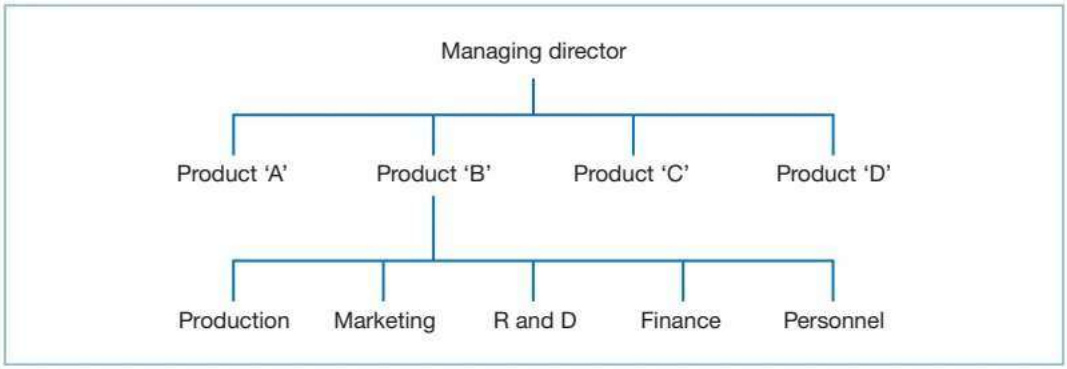
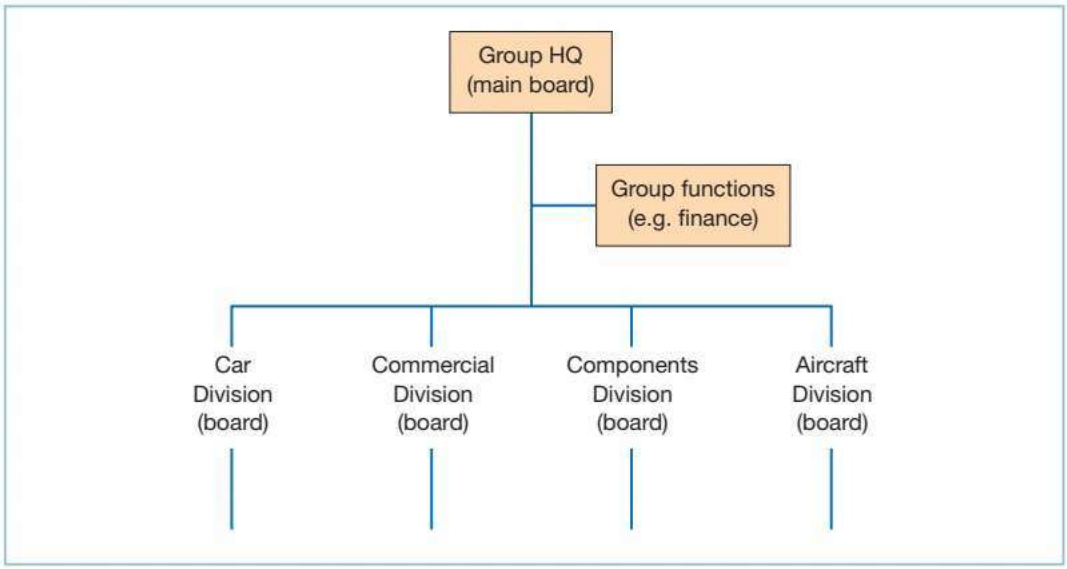


Figure 4 A divisional structure



and Japanese companies. Under this arrangement, the different elements of the organisation (usually companies) are coordinated and controlled by a parent body, which may be just a financial entity established to maintain or gain control of other trading companies. Holding companies are associated with the growth of firms by acquisition, which gives rise to a high degree of product or market diversification. They are also a popular means of operating a multinational organisation.

Mini case A merger of equals?

Announced in July 2013, the planned merger between the French company Publicis and America's Omnicom will create the world's largest marketing and advertising business, assuming it receives regulatory approval, which, at the time of writing (October 2013), seems likely.

Publicis Omnicom Group – as the holding company will be known – plans to have dual headquarters in Paris and New York and will be led by the chief executive officers (CEOs) of the two organisations for the first two and a half years of its life. Thereafter the plan is to make one of the CEOs a non-executive chairman and the other the lead CEO for the whole group. In the spirit of what has been dubbed a 'merger of equals', the combined business will operate through a 16-person single-tier board, comprising the two CEOs and seven non-executive directors drawn from each part of the merged enterprise.

Observers have suggested that the newly formed organisation might experience some teething problems because of differences in culture and management style and because the two companies currently represent clients drawn from competing brands (e.g. Omnicom's clients include Volkswagen and Nissan; Publicis represents BMW and Renault).

web link For information on the proposed merger see, for example, *www.reuters.com*

Matrix structures

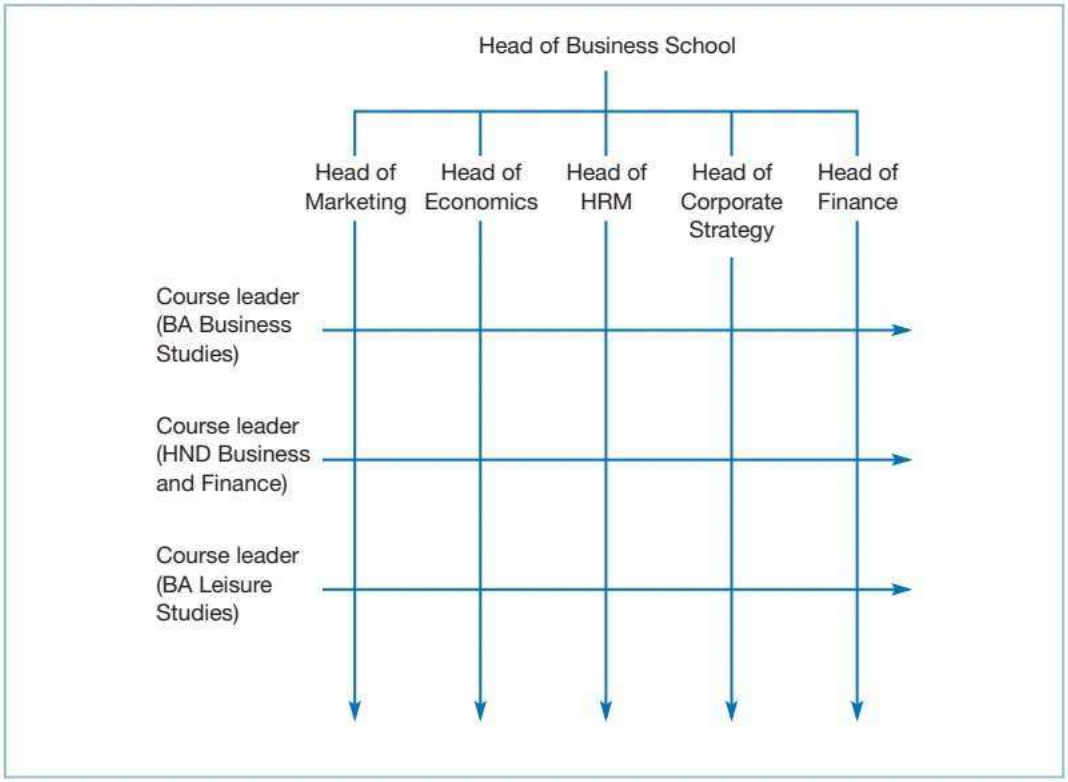
A **matrix structure** is an arrangement for combining functional specialisation (e.g. through departments) with structures built around products, projects or programmes (see Figure 5). The resulting grid (or matrix) has a two-way flow of authority and responsibility. Within the functional elements, the flow is vertically down the line from superior to subordinate and this creates a degree of stability and certainty for the individuals located within the department or unit. Simultaneously, as a member of a project group or product team, an individual is normally answerable horizontally to the project manager whose responsibility is to oversee the successful completion of the project, which in some cases may be of very limited duration.

Matrix structures offer various advantages, most notably flexibility, opportunities for staff development, an enhanced sense of ownership of a project or programme, customer orientation and the coordination of information and expertise. On the negative side, difficulties can include problems of coordination and control, conflicting loyalties for staff and uncertain lines of authority. It is not uncommon in an organisation designed on matrix lines for project or programme leaders to be unsure of their authority over the staff from the contributing departments. Nor is it unknown for functional managers to withdraw their cooperation and/or support for projects located outside their immediate sphere of influence.

Project teams

Despite its flexibility, the matrix often has a degree of permanence; in contrast, the **project team** is essentially a temporary structure established as a means of carrying out a particular task, often in a highly unstable environment. Once the task is complete, the

Figure 5 A matrix structure in a business school



team is disbanded and individuals return to their usual departments or are assigned to a new project.

Fashioned around technical expertise rather than managerial rank, and often operating closely with clients, project teams are increasingly common in high-technology firms, construction companies and some types of service industry, especially management consultancies and advertising. Rather than being a replacement for the existing structure, they operate alongside it and utilise in-house staff (and, in some cases, outside specialists) on a project-by-project basis. While this can present logistical and scheduling problems and may involve some duplication of resources, it can assist an organisation in adapting to change and uncertainty and in providing products to the customer's specifications. Project teams tend to be at their most effective when objectives and tasks are well defined, when the client is clear as to the desired outcome and when the team is chosen with care.

The virtual organisation

As indicated above, traditional organisations have structures that are designed to facilitate the transformation of inputs into output. Increasingly, as the business environment changes, relationships both within and between organisations have needed to become more flexible and this has given rise to such developments as the growth in teleworking and the establishment of dynamic broker/agent networks involving considerable outsourcing of sub-tasks to 'agents' (e.g. manufacturing, distribution) by the core organisation (the 'broker'). It is fair to say that this demand for greater flexibility has been driven partly by the market and partly by cost considerations, and the process of change has been facilitated by relatively rapid developments in information technology. One area currently exciting the interest of writers on management and organisation is the concept of the **virtual organisation**, arguably the ultimate form of organisational flexibility.

The term virtual organisation or firm signifies an extremely loose web of essentially freelance businesses or individuals who organise themselves to produce a specific customer product (e.g. an individual holiday package with particular features unique to the customer). Without any permanent structure or hierarchy this so-called firm can constantly change its shape and, despite existing across space and time, tends to appear edgeless, with its inputs, outputs and employees increasingly dispersed across the linked world of information systems. Given modern forms of communication, opportunities exist for the creation of totally electronic-based organisations trading in expertise and information with no real-world physical identity. This stands in stark contrast to the traditional view of the firm as an arrangement which adds value by transforming basic economic inputs (e.g. land, labour, capital) into physical outputs or services.

Structural change

Internal change is an important feature of the modern business organisation. In order to remain competitive and meet stakeholder needs, a firm may have to find ways to restructure its organisation as the environment in which it operates changes.

Solutions can range from a partial or wholesale shift in the organisation's structural form to strategies for reducing the overall size and shape of the company (e.g. **downsizing**) or a radical redesign of business processes (e.g. **re-engineering**).

Whereas business re-engineering normally connotes a root-and-branch reform of the way in which the business operates, downsizing essentially involves shrinking the organisation to make it leaner and fitter and hopefully more flexible in its response to the marketplace. For some companies this means little more than reducing the size of the workforce through natural wastage and/or redundancies, as and when opportunities arise; for others it involves delayering the organisation by removing a tier, or tiers, of management, thus effectively flattening the organisation's hierarchy and helping it to reduce its unit costs of production.

In its most systematic and long-term form, downsizing can be used as a vehicle for cultural change through which an organisation's employees are encouraged to embrace notions of continuous improvement and innovation, and to accept that structural reform is a permanent and natural state of affairs. Under this approach, retraining and reskilling become vital tools in implementing the chosen strategy and in shaping the organisation to meet the demands of its changing environment. The danger is, however, that a firm may become too concerned with restructuring as a cure for all its problems, when the real cause of its difficulties lies in its marketplace. Cutting the number of employees, in such a situation, is unlikely to make unattractive products attractive, nor is it likely to boost morale within the organisation.

Aspects of functional management

Most organisation structures reflect a degree of **functional specialisation**, with individuals occupying roles in departments, units or sections which have titles such as Production, Finance, Marketing, Personnel, and Research and Development. These functional areas of the internal organisation, and the individuals who are allocated to them, are central to the process of transforming organisational inputs into output. The management of these functions and of the relationships between them will be a key factor in the success of the enterprise and in its ability to respond to external demands for change.

The interdependence of the internal functions can be demonstrated by a simple example. Providing goods and services to meet the market's needs often involves research and development, which necessitates a financial input, usually from the capital market or the organisation's own resources. It also requires, as do all the other functions, the recruitment of staff of the right quality, a task which is more often than not the responsibility of the Personnel or Human Resources department. If research and development activities lead to a good idea which the Marketing department is able to sell, then the Production department is required to produce it in the right quantities, to the right specifications and at the time the market needs it. This depends not only on internal scheduling procedures within the Production department but also on having the right kinds of materials supplied on time by the Purchasing department, an appropriate system of quality control and work monitoring, machinery that is working and regularly serviced, the finished items packed, despatched and delivered, and a multitude of other activities, all operating towards the same end.

The extent to which all of these requirements can be met simultaneously depends on internal factors, many of which are controllable, and also on a host of external influences, the majority of which tend to be beyond the organisation's control. To demonstrate this interface between the internal and external environments, two key areas of functional management are discussed briefly below – marketing and human resource management. An examination of the other functions within the organisation would yield similar findings.

Human resource management (HRM)

People are the key organisational resource; without them organisations would not exist or function. All businesses need to plan for and manage the people they employ if they are to use this resource effectively and efficiently in pursuit of their objectives. In modern and forward-looking organisations this implies a proactive approach to the management of people that goes beyond the bounds of traditional personnel management and involves the establishment of systems for planning, monitoring, appraisal and evaluation, training and development, and integrating the internal needs of the organisation with the external demands of the marketplace. Such an approach is associated with the idea of **human resource management**.

As in other areas of management, HRM involves a wide variety of activities related to the formulation and implementation of appropriate organisational policies, the provision of opportunities for monitoring, evaluation and change, and the application of resources to the fulfilment of organisational ends. Key aspects of 'people management' include:

- recruitment and selection;
- working conditions;
- training and career development;
- job evaluation;
- employee relations;
- manpower planning;
- legal aspects of employment.

In most, if not all, cases these will be affected by both internal and external influences (e.g. size of the firm, management style, competition, economic and political developments), some of which will vary over time as well as between organisations.

The provision of these activities within an organisation can occur in a variety of ways and to different degrees of sophistication. Some very small firms may have little in the way of a recognisable HRM function, being concerned primarily with questions of hiring and firing, pay and other working conditions, but not with notions of career development, staff appraisal or job enrichment. In contrast, very large companies may have a specialist HRM or personnel department, often organised on functional lines and responsible for the formulation and implementation of personnel policies throughout the organisation. Such centralisation provides not only some economies of scale but also a degree of standardisation and consistency across departments. To allow for flexibility, centralised systems are often combined with an element of decentralisation which permits individual departments or sections to exercise some influence in matters such as the recruitment and selection of staff, working conditions, training and career development.

To illustrate how the different aspects of HRM are influenced by external factors, one part of this function – recruitment and selection of staff – has been chosen. This is the activity within the organisation that seeks to ensure that it has the right quantity and quality of labour in the right place and at the right time to meet its requirements at all levels. To achieve this aim, the organisation initially needs to consider a large number of factors, including possible changes in the demand for labour, the need for new skills and likely labour turnover, before the processes of recruitment and selection can begin. These aspects in turn will be conditioned by a variety of factors such as changes in the demand for the product, the introduction of new technology, and social, economic and demographic changes, some of which may not be anticipated or expected by strategic planners.

Once recruitment and selection are ready to begin, a further raft of influences will impinge upon the process, some of which emanate from external sources. In drawing up a job specification, for example, attention will normally need to be paid to the state of the local labour market, including skill availability, competition from other employers, wage rates in comparable jobs and/or organisations, and socio-demographic trends. If the quality of labour required is in short supply, an organisation may find itself having to offer improved pay and working conditions simply to attract a sufficient number of applicants to fill the vacancies on offer. Equally, in fashioning its job advertisements and drawing up the material it sends out to potential applicants, a firm will need to pay due attention to the needs of current legislation in areas such as equal opportunities, race discrimination and employment protection, if it is not to infringe the law.

Among the other external factors the enterprise may need to take into consideration in recruiting and selecting staff will be:

- the relative cost and effectiveness of the different advertising media;
- existing relationships with external sources of recruitment (e.g. job centres, schools, colleges, universities);
- commitments to the local community;
- relationships with employee organisations (e.g. trade unions, staff associations);
- opportunities for staff training and development in local training and educational institutions.

Ideally, it should also pay some attention to possible future changes in the technology of the workplace, in order to recruit individuals either with appropriate skills or who can be retrained relatively easily with a minimum amount of disruption and expense to the organisation.

The marketing function

The processes of human resource management are a good illustration of the interactions between a firm's internal and external environments. An even better example is provided by an examination of its marketing activities, which are directed primarily, though not exclusively, towards what is happening outside the organisation.

Like 'management', the term **marketing** has been defined in a wide variety of ways, ranging from Kotler's essentially economic notion of an activity directed at satisfying human needs and wants through exchange processes, to the more managerial definitions associated with bodies such as the Chartered Institute of Marketing.[5] A common thread running through many of these definitions is the idea that marketing is

concerned with meeting the needs of the consumer in a way that is profitable to the enterprise. Hence, strategic marketing management is normally characterised as the process of ensuring a good fit between the opportunities afforded by the marketplace and the abilities and resources of an organisation operating in it.

web link

Information about the Chartered Institute of Marketing is available at *www.cim.co.uk*

This notion of marketing as an integrative function within the organisation – linking the needs of the consumer with the various functional areas of the firm – is central to modern definitions of the term and lies at the heart of what is known as the **marketing concept**. This is the idea that the customer is of prime importance to the organisation and that the most significant managerial task in any enterprise is first to identify the needs and wants of the consumer and then to ensure that its operations are geared to meeting those requirements profitably. Though it would be true to say that not all organisations subscribe to this view, it is generally accepted that the successful businesses are predominantly those with a customer rather than a production or sales orientation. Equally, the evidence suggests that the need to adopt such a customer-centred approach applies not only to private sector trading organisations but also increasingly to public sector enterprises and to bodies not established for the pursuit of profits but for other purposes (e.g. charities, political parties, trade unions).

When viewed from a customer perspective, marketing can be seen to comprise a range of activities that goes beyond the simple production of an item for sale. These activities include:

- identifying the needs of consumers (e.g. through marketing research);
- designing different 'offerings' to meet the needs of different types of customers (e.g. through market segmentation);
- choosing products, prices, promotional techniques and distribution channels that are appropriate to a particular market (i.e. designing a 'marketing mix' strategy);
- undertaking market and product planning;
- deciding on brand names, types of packages and methods of communicating with the customer;
- creating a marketing information system.

As already indicated, in carrying out these activities the firm is brought into contact with a range of external influences of both an immediate and an indirect kind. This external marketing environment can have a fundamental impact on the degree to which the firm is able to develop and maintain successful transactions with its customers and hence on its profitability and chances of survival.

To illustrate how a firm's marketing effort can be influenced by external factors, the following brief discussion focuses on 'pricing', which is one of the key elements of the **marketing mix**, that is, the set of controllable variables that a business can use to influence the buyer's response, namely, product, price, promotion and place – the 4Ps. Of all the mix elements, price is the only one that generates revenue, while the others result in expenditure. It is therefore a prime determinant of a firm's turnover and profitability and can have a considerable influence on the demand for its products and frequently for those of its competitors.

Web link

There are lots of useful websites discussing the idea of the 'marketing mix'. Try typing the term into Google.

Leaving aside the broader question of a firm's pricing goals and the fact that prices will tend to vary according to the stage a product has reached in its life cycle, price determination can be said to be influenced by a number of factors. Of these, the costs of production, the prices charged by one's competitors and the price sensitivity of consumers tend to be the most significant.

In the case of cost-based pricing, this occurs when a firm relates its price to the cost of buying or producing the product, adding a profit margin or 'mark-up' to arrive at the final selling price. Such an approach tends to be common among smaller enterprises (e.g. builders, corner shops) where costs are often easier to estimate and where likely consumer reactions are given less attention than the need to make an adequate return on the effort involved. The essential point about this form of price determination is that many of the firm's costs are influenced by external organisations – including the suppliers of materials, components and energy – and hence pricing will often vary according to changes in the prices of inputs. Only larger organisations, or a group of small businesses operating together, will generally be able to exercise some influence over input prices and even then not all costs will be controllable by the enterprise.

Organisations that take an essentially cost-based approach to pricing will sometimes be influenced by the prices charged by competitors – particularly in markets where considerable competition exists and where the products are largely homogeneous and a buyer's market is evident (e.g. builders during a recession). The competitive approach to pricing, however, is also found in markets where only a few large firms operate and where the need to increase or maintain market share can give rise to virtually identical prices and to fierce non-price competition between the market leaders. In Britain, for instance, a big cross-Channel ferry operator will normally provide the service to customers at the same price as its rivals, differentiating its offering in terms of additional benefits (e.g. on-board entertainment) rather than price. Where this is the case, the external demands of the market rather than costs constitute the primary influence on a firm's decisions, and changes in market conditions (e.g. the actual or potential entry of new firms; changes in a competitor's prices; economic recession) will tend to be reflected in price changes.

This idea of market factors influencing pricing decisions also applies to situations where firms fix their prices according to the actual or anticipated reactions of consumers to the price charged for a product – known in economics as the price elasticity of demand. In this case, the customer rather than a firm's competitors is the chief influence on price determination, although the two are often interrelated in that consumers are usually more price sensitive in markets where some choice exists. Differential levels of price sensitivity between consumers of a product normally arise when a market has distinct segments based on factors such as differences in income or age or location. In such cases a firm will often fix its prices according to the segment of the market it is serving, a process known as 'price discrimination' and one that is familiar to students claiming concessionary fares on public transport.

While the above discussion has been oversimplified and does not take into account factors such as the price of other products in an organisation's product portfolio (e.g. different models of car), it illustrates quite clearly how even one of the so-called

controllable variables in a firm's marketing mix is subject to a range of external influences that is often beyond its ability to control. The same argument applies to the other elements of the marketing function and students could usefully add to their understanding of the internal/external interface by examining how the external environment impinges upon such marketing activities as promotion, distribution or market research.

Synopsis

The internal dimension of business organisations constitutes an extensive field of study and one to which students of business devote a considerable amount of time. In seeking to illustrate how a firm's internal organisation is influenced by its external environment, emphasis has been placed on a selected number of aspects of a firm's internal operations. Of these, its structure and functions were seen to provide a good illustration of the interface between the internal and external environments. Appreciating the existence of this interface is facilitated by adopting a systems approach to organisational analysis.

Summary

- Management is a key aspect of the internal environment of the business organisation.
- Theories of organisation and management fall broadly into three categories: classical theories, human relations approaches, systems approaches.
- The systems view of organisations depicts businesses as open systems interacting with their external environment as they convert inputs into outputs.
- The external environment of the organisation affects all aspects of the business, including its structures, functions and processes.
- To carry out their tasks, businesses can structure themselves in a variety of ways, including functionally, by product/service, by divisions, in a matrix format or via project teams. Each has its advantages and disadvantages.
- Structural change tends to be a feature of large modern organisations.
- Within the organisation the different business functions such as marketing, production, HRM, purchasing and so on are influenced by external factors of both a general and operational kind.
- An examination of the marketing and HRM functions reveals the importance of the wide range of external influences that can impinge upon these day-to-day areas of organisational work.
- Investigations of other functional areas within the organisation would produce a similar picture.

Case study

Reshuffle at Microsoft

When an organisation's fortunes appear to change for the worse, there is always a temptation to seek a remedy through a change in senior personnel and/or in the overall structure of the enterprise (e.g. leading professional football teams in Europe seem to change managers fairly regularly when results go badly). Whether this is invariably a good idea is open to question. Supporters see it as a way of revitalising the business by bringing in new faces with new ideas, of challenging existing ways of thinking and working; critics frequently portray it as 'reorganising the deckchairs on the Titanic', a failure to address the fundamental problem(s) facing the organisation. Time will tell which of these two viewpoints applies to the global business examined in this case study.

Faced with a demonstrable shift in consumer demand away from PCs and towards tablets, smartphones and touch devices – where it was struggling to compete with companies such as Apple and Google – Microsoft Chief Executive Steve Ballmer announced a major reorganisation of the business in July 2013. Aimed at promoting faster innovation and a much sharper focus on meeting consumer needs, Ballmer heralded the demise of the divisional approach favoured by his predecessor (Bill Gates), which was evidently seen as creating a hierarchical structure of competing businesses, each with its own strategy and with separate finance and marketing teams. Under the new arrangements, emphasis appears to be on how devices function rather than centred on particular products, the hope being that this will help to encourage greater cooperation across the organisation in place of internal rivalry.

The centrepiece of the new arrangements is the organisation of the business on the basis of function. Instead of divisions, Microsoft will operate via a number of functional groupings, including engineering, marketing, finance, advanced strategy and research, and business development and evangelism. In what is likely to prove an important change, the engineering division will be split into four major areas or groupings: operating systems, devices and studios, applications and services, cloud and enterprise. Responsibility for running the main functions within the new organisation will be vested in a reshuffled senior executive team.

Commenting on the new arrangements, *The Guardian* (12 July 2013: 24) suggested that they were reminiscent of the reorganisation undertaken by its rival Apple the previous October. This, it suggested, had been designed to encourage even greater collaboration between various aspects of the business: the world-class hardware, its software and its services teams. Put another way, structure can sometimes be an aid and sometimes an obstacle to a firm achieving its strategic objectives. Where the latter is the case, a partial or even radical restructuring of the organisation may be a necessary condition for putting the business on the right track. On its own, though, it is unlikely to prove sufficient in most cases.

Case study questions

1 What are thought to be the main advantages of restructuring an organisation that is facing problems?

2 Why is a decision to restructure an organisation unlikely to prove a 'sufficient condition' for its future success?

Review and discussion questions

1 In the systems approach to organisations, reference is made to 'feedback'. What is meant by this term and how can feedback influence the process of transforming 'inputs' into 'output'?

2 Should a firm's internal structure be influenced by considerations of management or by the market it serves? Are the two incompatible?

3 Examine ways in which a firm's external environment can influence one of the following functional areas: finance or production or research and development.

4 Describe the structure of an organisation with which you are familiar (e.g. through employment or work experience), indicating why the organisation is structured in the way it is. Are there any alternative forms of structure the organisation could adopt?

Assignments

1 As a student on a business studies course, you have decided to get some practical experience of the business world by running a small venture with a number of colleagues which you hope will also earn you enough income to support you during your time at college or university. Your idea involves printing and selling customised T-shirts throughout the institution and possibly to a wider market. Design an appropriate organisational structure which you feel will help you achieve your objectives, indicating your rationale for choosing such a structure and the formal pattern of relationships between individuals.

2 In self-selecting groups of three or four, identify an organisation you feel has a bureaucratic structure. Produce a report indicating:

   (a) those features of the organisation's structure, management and operations that best fit the idea of bureaucracy;
   (b) the practical consequences of these features for the working of the organisation.

   Give examples to support your comments.

Notes and references

1 See, for example, Mullins, L. J., *Management and Organisational Behaviour*, 9th edition, Financial Times/Prentice Hall, 2010; Cole, G. A. and Kelly, P., *Management: Theory and Practice*, 7th edition, International Thomson Business Press, 2011.

2 For a more detailed account of the three approaches see, *inter alia*, the texts referred to in note 1.

3 Ouichi, W. G., *Theory Z: How American Business Can Meet the Japanese Challenge*, Addison-Wesley, 1981.

4 The contingency approach is discussed in Cole, *op. cit.*

5 See, for example, Kotler, P. and Armstrong, G., *Principles of Marketing*, 15th edition, Prentice Hall, 2013.

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3 The global context of business

Businesses of all sizes operate in international markets – products are sold across borders; the resources used in production can come from anywhere in the world; communication is instantaneous; and financial markets are inextricably linked, as the events of 2013/14 demonstrate. Individual businesses operate across borders in a variety of ways – they can do this directly, through the formation of strategic alliances, or through merger and takeover. It is clear then that businesses need to be aware of the global context of their markets.

Learning outcomes

After reading this chapter, you should be able to:

- understand the difference between globalisation and internationalisation
- outline the main elements of globalisation
- illustrate the role of the multinational enterprise
- introduce the implications of globalisation for business

Key terms

Capital market flows
Consortium
Cross-subsidisation
Customs union
Emerging economies
Foreign direct investment (FDI)
Franchising
Free trade area
Globalisation
Hyperglobalisation
International trade
Internationalisation
Joint venture
Licensing
Multinational enterprises (MNEs)
Regional trade agreements (RTAs)
Regionalism
Strategic alliance
Transfer pricing
Transformationalism

Introduction

Businesses operate in a global context: even if they do not trade directly with other countries, they might be affected by a domestic shortage of skilled labour or may be subject to developments on the global financial markets. There is a difference between globalisation and internationalisation in the business literature but both result in increased exposure to global forces. This means that businesses need an understanding of the process of globalisation. The nature of globalisation is changing; it used to mean the westernisation of the developing world, but the newly emerging economies such as Brazil, China and India are redefining processes and institutions. In 1980 the share of the developing countries in world exports was 34 per cent; by 2011 it was 47 per cent and share of world imports had gone up from 29 per cent to 42 per cent in the same period. Globalisation is here to stay and the World Bank forecasts that the share of global gross domestic product (GDP) for developing countries will rise from 29 per cent (2010) to 39 per cent (2030).

Globalisation versus internationalisation

These terms are often used interchangeably but they refer to different processes. Although there is not a single accepted definition of **globalisation**, it is a term used to describe the process of integration on a worldwide scale of markets and production. The world is moving away from a system of national markets isolated from each other by trade barriers, distance or culture. Advances in technology and mass communications have made it possible for people in one part of the world to watch happenings in far- off places on television or via the internet. So, for globalisation, national boundaries are not important economically; free trade and movement of labour and other resources result in the breakdown of these boundaries and one big global marketplace. **Internationalisation**, meanwhile, refers to the increased links between nation state with respect to trade and the movement of resources. The relevant thing here is that the nation state is still important; it is participating and cooperating with other nation states to a common end.

Regionalism and regional trade agreements are also important in this process, the European Union (EU) being an example. The main difference is that with internationalisation, the nation state remains important whereas the process of globalisation breaks down the barriers between nation states. An extreme view of this process is called **hyperglobalisation**, where the world market is seen as a borderless global marketplace consisting of powerless nation states and powerful multinational corporations.1 The more generally accepted view is called transformationalism, which sees the process of globalisation as bringing about changes both in the power of countries and companies and in national characteristics and culture.2 Any differences do not disappear but are maintained, albeit in changed forms. The population in India might drink Coca- Cola and listen to western music, but this does not mean that they hold the same views and values as the west. Similarly, even within the EU national differences remain important (especially in times of crisis).

Although these definitions are important theoretically, they are difficult to apply in practice, so here the term globalisation is used to mean the process of integration of markets, however that happens. Until recently globalisation meant the westernisation (or Americanisation) of markets, but the world has started to change. Companies from **emerging economies** have started to compete with the older **multinational enterprises (MNEs)** and the nature of the MNE is being redefined. Globalisation has taken place because of closer economic ties between countries and because of developments in mass communications, transportation, electronics and the greater mobility of labour. A heated debate has taken place over the past decade between the pro- and the anti- globalisation lobbies.

The arguments put forward by the proponents of globalisation stem from the benefits brought about by increased **international trade** and specialisation (see Chapter 16 for a discussion). They argue that all countries open to international trade have benefited – only those that are closed to international trade (some African countries, for example) have become poorer. In the case of China, the opening up to world trade in 1978 has led to increases in GDP per capita, up from $1460 per head in 1980 to $6188 per head in 2013. The pro- globalisation arguments can be summarised as follows:

- Increased globalisation leads to greater specialisation so that all countries involved benefit from the increased international trade.
- Countries that are open to international trade have experienced much faster growth than countries that are not.
- Barriers to trade encourage industries to be inefficient and uncompetitive.
- It is not just the large multinationals that benefit from globalisation – small and medium- sized companies are also engaged in global production and marketing.

The arguments against globalisation are just as strong. It is claimed that the benefits of higher world output and growth brought about through globalisation have not been shared equally by all countries. The main beneficiaries have been the large multinationals rather than individual countries or people. It is suggested that the international organisations that promote free trade should pay more attention to the issues of equity, human rights and the natural environment rather than focusing simply on trade. It is also argued that increased globalisation leads to economic instability. The anti- globalisation arguments can be summarised thus:

- The benefits of globalisation have not been shared equitably throughout the world.
- Globalisation undermines the power of nation states – it empowers the large multinationals at the expense of governments, many multinationals being financially bigger than nation states.
- The large organisations that promote free trade (such as the WTO and the IMF) are not democratically elected and their decisions are not made in the public eye.
- The policies of these organisations are aimed at trade only – human rights and environmental concerns are often ignored.

The main international organisations concerned with globalisation are the World Trade Organisation (WTO), the International Monetary Fund (IMF), the World Bank and the Organisation for Economic Co-operation and Development (OECD). In addition to these there is the United Nations Conference on Trade and Development (UNCTAD), which is a permanent intergovernmental body of the United Nations that aims to maximise investment to the developing nations and to help them in their integration into the world economy.

There are several key elements of economic globalisation: international trade, **foreign direct investment (FDI)** and capital market flows. The OECD categorises members into three bands – high- income countries, which includes the EU, North America and Australasia; middle- income countries, which includes East Asia and the Pacific Rim; and low- income countries, which includes South Asia and Africa.

International trade

The share of international trade in goods as a percentage of GDP increased between 1990 and 2011 for all income groups and particularly for the low- income group (see Table 1). The same is true for services. Thus there is evidence of increased globalisation. Note that there are differences within each group – in the low- income group, for example, although the share has increased overall, there are countries that have experienced negative growth (Botswana and Togo for instance, both of which are open to international trade). Although the share of developing countries has increased over time, world markets are still dominated by the developed world, especially in high- value, high- tech products. It is also true that increased trade does not automatically lead to increased development, as in parts of sub- Saharan Africa where the products sold are basic primary products.

Table 1 Elements of economic globalisation

	Trade in goods as a % of GDP		*Gross private capital flows as a % of GDP**		*Gross FDI as a % of GDP*	
	1990	*2011*	*1990*	*2005*	*1990*	*2011*
Low income	23.6	58.1	2.4	6.7	0.4	3.8
Middle income	32.5	53.0	6.6	13.3	0.9	2.7
High income	32.3	53.0	11.0	37.2	1.0	2.7

*Not available after 2005.
Source: Adapted from Table 6.1, World Development Indicators, 2013, and the Little Data Book 2013, both World Bank.

Capital market flows

This refers to the flows of money from private savers wishing to include foreign assets in their portfolios. This also increased in all income bands between 1990 and 2005 (Table 1) – later figures are not available. The overall figures hide a greater volatility than in international trade or foreign direct investment and the fact that the flows have been largely restricted to emerging economies in East Asia. **Capital market flows** occur because investors want to diversify their portfolios to include foreign assets; it is therefore aimed at bringing about short- term capital gains. Unlike FDI, there is no long- term involvement on the part of the investor.

Foreign direct investment

This refers to the establishment of production facilities in overseas countries and therefore represents a more direct involvement in the local economy (than capital market flows) and a longer- term relationship. Between 1990 and 2000, the value of FDI worldwide more than doubled; since then FDI has moved in line with world economic conditions (see case study on FDI at the end of the chapter). FDI represents the largest form of private capital inflow into the developing countries. Each of the three elements of economic globalisation has a different effect and carries different consequences for countries. Capital market flows are much more volatile and therefore carry higher risk – these flows introduce the possibility of 'boom and bust' for countries where capital market flows are important. The financial crisis in the emerging countries in 2013– 14 had a lot to do with these capital flows. Openness to trade and FDI are less volatile and it is these that are favoured by the international organisations such as the World Bank and the WTO. It is also true that the benefits of globalisation have not been shared equally between those taking part – the developed nations have reaped more benefit than the poorer nations.

The role of multinational enterprises

Substantial amounts of foreign trade and hence movements of currency result from the activities of very large multinational companies or enterprises. Multinational enterprises/companies (MNEs/MNCs), strictly defined, are enterprises operating in a number of countries and having production or service facilities outside the country of their origin. These multinationals usually have their headquarters in a developed country, but this is beginning to change. At one time globalisation meant that businesses were expanding from developed to developing economies. The world is a different place now – business flows in the opposite direction and often between developing countries. One indication of this is the number of companies from the emerging nations that appear in the Global 500 list of the world's biggest companies. In 1980, 23 (5 per cent) came from emerging countries; in 2010, the number had gone up to 85 (17 per cent) and of these 54 were Chinese, including Lenovo, a Chinese computer manufacturer which bought IBM's personal computer business in 2005.

Multinationals can diversify their operations across different countries and many are well- known household names. The footloose nature of such companies brings with it certain benefits.

1. MNEs can locate their activities in the countries that are best suited for them. For example, production planning can be carried out in the parent country, and the production itself can be carried out in one of the newly industrialised countries where labour is relatively cheap and marketing can be done in the parent country where such activities are well developed. The relocation of production may go some way to explaining the decline in the manufacturing sector in the developed nations.

2. An MNE can cross- subsidise its operations. Profits from one market can be used to support operations in another one. The **cross-subsidisation** could take the form of price cutting, increasing productive capacity or heavy advertising.
3. The risk involved in production is spread not just over different markets but also over different countries.
4. MNEs can avoid tax by negotiating special tax arrangements in one of their host countries (tax holidays) or through careful use of **transfer pricing**. Transfer prices are the prices at which internal transactions take place. These can be altered so that high profits can be shown in countries where the tax rate is lower. The principle in place is that the transfer price should represent what an 'arm's length' customer would pay or an 'arm's length' supplier would charge. In 2019, Shell India was sold to its parent company for the price of Rs 8,000 crore but the Indian tax department valued the sale as Rs 80,000 crore. The Indian government is trying to tax the difference of Rs 72,000 crore (see mini case study on transfer pricing).
5. MNEs can take advantage of subsidies and tax exemptions offered by governments to encourage start- ups in their country.

The very size of MNEs gives rise to concern as their operations can have a substantial impact upon the economy. For example, the activities of MNEs will affect the labour markets of host countries and the balance of payments. If a subsidiary is started in one country there will be an inflow of capital to that country. Once it is up and running, however, there will be outflows of dividends and profits that will affect the invisible balance. Also, there will be flows of goods within the company, and therefore between countries, in the form of semi- finished goods and raw materials. These movements will affect the exchange rate as well as the balance of payments and it is likely that the effects will be greater for developing countries than for developed countries.

There is also the possibility of exploitation of less developed countries, and it is debatable whether such footloose industries form a viable basis for economic development. Added to this, MNEs take their decisions in terms of their overall operations rather than with any consideration of their effects on the host economy. There is therefore a loss of economic sovereignty for national governments.

The main problem with multinationals is the lack of control that can be exerted by national governments. As the mini case study shows, there are increased calls from around the world for more transparency, monitoring and control of their activities. In 2011 the OECD updated its Guidelines for Multinational Enterprises, which are not legally binding but are promoted by OECD member governments. These seek to provide a balanced framework for international investment that clarifies both the rights and responsibilities of the business community. The publication contains guidelines on business ethics, employment relations, information disclosure and taxation, among other things. Against all this is the fact that without the presence of MNEs, output in host countries would be lower, and there is evidence that on labour market issues the multinationals do not perform badly.

Transnationality

The transnationality index gives a measure of an MNE's involvement abroad by looking at three ratios – foreign assets/total assets, foreign sales/total sales and foreign employment/total employment. As such it captures the importance of foreign activities in its overall activities. Vodafone Group plc has a high index – this is because in all three

Mini case Transfer pricing

Although transfer pricing has always been a feature of the operation of multinationals, it became a huge public issue in 2013 and very unpopular. A survey by the Institute of Business Ethics in the UK found that tax avoidance had replaced remuneration as the issue that most concerned them about corporate behaviour.[3] In times of austerity, cutbacks in government spending and falls in real wages, anything that reduces the tax liability of large companies is seen as bad. There were many reports of the small amount of tax paid by multinationals such as Google, Starbucks and Amazon in countries where they do large amounts of business. In 2011, in the UK Amazon had sales of £3.35 billion but reported a tax expense of £1.8 million, while Google paid the UK government £6 million on a turnover of £395 million. Neither of these is illegal, both companies were operating within the law – it is tax avoidance, not tax evasion (see, for example, Chapter 9). This is an issue that affects all countries, rich and poor alike – according to Christian Aid, poor countries lose an estimated $160 billion per year from tax avoidance by multinational companies.

The problem with multinationals is that they can use tax loopholes such as transfer pricing to pay tax in the country where the tax rate is lower and as tax rates are largely under the control of individual countries, there is little that one country can do alone. There are international controls over transfer pricing which have been in place for some time. The European Commission, for instance, has had a Joint Transfer Pricing Forum since 2002, and the OECD issued guidelines in 1979 which were updated in 2010.4

The greater public awareness and the outcry the issue has created has increased the calls for more controls, both nationally and internationally. In 2013 the Global Alliance for Tax Justice was formed, made up of tax campaigners from many different countries, with the aim of increasing the pressure on international organisations. There is agreement in the OECD and the EU that multinational companies must reveal more information about their activities on a country-by-country basis, which would make action possible. Also, there are moves towards greater transparency; some tax havens (countries where tax rates are low) have agreed to start sharing information about bank accounts.

As well as government action on tax laws and increased transparency at national and international levels, there has been the 'naming and shaming' of the companies avoiding tax. This may have several effects on a company. First, the information could encourage customers to boycott the company – there have been such campaigns against Amazon and Google. Second, there will be reputational effects on the companies involved, and this could damage their claims to act with corporate responsibility. Third, as in the case of Starbucks in the UK, it could result in the payment of tax to the government. There has been direct action against these companies around the world, including sit- down protests and occupations which have sometimes caused stores to close. Social media has increased the velocity of these protests. It is difficult to assess the impact of naming and shaming – information on the extent of any boycott or its financial impact is impossible to come by. What is true is that with continued austerity there will be continued public pressure on governments and international organisations and that the campaign will continue.

ratios it has a high proportion of foreign involvement. Since 1990 the average index of transnationality for the top 100 MNEs has increased from 51 per cent to 54.4 per cent.

These multinationals are huge organisations and their market values often exceed the gross national product (GNP) of many of the countries in which they operate. There are more than 60,000 MNEs around the world and they are estimated to account for a quarter of the world's output. The growth in MNEs is due to relaxation of exchange controls, making it easier to move money between countries, and the improvements in

communication, which make it possible to run a worldwide business from one country. The importance of multinationals varies from country to country. Foreign affiliates are very important for some countries and not so important for others; in the case of Italy the level of foreign presence is low. For all countries, foreign affiliates have a bigger impact on production than employment.

Globalisation and business

Businesses of all sizes need to have an awareness of their international context. As noted above, even if they are not directly involved in international trade, firms will be affected by international forces that lie largely outside their control. Globalisation has meant that the financial crisis of 2008, for instance, affected virtually the whole world. Some of the issues facing businesses are discussed below in brief; many of them are discussed later in the book in more detail.

Markets

Globalisation means that firms are faced with bigger markets for their products. Many of these markets are covered by **regional trade agreements (RTAs)**, which are groupings of countries set up to facilitate world trade. All such agreements have to be notified to the World Trade Organisation and they can take a variety of forms. The most basic relationship and the most common is a **free trade area**, where trade barriers between members are abolished but where each member maintains its own national barriers with non- members. An example of this is the North American Free Trade Agreement (NAFTA). Agreements can also take the form of a **customs union** or common market, where members abolish trade barriers among themselves and adopt a common external tariff which is applied to non- members, as in the EU. All of these agreements increase the size of the marketplace for producers in the member countries and the enlargement of these agreements (the EU, for example) means that markets are increasing all the time.

In addition to these trade agreements, the opening up of the emerging economies (e.g. China and India) to international trade, their high growth rates and the corresponding increase in per capita income mean that there has been a huge increase in the demand for goods and services. The population in India is 1237 million, income per head has doubled since 2000 and GDP growth rate was 9.3 per cent between 2010 and 2011. The Chinese population stood at 1351 million in 2012, income per head has doubled since 2000 and the growth rate in 2012 was 7.8 per cent. Many believe that China's high growth rate has been fuelled by exports, but recent research shows that demand is more consumption driven than previously thought. It also shows that consumer demand has changed in favour of products that have a higher imported content. This is good news for the rest of the world.

Labour markets

It has been estimated that the global integration of emerging markets has doubled the supply of labour for the global production of goods. The OECD estimates that the percentage of the world population living outside their country of birth doubled between

1985 and 2010. About half of this is between the developed countries, the other half from developing to developed countries. The impact of migration is considered in more detail in the international case study at the end of Part Two ('Contexts').

International labour mobility can be used by businesses for hard-to-fill vacancies. Typically these are at the low- skill, high- risk and low- paid end of the spectrum and at the high- skill, high- paid end. Legal labour migration can be permanent (where migrants settle permanently) or temporary (where migrants eventually return home). The regulations pertaining to these will differ. In addition to international labour migration there are three other alternatives: outsourcing (for example, the location of US call centres in India involves the movement of jobs rather than people); cross- border commuting (for example, the commuting of Poles into western Europe); or the use of internet trade (where the work could take place anywhere).

For businesses wishing to recruit internationally, there are practical problems including locating the necessary people and dealing with the rules and regulations involved in employing migrants, such as work permits and visas. These requirements will vary from one country to another.

Other resources

As well as labour, businesses have to source and purchase other resources such as raw materials and energy. Natural resources are differentially distributed around the world and therefore they require international trade to take place if firms are to acquire these inputs. The market for energy, for example, is a global market, with attendant concerns about the environmental impact of the methods used for its generation.

Financial markets

Businesses need to raise capital to be able to produce, trade and invest. Although much of this takes place domestically, banks operate internationally and so businesses are exposed to global forces. Never has this been seen more vividly than in the events of recent years.

Mini case Currency crisis in emerging markets

Since the start of the global financial crisis in 2008, the emerging economies have done well out of international capital flows. Low interest rates in the developed nations (designed to stimulate the economies) made international capital look for higher rates of return and the emerging economies with their high growth rates were the recipients. It is estimated that $4 trillion has flowed into the emerging economies since 2008. This is speculative money looking for high rates of return. The tapering of quantitative easing (QE) in the USA in 2014 has made it a more attractive place to invest and there are worries that the emerging economies may face a sudden stop to these capital flows.

How did this happen? Since 2008 there have been four rounds of quantitative easing in the USA where the Federal Reserve Bank pledged to buy up bank debt, Treasury bonds and longer- term bonds. This has the effect of increasing liquidity in the economy – like 'printing money' – in the hope that this will stimulate economic growth. It also has the effect of reducing the rate of interest, which is good

for borrowers and business but bad for savers and investors. Speculators want to maximise their rate of return and if the rate of interest in the USA (and other developed nations) is too low, they look to other places to put their money. The emerging nations, including India, Turkey and South Africa, had high growth rates and were the recipients of these speculative flows.

With improvements in the state of the US economy, a tapering of QE was signalled by the Federal Reserve Bank in May 2013 and announced formally in December. The tapering off of the purchase of bonds will continue at a measured rate until the end of 2014 and the expectation is that it will have finished by spring 2015. This announcement had a significant effect on the emerging countries – there were dramatic falls in their exchange rates (the Turkish lira lost 10 per cent of its value between December 2013 and January 2014 and smaller falls have occurred in South Africa, Argentina, Brazil, India and Chile). Five countries have been identified as 'fragile' as they have large balance-of-payments deficits that need financing – these are Turkey, India, South Africa, Brazil and Indonesia. Hours before the December announcement, the Turkish central bank increased the benchmark interest rate from 4.5 per cent to 10 per cent. In South Africa the rate of interest went up to 5.5 per cent and in India it was 8 per cent. These interest rate rises attempt to stop the flow of international capital away from the country and to prop up their currencies, but of course have undesirable effects on other economic variables. It reduces the level of demand in the economy; it causes inflation through the higher price of imports; it means that the countries cannot service their external debts so there may be political repercussions; it affects their ability to finance their large balance-of-payments deficits. In 2001, in similar circumstances, Argentina defaulted on its external debts and the repercussions of that are still being felt.

It is not clear where this will end; the measures introduced in Turkey to support its currency have not worked and the pressure is still on all of these countries. Of course, this crisis is not only about US monetary policy, there are factors specific to each country, such as a major corruption scandal in Turkey and political unrest in the Ukraine. But many argue that the Federal Reserve is, in effect, the banker to the whole world and should consider other economies and not just the American one when deciding on policy.

This mini case shows how interrelated global markets are and how quickly measures announced in one part of the world can affect others. By the same argument, the repercussions of tapering of QE in the USA will find its way back to the USA. Globalisation is contagious.

Globalisation and the small and medium- sized firm

There are problems for small and medium- sized enterprises (SMEs) wishing to trade internationally. They will not have the same access to resources, finance or markets as the large multinationals or even the large national companies which could either trade directly or expand internationally through mergers and takeovers. SMEs, however, have a number of options, which are outlined briefly below as they are discussed more fully in later chapters of the book.

- A **strategic alliance** is a collaborative agreement between firms to achieve a common aim, in this context a presence in other markets. These agreements can take many forms.

- **Franchising** is an arrangement where one party (the franchiser) sells the rights to another party (the franchisee) to market its product or service. There are different types of franchise relationship and this is a possibility for international expansion. It is an attractive option for companies seeking international expansion without having to undertake substantial direct investments.
- **Licensing** is where a company (the licensor) authorises a company in another country (the licensee) to use its intellectual property in return for certain considerations, usually royalties. Licensors are usually multinationals located in developed countries.
- A **joint venture** is usually a jointly owned and independently incorporated busi nessventure involving two or more organisations. This is a popular method of expanding abroad as each party can diversify, with the benefit of the experience of the others involved in the venture and a reduction in the level of risk. Where a large number of members are involved in such an arrangement, this is called a **consortium**.

Summary

This chapter has looked at the global context of business. No business is immune from international forces, no matter what it is producing or how small its markets are. The whole concept of globalisation has been discussed, along with the claimed costs and benefits. The elements of globalisation have been outlined together with the impact of globalisation on businesses.

- There is a difference between globalisation and internationalisation that centres on the role of national boundaries.
- There are costs and benefits associated with the process of globalisation.
- There are three main elements of globalisation – international trade, capital market flows and foreign direct investment.
- Multinational enterprises are very important in the process of globalisation.
- With the arrival of the emerging economies in the global marketplace, some changes in the nature and the process of globalisation are evident.
- Globalisation affects all firms in one way or another – either through markets, access to resources or finance.
- There are several different possibilities for small and medium- sized businesses wishing to expand internationally.

Case study — FDI flows

Foreign direct investment is an important element in the process of globalisation and economic integration as it creates long- term links between economies. Unlike capital market flows, it carries a long- term interest in an economy and it is a source of investment funds, it promotes sharing of ideas between countries and can be an important tool in development. Inward flows are all direct investment in a country by non- residents; outflows represent direct investment by residents in other countries. FDI can take the form of the opening of new factories or subsidiaries, or mergers and acquisitions, and as would be expected multinational enterprises are very active in the process. FDI flows since 2000 have been mixed and volatile. There have been record flows of FDI and great variability in the performance of countries and groupings of countries.

Most of the groupings are well known but the one that might be less so is the 'Next 11' or N11.[5] This term was coined by Jim O'Neill of Goldman Sachs International Bank and it includes 11 countries that have good prospects for growth and openness to trade. Many commentators argue that the N11, along with the BRIC countries, are the ones that will push forward the global engine of growth. In 2012 it was forecast that the BRIC economies would be larger than the USA by 2015 and the G7 by 2032 and the N11 would be larger than the USA and twice the size of the EU by 2050.

These tables show great variability between the groupings and within each grouping there is even greater variability. The reasons put forward for the dramatic decline in total FDI flows in the early 2000s were the sluggishness of the global economy, some uncertainty over monetary policy in some countries and, most significantly, increasing international political instability and insecurity. The reasons put forward for the recovery in FDI flows between 2003 and 2008 were the relative decline in the value of the US dollar and large- value mergers and acquisitions during the period. The fall in flows from 2008 onwards was due to the global financial crisis, In the period 2003–4, FDI inflows fell for the EU while there was growth for all other groupings. The main reasons for this were the continuing effects of the recession and the expansion of the EU that occurred in 2004. The rapid growth in the 2005–7 period was universal, even if the growth was variable. In the last time period, 2008–12, the only groupings where flows increased were for the developing and emerging countries. The fall in inflows for the N11 countries was mainly due to political factors in individual countries – Egypt experienced a big reduction due to the repercussions of the 'Arab Spring', Turkey experienced a fall mainly due to corruption allegations against the government. By 2012 both FDI inflows and outflows for many countries and groupings had started to recover. The OECD compiles the FDI Regulatory Restrictiveness Index each year, which measures the restrictions to FDI according to four factors: limitations on foreign equity, screening mechanisms, restrictions of foreign employment and operational restrictions. The index can take any value between 0 – completely open – and 1 – completely closed. There does not seem to be very much correlation between the level of FDI flows and the FDI index. The three biggest recipients of FDI inflows in 2012 were (FDI index shown in brackets) USA (0.09), China (0.4) and Belgium (0.04). The biggest source of FDI outflows were USA, Japan (0.3) and the UK (0.06). The OECD calculates that the FDI index is higher in the service sector and that manufacturing is the most open sector for FDI. As a growing number of countries have emerged from the financial crisis, the global landscape is changing. After 2008, the highly indebted developed nations were in trouble and the emerging economies showed the most resilience and growth potential. But this was before the currency crisis of 2013– 14 (see mini case study). At the time of writing it is unclear how this will end, but it does seem that the wellknown developed economies may be resuming their position in the global economy. The USA, Canada and Japan are returning to slow growth, while in the EU the position is mixed and still uncertain. But the USA did not fall off a 'fiscal cliff',6 the Japanese tsunami did not return Japan to low growth, and the EU did not break up, even though there are still problems in these countries. As the case study shows, things change very quickly in such an interrelated world.

Case study questions

1. Why are FDI flows cyclical in nature?
2. How might a country make itself more attractive to inward FDI?

Review and discussion questions

1. What role does the advancement of ICT have in the process of globalisation?
2. What are the arguments for and against foreign ownership of strategic industries such as energy?
3. How are multinationals changing?
4. For a business considering expansion into another country, what methods of expansion are available? What are the advantages and disadvantages of each?
5. What has been the impact of the financial crisis in 2008 on the process of globalisation?

Assignments

1. You work in a local office of a multinational enterprise and your line manager has been invited to take part in a discussion arranged by the local newspaper on the pros and cons of globalisation. You have been asked to provide a briefing paper outlining the arguments for your line manager.
2. You have been asked to give a presentation on regional trade agreements to students of business at a local college. Research which regional trade agreements your country is a member of and what effects membership has on labour mobility. Prepare PowerPoint slides together with notes to accompany each slide.

Notes and references

1. See Gray, J., *False Dawn: The Delusions of Global Capitalism,* Granta Books, 1998.
2. See Held, D., McGrew, A., Goldblatt, D. and Perraton, J., *Global Transformations: Politics, Economics and Culture*, Polity Press, 1999.
3. http:// www.ibe.org.uk/userfiles/pressreleases/attitudes2013.pdf
4. Transfer Pricing Guidelines for MNE and Tax Administrations, OECD, 2010.
5. N11: Bangladesh, Egypt, Indonesia, Iran, South Korea, Mexico, Nigeria, Pakistan, the Philippines, Turkey and Vietnam. Emerging economies: (UNCTAD) Argentina, Brazil, Chile, Mexico, Peru, China, South Korea, Malaysia, Singapore and Thailand. There is some overlap between these two groupings.
6. In 2013 the USA faced a 'fiscal cliff' where attempts by President Obama to increase the debt ceiling to deal with the huge public sector budget deficit were rejected by the Republican House of Representatives. A stalemate ensued and public buildings were closed and public employees sent home. Eventually the crisis was averted when the House of Representatives agreed a compromise. The roots of the fiscal cliff go right back to 2001. For a further discussion see the mini case in Chapter 4, 'The power of the purse'.

Further reading

Daniels, J. D., Radebaugh, L. and Sullivan, D., International Business: Environments and Operations, 13th edition, Prentice Hall, 2010.

Griffiths, A. and Wall, S., Applied Economics, 12th edition, Financial Times/ Prentice Hall, 2011. Worthington, I., Britton, C. and Rees, A., Business Economics: Blending Theory and Practice, 2nd edition, Financial Times/ Prentice Hall, 2005.

The global car industry and the changing business environment

All businesses are affected by external factors, many of which lie outside their direct control. While some of these influences concern developments within an organisation's operational environment (e.g. loss of a supplier), others relate to changes of a more general or contextual kind, which can affect a wide variety of businesses, sometimes in different ways (e.g. fluctuations in the exchange rate). As the opening chapter of this book has illustrated, these general/contextual variables include political, economic, socio-cultural, technological, legal and ethical influences that can occur at all spatial levels from the local to the global. For organisations operating in the international/global marketplace, developments at both the micro- and macroenvironmental levels can represent a significant challenge (or opportunity) and can have a substantial influence on the strategic decision-making process.

To illustrate how organisations can be affected by some of the broader contextual changes discussed in Part Two, we examine the car industry, which comprises many well-known international brands, including Ford, Toyota, General Motors, Chrysler, Honda, Renault, PSA Peugeot Citroën, Fiat, Nissan, BMW and Volkswagen. As the mini case in Chapter 1 demonstrates, even some of the world's largest and most powerful businesses in this industry have faced variable trading conditions over recent years because of developments in their external environment and many have been forced to respond in a variety of ways.

What have been some of the major challenges and how have they affected the key players?

Rises in oil and other commodity prices

A combination of increased demand (e.g. because of growth in China and India) and tight supply has meant that oil and other commodity prices (e.g. steel) have risen quite substantially and this has affected production costs in the industry. As these price rises also affect consumers, sales of vehicles in some countries have tended to decline and many customers are switching to more economical/fuel-efficient models as petrol prices increase.

Economic downturn

The falling sales of vehicles being experienced in some parts of the world have not been helped by a general downturn in many economies as a result of the impact of the global financial crisis. As many countries have gone into recession, consumers have tended to defer spending on larger, more expensive items such as cars. This has affected both the market for new vehicles and the second-hand market in many parts of the world.

Emerging markets

While many economies are facing difficult circumstances, growth in some countries (e.g. China, India, Brazil, Russia) has created an opportunity for car producers to exploit new and expanding markets. By the same token, this growth is encouraging newer companies to come into the marketplace and to increase the possibility of future competition in the traditional areas of the international car market (e.g. Europe and the USA).

Environmental issues

The growing threat of climate change has led to the environmental impact of cars and other vehicles becoming a prime concern for both governments (see below) and consumers. As far as the latter are concerned, there has been a slight shift in consumer taste away from high-polluting, gas-guzzling models (e.g. SUVs, 4×4s, pick-ups) towards more fuel-efficient vehicles that have a smaller environmental impact. Rising oil prices have reinforced this trend towards smaller cars. There has also been increased investment in electric vehicles and hybrids.

Legislative/policy developments

Concerns over cars' contribution to climate change have resulted in governmental and intergovernmental negotiations over future legislation and/or targets

regarding vehicle CO_2 emissions. In the EU, for example, member states have set obligatory targets for vehicle emissions for the period up to 2020. Discussions on future emissions standards have also taken place in the United States.

Currency fluctuations

For firms involved in international trade, exchange rate fluctuations/volatility can sometimes be problematical (see Chapter 16). Such fluctuations in the values of the dollar, yen and euro in recent years have had a direct impact on the major car producers in the USA, Japan and Europe, making prices sometimes more and sometimes less competitive. As oil is also priced in dollars, a fluctuation in the dollar exchange rate has also impacted on the industry.

How should the major players respond/ how have the major players responded?

As the analysis above illustrates, the international car industry has faced significant changes in the external environment over recent years. While some of these changes have generated opportunities for the major players, many have been particularly challenging and have caused vehicle manufacturers to look at both the supply side (e.g. costs) and the demand side (e.g. market development) of their businesses. Some of the key questions being faced by the major brands are:

- How can costs be reduced (e.g. should the workforce be reduced)?
- What product mix should be offered to the consumers (e.g. should some of the less fuel-efficient models be phased out)?
- What markets should be targeted (e.g. should the focus shift towards the emerging markets)?
- How should the new markets be accessed (e.g. are cross-national collaborations a better solution than direct manufacturing?
- Where should production take place (e.g. can costs be reduced and/or new markets be exploited more effectively by manufacturing cars in the emerging countries)?
- How can the new, emerging competitors be challenged (e.g. should new models be developed)?
- How can legislative requirements be met (e.g. how and where should the industry lobby against tougher emission standards)?
- Where should future investment take place (e.g. if the UK withdraws from the EU following a planned referendum, should production facilities be relocated to mainland Europe)?

For the major international players in the car industry, these are some of the important strategic issues they are facing and a number of key trends have emerged. For example, many car producers are looking towards Asia as a suitable place for manufacture and/or joint venture, with India and China potentially becoming global hubs for small car production, thanks to lower costs and the skills of the workforce. Added to this, the big players are being forced towards global product development (with future models likely to be based on a common platform and sold on a global basis) and/or some form of integration (e.g. Chrysler's merger with Fiat and the decision by Daimler, Renault and Nissan to work together in certain areas, particularly technology sharing). Political uncertainties (e.g. the UK's relationship with the EU) are also likely to delay future investment decisions.

4 Legal structures

Market-based economies comprise a rich diversity of business organisations, ranging from the very simple enterprise owned and operated by one person, to the huge multinational corporation with production and distribution facilities spread across the globe. Whatever the nature of these organisations or their scale of operation, their existence is invariably subject to legal definition and this will have consequences for the functioning of the organisation. Viewing the business as a legal structure provides an insight into some of the important influences on business operations in both the private and public sectors.

Learning outcomes

After reading this chapter, you should be able to:

- discuss the legal structure of UK business organisations in both the private and public sectors
- compare UK business organisations with those in other parts of Europe
- illustrate the implications of a firm's legal structure for its operations
- explain franchising, licensing and joint ventures

Key terms

Articles of Association
Black economy
Charitable Incorporated Organisation (CIO)
Community Interest Company (CIC)
Company
Company directors
Consortium
Consumer societies
Corporate governance
Executive directors
Franchising
Gearing
Golden share
Joint venture
Licensing
Managing director
Memorandum of Association
Nationalised industry
Non- executive directors
Partnership
Private limited company
Public corporation
Public limited company (PLC)
Public sector organisations
Shareholders
Social enterprises
Sole trader
Stakeholders
Unlimited personal liability
Workers' co-operatives

Introduction

Business organisations can be classified in a variety of ways, including:

- size (e.g. small, medium, large);
- type of industry (e.g. primary, secondary, tertiary);
- sector (e.g. private sector, public sector);
- legal status (e.g. sole trader, partnership, and so on).

These classifications help to distinguish one type of organisation from another and to focus attention on the implications of such differences for an individual enterprise. In this chapter we examine business organisations as legal structures and investigate the consequences of variations in legal status in some detail. Subsequent chapters in this section investigate alternative structural perspectives in order to highlight how these too have an important bearing on the environment in which businesses operate. We begin our analysis with an examination of the main forms of legal structure in the UK.

Private sector organisations in the UK

The sole trader

Many individuals aspire to owning and running their own business – being their own boss, making their own decisions. For those who decide to turn their dream into a reality, becoming a sole trader (or sole proprietor) offers the simplest and easiest method of trading.

As the name suggests, a **sole trader** is a business owned by one individual who is self-employed and who may, in some cases, employ other people on either a full-time or a part-time basis. Normally using personal funds to start the business, the sole trader decides on the type of goods or services to be produced, where the business is to be located, what capital is required, what staff (if any) to employ, what the target market should be and a host of other aspects concerned with the establishment and running of the enterprise. Where the business proves a success, all profits accrue to the owner and it is common for sole traders to reinvest a considerable proportion of these in the business and/or use them to reduce past borrowings. Should losses occur, these too are the responsibility of the sole trader, who has **unlimited personal liability** for the debts of the business.

Despite this substantial disadvantage, sole proprietorship remains the most popular form of business organisation numerically. In the United Kingdom (and in most other countries) it is estimated that 80 per cent or more of all businesses are sole traders and in some sectors – notably personal services, retailing, building – they tend to be the dominant form of business enterprise. Part of the reason for this numerical dominance is the relative ease with which an individual can establish a business of this type. Apart from minor restrictions concerning the use of a business name – if the name of the proprietor is not used – few other legal formalities are required to set up the enterprise, other than the need to register for Value Added Tax if turnover exceeds a certain sum

(e.g. £79,000 in 2013) and/or to fulfil any special requirements laid down by the local authority prior to trading (e.g. some businesses require licences). Once established, the sole trader, like other forms of business, will be subject to a variety of legal requirements (e.g. contract law, consumer law, employment law) – though not the requirement to file information about the business in a public place. For some, this ability to keep the affairs of the enterprise away from public scrutiny provides a further incentive to establishing this form of business organisation – some of which may operate wholly or partly in the **black economy** (i.e. beyond the gaze of the tax authorities).

A further impetus towards sole ownership comes from the ability of the individual to exercise a considerable degree of control over her/his own destiny. Business decisions – including the day-to-day operations of the enterprise as well as long-term plans – are in the hands of the owner and many individuals evidently relish the risks and potential rewards associated with entrepreneurial activity, preferring these to the relative safety of employment in another organisation. For others less fortunate, the 'push' of unemployment rather than the 'pull' of the marketplace tends to be more of a deciding factor and one that clearly accounts for some of the growth in the number of small businesses in the UK in recent decades.

Ambitions and commitment alone, however, are not necessarily sufficient to guarantee the survival and success of the enterprise and the high mortality rate among businesses of this kind, particularly during a recession, is well known and well documented. Part of the problem may stem from developments largely outside the control of the enterprise – including bad debts, increased competition, higher interest rates, falling demand – and factors such as these affect businesses of all types and all sizes, not just sole traders. Other difficulties, such as lack of funds for expansion, poor marketing, lack of research of the marketplace and insufficient management skills, are to some extent self-induced and emanate, at least in part, from the decision to become a sole proprietor rather than some other form of business organisation. Where such constraints exist, the sole trader may be tempted to look to others to share the burdens and the risks by establishing a partnership or co-operative or limited company, or by seeking a different approach to the business venture, such as through franchising. These alternative forms of business organisation are discussed in detail below.

The partnership

The Partnership Act 1890 defines a **partnership** as 'the relation which subsists between persons carrying on a business in common with a view to profit'. Like the sole trader, this form of business organisation does not have its own distinct legal personality and hence the owners – the partners – have unlimited personal liability, both jointly and severally. This means that in the case of debts or bankruptcy of the partnership, each partner is liable in full for the whole debt and each in turn may be sued or their assets seized until the debt is satisfied. Alternatively, all the partners may be joined into the action to recover debts, unless by dint of the Limited Partnership Act 1907, a partner (or partners) has limited liability. Since it tends to be much easier to achieve the same ends by establishing a limited company, limited partnerships are not common, nor can all partners in a partnership have limited liability. Hence the following discussion focuses on the partnership as an unincorporated association, operating in a market where its liability is effectively unlimited.

A partnership comes into being when two or more people establish a business which they own, finance and run jointly for personal gain, irrespective of the degree of formality involved in the relationship. Such a business can range from a husband and wife running a local shop as joint owners, to a very large firm of accountants or solicitors with in excess of 100 partners in offices in various locations. Under the law, most partnerships are limited to 20 or less, but some types of business, particularly in the professions, may have a dispensation from this rule (Companies Act 1985, s 716). This same Act requires businesses that are not exempt from the rule and that have more than 20 partners to register as a company. A limited company can also be a partner in a partnership since it counts as a 'legal person'.

While it is not necessary for a partnership to have a formal written agreement, most partnerships tend to be formally enacted in a Deed of Partnership or Articles, since this makes it much easier to reduce uncertainty and to ascertain intentions when there is a written document to consult. Where this is not done, the Partnership Act 1890 lays down a minimum code, which governs the relationship between partners and which provides, among other things, for all partners to share equally in the capital and profits of the business and to contribute equally towards its losses.

In practice, where a Deed or Articles exist, these will invariably reflect differences in the relative status and contribution of individual partners. Senior partners will often have contributed more financially to the partnership and not unnaturally will expect to receive a higher proportion of the profits. Other arrangements – including membership, action on dissolution of the partnership, management responsibilities and rights, and the basis for allocating salaries – will be outlined in the partnership agreement and as such will provide the legal framework within which the enterprise exists and its co-owners operate.

Unlike the sole trader, where management responsibilities devolve on a single individual, partnerships permit the sharing of responsibilities and tasks and it is common in a partnership for individuals to specialise to some degree in particular aspects of the organisation's work – as in the case of a legal or medical or veterinary practice. The fact that more than one person is involved in the ownership of the business tends to increase the amount of finance available to the organisation, thus permitting expansion to take place without the owners losing control of the enterprise. These two factors alone tend to make a partnership an attractive proposition for some would-be entrepreneurs, while for others the rules of their professional body – which often prohibits its members from forming a company – effectively provide for the establishment of this type of organisation.

On the downside, the sharing of decisions and responsibilities may represent a problem, particularly where partners are unable to agree over the direction the partnership should take or the amount to be reinvested in the business, unless such matters are clearly specified in a formal agreement. A more intractable problem is the existence of unlimited personal liability – a factor which may inhibit some individuals from considering this form of organisation, particularly given that the actions of any one partner are invariably binding on the other members of the business. To overcome this problem, many individuals, especially in manufacturing and trading, look to the limited company as the type of organisation that can combine the benefits of joint ownership and limited personal liability – a situation not necessarily always borne out in practice. It is to this type of business organisation that the discussion now turns.

Limited companies

In law a **company** is a corporate association having a legal identity in its own right (i.e. it is distinct from the people who own it, unlike in the case of a sole trader or partnership). This means that all property and other assets owned by the company belong to the company and not to its members (owners). By the same token, the personal assets of its members (the **shareholders**) do not normally belong to the business. In the event of insolvency, therefore, an individual's liability is limited to the value of shares invested in the business but which remain unpaid.[1] One exception to this would be where a company's owners have given a personal guarantee to cover any loans they have obtained from a bank or other institution – a requirement for many small, private limited companies. Another occurs where a company is limited by guarantee rather than by shares, with its members' liability being limited to the amount they have undertaken to contribute to the assets in the event of the company being wound up. Companies of this type are normally non-profit-making organisations – such as professional, research or trade associations – and are much less common than companies limited by shares. Hence, in what follows, we concentrate on the latter as the dominant form of business organisation in the corporate sector of business.[2]

Companies are essentially business organisations consisting of two or more individuals who have agreed to embark on a business venture and who have decided to seek corporate status rather than to form a partnership.[3] Such status could derive from an Act of Parliament or a Royal Charter, but is almost always nowadays achieved through 'registration', the terms of which are laid down in the various Companies Acts. Under legislation, enacted in 1985, 1989 and 2006, individuals seeking to form a company are required to file numerous documents, including a **Memorandum of Association** and **Articles of Association**, with the Registrar of Companies. If satisfied, the Registrar will issue a Certificate of Incorporation, bringing the company into existence as a legal entity. As an alternative, the participants could buy a ready-formed company 'off the shelf', by approaching a company registration agent who specialises in company formations. In the UK, advertisements for ready-made companies appear regularly in magazines such as *Exchange and Mart* and *Dalton's Weekly*. They can also be found on eBay.

Companies House can be accessed at *www.companieshouse.gov.uk*

Information on how companies are created, run and wound up is contained in the 2006 Companies Act, which essentially consolidates all previous legislation and case law into one Act of Parliament. As this Act shows, under British law a distinction is made between public and private companies. **Public limited companies** (PLCs) – not to be confused with public corporations, which in the UK are state-owned businesses (see below) – are those limited companies which satisfy the conditions for being a PLC. These conditions require the company to have:

- a minimum of one shareholder (although two or more is normal);
- at least two directors;
- a minimum (at present) of £50,000 of issued share capital;
- the right to offer its shares (and debentures) for sale to the general public;

- a certificate from the Registrar of Companies verifying that the share capital requirements have been met; and
- a memorandum which states it to be a public company.

A company that meets these conditions must include the title 'public limited company' or 'PLC' in its name and is required to make full accounts available for public inspection. Any company unable or unwilling to meet these conditions is therefore, in the eyes of the law, a 'private limited company', normally signified by the term 'Limited' or 'Ltd'.

Like the public limited company, the **private limited company** must have a minimum of one shareholder, but its shares cannot be offered to the public at large, although it can offer them to individuals through its business contacts. This restriction on the sale of shares, and hence on their ability to raise considerable sums of money on the open market, normally ensures that most private companies are either small or medium sized, and are often family businesses operating in a relatively restricted market; there are, however, some notable exceptions to this general rule (e.g. Virgin). In contrast, public companies – many of which began life as private companies prior to 'going public' – often have many thousands, even millions, of owners (shareholders), some of whom may be other companies, and they normally operate on a national or international scale, producing products as diverse as computers, petro-chemicals, cars and banking services. Despite being outnumbered by their private counterparts, public companies dwarf private companies in terms of their capital and other assets, and their collective influence on output, investment, employment and consumption in the economy is immense.

Both public and private companies act through their **company directors**. These are individuals chosen by a company's shareholders to manage its affairs and to make the important decisions concerning the direction the company should take (e.g. investment, market development, mergers and so on). The appointment and powers of directors are outlined in the Articles of Association (the 'internal rules' of the organisation) and so long as the directors do not exceed their powers, the shareholders do not normally have the right to intervene in the day-to-day management of the company. Where a director exceeds his or her authority or fails to indicate clearly that they are acting as an agent for the company, they become personally liable for any contracts they make. Equally, directors become personally liable if they continue to trade when the company is insolvent and they may be dismissed by a court if it considers that an individual is unfit to be a director in view of their past record (Company Directors Disqualification Act 1985).

The 2006 Act sets out in detail the statutory duties of company directors, including the duty to promote the success of the organisation, to exercise reasonable care, skill and diligence and to give appropriate consideration to issues that go beyond the balance sheet. For example, directors of UK companies now have a duty to consider the impacts of their business operations on the environment and the community generally and quoted public companies must report on issues of social and environmental responsibility as part of an expanded review of the business.

In the corporate world it is usual for a board of directors to have both a chairperson and a managing director, although some companies choose to appoint one person to both roles. The chairperson, who is elected by the other members of the board, is usually chosen because of their knowledge and experience of the business and their skill both internally in chairing board meetings and externally in representing the best interests of the organisation. As the public face of the company, the chairperson has an

important role to play in establishing and maintaining a good public image and hence many large public companies like to appoint well-known public figures to this important position (e.g. former Cabinet ministers). In this case knowledge of the business is less important than the other attributes the individual might possess, most notably public visibility and familiarity, together with a network of contacts in government and in the business world.

The **managing director**, or chief executive, fulfils a pivotal role in the organisation, by forming the link between the board and the management team of senior executives. Central to this role is the need not only to interpret board decisions but to ensure that they are put into effect by establishing an appropriate structure of delegated responsibility and effective systems of reporting and control. This close contact with the day-to-day operations of the company places the appointed individual in a position of considerable authority and he/she will invariably be able to make important decisions without reference to the full board. This authority is enhanced where the managing director is also the person chairing the board of directors and/or is responsible for recommending individuals to serve as executive directors (i.e. those with functional responsibilities such as production, marketing, finance).

Like the managing director, most, if not all, **executive directors** will be full-time executives of the company, responsible for running a division or functional area within the framework laid down at board level. In contrast, other directors will have a **non-executive** role and are usually part-time appointees, chosen for a variety of reasons, including their knowledge, skills, contacts, influence, independence or previous experience. Sometimes, a company might be required to appoint such a director at the wishes of a third party, such as an investment bank or hedge fund, which has agreed to fund a large capital injection and wishes to have representation on the board. In this case, the individual tends to act in an advisory capacity – particularly on matters of finance – and helps to provide the financing institution with a means of ensuring that any board decisions are in its interests.

In Britain, the role of company directors and senior executives has come under an increasing amount of public scrutiny, culminating in a number of enquiries into issues of power and pay. In the Cadbury Report (1992), a committee, with Sir Adrian Cadbury as chairperson, called for a non-statutory code of practice, which it wanted applied to all listed public companies. Under this code the committee recommended:

- a clear division of responsibilities at the head of a company to ensure that no individual had unfettered powers of decision;
- a greater role for non-executive directors;
- regular board meetings;
- restrictions on the contracts of executive directors;
- full disclosure of directors' total emoluments;
- an audit committee dominated by non-executives.

The committee's stress on the important role of non-executive directors was also a theme taken up in the Greenbury Report (1995), which investigated the controversial topic of executive salaries in the wake of a number of highly publicised pay rises for senior company directors. Greenbury's recommendations included:

- full disclosure of directors' pay packages, including pensions;
- shareholder approval for any long-term bonus scheme;
- remuneration committees consisting entirely of non-executive directors;

- greater detail in the annual report on directors' pay, pensions and perks;
- an end to payments for failure.

Greenbury was followed by a further investigation into corporate governance by a committee under the chairmanship of ICI chairman Ronald Hampel. The Hampel Report (1998) advocated company self-regulation and called for greater shareholder responsibility by companies and increased standards of disclosure of information; it supported Cadbury's recommendation that the role of chairperson and chief executive should normally be separated. A year later, the Turnbull Report (1999) considered the issue of **corporate governance** and information disclosure from the perspective of risk management, arguing that companies need to take steps to manage and disclose corporate risks formally.

As far as the issue of non-executive directors was concerned, this was investigated further by the Higgs Committee, which was established in 2002 and which reported the following year. The committee's report set down a code of non-binding corporate guidelines regarding the role of non-executive directors on company boards. Like the Cadbury Report, Higgs recommended that the role of chairperson and chief executive should be kept separate and that the former should be independent, though not necessarily non-executive. As for non-executive directors, Higgs recommended that at least half the board should be independent and that non-executives should play key roles in areas such as strategy, performance, risk and the appointment and remuneration of executive directors. The latter issue, in particular, has been an area of considerable controversy in the UK in recent years and seems destined to remain so for some time (see mini case: Companies under pressure).

Mini case Companies under pressure

Public companies have to satisfy the conflicting demands of a range of stakeholder groups (see below), not least their shareholders, who expect the organisation to operate in their interest. On the whole, individual shareholders are usually relatively quiescent, leaving the strategic and day-to-day decisions to the organisation's directors and senior executives. As an increasing number of public companies have found, however, many shareholders are becoming more actively involved in corporate decisions which they believe affect their investments and have been willing to voice their feelings at shareholders' meetings and to the media. This is particularly true of large corporate investors.

In the two previous editions of this book we reported on the rise of shareholder militancy at companies such as Daimler-Benz, Marks and Spencer and Exxon Mobil, with issues ranging from poor company performance and the firm's negative impact on the natural environment, to executive remuneration and the combining of the roles of chairman and chief executive. Boardroom pay has continued to be a particular bone of contention in the UK (e.g. at Tesco, Sainsbury, Burberry), with shareholders raising questions not only about the level of total rewards but also the often less than challenging performance targets set for directors when receiving bonuses and lucrative share options. To go some way towards addressing these concerns, the UK government introduced reforms in October 2013 – under the Enterprise and Regulatory Reform Act – which will require quoted companies to provide clearer information on the pay of top executives, to give shareholders a regular vote on company remuneration policy and to set out details on the non-financial aspects of the firm's operations, including its performance

on human rights, greenhouse gas emissions and gender representation at senior levels. The aim of this aspect of the legislation is to make company decisions more transparent both to the firm's owners and to its other key stakeholders; this is seen as a central aspect of good corporate governance in UK larger businesses.

The issue of transparency applies equally to the question of the gender composition of major companies at senior levels, particularly top executives and board members. In 2010, for example, the Financial Reporting Council proposed a corporate governance code under which the UK's largest 350 companies would be required to hold annual re-elections for board members and appoint more women to board positions, calling upon them to explain to shareholders if these two developments did not occur. The following year the Davies Committee recommended that by 2015 the UK's largest businesses should have at least 25 per cent of boardroom positions occupied by women and called for more female representation in senior positions (e.g. in executive committees), although it stopped short of imposing a quota. In a potentially crucial development in late 2013, one of the City's largest fund managers, Legal and General, warned that it would vote against the chairman of any FTSE 100 company that retained an all-male board by the 2015 deadline. Many observers believe that the financial power of major institutional investors is likely to prove a more potent weapon in achieving organisational change than attempts by government to force businesses to become more diverse in their recruitment policies.

Co-operatives

Consumer co-operative societies

Consumer societies are basically 'self-help' organisations which have their roots in the anti-capitalist sentiment that arose in mid-nineteenth-century Britain and which gave rise to a consumer co-operative movement dedicated to the provision of cheap, unadulterated food for its members and a share in its profits. Today this movement boasts a multi-billion-pound turnover, a membership numbered in millions and an empire that includes thousands of food stores, numerous factories and farms, dairies, travel agencies, opticians, funeral parlours, an insurance company, and property and development business.

Taken together, these activities ensure that the Co-operative Group remains the world's largest consumer co-operative and a powerful force in British retailing, although it has recently (October 2013) lost control of its banking arm to a number of hedge funds. Survey evidence indicates that it has been one of the UK's most trusted and ethical brand names; this may change to some degree as a result of recent developments at the Co-operative Bank.

The Co-operative Group's website address is *www.co-operative.coop*

Although the co-operative societies, like companies, are registered and incorporated bodies – in this case under the Industrial and Provident Societies Act – they are quite distinct trading organisations. These societies belong to their members (i.e. invariably customers who have purchased a share in the society), who elect Area Committees to oversee trading areas. These committees have annual elections and meetings for all

members and these in turn appoint members on to regional boards and elect individual member directors to the Group Board. The Group Board also includes directors of corporate members who are representatives of other societies; individual stores may also have member forums. Any profits from the Group's activities are supposed to benefit the members. Originally this took the form of a cash dividend paid to members in relation to their purchases, but this was subsequently replaced either by trading stamps or by investment in areas felt to benefit the consumer (e.g. lower prices, higher-quality products, modern shops and so on) and/or the local community (e.g. charitable donations, sponsorship). The twice-yearly cash dividend was, however, reintroduced in 2006, a move which saw a significant increase in the membership of the organisation.

The societies differ in other ways from standard companies. For a start, shares are not quoted on the Stock Exchange and members are restricted in the number of shares they can purchase and in the method of disposal. Not having access to cheap sources of capital on the stock market, co-operatives rely heavily on retained surpluses and on loan finance, and the latter places a heavy burden on the societies when interest rates are high. The movement's democratic principles also impinge on its operations and this has often been a bone of contention as members have complained about their increasing remoteness from decision-making centres. Some societies have responded by encouraging the development of locally elected committees to act in an advisory or consultative capacity to the society's board of directors and it looks likely that others will be forced to consider similar means of increasing member participation, which remains limited.

The movement's historical links with the British Labour Party are also worth noting and a number of parliamentary candidates are normally sponsored at general elections. These links, however, have tended to become slightly looser in recent years, although the movement still contributes to Labour Party funds and continues to lobby politicians at both national and local levels. It is also active in seeking to influence public opinion and, in this, claims to be responding to customer demands for greater social and corporate responsibility. Among its initiatives are the establishment of a customer's charter (by the Co-operative Bank) and the decision to review both its investments and the individuals and organisations it does business with, to ascertain that they are acceptable from an ethical point of view.

Workers' co-operatives

In Britain, **workers' co-operatives** are found in a wide range of industries, including manufacturing, building and construction, engineering, catering and retailing. They are particularly prevalent in printing, clothing and wholefoods, and some have been in existence for more than a century. The majority, however, are of fairly recent origin, having been part of the growth in the number of small firms which occurred in the 1980s.

As the name suggests, a workers' co-operative is a business in which the ownership and control of the assets are in the hands of the people working in it, having agreed to establish the enterprise and to share the risk for mutual benefit. Rather than form a standard partnership, the individuals involved normally register the business as a friendly society under the Industrial and Provident Societies Acts 1965–78, or seek incorporation as a private limited company under the Companies Act 1985. In the case of the former, seven members are required to form a co-operative, while the latter

requires only two. In practice, a minimum of three or four members tends to be the norm and some co-operatives may have several hundred participants, frequently people who have been made redundant by their employers and who are keen to keep the business going.

The central principles of the movement – democracy, open membership, social responsibility, mutual co-operation and trust – help to differentiate the co-operative from other forms of business organisation and govern both the formation and operation of this type of enterprise. Every employee may be a member of the organisation and every member owns one share in the business, with every share carrying an equal voting right. Any surpluses are shared by democratic agreement and this is normally done on an equitable basis, reflecting, for example, the amount of time and effort an individual puts into the business. Other decisions, too, are taken jointly by the members and the emphasis tends to be on the quality of goods or services provided and on creating a favourable working environment, rather than on the pursuit of profits – although the latter cannot be ignored if the organisation is to survive. A workers' co-operative tends to focus on people and on the relationship between them, stressing the co-operative and communal traditions associated with its origins, rather than the more conflictual and competitive aspects inherent in other forms of industrial organisation.

Despite these apparent attractions, workers' co-operatives have never been as popular in Britain as in other parts of the world (e.g. France, Spain, Italy, Israel), although a substantial increase occurred in the number of co-operatives in the 1980s, largely as a result of growing unemployment, overt support across the political spectrum and the establishment of a system to encourage and promote the co-operative ideal (e.g. Co-operative Development Agencies).[4] More recently, however, their fortunes have tended to decline, as employee shareholding and profit schemes (ESOPs) have grown in popularity. It seems unlikely that workers' co-operatives will ever form the basis of a strong third sector in the British economy, between the profit-oriented firms in the private sector and the nationalised and municipal undertakings in the public sector.

Social enterprises

Some businesses may be set up with the specific intention of helping people or the community; these are usually referred to as **social enterprises** and can take a variety of legal forms, including those identified above. Alternatively, the individuals or groups establishing a social enterprise may opt to set up a **Charitable Incorporated Organisation (CIO)** or **Community Interest Company (CIC)** in order to achieve their objectives. CIOs are the new legal form for a charitable organisation, registered by the Charity Commission as an incorporated body with particular advantages (e.g. tax exemptions) but not a company as such in the legal sense of the word. CICs, in contrast, are a special type of company in which the assets and the profits of the business are used for public good in areas such as fair trade, the environment, community support and local regeneration. While such organisations do not have the tax advantages available for CIOs, they are generally more lightly regulated and are regarded as a more flexible model for achieving public benefits.

Public sector business organisations in the UK

Public sector organisations come in a variety of forms. These include:

- central government departments (e.g. Department for Business, Innovation and Skills);
- local authorities (e.g. Lancashire County Council);
- regional bodies (e.g. the former Regional Development Agencies);
- non-departmental public bodies or quangos (e.g. the Arts Council);
- central government trading organisations (e.g. The Stationery Office);
- public corporations and nationalised industries (e.g. the BBC).

Some of these were discussed in Chapter 4, which examined the political environment, and numerous other references to the influence of government on business activity can be found throughout the book. We discuss below public sector organisations which most closely approximate businesses in the private sector, namely, public corporations and municipal enterprises.

Public corporations

Private sector business organisations are owned by private individuals and groups who have chosen to invest in some form of business enterprise, usually with a view to personal gain. The state can also own assets in various forms, which it uses to provide a range of goods and services felt to be of benefit to its citizens, even if this provision involves the state in a loss. Many of these services are provided directly through government departments (e.g. social security benefits) or through bodies operating under delegated authority from central government (e.g. local authorities, health authorities). Others are the responsibility of state-owned industrial and commercial undertakings, specially created for a variety of reasons and often taking the form of a **public corporation**. These state corporations or government-owned enterprises are an important part of the public sector of the economy and have contributed significantly to national output, employment and investment. Their numbers have declined substantially, however, following the wide-scale privatisation of state industries which occurred in the 1980s, a process which continued through the 1990s and beyond with the sale of corporations such as British Coal, British Rail, British Energy and Royal Mail.

Public corporations are statutory bodies, incorporated (predominantly) by special Act of Parliament and, like companies, they have a separate legal identity from the individuals who own them and run them. The statute setting up the corporation identifies the powers, duties and responsibilities of the organisation and its relationship with the government department which oversees its operations. In the past these operations have ranged from providing a variety of national and international postal services (the Post Office), to the provision of entertainment (the BBC), an energy source (British Coal) and a national rail network (British Rail). Where such provision involves the organisation in a considerable degree of direct contact with its customers, from whom it derives most of its revenue, the corporation tends to be called a **nationalised industry**.

In reality, of course, the public corporation is the legal form through which the industry is both owned and run and every corporation is to some degree unique in structure as well as in functions.

As organisations largely financed as well as owned by the state, public corporations are required to be publicly accountable and hence they invariably operate under the purview of a 'sponsoring' government department, the head of which (the Secretary of State) appoints a board of management to run the organisation. This board tends to exercise a considerable degree of autonomy in day-to-day decisions and operates largely free from political interference on most matters of a routine nature. The organisation's strategic objectives, however, and important questions concerning reorganisation or investment, would have to be agreed with the sponsoring department, as would the corporation's performance targets and its external financing limits.

The link between the corporation and its supervising ministry provides the means through which Parliament can oversee the work of the organisation and permits ordinary Members of Parliament to seek information and explanation through question time, through debates and through the select committee system. Additionally, under the Competition Act 1980, nationalised industries can be subject to investigation by the Competition Commission, and this too presents opportunities for further parliamentary discussion and debate, as well as for government action. Public accountability has also, historically, been provided through the establishment of industry-specific Consumers' or Consultative Councils, which were set up to consider complaints from customers and to advise both the board and the department concerned of public attitudes to the organisation's performance and to other aspects of its operations (e.g. pricing).

It is interesting to note that mechanisms for public accountability and state regulation have been retained to some degree even where public utilities have been privatised (i.e. turned into public limited companies). Industries such as gas, electricity, water and telecommunications are watched over by regulatory bodies, which are designed to protect the interests of consumers, particularly with regard to pricing and the standard of service provided. Ofgas, for instance, which used to regulate British Gas, monitored gas supply charges to ensure that they reasonably reflected input costs and these charges could be altered by the regulator if they were seen to be excessive. Similarly, in the case of non-gas services, such as maintenance, the legislation privatising the industry allowed prices to be raised only to a prescribed maximum, to ensure that the organisation was not able to take full advantage of its monopoly power. The regulator of the gas market is now Ofgem.

An additional source of government influence has come through its ownership of a **golden share** in a privatised state industry, which effectively gives the government a veto in certain vital areas of decision-making. This notional shareholding – which is written into the privatisation legislation – usually lasts for a number of years and can be used to protect a newly privatised business from a hostile takeover, particularly by foreign companies or individuals. Ultimately, however, the expectation is that this veto power will be relinquished and the organisation concerned will become subject to the full effects of the market. Rulings in the European courts over the last decade – against the use of golden shares by the French, German, Italian, Portuguese, Belgian, Spanish and UK governments – indicate that the demise of this mechanism may be imminent.

The existence of a golden share should not be equated with the decision by government to retain (or purchase) a significant proportion of issued shares in a privatised (or

already private) business organisation, whether as an investment and/or future source of revenue, or as a means of supporting an organisation or of exerting influence in a particular industry or sector. Nor should it be confused with government schemes to attract private funds into existing state enterprises, by allowing them to achieve notional company status in order to overcome Treasury restrictions on borrowing imposed on public bodies. In the latter case, which often involves a limited share issue, government retains full control of the organisation by owning all (or the vast majority) of the shares – as in the case of Consignia (formerly known as the Post Office). In March 2001, Consignia was incorporated as a government-owned public company. This change in legal status allowed the company more freedom to borrow and invest in the business, to make acquisitions and to enter into joint ventures and to expand internationally. The name Consignia was subsequently dropped in favour of the brand name Royal Mail. This organisation has recently been privatised (October 2013).

Municipal enterprises

UK local authorities have a long history of involvement in business activity. In part this is a function of their role as central providers of public services (e.g. education, housing, roads, social services) and of their increasing involvement in supporting local economic development initiatives. But their activities have also traditionally involved the provision of a range of marketable goods and services, not required by law but provided voluntarily by a local authority and often in direct competition with the private sector (e.g. theatres, leisure services, museums). Usually such provision has taken place under the aegis of a local authority department, which appoints staff who are answerable to the council and to its committees through the department's chief officer and its elected head. Increasingly, though, local authorities have turned to other organisational arrangements – including the establishment of companies and trusts – in order to separate some of these activities from the rest of their responsibilities and to create a means through which private investment in the enterprise can occur. Under UK official definitions, some of these organisations are classified as public corporations, although municipal enterprises is arguably a more meaningful concept.

A good example of municipal enterprise is the local authority-controlled airport, which is normally the responsibility of a number of local authorities which operate through a joint board, representing the interests of the participating district councils (e.g. Manchester International Airport). Since the Airports Act 1986, local authorities with airports have been required to create a limited company in which their joint assets are vested and which appoints a board of directors to run the enterprise. Like other limited companies, the organisation can, if appropriate, seek private capital and must publish annual accounts, including a profit and loss statement. It can also be privatised relatively easily if the local authorities involved decide to relinquish ownership (e.g. East Midlands Airport is part of the Manchester Airports Group).

Such developments, which have parallels in other parts of the public sector, can be seen to have had at least four benefits:

1 They have provided a degree of autonomy from local authority control that is seen to be beneficial in a competitive trading environment.
2 They have given access to market funds by the establishment of a legal structure that is not fully subject to central government restrictions on local authority borrowing.

3 They helped local authority organisations to compete more effectively under the now defunct system of compulsory competitive tendering (CCT), by removing or reducing charges for departmental overheads that are applied under the normal arrangements.
4 They have provided a vehicle for further private investment, including via a joint venture, and for ultimate privatisation of the service.

Given these benefits and the current fashion for privatisation, there is little doubt that they will become an increasing feature of municipal enterprise in the foreseeable future. That said, local authorities are restricted in their degree of ownership of companies following the passage of the 1990 Local Government and Housing Act.

Business organisations in mainland Europe

Sole traders, partnerships, co-operatives and limited companies are to be found throughout Europe and beyond, and in many cases their legal structure is similar to that of their British counterparts. Where differences occur, these are often a reflection of historical and cultural factors, which find expression in custom and practice as well as in law. Examples of some of these differences are contained in the brief discussions below, which focus on France, Germany, Denmark and Portugal.

France

Numerically, the French economy is dominated by very small businesses (i.e. fewer than ten employees), the majority of which are sole traders. As in Britain, these are owner managed and operated enterprises, with a husband and wife often assuming joint responsibility for the business. Formal requirements in this type of organisation tend to be few, although individuals as well as companies engaging in a commercial business are required to register before trading officially begins. Since this process is relatively simple and there are no minimum capital requirements or significant reporting obligations, sole traderships tend to be preferred by the vast majority of individuals seeking to start a business and they are particularly prevalent in the service sector. They carry, however, unlimited personal liability for the owner, whose personal assets are at risk in the event of business failure.

Most of the remaining French business organisations are limited companies, many of which are Petites et Moyennes Entreprises (PMEs) – small and medium enterprises – employing between 10 and 250 employees. These companies come in a variety of legal forms, but two in particular have tended to predominate: the Société à Responsabilité Limitée (SARL) and the Société Anonyme (SA). A further company form, the Société Par Actions Simplifée, was created by statute in 1994 and combines the legal status of a corporation with the flexibility of a partnership.

The SARL has generally been the form preferred by smaller companies, whose owners wish to retain close control of the organisation; hence many of them are family businesses – an important feature of the private sector in France. This type of enterprise can now be established with a minimum capital of €1, cannot issue shares to the general public, has restrictions on the transfer of shares and is run by individuals appointed by

the shareholders – usually the shareholders themselves and/or relatives. These various restrictions help to ensure that the owner-managers remain dominant in the organisation and the appointed head of the company will invariably be the most important decision-maker. They also provide the organisation with a defence against hostile takeover, particularly by overseas companies looking for a French subsidiary in order to avoid the special rules which apply to branches and agencies (e.g. a foreign parent company has unlimited liability for the debts of its branch or agency, since these do not have a separate legal identity).

The SA is the legal form normally chosen by larger companies seeking access to substantial amounts of capital. In the case of a privately owned company, the minimum capital requirement is currently €37,000; if publicly owned, the minimum is €225,000. Where capital assets are substantial, this tends to ensure that financial institutions are large shareholders in SAs and many of them have interests in a wide range of enterprises which they often manage through a holding company (see below). One advantage of this arrangement is that it provides the financial institution with a means of managing its investments and of exerting influence over companies in which it has a large minority stake. Another is that it provides a means of defending French companies from hostile takeovers and hence small and medium enterprises often seek backing from holding companies to help fend off foreign predators.

As in Britain, the legal basis of the SA provides for a clear distinction between the roles of the owners (the shareholders) and the salaried employees, and it is the former who appoint the company's board of directors. In smaller companies, the chairperson and managing director is often the same person and many smaller French companies continue to have extremely strong central control, often by the head of the owning family. In larger companies, the two roles are normally separated, with the managing director assuming responsibility for the day-to-day operations of the enterprise and forming the link between the board and the company's senior executives and managers, some of whom may have considerable delegated authority.

It is worth noting that in companies with more than 50 employees, there is a legal requirement to have elected work councils, and workers' delegates have the right to attend board meetings as observers and to be consulted on matters affecting working conditions. In companies with more than ten employees, workers have the right to elect representatives to look after their interests and regular meetings have to take place between management and workers, over and above the obligation of employers to negotiate annually on pay and conditions. Despite these arrangements and the legal right for unions to organise on a company's premises, trade union membership – outside state-run companies – remains low and hence union influence tends to be limited.

Germany

All major forms of business organisation are to be found in Germany, but it is the limited company that is of particular interest. Some of these are of relatively recent origin, having formerly been East German state-owned enterprises which have undergone privatisation following the reunification of the country.

In numerical terms it is the private limited company (*Gesellschaft mit beschränkter Haftung* – GmbH) that predominates and which is the form chosen by most foreign companies seeking to establish an enterprise in Germany. As in Britain, this type of

organisation has to be registered with the authorities and its founding members must prepare Articles of Association for signature by a public notary. The Articles include information on the purpose of the business, the amount of capital subscribed, the members' subscriptions and obligations and the company's name and registered address. Once the registration process is complete – usually a matter of a few days – the personal liability of the members becomes limited to the amount invested in the business. Currently, the minimum amount of subscribed share capital required for registration is €25,000, half of which must be paid up by the company itself.

Large numbers of GmbHs are owned and run by German families, with the banks often playing an influential role as guarantors of part of the initial capital and as primary sources of loan finance. As in France, this pattern of ownership makes hostile takeovers less likely, as well as ensuring that the management of the enterprise remains in the hands of the owners. Significantly, the management of a proposed GmbH is subject to quality control, being required to prove that they are qualified for the task prior to trading. This requirement stands in stark contrast to arrangements in Britain, where no such guarantees are needed, other than those implicit in a bank's decisions to help finance a proposed venture on the basis of a business plan.

The procedures for establishing other types of business organisation are similar to those of the GmbH, although in the case of the public limited company (*Aktiengesellschaft* – AG), the current minimum amount of capital required at start-up is €50,000. Unlike British companies, the AG usually consists of two boards of directors, one of which (the supervisory board) decides on longer-term strategy, while the other (the managing board) concentrates on more immediate policy issues, often of an operational kind. Normally half the members of the supervisory board (*Aufsichtrat*) are elected by shareholders, while the other half are employees elected by the workforce, and it is the responsibility of the board to protect the interests of employees as well as shareholders.

Such worker representation at senior levels is an important element of the German system of business organisation and even in smaller enterprises workers have the right to establish works councils and to be consulted on social and personnel issues and on strategic decisions. Equally, all employees have a constitutional right to belong to a trade union – most of which are organised by industry rather than by craft or occupation, as is largely the case in the UK. Consequently, German companies typically negotiate with only one union, usually in an atmosphere that stresses consensus and an identity of social and economic interests, rather than conflict and confrontation.

Corporate finance is another area in which German experience differs from that in the United Kingdom, although the situation has changed to some degree in recent years. Historically, in Britain a substantial amount of company finance has been raised through the stock market and this is also the case in the United States and Japan. In Germany (and for that matter in France, Italy and Spain), the banks and a number of other special credit institutions play a dominant role, with bank loans far outstripping joint-stock financing as a source of long-term capital. Traditionally, German banks have been willing to take a longer-term view of their investment, even at the expense of short-term profits and dividends, and this has benefited German companies seeking to expand their operations. In return, the banks have tended to exert a considerable amount of influence in the boardrooms of many German companies, usually by providing a substantial number of members of a company's supervisory board, including the chairperson.

Denmark

Denmark, like France, is a country whose economy is dominated by small businesses, many of which are sole traders. As in other countries, there are very few regulations governing the establishment of this type of enterprise, other than the need to register for VAT if turnover exceeds a predetermined limit and to meet taxation and social security requirements. In keeping with practice throughout Europe and beyond, sole traders have unlimited personal liability and this imposes a considerable burden on the organisation's owner and family, who often run the business jointly. The same conditions also apply in the case of Danish partnerships – whether formal or informal – with the joint owners having full and unlimited liability for all debts accruing to the organisation.

Limited companies in Denmark also reflect practice elsewhere, being required to register under the Companies Act and having a legal existence separate from the owners and employees. Three main types of limited liability company can be distinguished:

1 The *Anpartselskaber* (ApS), which is a private joint-stock company, often run by a family and owned and controlled by a handful of individuals, one of whom may simultaneously occupy the roles of main owner, chairperson and managing director. Many of these companies began life as sole traders, but for reasons of taxation and liability have registered as an ApS.
2 The *Aktieselskaber* (A/S), which is a quoted or (more regularly) unquoted public limited company, subject essentially to the same regulations as the ApS, but having a much larger minimum capital requirement on registration. A large number of A/S companies are still small businesses, run by family members who wish to retain control of the enterprise as an increase in assets occurs.
3 The AMBA is a special kind of limited company – in essence a tax-free co-operative with its own regulations. Many of these companies have grown over the years through merger and acquisition and some of them belong to larger Danish companies and employ a substantial number of workers. They tend to be concentrated in farm-related products, but can also be found in the service sector, especially wholesaling and retailing.

Portugal

A brief look at Portuguese business organisations reveals a range of legal structures that includes sole traders, joint ventures, complementary groups, unlimited companies, limited partnerships and public and private limited companies. In the case of the latter, capital requirements tend to be an important distinguishing feature, with the public limited company or corporation (*Sociedade Anonima* – SA) having a much larger minimum capital requirement than the private company (*Sociedade Por Quotas or Limitada* – LDA) as in other countries.

The public sector in mainland Europe

Given the number of countries involved, it is impossible to survey the whole of the public sector in the rest of Europe and beyond. Students with an interest in this area are encouraged to read further and to consult the various specialist sources of information

covering the countries they wish to investigate. A number of general points, however, are worthy of note:

1 Public sector business organisations can be found in all countries and invariably exist because of the decision by the state to establish a particular organisation under state ownership and control, or to nationalise an existing private business (or industry).
2 In some countries (e.g. France, Greece, Portugal) the state has traditionally played an important role in business and still controls some key sectors of the economy.
3 State involvement in business often includes significant shareholdings in a number of large enterprises, not only by the national government but also by regional and/or local government (e.g. in Germany).
4 State intervention often occurs in organisations or industries that can be deemed 'problematic' (e.g. in Greece).
5 Privatisation of state-owned enterprises has occurred throughout Europe and in other parts of the world. In the former East Germany most of the state-owned companies have been transferred to private ownership, by turning them initially into trusts which became the vehicle for privatisation and/or joint ventures. Similarly in Portugal, the wholesale nationalisation of the economy after the 1974 Revolution has been reversed and the government is committed to a phased programme of privatisation, involving employees and small investors as well as large national and international organisations. Other European countries, too, have faced pressures to reduce the size of the public sector (e.g. Greece), particularly in response to the global financial crisis and its aftermath.

This latter point serves to re-emphasise that the business environment is subject to change over time and the fashions of today may tomorrow become things of the past. This fluctuating environment is as applicable to the public sector as it is to the private sector of the economy.

Legal structure: some implications

For businesses in the private sector, the choice of legal structure has important implications. Among the factors the aspiring entrepreneur has to take into account when deciding what form of business enterprise to establish are:

- the degree of personal liability;
- the willingness to share decision-making powers and risks;
- the costs of establishing the business;
- the legal requirements concerning the provision of public information;
- the taxation position;
- commercial needs, including access to capital; and
- business continuity.

For some, retaining personal control will be the main requirement, even at the risk of facing unlimited personal liability and reducing the opportunities for expansion. For others, the desire to limit personal liability and to provide increased capital for growth will dictate that the owner seeks corporate status, even if this necessitates sharing

decision-making powers and may ultimately result in a loss of ownership and/or control of the enterprise.

This link between an organisation's legal structure and its subsequent operations can be illustrated by examining three important facets of organisational life: the organisation's objectives, its sources of finance and its stakeholders. As the analysis below illustrates, in each of these areas, significant differences occur between alternative forms of business organisation, both *within* the private sector and *between* the state and non-state sectors of the economy. In some cases, these differences can be attributed directly to the restraints (or opportunities) faced by an organisation as a result of its legal status, suggesting that the legal basis of the enterprise conditions its operations. In other cases operational considerations tend to dictate the organisation's legal form, indicating that these are as much a cause of its legal status as a result of it – a point well illustrated by the workers' co-operative and the public corporation.

Organisational objectives

All business organisations pursue a range of objectives and these may vary to some degree over time. New private sector businesses are likely to be concerned initially with survival and with establishing a position in the marketplace, with profitability and growth seen as less important in the short term. Most well-established businesses will tend to regard profits and growth as key objectives and may see them as a means towards further ends, including market domination, maximising sales revenue and/or minimising operating costs.

Organisational objectives are also conditioned by the firm's legal structure. In sole traders, partnerships and some limited companies, control of the enterprise rests in the hands of the entrepreneur(s) and hence organisational goals will tend to coincide with the personal goals of the owner(s), whatever the point in the organisation's life cycle. In public companies, however – where ownership tends to be separated from control – the goals of the owners (shareholders) may not always correspond with those of the directors and senior managers who run the organisation, particularly when the latter are pursuing personal goals to enhance their own organisational position, status and/or rewards.

The possibility of goal conflict also occurs where an individual company becomes a subsidiary of another organisation, whether by agreement or as a result of a takeover battle. This parent–subsidiary relationship may take the form of a holding company which is specially created to purchase a majority (sometimes all) of the shares in other companies, some of which may operate as holding companies themselves. Thus, while the individual subsidiaries may retain their legal and commercial identities and may operate as individual units, they will tend to be controlled by a central organisation which may exercise a considerable degree of influence over the objectives to be pursued by each of its subsidiaries. It is not inconceivable that some parts of the group may be required to make a loss on paper, particularly when there are tax advantages to be gained by the group as a whole from doing so.

Workers' co-operatives and public corporations provide further evidence of the relationship between an organisation's legal status and its primary objectives. In the case of the former, the establishment of the enterprise invariably reflects a desire on the part of

its members to create an organisation which emphasises social goals (e.g. democracy, co-operation, job creation, mutual trust) rather than the pursuit of profits – hence the choice of the 'co-operative' form. Similarly, in the case of the public corporation, a decision by government to establish an entity which operates in the interests of the public at large (or 'national interest') favours the creation of a state owned and controlled organisation, with goals laid down by politicians and generally couched in social and financial terms (e.g. return on assets, reinvestment, job creation) rather than in terms of profit maximisation.

This apparent dichotomy between the profit motive of the private sector and the broader socio-economic goals of public bodies has, however, become less clear-cut over the last decade, as an increasing number of state-owned organisations have been 'prepared' for privatisation and successive governments have sought to bring private money into public projects by creating public/private partnerships. Equally, in other parts of the public sector – including the health service and local government – increasing stress is being laid on 'best value' and on operating within budgets – concepts that are familiar to businesses in the private sector. While it is not inconceivable that a change in government could reverse this trend, current evidence suggests that a shift in cultural attitudes has occurred and public bodies can no longer rely on unconditional government support for their activities. If this is the case, further convergence is likely to occur between state and privately owned bodies, with the former moving towards the latter rather than vice versa.

Finance

Business organisations finance their activities in a variety of ways and from a range of sources. Methods include reinvesting profits, borrowing, trade credit and issuing shares and debentures. Sources include the banks and other financial institutions, individual investors and governments, as well as contributions from the organisation's original owners.

In the context of this chapter it is appropriate to make a number of observations about the topic as it relates generally to the business environment:

1 All organisations tend to fund their activities from both internal (e.g. owner's capital, reinvested profits) and external sources (e.g. bank borrowing, sale of shares).
2 Financing may be short term, medium term or longer term, and the methods and sources of funding chosen will reflect the time period concerned (e.g. bank borrowing on overdraft tends to be short term and generally needed for immediate use).
3 Funds raised from external sources inevitably involve the organisation in certain obligations (e.g. repayment of loans with interest, personal guarantees, paying dividends) and these will act as a constraint on the organisation at some future date.
4 The relationship between owner's capital and borrowed funds – usually described as an organisation's **gearing** – can influence a firm's activities and prospects in a variety of ways (e.g. high-geared firms with a large element of borrowed funds will be adversely affected if interest rates are high).
5 Generally speaking, as organisations become larger, many more external sources and methods of funding become available and utilising these can have implications for the structure, ownership and conduct of the organisation.

This latter point is perhaps best illustrated by comparing sole traders and partnerships with limited companies. In the case of the former, as unincorporated entities neither the sole trader nor the partnership can issue shares (or debentures) and hence their access to large amounts of external capital is restricted by law. Companies have no such restrictions – other than those which help to differentiate a private company from a public one – and consequently they are able to raise larger amounts by inviting individuals (and organisations) to subscribe for shares. Where a company is publicly quoted on the stock market, the amounts raised in this way can be very large indeed and the resultant organisation may have millions of owners who change on a regular basis as shares are traded on the second- hand market.

Organisations that decide to acquire corporate status in order to raise funds for expansion (or for some other purposes) become owned by their shareholders, who may be the original owners or may be individual and institutional investors holding equity predominantly as an investment and with little, if any, long- term commitment to the organisation they own. As indicated above, in the latter case, a separation tends to occur between the roles of owner (shareholder) and controller (director) and this can lead to the possibility of conflicting aims and objectives or differences in opinion over priorities within the enterprise – a problem discussed in more detail below under 'Stakeholders'.

A further illustration of the relationship between an organisation's legal structure and its ability to raise finance is provided by the public corporation. In this case, as a public body accountable to Parliament and the public via government, the public corporation is normally required to operate within a financial context largely controlled by government and this will be conditioned by the government's overall fiscal policy, including its attitude to the size of the public deficit. One aspect of this context in Britain in recent decades has been the establishment of external financing limits (EFLs) for each nationalised industry, arrived at by negotiation between government and the board running the public corporation, and used as a means of restraining monetary growth and hence the size of the public debt. Unfortunately this has also tended to prevent the more financially sound corporations, such as British Telecom before privatisation, from borrowing externally on a scale necessary to develop their business – a restriction that tends to disappear when the corporation becomes a fully fledged public company, either through privatisation or by some other means.

Stakeholders

All organisations have **stakeholders**; these are individuals and/or groups who are affected by or affect the performance of the organisation in which they have an interest. Typically they would include employees, managers, creditors, suppliers, shareholders (if appropriate) and society at large. As Table 1 illustrates, an organisation's stakeholders have a variety of interests which range from the pursuit of private gain to the more nebulous idea of achieving public benefit. Sometimes these interests will clash as, for example, when managers seek to improve the organisation's cash flow by refusing to pay suppliers' bills on time. On other occasions, the interests of different stakeholders may coincide, as when managers plan for growth in the organisation and in doing so provide greater job security for employees and enhanced dividends for investors.

Table 1 Organisational stakeholders and their interests

Types of stakeholder	*Possible principal interests*
Employees	Wage levels; working conditions; job security; personal development
Managers	Job security; status; personal power; organisational profitability; growth of the organisation
Shareholders	Market value of the investment; dividends; security of investment; liquidity of investment
Creditors	Security of loan; interest on loan; liquidity of investment
Suppliers	Security of contract; regular payment; growth of organisation; market development
Society	Safe products; environmental sensitivity; equal opportunities; avoidance of discrimination

The legal structure of an organisation has an impact not only on the type of stakeholders involved but also to a large degree on how their interests are represented. In sole traders, partnerships and smaller private companies, the coincidence of ownership and control limits the number of potential clashes of interest, given that objectives are set by and decisions taken by the firm's owner-manager(s). In larger companies, and, in particular, public limited companies, the division between ownership and control means that the controllers have the responsibility of representing the interests of the organisation's shareholders and creditors and, as suggested above, their priorities and goals may not always correspond.

A similar situation occurs in public sector organisations, where the interest of taxpayers (or ratepayers) is represented both by government and by those individuals chosen by government to run the organisation. In this case, it is worth recalling that the broader strategic objectives of the enterprise and the big decisions concerning policy, finance and investment tend to be taken by politicians, operating with advice from their officials (e.g. civil servants, local government officers) and within the context of the government's overall economic and social policies. The organisation's board of management and its senior executives and managers are mainly responsible for the day-to-day operations of the business, although the board and the person chairing it would normally play a key role in shaping overall objectives and decisions, through regular discussions with government and its officials.

One important way in which public sector organisations differ from their private sector counterparts is in the sanctions available to particular groups of stakeholders who feel that the organisation is not representing their best interests. Shareholders in a company could withdraw financial support for a firm whose directors consistently disregard their interests or take decisions which threaten the security and/or value of their investment, and the possibility of such a reaction normally guarantees that the board pays due attention to the needs of this important group of stakeholders. The taxpayer and ratepayer have no equivalent sanction and in the short term must rely heavily on government and its agencies or, if possible, their power as consumers to represent their interest *vis-à-vis* the organisation. Longer term, of course, the public has the sanction of the ballot box, although it seems highly unlikely that the performance of state enterprises would be a key factor in determining the outcome of general or local elections.

The relative absence of market sanctions facing state-owned organisations has meant that the public has had to rely on a range of formal institutions (e.g. parliamentary scrutiny committees, consumer consultative bodies, the audit authorities) and on the media

to protect its interest in areas such as funding, pricing and quality of service provided. As these organisations are returned to the private sector, the expectation is that the sanctions imposed by the free market will once again operate and shareholders in privatised utilities will be protected like any other group of shareholders in a privately owned enterprise. To what extent this will occur in practice is open to question, while the newly privatised public corporations face little, if any, competition. Government, it seems, prefers to hedge its bets on this question, at least in the short term – hence the establishment of regulators with powers of investigation into performance and some degree of control over pricing.

Franchising, licensing and joint ventures

To complete this review of the legal structure of business organisations, it is useful to consider three developments which have a legal aspect: franchising, licensing and joint ventures. All three may be seen as a means of carrying out a business venture in a way that reduces some of the risks normally faced by the entrepreneur.

Franchising

Franchising, which has grown significantly in recent years, is an arrangement where one party (the franchiser) sells the right to another party (the franchisee) to market its product or service, in effect, to use its business model. In terms of their legal status the parties involved could be any of the forms described above, but in practice it is usually the case that the franchiser is a company while the franchisee tends to be a sole trader or partnership. Both parties in law have a separate legal identity, but the nature of the contract between them makes their relationship interdependent and this has important implications for the operation of the franchise.

Franchise arrangements come in a variety of forms. Probably the best known is the 'business format franchise' (or 'trade name franchise') under which the franchiser agrees to allow the franchisee to sell the product or service with the help of a franchise package which contains all the elements needed to set up and run a business at a profit. These would typically include the brand name, any associated supplies, promotional material and other forms of support and assistance. In return the franchisee usually pays an initial sum or fee for the use of the service and its various elements, remits royalties based on sales and/or profits, agrees to make a contribution for consultancy, training and promotion, and undertakes to maintain standards. Wimpy, Kentucky Fried Chicken, Burger King, Prontaprint and Dynarod are examples of this type of franchise.

Other forms include manufacturer/retailer franchises (e.g. car dealers), manufacturer/wholesaler franchises (e.g. Coca-Cola, Pepsi) and wholesaler/retailer franchises (e.g. Spar and Mace). It is estimated by the industry's trade body – the British Franchise Association – that in retailing alone franchising accounts for more than 20 per cent of sales in the United Kingdom. One indication of its growing significance is the spread of franchising into further and higher education, with universities and other colleges of higher education franchising some of their courses to local further education colleges, which in turn may franchise some of their courses to schools and/or sixth-form colleges. Another indicator is the decision by many clearing banks and firms of accountants to establish franchise sections to help and advise individuals who want to open a franchise or who have already done so and are seeking further guidance.

web link The British Franchise Association's main website is *www.thebfa.org*

Undoubtedly the mutual benefits to be derived from a franchise arrangement help to explain its popularity as a way of doing business in both domestic and external markets and it has proved an attractive vehicle for some companies seeking rapid overseas expansion, without undertaking substantial direct investments – although this is sometimes necessary to support the operation (e.g. McDonald's had to invest in a plant to make hamburger buns in the United Kingdom). Equally, many would-be entrepreneurs find the security of a franchise more attractive than other methods of starting a business, especially as there is some evidence to suggest that franchises have better survival rates than the more conventional forms of independent enterprise (e.g. sole traders).

Licensing

Licensing is another form of non-equity agreement under which a firm in one country (the licensor) authorises a firm in another country (the licensee) to use its intellectual property (e.g. patents, copyrights, trade names, know-how) in return for certain considerations, usually royalty payments. Licences may be granted to individuals, independent companies, subsidiaries of a multinational company or to government agencies and the rights granted may be exclusive or non-exclusive.

Companies invariably enter into licensing agreements to gain certain advantages. These might include:

- reducing competition by sharing technology;
- seeking overseas profits without direct foreign investment;
- protecting an asset from potential 'pirates';
- avoiding restrictions on foreign investment or imports imposed by other countries;
- recouping some research and development costs;
- gaining a share of an overseas market.

Needless to say, most organisations granting licences tend to be based in the advanced industrial economies and are frequently multinationals, which regard their trademarks and technologies as an integral part of their asset base. One problem of transferring the use of such assets to another firm is that the owner loses a degree of control over the asset, including the quality of production, and this may affect the product's image and sales elsewhere. Another is the possibility of the licensee dominating the market after the agreement ends, even to the extent of excluding the licensor from the marketplace by aggressive competition or the development of an alternative product.

Joint ventures

The term **joint venture** tends to be used in two ways: to describe a contractual agreement involving two or more parties, or to describe a jointly owned and independently incorporated business venture involving more than one organisation that has been established in order to carry out a specific project or to achieve a continuing business relationship. It is the latter usage that is mainly applied here.

Joint ventures – which are popular with international companies – can take a variety of legal forms and almost every conceivable type of partnership may exist, ranging from two companies joining together in the same domestic market (e.g. Sainsbury's and British Home Stores set up the SavaCentre chain) to joint private/public sector ventures between participants from different countries. Sometimes numerous organisations may be involved and these may be based in one country or in several. Where this occurs, the term **consortium** is often used, as in the case of TransManche Link (TML), the international joint venture that built the Channel Tunnel.

Mini case Cross-national joint ventures

Joint ventures (JVs) between firms in different countries have become increasingly popular in recent years and are felt to provide many potential benefits. Participants frequently cite the exploitation of synergies, reduced costs and risks, access to markets and resources and knowledge sharing as some of the main advantages in setting up this form of partnership arrangement. As the following examples illustrate, JVs range across all industries, sectors and countries, including a growing trend towards collaborations between businesses in the emerging economies.

1 Volkswagen has a joint venture with the China state-owned FAW Group to produce VW and Audi vehicles. It also has another joint venture with China's SAIC Motor Group. The latter in turn has a partnership with General Motors.
2 Microsoft has formed a JV with Shanghai-based BesTV to develop games and related services, foreign games consoles having previously been banned in China because of concerns over their content.
3 Spanish cooperative Maier (part of the Mondragon Corporation) has linked up with India's UM Group to supply decorative plastic units and parts for the automotive sector.
4 India's Sterlite Technologies has established a joint venture with Brazil's Conduspar to build a plant in Brazil to produce optical fibre cables for the Latin American market. Sterlite has a similar collaboration with China's TCGI to produce optical fibres.

While joint ventures can potentially deliver considerable commercial and strategic benefits – including access to fast-growing markets – they are not without their difficulties. National laws and regulations, for example, may impose restrictions on what a foreign business can do or on how it operates, a point illustrated by Walmart's decision (October 2013) to end its retailing joint venture with India's Bharti because of strict foreign investment rules which prevented it from selling directly to customers.

As with licensing and franchising, joint ventures have increased in popularity in the last 25–30 years and have been one of the ways in which international companies have sought to develop an overseas market, particularly in the face of import restrictions, or heavy research and development costs. Multinational car companies have been active in this field – as evidenced by past links between General Motors and Toyota, Ford and Mazda – and these arrangements look likely to continue as markets become more global. For western companies wishing to exploit the gradual privatisation of the former planned economies of eastern Europe, joint ventures with indigenous producers are likely to prove a safer bet than direct inward investment, particularly given the degree of economic and political uncertainty. They are also likely to prove more politically acceptable in states seeking to establish their economic independence and identity after almost 50 years of regional domination.

Synopsis

Market-based economies throughout Europe and beyond have a range of business organisations with broadly similar legal structures. These legal structures help to determine not only the ownership and control of the enterprise but also other aspects of its operations, including its objectives, its access to finance and its external relationships and obligations. Viewing businesses as legal entities provides a useful insight into a number of the external influences which impinge upon their daily existence and highlights some of the consequences faced by organisations that transfer from public (i.e. state) to private ownership. It also sheds light on other important developments in entrepreneurial activity, including franchising, licensing and joint ventures.

Summary of key points

- Business organisations have a legal structure.
- The three most common forms of business in the private sector are sole traders, partnerships and limited companies.
- Whereas the owners of the first two types of business organisation face unlimited personal liability, in companies the legal separation of the firm from its owners affords the latter limited personal liability.
- Companies are normally run by directors who are appointed to represent the interest of the owners (the shareholders). In public companies this separation of ownership and control is a key distinguishing feature.
- Other forms of business organisation exist in the public sector (e.g. the public corporation) and the 'third sector' (e.g. the co-operative).
- Government-owned businesses are increasingly adopting private sector forms of organisation to provide for greater flexibility and freedom of action.
- The legal status of the organisation has implications for the objectives of the enterprise, how it is financed and its stakeholder relationships.

Case study Facebook: from fledgling start-up to global phenomenon

Most new businesses tend to start on a small scale (e.g. sole trader or partnership) and, if successful, grow steadily over time as profits are reinvested in the firm and/or outside sources of finance are injected into the organisation. Concepts such as the product life cycle echo this perception that growth of start-ups normally follows a relatively steady and predictable path with turnover and profits gradually starting to rise as the firm's product(s) become more attractive to consumers, many of whom are likely to be locally or nationally based. This stereotypical view of business growth and development has much to recommend it

and seems to accord well with both business practice and economic theorising. There will, however, always be exceptions to the general rule or conventional wisdom.

In early 2004 Harvard University psychology undergraduate Mark Zuckerberg, together with a number of fellow students, developed a Harvard social networking site on a desktop computer in his student dormitory. Initially named 'The facebook', the site was an instant hit with Harvard students, with more than 1000 signing up within a few hours of its launch. As interest continued to grow, the site was gradually rolled out to other US universities and became so popular that Zuckerberg and a colleague used their own funds to establish a limited liability company in mid-2004. This fledgling internet start-up became Facebook.com in August 2005 following the purchase of the domain name for a fee of $200,000.

With support from a business angel, Facebook began to spread to other educational establishments in the USA and beyond and eventually became available worldwide to anyone over 13 years old with an email address, at no charge. Given its rapidly growing popularity, Facebook was able to attract advertising revenue from major companies which used it to market themselves and their products to a global audience, which by 2007 numbered some 30 million registered users. The business was also attracting bids from other companies (e.g. Viacom and Yahoo in 2005–6), alongside an equity investment by the internet giant Microsoft, which bought a 1.4 per cent stake in 2007.

As the number of registered users grew rapidly – reaching 100 million by 2008 – Facebook eventually overtook MySpace as the internet's biggest social networking site, appealing to a global audience of technology-savvy young people who used the service on a daily basis. By early 2012, as the number of users approached 1 billion, Facebook's owners filed for an initial public offering (IPO) and subsequently brought the business to market in May of that year at an opening price per share of $38, making Facebook the most valuable company ever to go public in the United States.

With the stampede for shares by the institutions, wealthy individuals and the public, prices rose rapidly once trading began, making Zuckerberg a billionaire on paper and Facebook a star performer on the Nasdaq. As the market began to assimilate the situation, some investors began to worry whether the company could meet its obligations since its revenues were relatively small in comparison with its stock market valuation. By September, Facebook shares were trading at under $18, an embarrassing collapse in the share price and one which caught some investors by surprise.

As questions were being asked about Facebook's prospects, analysts began to suggest that the business might be reaching maturity in its traditional markets in the USA and western Europe and might not have made as much progress as it might have hoped in the rapidly growing markets in the Far East and Latin America (especially China, India and Brazil). Concerns were also being voiced over whether the company had fully adapted to the change in fashion from users going online via a PC to accessing the internet through a smart phone.

Against the backdrop of a changing environment, the firm acquired the photo-sharing site Instagram in September 2012 and the following year developed an application that allows Facebook home users to receive news and photographs from friends (along with advertising) on certain Android phones, including a new handset from HTC, in effect, an 'app' designed to turn Android smartphones into a Facebook phone. Whether it will subsequently create a Facebook branded phone of its own remains to be seen; some observers, however, believe this is inevitable if the company is to reach the next billion internet users in a highly competitive and rapidly changing market.

Postscript

Despite achieving 1 billion users by October 2013, the Global Social Media Impact Survey in that year found that Facebook's appeal to older teenagers appeared to be on the slide. As parents and older users were starting to saturate the site, their children were beginning to desert it, moving instead to Twitter, Instagram, WhatsApp and Snapchat. Researchers at Princeton University have predicted that the platform will be largely abandoned by 2017, a view which may underestimate Zuckerberg's capacity for innovation.

In a further development, Facebook purchased the messaging service WhatsApp for $19 billion in

mid-February 2014. It remains to be seen whether this was a wise strategic investment or whether it was an essentially defensive move by the company.

Case study questions

1 What were the main reasons for Facebook's rapid growth as a company?

2 Why are the vast majority of small start-up businesses highly unlikely to emulate Facebook's growth trajectory?

Review and discussion questions

1 Numerically, the sole proprietorship is the most popular form of business organisation throughout Europe. How would you account for this?

2 To what extent is corporate status an asset to a business organisation? Does it have any disadvantages?

3 Examine the implications of privatising a public sector business organisation.

4 Discuss how the legal status of a business affects its objectives, its methods of finance and its stakeholders.

5 How would you explain the rise in the popularity of franchising in recent years?

Assignments

1 You have recently been made redundant and decide to set up your own small business, possibly with a friend. Assuming that you have £25,000 to invest in your new venture, draft a business plan which is to be presented to your bank manager in the hope of gaining financial support. Your plan should include a clear rationale for the legal form you wish your business to take, your chosen product(s) or service(s), evidence of market research, an indication of anticipated competition and supporting financial information.

2 You work in a local authority business advice centre. One of your clients wishes to start a business in some aspect of catering. Advise your client on the advantages and disadvantages of the various legal forms the proposed enterprise could take.

Notes and references

1 Liability may be extended where a company continues trading after insolvency.

2 It is also possible to have unlimited companies.

3 Under regulations issued in 1992 it is possible to have single member private companies with limited liability status, but these are the exception rather than the general rule.

4 A similar growth occurred in the number of 'community businesses' in Scotland during this period. Though not strictly 'co-operatives', they are also part of the so-called third sector of business.

Further reading

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Palmer, A. J. and Hartley, R., *The Business Environment,* 7th edition, McGraw-Hill, 2011.

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5 Size structure of firms

Businesses range in size from the single proprietor at one extreme to the large multinational at the other which employs thousands of people over several countries. The structures of these businesses will be very different and the problems they face will vary as a result of the differences in size. The size structure of business will depend on many factors, which range from choice (the sole proprietor may choose to remain small) to external factors that are beyond the control of the firm.

Learning outcomes

Having read this chapter you should be able to:

- outline the size structure of UK industry
- provide reasons for why organisations grow in size
- demonstrate the way in which organisations grow and the methods of finance
- explain the limitations to growth
- survey the level of merger activity in the United Kingdom and the European Union
- demonstrate the role and importance of the small-firm sector
- discuss the idea of networking between firms

Key terms

Capital market
Concentration
Conglomerate merger
Debentures
Diseconomies of scale
Diversification
Dividends
Enterprise
Equity
Establishment
External growth
Flexible firm
Gearing
Horizontal merger
Industrial concentration
Internal growth
Joint venture
Merger
Money market
Multinational corporation
Networking
Profit
Small firm
Stock Exchange
Subcontracting
Takeover
Vertical integration
Virtual organisation

Introduction

Evidence suggests that national concentration levels have increased over time due to mergers and takeovers but that global concentration levels are lower than national ones.[1] Such an increase in the size of business organisations gives rise to worries about the concentration of power in the hands of a few producers and potential abuses of this power. If the companies are multinationals, they may be beyond the control even of national governments. More recently the trend towards greater **concentration** has been reversed and there seems to be a movement towards employment in smaller units. This chapter will look at the size structure of British industry and the reasons for such a structure, with some international comparisons. It will consider the role of small and large firms in the economy. It will also examine the reasons for growth, the ways in which organisations grow, the financing of growth and the limits to growth. Consideration will be given to the relatively more recent trend towards cooperation in production, rather than competition, through activities such as joint ventures and networking.

The size structure of UK industry

When looking at the size of firms it is important to define the terms used in official data. The firm, or '**enterprise**', is the organisation as a whole, and it might be comprised of several units or '**establishments**'. Small firms like the corner shop will mostly be enterprises with only one establishment. Large firms like Sainsbury's will have many establishments as they have branches in most towns.

There are many different ways to measure the size of firms. Common measures used are turnover, the value of output, the capital employed or the level of employment. Such measurement is beset by problems, not least the difficulty of defining the small firm, as we will see later in this chapter. The three measures mentioned above might give conflicting pictures, as an industry that is becoming increasingly mechanised will probably have rising levels of average capital employed and output but falling average levels of employment. Table 1 shows the 'top ten' companies in the United Kingdom in 2012 using two of these measures and it illustrates the point

Table 1 The ten largest companies in the UK, 2012

Ranking by turnover	*Ranking by employment*
1 EDF Trading Ltd	1 G4S plc
2 Tesco plc	2 Tesco plc
3 Vodafone Group plc	3 Compass Group plc
4 Unilever plc	4 HSBC Holdings plc
5 ConocoPhillips Holdings Ltd	5 Royal Mail Holdings plc
6 SSE Energy Supply Ltd	6 Asda Group Ltd
7 SSE plc	7 Wal-Mart Stores (UK) Ltd
8 Imperial Tobacco Group plc	8 Asda Stores Ltd
9 Aviva plc	9 Unilever plc
10 Phillips 66 Ltd	10 Royal Mail Group plc

Source: Key British Enterprises, 2013.

Table 2 Size structure of UK industry by employment, 2013

Employment size group	*Number of units*	*% of total*	*Employment (000s)*	*% of total*
1–9	2 170 080	82.7	3 848	19.2
10–49	367 055	14.0	3 471	17.4
50–249	76 635	2.9	2 909	14.6
250 +	11 720	0.4	9 763	48.8

Source: Adapted from Table A1.2 UK Business: Activity, size and location, 2013, *www.ons.gov.uk*

that different measures of the size of a firm will give different rankings. Some of these names will be familiar to the reader while others will be less so. Compass Group plc, for example, is a food service organisation that provides catering and support services to its clients, and ConocoPhillips Holdings Ltd is a multinational petrochemical company.

The most common measure of size used is the level of employment. Table 2 shows the size structure of units in all industries by the number of employees in the UK in 2013. The table shows that smaller firms predominate in terms of numbers, with 96.7 per cent of firms employing fewer than 50 employees. In terms of employment, however, these firms account for only 36.6 per cent of the total level of employment in manufacturing. At the other end of the scale, establishments with more than 250 employees account for only 0.4 per cent of the total number but 48.8 per cent of total employment. The pattern of size structure varies across industries and over time. In the last 30 years there seems to have been an increase in the importance of small firms and a decline in the importance of large firms in their contribution to employment. In 1980, establishments with fewer than 200 employees accounted for 31.9 per cent of total employment and establishments with more than 500 employees accounted for 49.8 per cent. The comparable figures for 2013 were 41.0 per cent and 48.9 per cent.

Many of the large companies listed in Table 1 operate in more than one country and are therefore multinationals. **Multinational corporations** strictly defined are enterprises operating in a number of countries and having production or service facilities outside the country of their origin.[2] Multinationals pose particular problems for governments and economies because of their size.

Organisational growth

The reasons for organisational growth

Firms grow in size for many reasons. Growth could be an explicit objective of management or could be necessary for the successful operation of the firm:

- Growth could be a managerial objective if it brings benefits to management such as greater security and higher remuneration.
- It could be that the market in which the business operates is expanding and growth is necessary to maintain market share. This is especially the case as markets become more international.
- Growth enables the organisation to reap the benefits of economies of scale.

- Growth enables firms to diversify into other markets, which means that risk can be spread further.
- Industries that are capital intensive will of necessity be comprised of large firms.
- In the area of product development it is possible that the necessary research and development could be carried out by large companies only.
- Growth could be pursued as a defensive strategy, as a reaction to the activities of competitors.

The European Commission puts forward the following motives for merger and acquisition activities: a search for efficiency gains through new combinations of material and immaterial assets; a drive to increase market shares and market power; a desire to safeguard access to important inputs; a search for access to new technologies and know-how; a drive to gain access to new customer groups or new geographic markets; and a desire for **diversification**.[3] The OECD[4] recognises that there are efficiencies involved in growth and it classifies these into 'static' and 'dynamic' efficiencies. Static efficiencies are one-off improvements such as economies of scale in production. Dynamic efficiencies are those that enable improvements in cost, quality, service or new product development on an ongoing basis. In considering the benefits of a takeover or merger, for example, it may be that the dynamic efficiencies will eventually overtake the initially bigger static efficiencies. Examples of dynamic efficiencies include:

- economies of scale and scope in R&D;
- better risk-spreading, especially for R&D;
- increased financial resources for R&D;
- better intellectual property rights protection.

In industrial economics, firm size is seen as a function of growth. It is suggested that although there is no limit on the size of a firm, there are limits on the rate of expansion. Growth rates are seen by different theorists to depend on different things, including the availability of finance, the level of consumer demand and the limitations of management. These theories, however, are primarily concerned with large firms and their development. Small firms are seen as potentially large firms that failed to grow for some reason or other. One interesting theory of growth is the stages model, where the firm is seen as passing through various stages in its development from small sole proprietor/partnership through the decision to expand into a large organisation. This again is a 'grow or fail' theory, which does not apply well to industries that are dominated by successful small firms, as we will see later in the chapter.

Methods of growth

Firms grow in size internally as part of normal business operation or externally through takeover and merger.

Internal growth

Growth is a natural process for many firms that start small, capture a segment of the market and then continue to expand either by producing more of the same goods or by extending their product lines. The advantage of **internal growth** over external growth is

that the company grows within the existing structure of management; there are none of the problems of bringing together two different management systems. There might also be economies of scale from building a bigger plant that might not be available when companies merge and plant size does not change. Set against these, internal growth has certain disadvantages and this is why most of the growth in the size of organisations has occurred through external growth.

External growth

Growth by acquisition is called **external growth** and occurs through **takeover** or **merger**. A merger is the voluntary coming together of two companies with the agreement of the management of both companies, the result of which is the creation of a new legal identity. A takeover is where one company makes an offer to the shareholders of another. If the management of the threatened company resist, it is called a hostile takeover, but if the price offered to shareholders is high enough, they will accept. Takeover bids can be and have been successfully fought off by the management of the second firm. A holding company is a new company that is formed to acquire assets in other companies. The acquired companies retain their independent identities but are directed by the holding company.

External growth can be seen to have a number of advantages:

1 It is fast, so that productive capacity can be increased very quickly.
2 The acquiring firm has access to an established management team and system.
3 If the shares of the acquiring company have sufficiently high values relative to the acquired firm, there might be no need for additional cash to be raised.
4 The purchase of existing assets could be cheaper than building new productive capacity.

But set against these is the fact that the process might not be an easy one; it is a difficult job to merge two companies smoothly and successfully and there are likely to be many teething problems. Research by PricewaterhouseCoopers found that top executives regarded half of the takeovers in which they had been involved as failures. The main reasons for failure were lack of planning and managerial problems.

Although the definitions of merger and takeover are clear enough, it is often difficult to tell them apart in practice and they are usually put together in official publications under the heading of acquisitions. In order to understand fully the motivation for mergers and takeovers it is important to recognise that there are different types of mergers.

Horizontal mergers

A **horizontal merger** is where a combination between firms at the same stage in a production process takes place, for example between two car manufacturers or between two brewers. The vast majority of mergers that take place are of this type and many of our largest companies have been formed through horizontal merger. Examples include mergers between banks and building societies. The main motives for this type of merger are as follows:

- To benefit from economies of scale. Horizontal mergers allow the merged firms a greater level of specialisation and the benefits of other economies of scale.

- Greater market share. When firms come together there will be a reduction in competition in the market and the resulting firm will automatically have a much larger share of the market.
- Rationalisation of output. If the level of demand for a good is shrinking, merger between the producers could be necessary in order to rationalise output.
- Reaction to competitors. In markets where mergers are taking place, companies may feel that they have to do the same in order to maintain their market position.

A recent example of a horizontal merger is that between American Airlines and US Airways in December 2013, which created the biggest airline in the world.

Vertical mergers

A vertical merger involves firms at different stages of the same production process. It is vertical since it runs along the production process from extraction of raw materials to distribution. An example would be a merger between a car manufacturer and a metal-pressing company. **Vertical integration** can take place 'backwards' towards the beginning of the production process or 'forwards' towards the end of it and it can occur for several reasons:

1. In the case of backwards integration, to control the supplies of raw materials with respect to their quantity and quality. This brings greater security to the acquiring firm.
2. To restrict supplies of the raw materials to competitors.
3. In the case of forwards integration, to control the quality of the outlets for the finished product. Manufacturers finance the majority of advertising and they might well feel that a forwards merger would enable them to ensure that the good was being sold in the most appropriate setting.
4. In both cases, economies of scale are possible if different parts of the production process are brought together.
5. Again, vertical mergers can be carried out as a reaction to the activities of competitors.

The proposed and talked about takeover of Intel by Apple in 2013 is an example of a vertical merger as Apple has been using Intel processors since 2005.

Conglomerate mergers

These mergers are neither vertical nor horizontal but involve a merger between firms involved in producing different goods. The takeover of Boston Dynamics, a manufacturer of robots, by Google in 2013 is an example of a **conglomerate merger**. The main motivation for this type of merger is diversification. It reduces the risk involved in producing for only one market and allows the firm to spread risk further. It can also provide the firm with another option if the original market declines in size. There has been much speculation over Google's motive in taking over Boston Dynamics, its ninth such acquisition in 2013, so there is a clear indication that Google is diversifying into new territory.

As far as the economy is concerned, the main gains of mergers are in increased efficiency resulting from economies of scale and also the increased scope for research and

development. A common view is that merger and takeover activity serves the purpose of rationalising business. The weak businesses go and the strong survive. Even when a takeover is carried out for the purpose of asset stripping this will be the case.

Mini case The story of a failed merger

In 2012 a merger was proposed and agreed between two large soft drinks producers in the UK, A. G. Barr, which produces Irn-Bru and Orangina, and Britvic, which produces Tango and Robinsons. The merger would produce a new company called Barr Britvic Soft Drinks, 37 per cent owned by shareholders of A. G. Barr and 63 per cent owned by shareholders of Britvic. This is an example of a horizontal merger, both companies producing similar products, and as such benefits would accrue to both companies. It was argued that the merger would:

1 Enhance the market position of each company – A. G. Barr has a strong presence in Scotland and Britvic has a strong pub presence, so they complemented each other.
2 Achieve synergies for both companies – the merger would give rise to £40 million in cost savings through rationalisation of production and the subsequent loss of up to 500 jobs.
3 Increase shareholder value.

Despite these strong arguments, some commentators suggested that the proposed merger was a defensive one, as the soft drinks market in the UK had suffered as a result of the bad weather in the summer of 2012 and Britvic had experienced an embarrassing recall of its Fruit Shoot brand because of problems with the bottle tops, an exercise which cost the company £25 million. Early in 2013 the merger was referred for investigation to the Competition Commission, which cleared it in June 2013. It ruled that the proposed merger would not adversely affect competition in the market or affect prices to the consumer. By the time the Competition Commission had ruled, Britvic had managed to regroup, recruited a new CEO and recovered from the Fruit Shoot recall. Britvic rejected the revised offer from A. G. Barr. The merger was off. The negotiations had cost A. G. Barr £5 million and Britvic £9.6 million.

What has happened to these companies since then? The market for soft drinks did well in 2013, largely due to very hot weather in the UK in the summer. Both companies posted positive sales and profits growth for the second half of 2013. A. G. Barr has managed to expand into England and Wales successfully without the help of Britvic, and has opened new production capacity in Milton Keynes. Britvic has managed to expand into the USA and Europe and had India in its sights for 2014. It has managed to obtain synergies without merger through the proposed closure of two factories in 2014 and the loss of 300–400 jobs.

It seems that the two companies have gained the benefits resulting from merger without having to go ahead with the merger, and this is at least partly due to market conditions.

Growth by merger and takeover

Growth through merger and takeover first appeared in the USA more than 100 years ago and merger activity tends to come in waves (see the discussion later in this chapter). Six periods of heightened merger activity have been identified in the USA:

- The period 1880 to 1905 – this coincided with the proliferation of the joint stock company and the international establishment of stock exchanges. This period was characterised by mergers of a horizontal nature.

- The 1920s – at this time the mergers were largely vertical in nature, as manufacturers took control of both suppliers and distributors.
- The 1960s – mergers in this period were mainly about diversification and the establishment of conglomerates.
- The post-1980 period – this wave of activity took place in a period of recession and was largely about cost-cutting and rationalisation.
- The late 1990s – companies in mature industries attempted to become global operators. The pace of this surge of activity slowed for a period after September 11th 2001, but by 2004 the boom in activity had restarted.
- The 2000s – from 2004 to 2007 the boom continued until the credit crunch in the USA caused a sharp fall in merger activity, including a 36 per cent decline in the first half of 2008. Since then the level of activity has remained fairly constant.

The first two periods of heightened merger activity in the USA had little effect in Europe; however, there were waves of activity in Europe which coincided with the later periods. The first wave of merger activity in Europe came in the 1960s after obstacles to trade were removed by the establishment of the European Economic Community (EEC) in 1957. The second wave of mergers came in the 1980s in the run-up to the establishment of the Single European Market in 1992. Since then the cycles in merger and acquisition activity in the USA have been mirrored in Europe. Since 2008 the level of global mergers and acquisition activities has gradually fallen, and in 2013 the level of mergers and acquisitions was at its lowest for eight years.

Finance for growth

Internal sources

As part of its operation the firm will generate income in the form of **profit**. Part of this profit will be distributed in the form of **dividends** to shareholders, the rest can be used for reinvestment and to finance growth. Although this is seen as a relatively easy and cheap source of finance, it does carry an opportunity cost and therefore should be judged on its rate of return like any other source of finance. Table 3 is provided for illustrative purposes and shows that internal funds were the largest single source of finance for UK industry during the 1990s. It also shows that the totals available and the pattern of sources vary a great deal from year to year. (This data is no longer compiled by the Office for National Statistics.)

External sources

As the size and availability of retained earnings will be limited, most firms will also have to seek other sources of finance for expansion. There are many external sources of finance and a typical firm's capital structure will comprise a combination of these. The sources are as follows.

Table 3 Sources of funds for industry, 1990, 1994 and 1997 (£ million)

Source	*1990*	*1994*	*1997*
Internal funds	33 838	61 406	56 363
Banks and other short-term borrowing	19 911	–4841	6630
Loans and mortgages	9120	4557	4384
Ordinary shares	1880	8495	19 616
Debentures and preference shares	6367	1008	10 640
Other capital issues	7485	5067	10 526
Other overseas investment	11 233	–1400	25 938
Other	1444	3766	953
Total	91 278	78 056	135 050

Source: Financial Statistics, January 1993, 1996 and 1999. Crown copyright 1999. Reproduced by permission of the Controller of HMSO and of the Office for National Statistics, UK.

Banks

Banks provide short- and medium-term finance to companies in the form of loans or overdrafts. The relative cost of these depends upon how the firm wishes to use the funds. Loans carry a lower rate of interest but the interest is paid on the whole amount, while the interest on overdrafts is paid only on the amount drawn. British banks have been criticised for failing to provide longer-term finance for business, as banks do in other countries.

Capital market

The **capital market** is the place where stocks and shares are traded and is therefore a key provider of long-term finance to firms. The main institution in the capital market is the **Stock Exchange**. The capital market is made up of two parts: the primary part, which involves the buying and selling of new stocks and shares, and the secondary part, which involves the buying and selling of existing stocks and shares. It is therefore the primary part of the market that is the source of finance for firms. The secondary part of the market is also important in this process, however, as individuals and organisations are more likely to buy stocks and shares with the knowledge that there is a ready market on which they can be traded at a later date.

The main institutions that buy stocks and shares are the insurance companies, hedge funds, pension funds, investment trusts, unit trusts and other large financial institutions such as building societies.

A new issue of shares takes place when an existing company needs extra finance or when a company becomes a public limited company.

Types of stocks and shares

1 *Preference shares*. These are shares in a company that carry a fixed dividend. Holders have preference over other shareholders in the payment of dividends and on the liquidation of the firm. Preference shares usually carry no voting rights, so holders have little influence over how the company is run.
2 *Ordinary shares*. Ordinary shares are called the '**equity**' of the company. They do not usually carry a fixed dividend; the company declares a dividend, depending upon its performance in that year. This means that in good years ordinary shareholders could receive high dividends, while in bad years possibly none at all. Ordinary

shares are therefore more risky than preference shares, and in recognition of this they usually carry voting rights, so that holders can exercise some influence over how the company is run.

3 *Debentures*. **Debentures** or loan stock are bonds that are given in exchange for a loan to the company. The company agrees to repay the borrowed amount at some date in the future and to make annual payments of interest in the meantime. Interest on debentures is paid before payment of any dividends and the interest is allowable against tax. A debenture holder is a creditor of the company, a shareholder is an owner of the company.

New issue of shares

A company will go to an issuing house or investment bank, which will advise it on the type and number of shares to issue, the price at which they should be offered and other matters. They will often carry out the issue of shares on behalf of the firm. A new issue of shares is not a big source of finance for growth as it is fairly expensive; retained earnings are more convenient and cheaper. Also the amount of information that is required from companies that issue shares to the general public can act as a disincentive.

It is worth noting that in recent years in the UK the stock market has had two main equity markets, the main market and the Alternative Investment Market (AIM), the former dealing in the shares of large and well-established companies, the latter providing an opportunity for growing smaller companies to raise capital and to have their shares traded in a market without the considerable expense of a full market listing.

Money market

The **money markets** provide short-term finance for companies, often for as brief a period as overnight.

Government and other institutions

The government is a source of finance for firms. Through its regional policy it gives tax allowances, loans, grants and training allowances to firms in certain parts of the country. It has many schemes for helping business, particularly small businesses. This will be covered more fully later in this chapter.

Other sources

Other sources include trade credit and hire purchase (i.e. receiving assets now and paying later). This is only a small source of finance for companies. UK businesses also draw a fairly high proportion of their funding from overseas. This includes finance from many different sources, including individuals, governments, financial institutions overseas and companies.

Firms will typically go for a mixture of different types of finance. The exact combination will depend upon many factors, including their relative costs, their availability and the desired capital structure of the firm. A firm's desired capital structure will largely depend upon the type of market in which it operates. The different types of finance are classified under the two headings of debt and equity. Debt refers to all types of capital on which payments have to be made each year regardless of how the firm has performed; this would include loans and preference shares. Equity refers to ordinary shares where the payment of a dividend depends upon the performance of the firm. As a source of

finance, debt is generally cheaper but it is also more risky since in bad years the firm will have to meet the interest payments. The ratio of debt to equity is called the **gearing** of the company. Debt is not well suited to firms in industries where profits fluctuate and such firms will have lower gearing than those in more stable markets.

Limits to growth

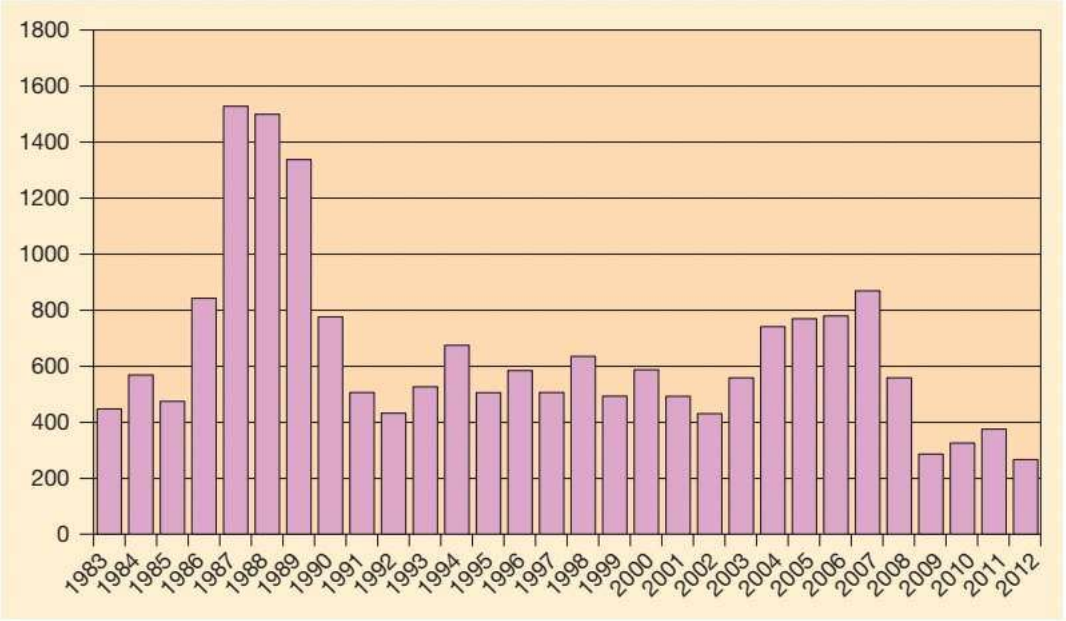
Several factors tend to act as a limit to organisational growth:

- To finance growth, excessive borrowing might have taken place and the firm may have trouble meeting debt repayments; therefore there is increased risk of bankruptcy.
- A serious constraint to growth might be the abilities of management. As organisations grow in size they may experience **diseconomies of scale**, which are mainly to do with managerial problems, including communication and control.
- If the size of the market for the product is stagnant or declining it may be both unnecessary and impossible for the firm to grow.
- Government policies, too, can have an important impact on growth. Every government has policies on competition which seek to limit anti-competitive practices and which normally regulate merger activity.

Merger activity in the United Kingdom

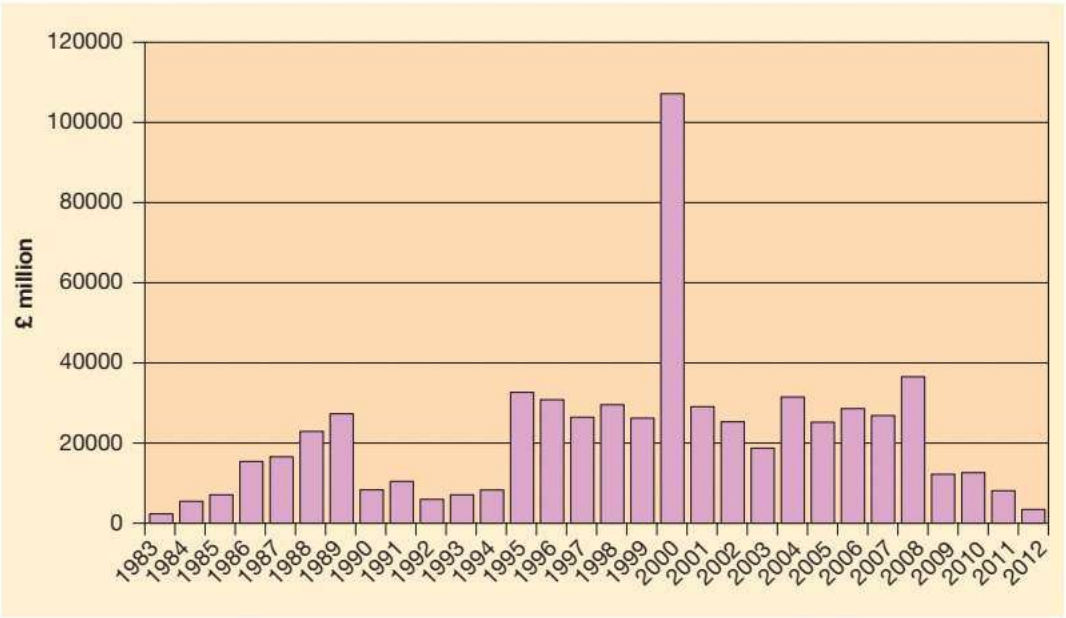
There are two common ways of measuring the level of merger activity – by the number of transactions or by the total value of the transactions. Figure 1 shows the level of merger activity in the UK according to the number of companies acquired in the UK by UK companies. It can be seen that there was a sharp rise in merger activity in the mid-1980s and a downturn in 1989. The cyclical pattern continues into the 1990s and 2000s but the amplitude is reduced. This cyclical pattern is repeated in other countries and in the

Figure 1 UK merger activity by number, 1983–2012



Source: Adapted from Table 8, 'Mergers and acquisitions involving UK companies, Q2 2013', ONS.

Figure 2 UK merger activity by value, 1983–2012



Source: Adapted from Table 8, 'Mergers and acquisitions involving UK companies, Q2 2013', ONS.

EU as a whole and it implies that the level of mergers is in some way related to the state of the economy.

The rise in the mid-1980s was due partly to an improvement in the state of the economy and partly to the liberalisation of the financial markets, which made finance for takeover bids more freely available. The fall in 1989 was due partly to the recession and partly to the problems that some companies subsequently experienced by over-stretching themselves in the mid-1980s. The subsequent rise in the level of merger activity was due to the restructuring that took place in many diverse industries, such as the financial services sector and the public utilities. Since 2008 – the start of the credit crunch – both the number of transactions and their value have fallen.

Figure 2 shows the level of merger activity in the UK according to the value of the transactions, and the same cyclical path can be discerned, although the peaks and troughs do not exactly coincide with the number of transactions. The use of the value of the transactions as a measure of merger activity is problematic in that it will be distorted by any very high-value deals that take place, as in 1995–7 and 2000 when the number of transactions fell but their value rose. The first half of 2007 showed record activity but by the end of the year markets had slowed because of the impact of the global financial crisis.

Global merger activity

The cyclical pattern seen in the UK data is also evident in the EU and the world as a whole (see Table 4). There was a decline in merger and acquisitions in the early 2000s followed by a surge in activity in 2004. During the 1990s the boom in merger activity was dominated by the telecommunications sector, while in the 2004–8 recovery the activity was taking place mainly in the financial services sector.

The impact of the credit crunch on merger and acquisition activity can be seen in Table 4, with a dramatic fall in 2009. The market recovered somewhat after that but fell back again in 2012. Global merger and acquisition activity was at its lowest for eight

Table 4 Cross-border mergers and acquisitions to and from OECD countries, 1999–2012 ($ billion)

Year	*Outwards*	*Inwards*
1999	801	775
2000	1166	1136
2001	606	585
2002	376	410
2003	321	338
2004	422	444
2005	673	635
2006	847	818
2007	1028	1033
2008	1644	1060
2009	912	650
2010	1052	737
2011	1284	916
2012	982*	578*

*Estimated.
Source: Adapted from Figures D.10.1. and D.10.2. from OECD (2010), Measuring Globalisation: OECD Economic Globalisation Indicators 2010, OECD Publishing. http://dx.doi.org/10.1787/9789264084360-en.

years in 2013 and in the EU it was at its lowest for three years[5] and there were fewer 'mega-deals' (over $10 million) in 2013. The number of deals globally was 37,257 in 2013 and the total value of those deals was $2.3 trillion.[6] Globally, the biggest market for mergers is the USA, followed by Asia-Pacific, with the EU in third place. General political and economic uncertainty and low growth rates in the EU have contributed to this – the markets are still cautious. Many analysts were predicting a pick-up in merger activity in 2014 based on surveys of companies' expectations.[7]

Small firms

There are serious problems in the analysis of the small-firm sector, including the lack of data over a long period of time and the problem of defining exactly what is a **small firm**. *The Bolton Report,*[8] published in 1971, was the report of a committee set up to look into the role of small firms in the UK economy. It used various definitions for statistical purposes, depending upon the industry being considered, on the grounds that what is small in one industry might be large in another. Table 5 shows the size distribution of firms based on their turnover for a selection of industries for 2012.

It is clear from Table 5 that the definition of 'big' will vary with the industry. In the *Bolton Report* the definition used for small firms in manufacturing was 'less than 200 employees', while in construction it was 'less than 25 employees'. In some industries turnover limits were chosen while in others a mixture of employment and turnover was used. Although this is confusing and makes comparison between industries and countries difficult, it was accepted that there could not be a single definition that would apply to all sectors. The European Commission in 2005 introduced a new measure based on employment and turnover to improve consistency between member

Table 5 Size of companies by turnover across different industries, 2012 (%)

Industry	*Turnover size ('000)*		
	up to £250	*£250–£500*	*over £500*
Agriculture, forestry and fishing	80	11	9
Mining and quarrying and public utilities	53	13	34
Manufacturing	57	13	30
Construction	70	13	17
Wholesaling	47	14	39
Retailing	63	19	18
Financial services and insurance	72	11	17
Business services	71	11	18

Source: Adapted from Table B5.1, *UK Business Activity by Size and Location,* National Statistics, 2012.

states and to facilitate the aid offered to SMEs in the EU. This definition is shown in Table 6 and uses employment size and annual turnover *or* annual balance sheet total in its definition.

Table 6 The EU SME definition

Enterprise category	*Headcount*	*Annual turnover or*	*Annual balance sheet total*
Micro	0–9	<€2 million	<€2 million
Small	0–49 (includes micro)	<€10 million	<€10 million
Medium	50–249	<€50 million	<€43 million
Large	250 +	Over €50 million	Over €43 million

Source: Implementing the SME definition, 2009, *http://ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_report_2009_en.pdf*

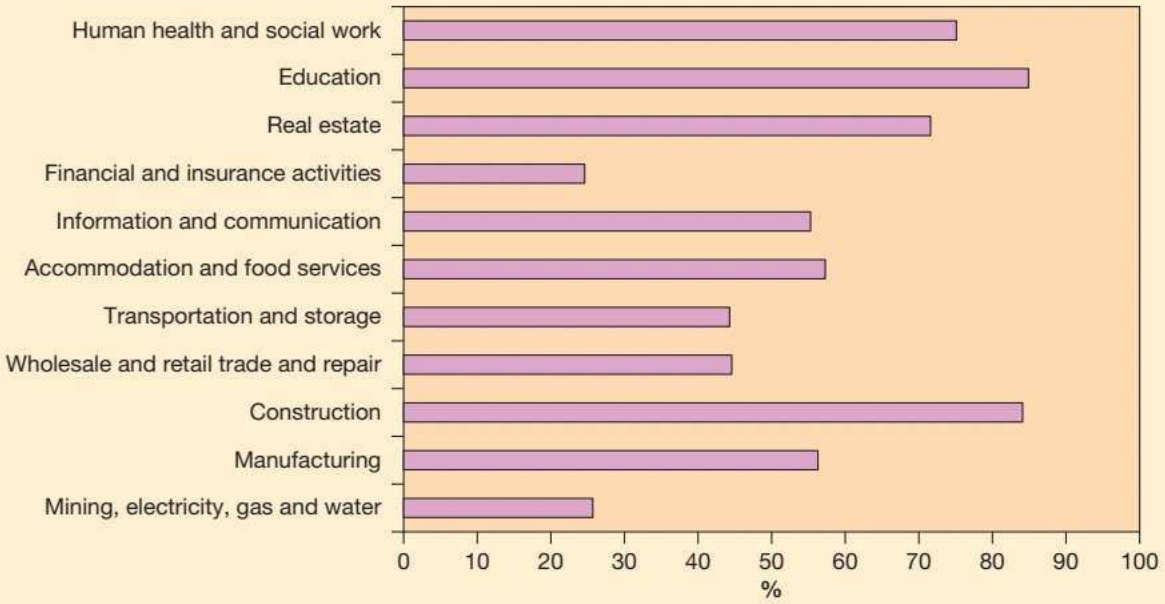
Applying this definition to Table 2, it can be seen that 82.7 per cent of enterprises in the UK are micro businesses, 96.7 per cent are small, 2.9 per cent are medium sized and 0.4 per cent are large. Although there are some national differences (the southern-most countries have relatively more micro businesses than the northern countries), the pattern of size structure is similar in the EU as a whole – 92.1 per cent of all enterprises are micro businesses, 6.6 per cent are small, 1.1 per cent are medium sized and 0.2 per cent are large.[9] Using these definitions it is estimated that 99.8 per cent of all enterprises in the EU-27 were SMEs and that they provided around 86.8 million jobs.

No matter how small firms are defined, they will suffer from similar problems, which are very different from those faced by larger companies.

Trends in the small-firm sector

The percentage share of small establishments in total manufacturing employment in the UK was in decline for the 1930s up to the early 1970s, when its importance increased dramatically.[10] In recent years the percentage has stayed around 40 per cent. Table 2 showed that for UK industry small firms are very important in terms of the number of businesses, accounting for almost 97 per cent of total firms. Even though they were less important in terms of employment, they still accounted for 36.6 per cent of total employment. Figure 3 shows the share of employment in SMEs by sector; as can be seen, there is a great deal of variation between sectors.

Figure 3 Share of employment of SMEs, UK, 2010



Source: Adapted from Figure 4, 'Business Population Estimates, 2010', Department for Business Innovation and Skills.

Mini case 'Olderpreneurs' and small firms

The recent rise in the number of over 50 year olds starting their own businesses in the UK has given rise to the new term 'olderpreneurs'. Table 7 shows that there has been a gradual increase in the level of self-employment in the UK over time, with a more rapid increase after 2008, the start of the economic downturn. According to the Office for National Statistics, 85 per cent of the increase in self-employment since 2008 has been in those over the age of 50 years.

Table 7 shows the age profile of all self-employed people in 2008, 2011 and 2012 and it can be seen that the overall growth varies by age group. There has been a growth in the 16 to 24 age group and the over 50s. The other two age groups have declined in importance.

Table 7 The age profile of the self-employed (shown as a percentage of the total)

Age group	*2008*	*2011*	*2012*
16–24	4	4.1	4.4
25–34	16.2	15.9	15.8
35–49	41.7	39.1	37.8
50 and over	38.1	40.7	42.1

Source: Adapted from Annual Abstract of Statistics (various), *www.ons.gov.uk*

In terms of growth characteristics, there are two time periods:

- Between 2008 and 2011, the growth in self-employment was concentrated in the over 65s, women (who accounted for 80 per cent of the increase) and people working less than 30 hours per week.
- Between 2011 and 2012 the increase was mainly in those aged 50 to 64, men (64 per cent of the total) and people working more than 30 hours per week.

According to PRIME (the Prince's Initiative for Mature Enterprise), the over 50s are more successful – 70 per cent of the businesses started by people over the age of 50 survive for more than five years, compared with 28 per cent for younger age groups. Olderpreneurs' start-ups tend to be smaller and often in the craft sector, catering or services.

Why should olderpreneurs be more successful than other age groups? Possible explanations include:

- capital – many olderpreneurs start business after redundancy or retirement so they have some degree of financial fallback;

- networks – olderpreneurs have had more time to build up networks of clients and helpers;
- experience – learning through mistakes;
- good knowledge of the sector – competitive advantage.

Their number is likely to increase with lower pensions, increased health and higher retirement ages.

Reasons for the growth in the small-firm sector

There has clearly been a resurgence in the importance of the small-firm sector, which appears to have been more pronounced in the United Kingdom than in other countries. Why? Some causal factors are as follows:

1 *The changing pattern of industry*. There has been a change in the industrial structure of the UK away from manufacturing and towards services. Since many services are dominated by small firms, there will be a corresponding change in average firm size. However, this does not provide the full explanation as there has been a growth in the share of small firms even in the manufacturing sector. And it does not explain the international differences since there have been similar changes in industrial structure in other countries.
2 *Changes in consumer spending habits*. A move from mass-produced goods to more specialised products puts small firms at an advantage as they can react more quickly to changes in demand and shorter product life cycles.
3 *Flexible specialisation and the growth of subcontracting*. A debate that started in the late 1980s centres round the idea of the **flexible firm**.[11] As a result of the recession of the early 1980s there was a drive by firms to reduce their costs in order to remain competitive. One way of reducing overhead costs was to move to a flexible firm structure whereby the firm's activities are divided into core and peripheral activities. The core activities, which are central to the activities of the firm, would be kept 'in-house' and carried out by full-time permanent workers. The peripheral activities would be carried out by temporary workers or would be subcontracted. The firm has then reduced its overheads and can react to peaks in demand by increasing the amount of temporary labour it uses or increasing the amount of **subcontracting**. This might also have had the effect of increasing the relative importance of the small-firm sector, although, outsourcing does not happen only to small firms.
4 *Reorganisation and job reduction*. There has been an increase in the phenomenon of downsizing by organisations in an attempt to reduce costs. Ninety per cent of large companies have reorganised and cut jobs since 1985.
5 *Government policy*. After the *Bolton Report* there was much greater interest in the role of the small firm in the regeneration of the economy and in the provision of jobs. But most of the initiatives designed to help the small firm came after the start of the resurgence of the small-firm sector in the early 1970s.
6 *The growth in self-employment*. A part of the growth in the small-firm sector has been due to the growth in the number of self-employed. The self-employed accounted for 9.8 per cent of the workforce in 1984 and 14.3 per cent in 2013 (see Table 8). This represents a 35 per cent increase in the number of those self-employed over this period, much of it since 2008, the beginning of the economic downturn (see mini case study on 'olderpreneurs').

The level of self-employment is likely to be related to the level of unemployment, so that as unemployment increased after 2008, there was an increase in the level of self-employment. Again, however, it does not provide the full explanation as business births were growing in the late 1960s when unemployment was falling.

7 *Technological change*. Changes in technology, particularly information technology and the miniaturisation of components, have made it possible for small firms to benefit to a similar extent to large firms. This has had the effect of reducing the importance of economies of scale and enabling small firms to compete more effectively with large ones. The use of 3D printers could potentially benefit small firms at the expense of other businesses.

8 *Competitive forces*. As far as the international differences are concerned, the *Bolton Report* found that industry in the UK was biased towards large size in comparison with other countries. So what may have happened as a result of competitive forces is that the balance of industry in the UK has moved towards the norm of other countries.

Table 8 Percentage of workforce self-employed, 1984–2013 (UK)

Year	*% self-employed*
1984	9.8
1985	10.0
1986	10.0
1987	10.9
1988	11.3
1989	12.1
1990	12.3
1991	11.9
1992	11.3
1993	11.2
1994	11.7
1995	11.6
1996	11.6
1997	11.5
1998	10.9
1999	10.8
2000	10.6
2001	11.3
2002	11.2
2003	11.6
2004	11.7
2005	11.6
2006	11.8
2007	12.4
2008	12.9
2009	13.2
2010	13.1
2011	13.8
2012	14.0
2013*	14.3

*June 2013.
Source: Adapted from *Annual Abstract of Statistics* (various), *www.ons.gov.uk*

The role of the small-firm sector

The growing importance of the small-firm sector implies that small firms do have a valuable role in the economy apart from being mere providers of employment. The areas in which the small firm has advantages over large firms are those where there are:

1 *Clearly defined small markets*. It is not worthwhile for large firms to enter such markets since there are no economies of scale and no scope for mass production.
2 *Specialist, quality, non-standardised products*. Again it would not be worth a large firm entering such a market as the benefits of large-scale production cannot be reaped.
3 *Geographically localised markets*. For example, the small corner shop.
4 *Development of new ideas*. It is often argued that the small firm is the 'seedbed' of ideas and that, because of greater motivation and commitment on the part of the owner of the small firm, it is conducive to invention and innovation.

Aid to the small-firm sector

The thinking on small firms has changed over time. Initially they were viewed favourably, but after the Second World War the dominant thinking was that large-scale production could take advantage of large economies of scale and that costs would be lower and production more efficient. It was not until more recently that the interest in the small-firm sector increased again. The main reasons for the renewed interest are seen in the results of empirical studies which have shown that the role of the small firm is greater than previously thought in areas such as innovation, the balance of payments and employment.

The main argument for giving support to the small-firm sector is that it has a valuable role to play in the economy. In the 1980s and 1990s, for example, small firms were seen as a mechanism for reducing the very high levels of unemployment. Between 1983 and 1993 the small-firm sector created 2.5 million jobs. The basic premise for support is that small firms are at a disadvantage with respect to large businesses in areas such as raising capital, research and development and risk bearing. The 2007 EU Observatory Survey of SMEs in Europe found that there were three main problems facing small firms:

- The burden of regulation – reported as acting as a constraint by 36 per cent of SMEs within Europe. It is estimated that large firms spend €1 per employee on regulatory compliance compared with €10 for SMEs. The Small Business Act for Europe (2008) has put in place measures to reduce the regulatory burden for SMEs.
- Access to finance – including cash flow problems resulting from late or non-payment of bills. In the UK all public limited companies are required by law to state in their annual reports the average length of time it takes to pay their bills. The Federation of Small Business in the UK publishes a 'name and shame' list of slow payers.
- Access to new markets – between 1996 and 2010 it has been estimated that 58 per cent of the UK's productivity growth came from exporting firms. Only 13 per cent of European SMEs export outside of the EU single market.

Government policy

Within the UK, national policy for small firms has increasingly become a vital component of governmental attempts to create a competitive economy capable of achieving sustainable economic growth. To this end policy initiatives in recent years have become

more focused and have tended to adopt a multi-agency approach, aimed at improving the environment in which small businesses emerge and grow, and at fostering enterprise and innovation. Key developments over the last decade or so have included:

- Business Link – a national network of 'one-stop shops' to provide information and support to small firms – this was disbanded in 2011;
- The Knowledge Transfer Partnerships – these are part-government-funded measures to link UK higher education establishments and businesses;
- the SMART Awards – designed to promote technological development and innovation;
- the Red Tape Challenge – a scheme which aims to identify areas where regulations can be simplified and reduced;
- Greatbusiness – a joint private/public partnership which brings together links on growing, financing and exporting for small business;
- Mentorsme – an online gateway which brings together mentors with small companies needing mentoring;
- Funding for Lending Scheme – a government scheme which provides banks and building societies with £17.6 billion at low rates of interest for lending to businesses and households;
- other state-backed SME lending and equity schemes, including Start-Up Loans, the Enterprise Finance Guarantee, UK Export Finance and Angel Coinvestment Funds.

There have also been a number of legislative and fiscal changes aimed at reducing the burdens on small businesses (e.g. levels of corporation tax). Some of the more recent developments have included the launch of the University for Industry (now a charitable trust), the Business Enterprise Fund (a social enterprise) and the H2020 initiative of the EU. The latter, introduced in 2013, aims to provide a single online portal for all EU financial instruments for SMEs. There have also been attempts to reduce the flow and improve the quality of regulation affecting smaller businesses and an action plan to make the UK the number one location for starting and growing a business.

In November 2013 the UK government announced a major campaign to help small firms. The measures included the initial funding for the Business Bank (£1 billion to dispose of to business starting in 2014), a new Mentoring Challenge Fund with £1 million of funding, a fund of £10 million to the Biotechnology and Biological Sciences Research Council to help synthetic biological start-ups, and a Growth Accelerator Scheme, which provides coaching to small businesses with high growth potential. In addition to these, in January 2014, other measures were announced which included a doubling of the Small Business Rate Relief, the introduction of growth vouchers to help small firms with the cost of hiring and marketing, and the Red Tape Challenge.

www.greatbusiness.gov.uk

Networking between firms

While competition between firms remains the norm in a market economy, cooperation between businesses can, and does, also sometimes occur.[12] This cooperation can take many forms: for example, subcontracting, networking (both formal and informal)

and joint ventures. Such cooperation can be (and is) used by large as well as small and medium-sized enterprises. For large companies it is a way to grow and diversify without risk. For smaller firms it allows them to stay small but at the same time to benefit from some of the advantages of large-scale production such as specialisation.

Subcontracting

There has been an increase in the amount of subcontracting, where firms do not carry out the whole of the production process themselves but subcontract some of their activities to other firms. This represents a rejection of vertical integration and it is related to the notion of the flexible firm mentioned earlier. Subcontracting goes some way to explaining the phenomenal growth rate in 'business services' that occurred in the 1980s. It is increasingly common for businesses to subcontract specialist work in areas such as human resource management to outside consultancies. 'Partnering' between companies and consultancies is becoming more common where the consultancy is retained on a semi-permanent basis to give advice on a whole range of human resource matters, from recruitment to planning for succession. This will obviously boost the small-firm sector. There has also been an increase in 'partnership sourcing' as large firms are developing long-term relationships between themselves and their suppliers. This phenomenon brings benefits to the large firms in the form of reducing stock levels and associated costs and facilitating just-in-time production methods. It also brings benefits to small firms, many of which are the suppliers, in the form of greater security.

Networking

Networking refers to the relationships that exist between organisations and the people within those organisations. These relationships can be of different types, both formal and informal, and there is increasing recognition of the importance of these relationships, especially to small firms (e.g. they may be based on the exchange of goods and services, like the relationship between a firm and its supplier or client). Subcontracting is an example of this kind of network, but there are other links not based on exchange, such as the relationship between a firm and the bank manager or other advisers. There are also informal links between the entrepreneur and family and friends, and between entrepreneurs in different organisations. There might also be cooperative links between firms. This can be seen in the market for executive recruitment where there has been a growth in the links between consultancies, particularly for international work. The creation of the Single European Market and the increased internationalisation of business left the smaller consultancies in a weak position relative to the large international recruitment firms such as Korn Ferry International, which have branches in most European countries.

The smaller consultancies have reacted by forming networks. There are basically two types of network:

1 Where firms are members of a network but where the network has a different name from the individual firms and the firms operate under their own name (i.e. the network has an identity of its own). The members are independent firms that cooperate in carrying out their business. There are 16 such groups in Europe, including EMA Partners International and Amrop.

2 Where firms are part of a network of independent firms but where the network does not have a separate identity and the firms operate under their own names. There are ten such groups in Europe.

web link

For information on companies mentioned see *www.kornferry.com*, *www.ema-partners.com* and *www.amrop.com*

The firm is seen as existing within a spider's web of relationships, as Figure 4 shows. It is possible for two firms to be linked in a variety of ways; in one market they may be competitors, in the next co-operators, customers in another and suppliers in another.

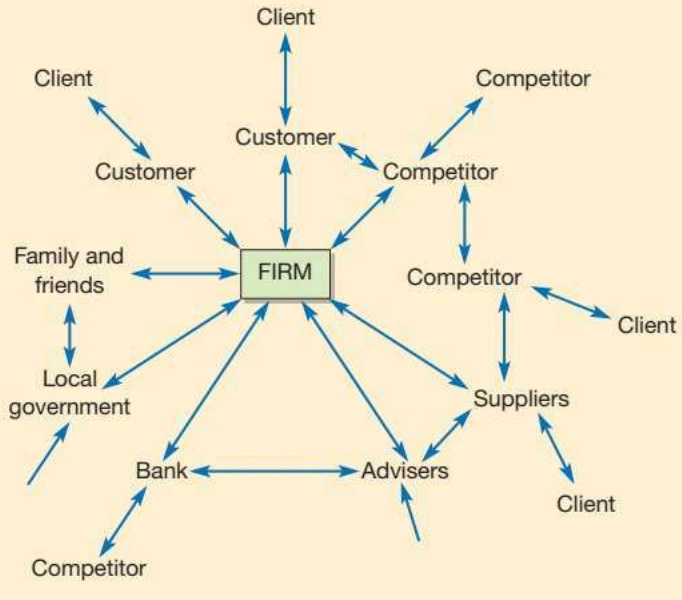
Networking has taken on greater significance because of changes that are taking place in the economy, which include the reversal of the trend towards higher **industrial concentration**, the adoption of Japanese methods of production, the decline of 'mass markets' and technological change that requires greater specialisation than previously. All of these changes favour the formation of networks.

The role of strategic alliances between firms has been recognised, especially in the small-firm sector where expansion through other means is often impossible and in the process of internationalisation.

The virtual organisation

The **virtual organisation** is a network-based structure built on partnerships where a small core operating company outsources most of its processes. It is a network of small companies specialising in various aspects of production. The organisation can be very big in trading terms but very small in the numbers of permanent staff. The process is typically mediated by information technology.

Figure 4 A typical network



The main benefit of the virtual structure is that it helps organisations to deal with uncertainty. When virtual organisations are managed properly they can simultaneously increase efficiency, flexibility and responsiveness to changes in market conditions. The organisation is reaping the benefits of specialisation without having to develop those specialisms itself. Therefore overhead costs are minimised, as are training costs and support costs. Information technology assumes many of the coordinating and managing roles that managers and committees carry out in large organisations. Information technology enables communication and the sharing of information across geographical boundaries. It is often the case, however, that the creation of a virtual organisation is driven solely by cost considerations rather than strategic considerations, in which case the benefits might not be realised. There will be a loss of control over outsourced activities and it may actually cost more to manage such activities. The organisation can become locked into contracts and specific relationships so that flexibility is reduced. There may be a lack of commitment of key resources (i.e. contractors) to the company and the loss of a contractor will be very serious.

There is some evidence that the incidence of virtual organisations is on the increase, facilitated by developments in information technology. It is a matter of 'wait and see' if this will become the dominant organisational structure in the future.

Joint ventures

As indicated earlier in this chapter, **joint ventures** are a good way for firms to diversify and enter other countries' markets. Joint ventures benefit both parties as each can diversify with the benefit of the experience of the other, and the level of risk is minimised. Again, there are examples in the area of executive recruitment. The International Search Group, for instance, was set up as a joint venture between five companies in France, the UK, Austria, Germany and Italy in order to offer a European service to its customers.

Consortia

In some industries cooperative behaviour has come about for particular reasons. In process plant contracting, for example, the projects are often too large for single firms and so they form consortia in order to bid for the contract. The consortium will include contractors, suppliers and bankers who together will have the expertise and the resources to carry out the project.

Multinationals

At the opposite end of the scale from the very small business are companies which have the capability to produce goods or services in more than one country but where control usually resides in a central location. Multinationals are often well-known household names, as the examples below illustrate:

- UK multinationals – BP, GlaxoSmithKline.
- European multinationals – Nestlé, Volkswagen.
- US multinationals – General Motors, IBM.

These multinationals are huge organisations and their market values often exceed the GNP of many of the countries in which they operate. They are estimated to account for a quarter of the world's output.

The growth in the multinationals is due to relaxation of exchange controls making it easier to move money between countries, and the improvements in communication which make it possible to run a worldwide business from one country. See Chapter 3 for a full discussion of the operation of multinational enterprises.

web link

For information on the companies mentioned on this page see: *www.bp.com, www.gsk.com, www.nestle.com, www.vw.com, www.gm.com* and *www.ibm.com*

Synopsis

This chapter has looked at the size structure of industry in the United Kingdom and Europe as a whole. It examined the motives for and the methods of growth, as well as the sources of finance for such growth. The role of the small firm was considered, including the growth in self-employment. Although many industries are dominated by huge companies, the trend seems to be moving away from growth towards a process of disintegration for a variety of reasons. As a result of this trend there has been an upsurge in the small-firm sector, and an increase in the level of cooperative behaviour between firms.

Summary of key points

- The size structure of firms varies greatly within industries, within a country and between countries.
- Firms can grow internally through organic growth or externally through merger and takeover.
- There are many motivations for growth, including increased market share, the reaping of economies of scale, the diversification of risk.
- Growth can be financed internally through reinvested profits or externally through banks, the capital market and the money market.
- There are limits to organisational growth, such as diseconomies of scale.
- The level of merger activity in the UK and in Europe follows a cyclical pattern and is related to economic conditions.
- The small-firm sector is an important source of output and employment, and this importance has increased over time.
- Many factors have influenced the growth of the small-firm sector, including the changing pattern of industries, changes in demand, technological change, the trend towards increased subcontracting and government policy.
- At the other end of the size spectrum, multinational corporations have a massive impact on world output and employment through their activities.

Case study

Gazprom, the Russian giant

Gazprom was created in 1989 as a result of the privatisation of the Russian Ministry of Gas, and the Russian government still owns 50.002 per cent of the company. The company is the biggest extractor of natural gas in the world and it is one of the world's largest companies. Gazprom supplies natural gas to Russia and the rest of the world – in 2012 it accounted for 14 per cent of the world output and 74 per cent of Russian output of natural gas. It owns the largest gas transmission network in the world – 168,000km of pipeline – and exports gas to more than 30 countries. It extracts natural gas from very difficult terrains, most of it coming from the Yamal Peninsula, which lies east of Moscow in North West Siberia, a permanently frozen area.

The sheer size of Gazprom protected it; it has a monopoly in domestic gas production and on gas exports. The price of gas worldwide was high and as a result profits flowed back into Russia. The situation, however, is changing. Gazprom has been badly affected by:

1. Economic downturn in Europe, which has had a negative impact on the demand for gas. Europe is a very important market for Gazprom – 25 per cent of the gas bought in Europe in 2012 came from Gazprom.
2. The exploitation of shale gas (see case study in Chapter 7) through fracking, which has increased the supply of natural gas from other countries and made them more self-sufficient in gas.
3. The price of Gazprom's gas, which compares unfavourably with the price of shale gas.
4. Negative reputational effects – in 2009 Gazprom cut off the supply of gas to Ukraine for two weeks, making people nervous and distrustful. More recently, the arrest of the Arctic 30 has impacted upon Gazprom's reputation.

Gazprom reported that profits were down by 9.5 per cent in 2012, the first time a decline had been reported for ten years, and cited two main reasons for this: declining demand from Europe and higher operating costs. Many business commentators say that Gazprom is too big (e.g. it has subsidiaries in banking, media, agriculture and other industries) and needs to be broken up. This is unlikely to happen.

One problem Gazprom faces is that it has to keep two groups of people happy – on the one hand it has shareholders who are expecting returns on their investment, and on the other it has the government. Russian President Vladimir Putin has made Gazprom a 'national champion', which gives it two objectives – making profits and advancing Russian national interests. These sometimes come into conflict, for example gas is sold inside Russia at lower than the price set outside through the use of subsidies. This advances Russian national interests but at the expense of lower profitability. The controlling interest of the government makes Gazprom susceptible to political meddling; in fact, Putin oversees all major energy deals in Russia and many claim that it is used as a tool of Russian foreign policy. Putin has recently agreed a big reduction in the price of gas for the Ukraine ($268.5 per 1000 cubic metre instead of the previous price of $400). This could be seen as an attempt to deter Ukraine from turning towards Europe and the EU plans for a 'Eurasian Union'.

So what is the future for Gazprom? Increased production of shale gas will push the price of gas downwards and means that other countries do not have to buy from Gazprom. Putin has been negotiating for several years with China, which is the world's biggest user of energy, to supply it with gas. They have not managed to agree on a price so far, but if they did it would reduce the dependence of Gazprom on Europe. A year-long anti-trust investigation by the European Union into some of the activities of Gazprom was due to conclude in early 2014. Gazprom has allegedly blocked supplies of gas in central and eastern Europe and been overcharging its customers by linking the price of gas to oil. Depending upon the outcome of this investigation, Gazprom could face a €10 billion fine. There are also problems with bilateral agreements made with six EU members regarding the construction of gas pipelines; the agreements do not comply with EU rules. Within Russia itself Gazprom is facing increased competition

from two other gas producers: Novatek, established in 1994, and Rosneft, established in 1993.

Many argue that the way forward involves the splitting up of the business into parts – the pipeline business from the gas production – but as this case study shows, the situation is a complex one where market forces are not the most important factor.

Case study questions

1 Why does the nature of the product, natural gas, make this an industry that is likely to be dominated by large companies?

2 What impact is fracking (see Chapter 7) likely to have on this market and this company?

Review and discussion questions

1 How might a global financial crisis impact on merger and acquisition behaviour?

2 Can you see any dangers in the creation of super-utilities (large, diversified organisations which supply a range of utilities – gas, electricity and water)?

3 What advantages does networking bring to small firms and the economy as a whole?

4 How has the balance between large and small firms in manufacturing changed in the last ten years? Do you expect these trends to continue?

Assignments

1 You are an information officer at your local business advice centre and you have been given the job of designing and writing a leaflet aimed at the proprietors of small firms, outlining the government aid that is available to small businesses. Your brief is to keep the leaflet short and readable but with maximum information. (Information on government aid will be available at your local library or business advice centre.)

2 As part of 'Business Week' you have been asked to give a short talk on the size structure of UK industry to local sixth formers doing Business Studies A-level. Prepare your talk by choosing two industries, describing and giving reasons for the typical size structure of the firms in those industries.

Notes and references

1 See Vehorn, C. L., Kopf, J. and Carnevale, J., *Global Markets: Four Firm Concentration Ratios,* 2012 available at *www.sbrconferences.com*

2 *Penguin Dictionary of Economics.*

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6 The market system

As part of their normal production activity, businesses are involved in buying (inputs – such as labour and raw materials) and selling (outputs – the finished product). Buying and selling take place in markets and although there are many different types of market, the basic analysis remains the same.

Learning outcomes

Having read this chapter you should be able to:

- explain the working of the market system
- apply the theory to the real world
- demonstrate the importance of key concepts such as elasticity to business
- discuss the wider economic effects of changes in market forces

Key terms

Buyers' market
Complements
Cross-price elasticity
Demand
Demand curve
Effective demand
Effective supply
Elasticity
Elasticity of demand
Elasticity of supply
Equilibrium price
Equilibrium quantity
Excess demand
Excess supply
Factor market
Free market
Income elasticity
Inelasticity
Inferior goods
Law of demand
Law of supply
Market
Market system
Normal goods
Price ceiling
Price controls
Price elasticity
Price floor
Product market
Sellers' market
Substitutes
Supply
Supply curve

Introduction

The **market system** is an economy in which all of the basic economic choices are made through the market. The **market** is a place where buyers and sellers of a product are brought together. The nature and location of the market depends on the product. For example, within your local town there is likely to be a vegetable market where you would go to buy vegetables. Here, buyers and sellers meet face to face in the same location, but this is not always the case. The market for used cars might be the local newspaper classified section; the sale of stocks and shares passes through a broker so that the buyer never meets the seller. There are many different types of market, involving different buyers and sellers. Firms sell the goods and services they produce to households on the **product markets**, while in the **factor markets** firms are buying resources such as labour and raw materials. The discussion in this chapter will concentrate on the product markets, but much of the analysis could also be applied to the factor markets.

A **free market** system is one in which the basic economic choices are made through the market, without any intervention by the government. In reality, markets are not completely free; governments intervene in markets for many reasons and in many different ways, but in this chapter such intervention will be ignored.

The market mechanism

In every market there will be a buyer and a seller, and somehow they have to be brought together so that a sale can take place. The market mechanism is the way in which this takes place in a market economy. In the product market, the buyer is the household and the seller is the firm. In economic language, the household **demands** the good or service and the firm **supplies** the good or service. Each of these will be considered separately first and then brought together.

Demand

The quantity demanded refers to the quantity of a good or service that households are willing and able to purchase at a particular price. This definition shows that it is **effective demand** that is important; although many people would like to own a Rolls-Royce, they could not afford it and so their demand is not effective on the market. The demand for a good or service depends on a number of factors, the most important of which are:

- the price of the good;
- the prices of other goods;
- disposable income;
- tastes.

To begin with, the relationship between quantity demanded and price will be looked at, assuming that the other factors above remain the same. This assumption will be relaxed in the subsequent analysis.

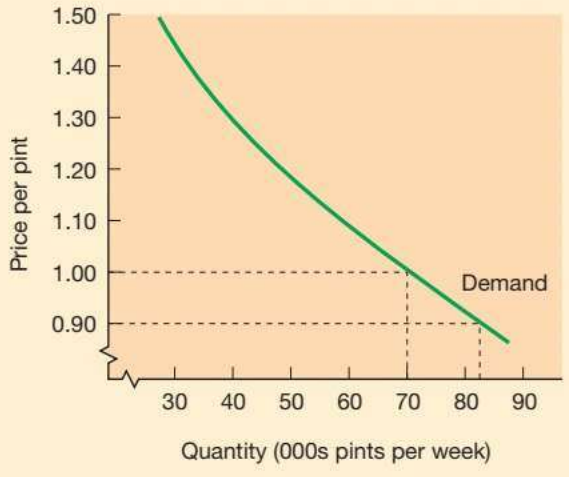
Table 1 The demand for 'Real Brew' draught beer

Price (£ per pint)	*Quantity demanded (000s of pints/week)*
0.90	83
1.00	70
1.10	58
1.20	48
1.30	40
1.40	35
1.50	32

Table 1 shows what happens to the quantity demanded of beer as the price per pint goes up. Note that demand is measured over some period of time. The information is then presented in a graphical form in Figure 1; the line joining the various combinations of price and quantity demanded is called a **demand curve**. The demand curve shows that if all of the other factors that influence demand are constant, then as price goes up, quantity demanded goes down. This is commonly referred to as the **law of demand**. What happens when price rises is that some individuals will cut down their consumption of beer and others may switch to other types of beer. There are some goods where this relationship might not hold:[1] for example, in the stock market where a rise in share prices might lead to the expectation of further price rises and therefore an increase in demand on the part of those wishing to make a capital gain. However, these exceptions are rare and it is therefore safe to assume that the law of demand holds.

If the price of beer changes, there is a movement along the demand curve. For example, if the price of beer goes up from 90p a pint to £1.00 a pint, the quantity demanded goes down from 83,000 pints per week to 70,000 pints per week. In drawing the demand curve, the assumption was made that other factors affecting demand are constant. If this assumption is relaxed, what happens to the demand curve?

Figure 1 A demand curve for 'Real Brew' draught beer



Price of other goods

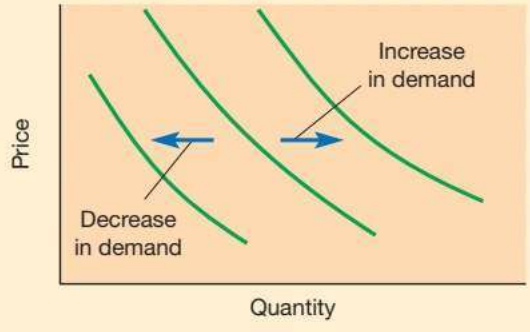
The quantity of beer consumed will be affected by the prices of other goods. These other goods are likely to be **substitutes** or **complements**. A substitute for beer may be lager, and if the price of lager goes down, some individuals may switch from beer to lager; thus the demand for beer goes down. What happens to the demand curve is that at all price levels, the demand for beer is now lower. Thus the demand curve shifts to the left, indicating that at £1.00 per pint only 60,000 pints of beer are demanded per week. If the price of a substitute goes up, there will be an increase in the demand for beer. The demand curve moves to the right. These movements are shown in Figure 2. The closer the goods are as substitutes and the greater the change in the price of the substitute, the greater will be the shift in the demand curve.

A complementary good is one that tends to be consumed with another good. For beer, it is possible that individuals eat crisps or smoke cigarettes at the same time as drinking beer. The relationship is the opposite of that for substitutes. If the price of a complement goes up, individuals might be less likely to drink beer, and demand will fall. The demand curve moves to the left. If the price of a complement goes down, the demand for beer will rise. Again, the closer the goods are as complements, and the greater the price change of that complement, the greater will be the shift in the demand curve.

Disposable income

Changes in disposable income will clearly affect demand. If the economy moves into recession, then retail sales and the housing market might suffer. As incomes increase once the economy recovers, then such sectors will pick up again. Higher incomes will lead to increased consumption of most goods. If your income is boosted, how will this affect your consumption? You might buy more textbooks, and probably spend more money on leisure activities and clothes. Most students might also drink an extra pint of beer per week. Thus, an increase in disposable income will lead to an increase in demand for these goods, indicated by a rightward shift in the demand curve. As incomes fall the demand for these goods will fall, indicated by a leftward shift in the demand curve. These types of goods are called **normal goods**.

Figure 2 Shifting demand curves



There are goods, however, that experience a fall in demand as a result of income increases. These goods are called **inferior goods**. A good example is hard toilet paper; as individuals become richer, they are likely to substitute more expensive soft toilet paper, and thus the demand for hard toilet paper will fall.

Tastes

Taste includes attitudes and preferences of consumers, and will be affected by such things as fashion, and advertising campaigns by producers or by governments. For example, a successful advertising campaign by the government pointing out the effects of smoking would cause tastes to change and demand for cigarettes to fall.

The demand curve, then, is downward sloping, indicating that as the price of the good rises the quantity demanded by households falls, shown by a *movement along the demand curve*. Changes in the other determining factors lead to *movements of the demand curve*.

Supply

The other side of the market is the supply side. In the market for goods and services it is the firm that is the supplier. The quantity supplied of a good is defined as the quantity that firms are willing and able to supply to the market at a particular price. Again, notice the wording of the definition is such that it only includes **effective supply** and, as with demand, it is measured over a specific time period.

The quantity supplied to the market depends on a number of factors, the most important of which are:

- the price of the good;
- the prices of other goods;
- the prices of the resources used to produce the good;
- technology;
- expectations;
- number of suppliers.

In the same way as for demand, all factors other than price will be assumed to be constant and the relationship between quantity supplied and price will be considered first.

Table 2 provides some information on price and quantity supplied of beer. The same information is represented graphically in Figure 3; the line joining the points together

Table 2 The supply of 'Real Brew' draught beer

Price (£ per pint)	*Quantity supplied (000s of units/week)*
0.90	0
1.00	35
1.10	43
1.20	48
1.30	55
1.40	60
1.50	68

Figure 3 The supply of 'Real Brew' draught beer

is called the **supply curve**. The upward-sloping curve illustrates the **law of supply**. This states that, as the price of a good rises, the quantity that firms are willing to supply also rises. This is because if costs are constant as we have assumed, then higher prices must mean higher profits to the firm.

Note that there is no supply at a price below 90p per pint; this is the minimum price required by the producer to produce the beer. If the price per pint changes, there is a movement along the supply curve in the same way as for demand. If any of the other factors listed above change, there will be a movement of the supply curve.

Other prices

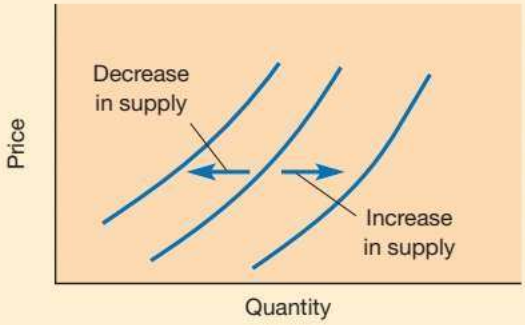
The supply of one good can be influenced by the price of another. For example, if the brewery in which Real Brew beer is brewed is also producing lager, then an increase in the price of lager (with the price of beer remaining the same) will encourage the firm to produce less beer and more lager, as lager is now more profitable to produce. The supply curve for beer would shift to the left, indicating that at every possible price, less is now supplied than before. If the price of lager fell, the supply of beer would increase. This is shown by a rightward shift of the supply curve. The size of the shift would depend upon the degree to which the goods could be substituted for each other in production, and the size of the price change. These shifts are illustrated in Figure 4.

Goods can also be complements in their production process; for example, beef and leather hides. An increase in the price of beef would increase not only the supply of beef but also the supply of hides. There would be a corresponding shift in the supply curve for hides.

The prices of the resources used in the production of the good

If any of the costs of production (wages, rent, rate of interest, and so on) increased, then the profitability of that good at each price would fall and there would be a tendency for supply to be reduced. The supply curve would move to the left. If costs of production

Figure 4 Shifting supply curves



fell there would be an increase in supply and a rightward movement of the supply curve. The extent of the shift depends upon the size of the price change, the significance of that factor in production, and the degree to which the factor could be substituted for another factor.

Technology

Technical development in all aspects of production has led to great improvements in output per worker. Such improvements generally result in either more being produced with the same resources, or the same being produced with fewer. In most cases it would also lead to a substitution of one factor of production for another. For example, car production becomes less labour intensive as robotic techniques take over. Even such a product as traditional British beer has benefited from significant technical improvements in production. The effect of such advances would result in increased supply at each price level and hence a movement of the supply curve to the right.

Business expectations

Expectations play a crucial role in the decision-making of firms. Good expectations of the future would encourage firms to invest in new plant and machinery, which would increase their productive potential. Chancellors of the Exchequer are occasionally accused of trying to 'talk the economy up': that is, they may paint a rosy picture of the current and future state of the economy in the hope that this will enhance business expectations, and help pull the economy out of recession. If business does become increasingly confident, or perhaps more inclined to take risks, then this would shift the supply curve to the right. The reverse would shift it to the left.

The number of suppliers

As the number of suppliers in a market increases, the supply will rise; the supply curve shifts to the right. If suppliers leave the market, supply will fall and the supply curve moves to the left.

Price determination

The market is the place where buyers and sellers meet and where demand and supply are brought together. The information on demand and supply is combined in Table 3 and presented graphically in Figure 5.

Table 3 The supply and demand for 'Real Brew' draught beer

Price (£ per pint)	*Quantity demanded (000s/wk)*	*Quantity supplied (000s/wk)*
0.90	83	0
1.00	70	35
1.10	58	43
1.20	48	48
1.30	40	55
1.40	35	60
1.50	32	68

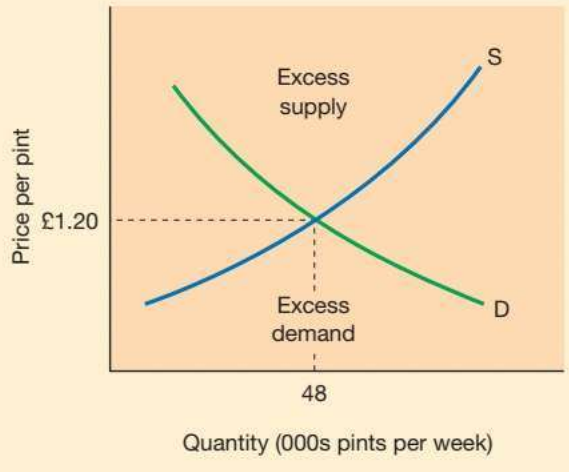
The equilibrium price

At a price of £1.20, the quantity demanded is the same as the quantity supplied at 48,000 pints per week. At this price the amount that consumers wish to buy is the same as the amount that producers wish to sell. This price is called the **equilibrium price** and the quantity being bought and sold is called the **equilibrium quantity**. The point of equilibrium can be seen on the figure at the point where the demand and supply curves cross.

At price levels above £1.20 the quantity that producers wish to supply is greater than the quantity consumers wish to buy. There is **excess supply** and the market is a 'buyers' market'. At prices less than £1.20 consumers wish to buy more than producers wish to supply. There is **excess demand** and the market is a **sellers' market**.

In competitive markets, situations of excess demand or supply should not exist for long as forces are put into motion to move the market towards equilibrium. For

Figure 5 The market for 'Real Brew' draught beer



example, if the price level is £1.30 per pint, there is excess supply and producers will be forced to reduce the price in order to sell their beer. Consumers may be aware that they are in a **buyers' market** and offer lower prices, which firms might accept. For one or both of these reasons, there will be a tendency for prices to be pushed back towards the equilibrium price. The opposite occurs at prices below equilibrium and price is pushed upwards towards equilibrium.

Shifts in demand and supply

So long as the demand and supply curves in any market remain stationary, the equilibrium price should be maintained. However, there are numerous factors that could shift either or both of these curves. If this were to happen, then the old equilibrium would be destroyed and the market should work to a new equilibrium. How does this happen?

In Figure 6 the original equilibrium price for Real Brew draught beer is P_1. Assume that the demand curve moves from D_1 to D_2. This increase in demand could be due to a variety of factors already mentioned. For example, the price of a rival drink may have increased; disposable income could have risen; or sales may have benefited from a successful advertising campaign. In any event, at the old equilibrium price there now exists an excess of demand over supply of Q_1Q_3. It is likely that price will be bid upwards in order to ration the shortage in supply. As price rises, demand is choked off and supply exhausted. Eventually, there is a movement to a new equilibrium of P_2. At this new price both supply and demand at Q_2 are higher than they were at the previous equilibrium. If, alternatively, the demand curve had shifted to the left, then the process would have been reversed and the new equilibrium would have been at a level of demand and supply less than Q_1, with a price below P_1. Illustrate this process diagrammatically for yourself.

In Figure 7 there is a shift in the supply curve from S_1 to S_2. Refer back in this chapter to envisage specific reasons for such a shift. At the original equilibrium price of P_1 there would now be an excess supply over demand of Q_1Q_3. Price would therefore fall in a free market. As it does, demand will be encouraged and supply diminished. Eventually there

Figure 6 A shift in the demand curve

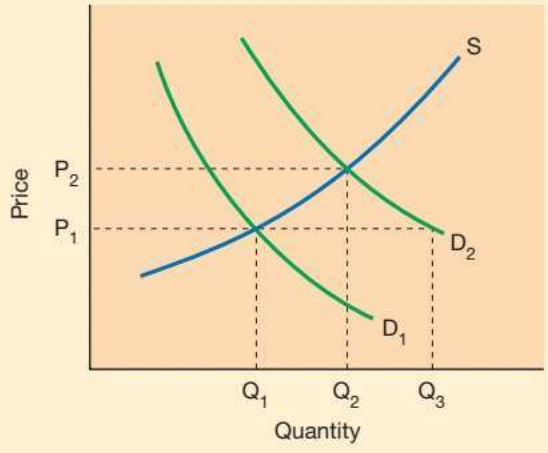
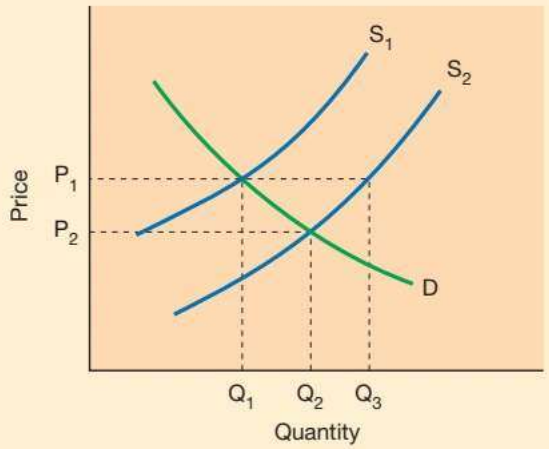


Figure 7 A shift in the supply curve



will be a new equilibrium at P_2 with a higher quantity demanded and supplied than at the previous equilibrium. If the supply curve had instead shifted to the left, then market forces would have resulted in a lower quantity supplied and demanded than before. Once again, illustrate this diagrammatically for yourself.

The analysis so far has been relatively straightforward; it has been assumed that either the demand or the supply curve moves alone. However, it is likely that in any given time period both curves could move in any direction and perhaps even more than once.

Given the many factors that may shift both the demand and the supply curves, it is easy to imagine that markets can be in a constant state of flux. Just as the market is moving towards a new equilibrium, some other factor may change, necessitating an adjustment in an opposite direction. Given that such adjustment is not immediate, and that market conditions are constantly changing, it may be the case that equilibrium is never actually attained. It is even possible that the very process of market adjustment can be destabilising.[2] The constant movement of price implied by the analysis may also be detrimental to business. The firm might prefer to keep price constant in the face of minor changes in demand and supply.

Mini case The effect of a factory fire on the market for microchips

In September 2013, a fire at a factory in China that makes memory chips for computers and mobile phones had a dramatic effect on the market and illustrates the importance of the forces of demand and supply. The company, owned by SK Hynix and a supplier to Apple, made a third of the dynamic random access memory (DRAM) chips sold worldwide. It was the second largest producer of these chips after Samsung, and the factory in China accounted for half of Hynix's output.

The impact on the price of the chips was dramatic and instantaneous – the cost of the DDR3 2 gigabit chip increased by 30 cents to $1.90 the day after the fire – and unless production could be increased fairly quickly, this price rise could endure for some time. The immediate price increase was moderated because the company held big inventories of the chip and could supply these to the market.

What would happen to price would depend upon how quickly production could return to normal. Some limited production started in the company the week after the fire, but it was not known how long it would take to resume production at normal levels. Hynix responded in the short term by switching production out of other products into the production of DDR3 chips. As a direct result of the fire Hynix missed its analyst's estimates of profits for the last quarter of 2013.

This case can be illustrated using a demand and supply diagram. In Figure 8, the demand curve is shown as fairly inelastic; this is because worldwide demand for mobile phones and computers is high and growing and the fact that for many these products are now necessities. Three supply curves are shown:

1. S4–9 is the supply curve on the day of the fire (price of a chip $1.60).
2. S5–9 is the supply curve the day after the fire (price of a chip $1.90).
3. S4–10 is the supply curve on 4 October 2013 (price of a chip $2.34).

Figure 8 The market for DDR3 micro chips

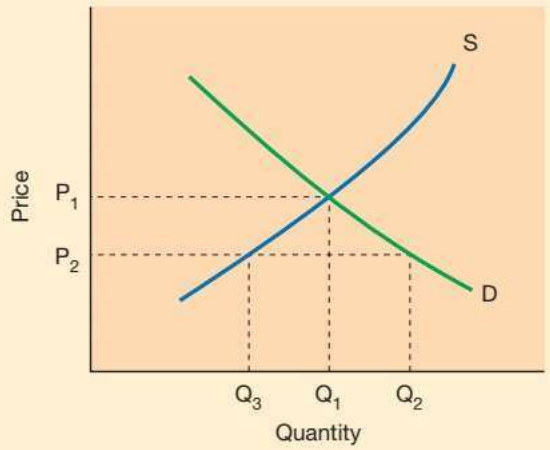
The price increase would, of course, have a knock-on effect on the price of mobile phones and computers, and this case illustrates well the effects of demand and supply on the price of products and interdependence between markets worldwide.

Price controls

Governments occasionally take the view that a particular equilibrium price is politically, socially or economically unacceptable. In such circumstances, one course of action is the imposition of **price controls**. This involves the institutional setting of prices at either above or below the true market equilibrium. For example, if it was felt that the equilibrium price of a good was too high, then the government might try to impose a lower price on the market. This would now be the maximum acceptable price or **price ceiling**. Price may not rise above this ceiling. Alternatively, the equilibrium price could be seen as too low. In this case, a higher price, or **price floor** is imposed, below which price should not fall.

Figure 9 illustrates the market for a basic foodstuff. Imagine that it is wartime and the disruption has shifted the supply curve to the left. This could be largely due to a movement of resources away from the production of this good and towards munitions. The free market price at P_1 is seen to be unacceptably high relative to the pre-war price, and the decision is made to impose a price ceiling of P_2. It is hoped that such a ceiling will alleviate the problems of consumers who could not afford the free market price. The problem now is that at the price ceiling only Q_3 units will be supplied, whereas demand is for Q_2. The volume of output Q_3Q_2 therefore represents an excess of demand over supply. Many customers are frustrated in their desire to purchase that good. To

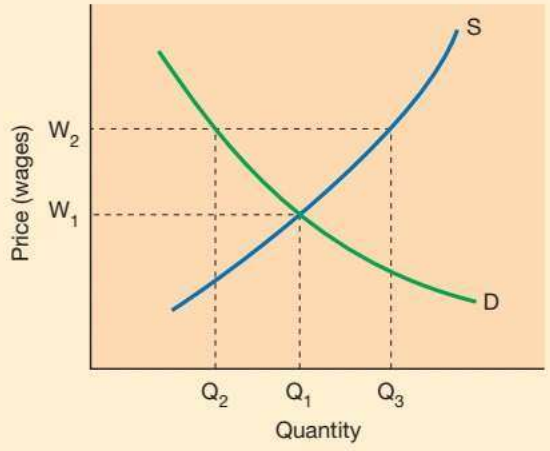
Figure 9 Imposition of a price ceiling



help bring order to the situation, a system of rationing might be introduced. This could allocate the limited output between the many customers in a more orderly fashion than 'first come, first served'. For example, one unit could be allocated per person and priority could be given to the old and the sick. This does not solve the problem of excess demand. It is commonly found in such situations that illegal trading starts to emerge at a price above the ceiling. To obtain the good, many would be willing to pay a higher price. This is commonly referred to as black market trading.

Figure 10 illustrates the market for a specific type of labour. The downward-sloping demand curve indicates that, at lower wages, employers will wish to take on additional workers. The supply curve shows how more people will offer themselves for work as wage rates increase. At the intersection of the curves, the market is in equilibrium. Imagine that this equilibrium wage is seen to be too low, and the authorities seek to impose a minimum wage of W_2. Employers are not permitted to pay any less than this amount. It is hoped that the policy will improve the welfare of workers by raising their living standards to some acceptable level.

Figure 10 Imposition of a price floor



At this minimum wage, employment becomes more attractive, and Q_3 persons seek employment. However, employers only wish to take on Q_2 workers. There is now a situation of excess supply. Only Q_2 find work; the remainder Q_2Q_3 are unsuccessful. The policy has actually reduced the level of employment from Q_1 to Q_2. In such a situation, there will be a temptation to flout the legislation. For example, unscrupulous employers observing the ranks of unemployed would realise that many would willingly work at less than the minimum wage.

The above examples illustrate the problems that arise once price is imposed away from its equilibrium. Further examples of such price controls would include the guaranteed minimum prices to farmers within the Common Agricultural Policy (CAP) of the European Union (see case study at the end of Chapter 12 of the fifth edition of this book), and various post-war attempts to control the cost of rented accommodation at a price affordable to the low paid. The former has been associated with overproduction and the need to control the mountains of excess supply, while the latter tended to result in landlords taking their properties off the rental market in order to seek more profitable returns. The success of such policies requires careful control and monitoring. In many circumstances, it might be better to consider alternative ways of achieving the policy goals.

Mini case The price of toilet rolls in Venezuela

In 2013 there were shortages of many goods in Venezuela, including basic foodstuffs such as milk, cooking oil and sugar and the one that has really hit the news – toilet rolls. In a free market, shortages are dealt with by rising prices, but this disadvantages the poor and goes against the policies of the Venezuelan government. This situation is illustrated in Figure 9; there is excess demand for toilet rolls. The solution to this problem adopted in Venezuela was to ration toilet rolls – there were queues outside supermarkets and customers were restricted to 12 rolls per visit. An Android app was even produced called Abasteceme (supply me), which alerts customers to the whereabouts of supplies of the shortage products.

There is much debate about the causes of the shortages, so what is at the bottom of the problem? Opponents of the government blame the volatile nature of the economic policy-making of the Chavez government, including regular devaluations of the currency and routine takeover of private companies, which makes for high levels of uncertainty for business. It is argued that price controls are a disincentive for local producers to produce. In other words, it is a supply issue.

The government blames an international conspiracy against its policies. It is a fact that income distribution in Venezuela is much more equal than in other countries in South America, but the problem is that national income is not growing. This, together with the shortages, means that the population does not feel any better off. In September 2013, the scarcity index stood at 21 per cent according to the Venezuela Central Bank, which means that 21 out of 100 goods were not available or in short supply. It was widely reported that the National Statistics Office of Venezuela attributed the shortage of toilet rolls to the fact that Venezuelans were eating three meals a day and hence the demand for toilet rolls was higher. In other words, it is a demand issue.

Whether the shortage of toilet rolls is due to demand or supply factors is up for debate, but the fact remains that there is a shortage. The population of Venezuela is 28.5 million and consumers use 125 million toilet rolls per month, thus there is a shortfall of 40 million rolls per month. The government has done two things to try to alleviate this: it has increased the import of toilet rolls to meet the demand and in September 2013 it took Manpa (the company that supplies 40 per cent of toilet rolls in Venezuela) into public ownership. It hopes that this will prevent hoarding on the part of the company and help meet the excess demand.

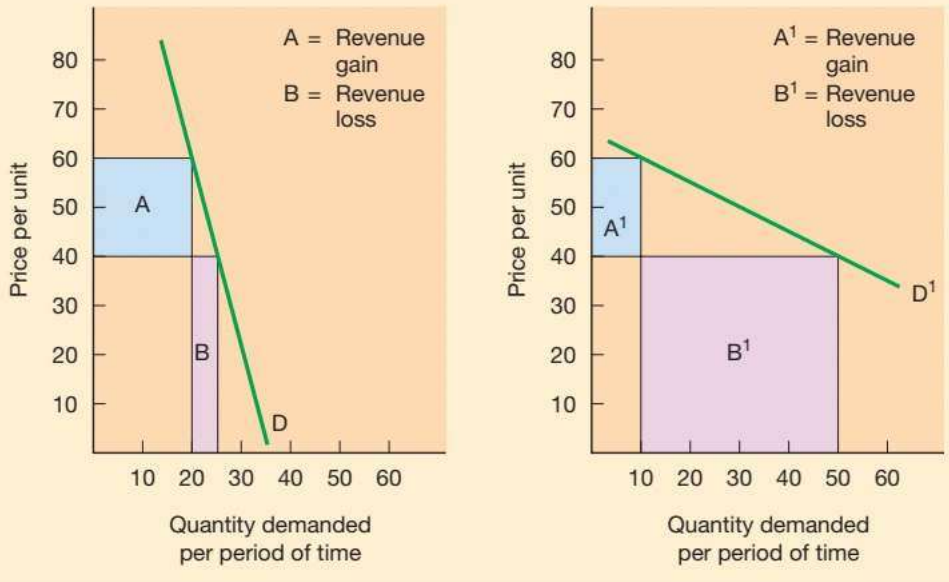
Elasticity of demand

It has been shown that as long as other factors affecting demand remain constant, a decrease in price would be expected to increase the quantity demanded by consumers. This knowledge is obviously important to business, in that it implies that sales will expand as the good becomes more price competitive. It does not, however, say anything about the degree to which sales might increase. As prices change, will demand change by a large or a small amount? At the end of the day, will the extra sales bring in more or less total revenue? In short, a measure is needed of the responsiveness of demand to price changes. In the same way, the responsiveness of quantity demanded to other factors like income or other prices can also be measured. It is also important to be aware of the responsiveness of supply to changes in prices. All of these are measured by the concept of **elasticity**.

Price elasticity of demand

Figure 11 illustrates two different-shaped demand curves and shows the effect of a price increase from 40p to 60p in each case. On the left-hand figure, the increase in price causes demand to fall from 25 to 20 units. Total revenue received by the producer (i.e. price multiplied by the number of units sold) changes from £10.00 (40p × 25 units) to £12.00 (60p × 20 units). As illustrated, the area A represents the gain in revenue as a result of the price change, while B shows the loss of revenue. In this case there is a clear net gain. The reason for this is that the significance of the price rise is greater than the fall in demand. Compare this with the right-hand figure. The same price rise now causes total revenue to fall from £20.00 (40p × 50 units) to £6.00 (60p × 10 units). The loss of revenue, area B_1, is clearly greater than the gain in revenue, area A_1. There is a net loss of

Figure 11 Responsiveness of demand to a price change



revenue. This is a situation where the decrease in demand is of greater significance than the increase in price.

The traditional way of measuring the responsiveness of demand to a change in price is via the concept of **price elasticity**, the formula being:

$$\text{Price elasticity of demand (Ep)} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

$$\text{Ep} = \frac{\%\text{ change in QD}}{\%\text{ change in P}}$$

The significance of this formula lies in whether the value of price elasticity is greater or less than 1. If it is greater, then the percentage change in quantity demanded is greater than the percentage change in price. Demand is referred to as being relatively elastic, or responsive to price changes. If, however, the percentage change in quantity demanded is less than the percentage change in price, then price elasticity will be less than 1. Demand is now referred to as being relatively **inelastic**, and demand is not very responsive to price changes.

The higher or lower the value of price elasticity, the greater or lesser the responsiveness of demand to the price change. Table 4 demonstrates the connection between price elasticity and total revenue. It will be observed that if price elasticity is greater than 1, then there is a negative relationship between price changes and total revenue. For example, an increase in price results in a decrease in total revenue, whereas if elasticity is less than 1, then there is a positive relationship.

Table 4 Elasticity and total revenue

Elasticity	*Price change*	*Change in total revenue*
Elastic	Upward	Downward
	Downward	Upward
Inelastic	Upward	Upward
	Downward	Downward

Calculating elasticity

From the information portrayed in Figure 11, in the left-hand figure price rose from 40p to 60p and demand fell from 25 to 20 units; thus:

$$\text{Ep} = \frac{\%\text{ change QD}}{\%\text{ change P}} = \frac{5/25 \times 100}{20/40 \times 100} = \frac{20\%}{50\%} = 0.4$$

This shows that demand is inelastic. One problem with this measurement is that if you measured elasticity when price fell from 60p to 40p the answer would be different:

$$\text{Ep} = \frac{\%\text{ change QD}}{\%\text{ change P}} = \frac{5/25 \times 100}{20/60 \times 100} = \frac{25\%}{33.3\%} = 0.75$$

The reason for this variation is that the percentage change in each case is being measured from a different base. When price rises from 20p to 40p, this is a 50 per cent rise.

Yet when it falls from 60p to 40p this is only a 33.3 per cent fall. The value of elasticity therefore varies. To avoid this ambiguity, elasticity is measured as the percentage change from the average value of price and quantity before and after the change, that is:

$$\% \text{ change} = \frac{\text{Change in value} \times 100}{\text{Average Value}}$$

The value of elasticity for the price increase and decrease must now be identical:

$$Ep = \frac{\% \text{ change QD}}{\% \text{ change P}} = \frac{5/22.5 \times 100}{20/50 \times 100} = \frac{22.2\%}{40\%} = 0.55$$

The determinants of elasticity

There is a number of factors that determine how responsive quantity demanded is to price changes. First, the nature of the good and how it is viewed by consumers. A good that is a necessity will have a low value of elasticity, as an increase in price will not have a very big impact on the quantity consumed. Goods like cigarettes will have inelastic demand because they are habit forming. The tastes of consumers will be important: whether they view a television, for example, as a necessity or a luxury will determine the value of elasticity. Another factor is whether substitutes are available for the good or not. If there is no substitute for a particular good and the household wishes to continue to consume it, an increase in price will have little effect on the level of demand. Other factors include the importance of the good in the household's total expenditure. The smaller the proportion of the household's budget spent on a particular good, the smaller will be the effect on demand of any change in price.

Income elasticity of demand

Income elasticity of demand is a measure of the responsiveness of quantity demanded to changes in income. It can be negative in the case of inferior goods, where an increase in income leads to a fall in the demand for a good, or positive in the case of a normal good, where an increase in income leads to an increase in demand. There is also a difference between luxuries and necessities. Luxuries will have positive income elasticities with values over 1. This means that an increase in income will cause an increase in demand for that good and that a 1 per cent increase in income will cause a more than 1 per cent increase in demand.

A necessity will also have a positive income elasticity, but its value will lie somewhere between 0 and 1, showing that an increase in income of 1 per cent causes an increase in demand by less than 1 per cent.

Income elasticity is calculated in a similar way to price elasticity except that it is income which is changing rather than the price of the good:

$$\text{Income elasticity} = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in income}}$$

The effect of changes in income on the overall level of expenditure depends upon the type of the good being considered, as Table 5 shows.

Table 5 Income elasticity and total expenditure

Type of good	*Income elasticity*	*Change in total expenditure brought about by an increase in income of 1%*
Inferior	Negative	Downward
Normal	Positive	Upward
Luxury	Positive and above 1	Upward by more than 1%
Necessity	Positive between 0 and 1	Upward by less than 1%

Cross-price elasticity of demand

Cross-price elasticity of demand is a measure of how the demand for one good is affected by changes in the prices of other goods. It is calculated with the formula:

$$\text{Cross-price elasticity} = \frac{\%\text{ change in quantity demanded of good X}}{\%\text{ change in the price of good Y}}$$

Like income elasticity it can be positive or negative, depending this time upon the nature of the relationship between the goods. If the goods are substitutes for one another, as the price of Y goes up, the quantity demanded of X will also rise, as consumers substitute the relatively cheaper good (e.g. margarine for butter). Therefore cross-price elasticity will be positive. If the goods are complements, as the price of Y rises the demand for X will fall and cross-price elasticity will be a negative value. The size will depend upon how closely the goods are related, either as substitutes or complements.

Elasticity of supply

The concept of elasticity can be applied to supply as well as to demand, and is a measurement of how responsive quantity supplied is to changes in the price of a good. Figure 12 illustrates two differently shaped supply curves and the effect of the same price change in each case.

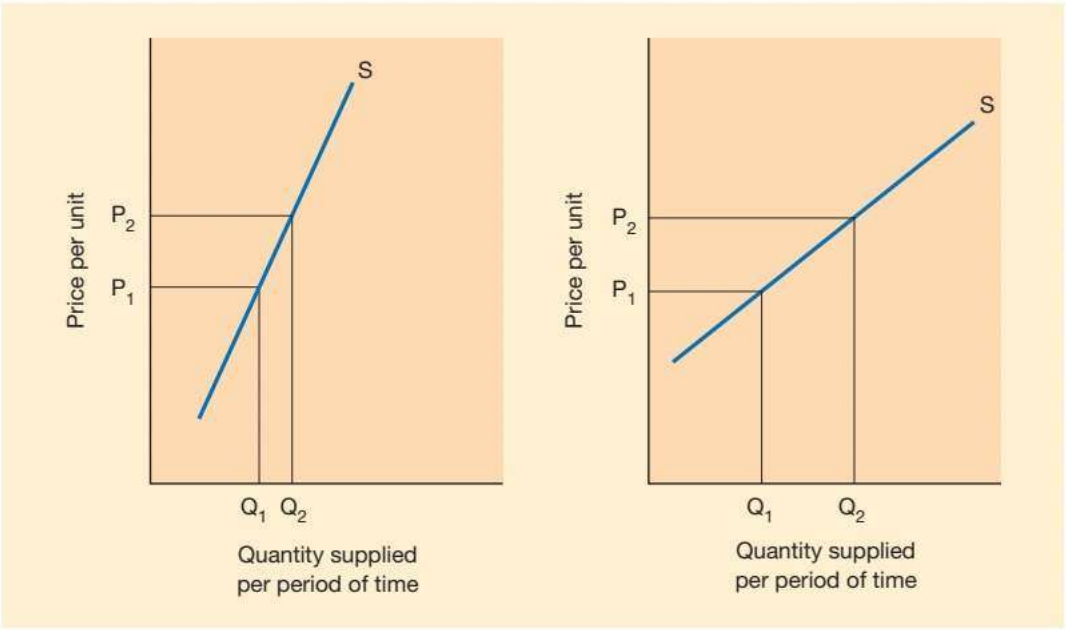
Elasticity of supply is measured with the following formula:

$$\text{Elasticity of supply} = \frac{\%\text{ change in quantity supplied}}{\%\text{ change in the price}}$$

The higher the numerical value, the more responsive is supply to changes in price.

The main determinants of the elasticity of supply for a good are the nature of the production process and the time-scale in question. It may well be easier to increase the supply of manufactured goods than agricultural goods, given the nature of the production processes involved. Even agricultural goods can be increased in supply, given time to replant stock, so supply is more responsive to price changes in the longer time period.

Figure 12 Responsiveness of supply to a price change



The importance of the market to business

All firms operate in markets, whether they are localised, national or international. Although firms might be able to influence the market conditions that face them, they need a knowledge of their own markets and how markets fit together in the market economy. Firms often have a range of products and they need to be aware of the differing conditions in each of their markets. They need a knowledge of the shape and position of the demand curve they face, including the following aspects:

- the nature of the good they produce;
- the way in which it is viewed by consumers;
- the factors that affect the demand for their good;
- any changes likely in the future which will affect the market;
- any likely government intervention in the market.

Only through this information can the firm hope to retain markets, expand existing markets and move into new ones.

An understanding is also needed of the concept of **elasticity of demand**. Knowing how the demand for its product responds to changes in its price will help the firm in its pricing policy. Measures of income elasticity help the firm in forecasting the effects of changes in income on the demand for its products. Economic growth will affect markets with high income elasticities much more than markets with low income elasticities. This knowledge will also help the firm in developing its marketing strategy. For example, goods with low income elasticities could be marketed as 'economical', thus hopefully increasing the market share.

If the firm wishes to be successful in existing markets and to expand into new markets, as well as detailed knowledge of demand conditions, it also needs to know about its own supply curve and production process and the supply curves of other firms.

Although the economy in which the firm operates is not a totally free market economy, the firm needs to know and understand the importance of market forces which form the basis of our economic system.

Changes in market forces can have dramatic effects, not only on the affected market but also on other related markets and the wider economy. Changes in one market will affect all other markets to a greater or lesser degree.

Synopsis

In this chapter, the market has been examined in some detail. The determinants of demand and supply have been considered and the effects on the market of changes in any of these factors have been shown. The concept of elasticity has also been examined and calculated and the importance of all these issues to business has been demonstrated.

Summary of key points

- In a free market both the quantity being traded and the price of a product are determined by the forces of demand and supply.
- The demand for a good or service depends upon a number of factors, including price, the price of other goods, the income of consumers, tastes and so on.
- The supply of a good or service also depends upon a range of influences, including price, the costs of production, technology and the number of suppliers.
- Changes in demand and supply cause changes in the price of the product and the quantity being traded.
- Where demand and supply are equal, the market is said to be in equilibrium.
- Where this occurs, equilibrium price and quantity result.
- Intervention in the market mechanism can take the form of minimum or maximum prices, taxation or subsidy.
- Elasticity is a measure of the responsiveness of demand or supply to various factors, including price, income and the price of other goods.
- It is important for businesses to be aware of the demand and supply characteristics of the good or service they are producing.

Case study

The housing market in the UK

One market where the operation of the market mechanism can easily be seen is in the market for houses. In the UK in November 2013 the average price for a house or flat was £174,910, up 7.7 per cent on the year before but still below the peak reached in 2007 (see Figure 13). House prices rose steadily through the 1990s and then rapidly through the 2000s when banks and building societies were lending to individuals with poor credit ratings up to 125 per cent of the value of the property and often without requiring any deposit. This created the 'housing bubble', which burst in 2007. Many people ended up in negative equity, where the value of the house was less than the value of the mortgage loan. This was not confined to the UK – the same thing happened in many other countries, including the USA.

Like all products, the price of houses depends upon demand and supply factors.

Supply factors

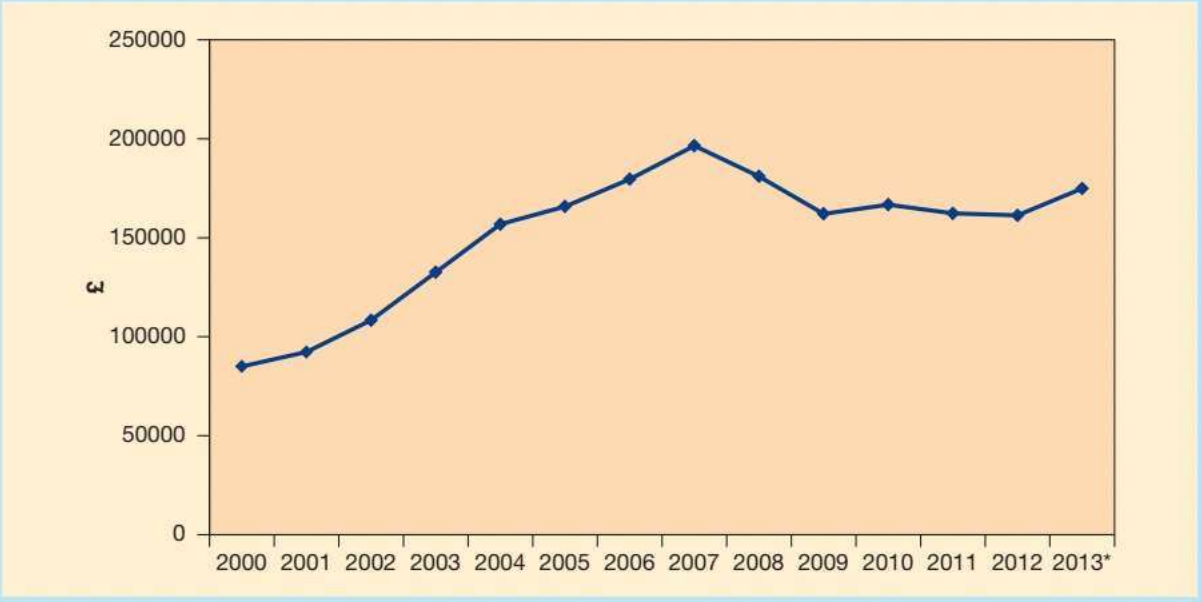
The supply of housing is inelastic; it is very difficult to increase the stock of houses quickly. House building in the UK has been low historically, and the National Housing Federation estimates that England needs 240,000 new homes to be built each year to meet the demand. Only 107,000 new homes were built in 2012–13, down 11 per cent on 2007. There is an increasing trend of 'letting to buy', where people buy a new property but rent out their old one instead of releasing it to the market, and this means that the supply of houses to buy is further restricted.

Demand factors

In the UK there is a high propensity for owner occupation – 64 per cent of households were either buying or owned their home outright at the end of 2013. This is higher than other countries; in Germany, for example, it is 52 per cent and in Switzerland it is only 44 per cent. This means that in the UK, demand is high. As most houses are bought through mortgages or loans, both the availability and the cost of these loans will be important.

As mentioned above, before the crash of 2007, banks and building societies were lending too much

Figure 13 Average price of a house or flat, UK, end of year 2000 to 2013



*Nov 2013.
Source: Adapted from Halifax Price Index, *www.lloydsbankinggroup.com*

to the wrong people with little or no security. After the crash of 2007, the banks and building societies became much more cautious about their lending, mortgages of 100 per cent or more disappeared and house buyers were required to put down a sizeable deposit. This made buying houses difficult or even impossible for many and therefore had an impact on demand. The cost of borrowing depends upon the rate of interest, and this has been low in much of the world since the crash of 2007. In the UK, the Bank of England has said that the rate of interest will not be changed until the level of unemployment reaches 7 per cent and even then might stay low. This means that both the cost of borrowing and the cost of repayment are low at present.

Income levels are expected to have a positive effect upon the demand for houses: as income increases, the demand for houses will increase. Since the crash bank and building society lending has reverted to how it used to be. The old rule they used in determining who to lend to was the ratio of three times salary – if your income was £25,000 per year, you would be awarded a mortgage of £75,000. This rule, and the typical requirement to put down a deposit, ensured that people had the ability to repay their loans. These new rules would again make buying a house difficult for many. The recent 'Help to Buy' scheme in the UK (see later) has led to the relaxation of this approach.

Another important demand factor is 'other prices' which in this market means rents, and these are at record highs according to the Land Registry. The cost of rent can often be higher than the cost of repaying a mortgage, in which case it would be better for people to buy; the costs are lower and there will be an asset at the end of the repayment period. This is again tempered by the availability of houses and the availability and affordability of finance. The lack of these forces more people into the rental market and therefore will push up rents. Population size impacts upon demand, and this would include the level of immigration, the incidence of second homes, the increase in the number households because of things like divorce and the buy to let market. There are regional differences in the increases in house prices in the UK; house prices in London are rising much faster than elsewhere in the UK (annual growth of 12.8 per cent in Hackney). Many of the purchasers of property in London are non-residents, so the market is international.

This brief analysis shows how the forces of demand and supply impact upon the price of houses, and that these forces have myriad effects. In addition to market forces, the housing market is a very political one and not immune to influence by the government. In the UK, the government has introduced two schemes which have had an effect on the housing market. The first, called Funding for Lending, was introduced in July 2012 and gave banks and building societies access to low-cost finance provided they lent it to small to medium-sized businesses or individuals. In December 2013 the Governor of the Bank of England announced that the scheme would be refocused on business from January 2014 as much of the finance had gone to individuals in the form of mortgages. Another scheme, called Help to Buy, was introduced in April 2013 and gave help to buyers of new properties. Both of these were introduced to get the housing market moving and help the economy but some fear it may fuel another housing bubble.

From April 2014, banks and building societies will have to apply much tougher affordability checks on those they lend money to, to ensure that they can still make their repayments if the rate of interest goes up. Interestingly the Help to Buy scheme, which is designed to help buyers, has also impacted upon the supply side. New orders in the construction industry were up by 20 per cent in the April to June 2013 period compared with the previous three months. These now orders were held up by lack of skilled construction workers. There was also an increase of 49 per cent in planning approaches to local authorities between April and June.

Case study questions

1 What has happened to house prices since the writing of this case study? You should think about both demand and supply factors to answer this question.

2 The average price of houses in parts of Wales fell in 2013. What factors might have made this happen?

web link *www.nationwide.co.uk/hpi/www.lloydsbankinggroup.com/media1/economic_insight/halifax_house_price_index_page.asp*

Review and discussion questions

1 The mini case study on Venezuela discusses two opposing views of how the shortage of toilet rolls has arisen – because of excess demand or because of reduced supply. Show both of these on demand and supply diagrams. What possible solutions are there in each case?

2 Considering the market for CDs, show the effects of the following changes using demand and supply diagrams:

(a) an increase in the number of people owning CD players;
(b) a fall in the cost of producing CDs;
(c) an increase in the number of people downloading music to mobile devices.

3 Have the changes you predicted in your answers to question 2 actually happened in the real world? If not, why not?

Assignments

1 Your company produces heavy products that are transported by road and recent increases in the price of petrol have had to be passed onto the consumer. Investigate possible solutions for the company. (You should use demand and supply diagrams to illustrate your answer.)

2 You work in the marketing department of a company that produces light bulbs. The company is considering increasing the price of its light bulbs by 20 per cent. At present a 100-watt light bulb costs 80p. The only information available is a study carried out in the previous year on the sensitivity of sales to price, the results of which are shown below.

Price	*Sales (million)*
80p	5800
100p	4000

Write a report for your manager on the likely effects of the proposed price increase, explaining the concept of elasticity of demand and the factors that are likely to affect it for this product.

Notes and references

1 In such cases the demand curve would be upward sloping, indicating that as price rises, demand rises. Other examples include 'snob goods', which are consumed because of their price.

2 In the markets described in this chapter there is an automatic tendency for the market to move back towards equilibrium once it is disturbed. However, it is possible for the demand and supply curves to be so shaped that once the market is disturbed, it tends to move away from equilibrium rather than towards it. This is called the cobweb model. The interested reader should look at Lipsey and Chrystal (2011).

Further reading

Begg, D., Fischer, S. and Dornbusch, R., *Economics,* 10th edition, McGraw-Hill, 2011.

Griffiths, A. and Wall, S., *Applied Economics: An Introductory Course,* 12th edition, Financial Times/Prentice Hall, 2011.

Lipsey, R. and Chrystal, A., *Economics,* 12th edition, Oxford University Press, 2011.

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7 Managing change

Business organisations operate within a changing and often uncertain environment. To ensure that corporate resources are used effectively in pursuit of organisational objectives, firms ideally need to examine the external influences upon them and, where possible, to anticipate the nature and extent of environmental change. The study and practice of strategic management and decision-making have provided a number of useful approaches in this area and generated a variety of techniques for analysing the business environment. These techniques rely on the generation of data and information, much of which is in the public domain. Accessing this information has become significantly easier with improvements in computer technology and in collecting and collating material from both national and international sources.

Learning outcomes

Having read this chapter you should be able to:

- demonstrate the need to monitor the changing business environment
- explain broad approaches to environmental analysis
- analyse a range of qualitative and quantitative techniques used by business organisations as an aid to decision-making
- access a variety of national and international sources of information and data useful to both students and practitioners of business

Key terms

Brainstorming
Cross-impact matrix
Delphi method
Environmental analysis
Environmental scanning
LoNGPEST/LoNGPESTLE analysis
PESTLE analysis
Porter's five-forces model
Scenario planning
Strategic fit
Strategic management
SWOT (or TOWS) analysis
Trend extrapolation
Trend–impact analysis

Introduction

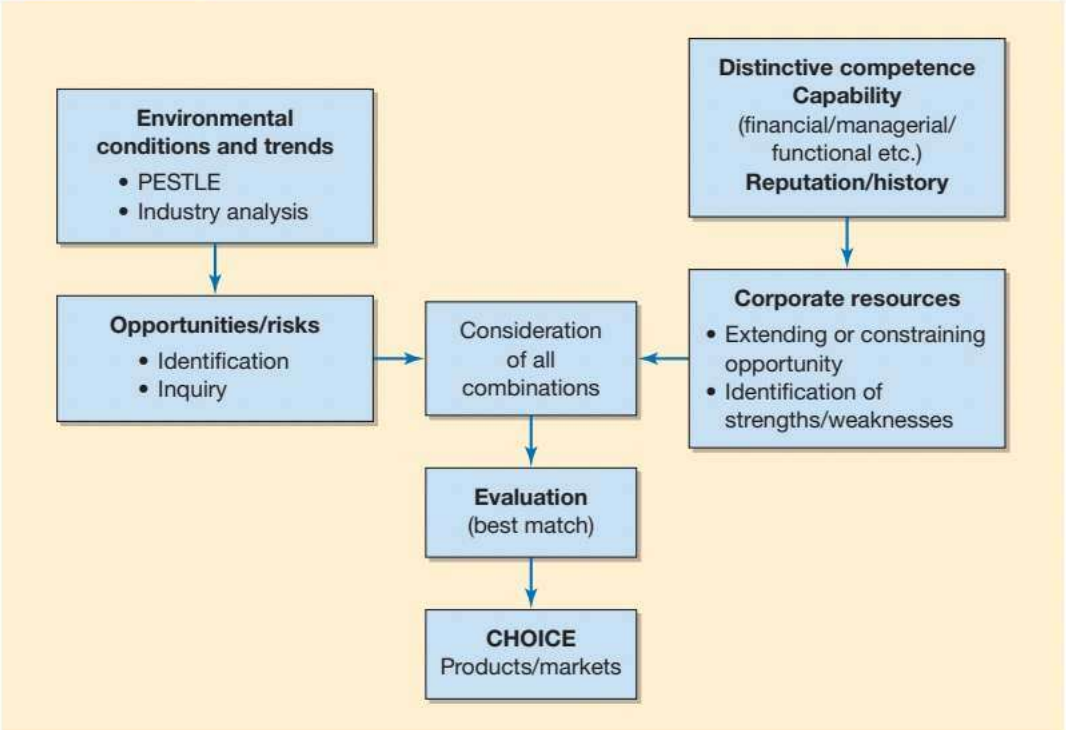
The purpose of strategy is to provide the future direction and objectives of the organisation and to identify and gather the resources necessary to achieve these objectives. A simplified and popular perspective of strategy views it as a series of chronological phases: strategic analysis, identification and selection of strategic choices and, finally, implementation. For many managers this begins with a consideration of the following questions:

- Where are we now?
- What is the situation we face?
- Where do we wish to be?
- Which factors in our environment may pose challenges or opportunities for us in the future?

Managers need to be keenly aware of their organisation's internal environment (where its strengths and weaknesses may lie), and also be able to diagnose their external environment. It can be argued that the successful strategies are those that best match the organisation's resources to the pressures and forces of the environment. In short, the organisation is seeking a **strategic fit** between the internal and external environments.

Kenneth Andrews, a Harvard professor acclaimed as one of the earliest and foremost thinkers in corporate strategy, believed that strategy could be prescribed and should adopt the structure shown in Figure 1 in its development and application within an organisation. This structure emphasises the importance of assessing environmental

Figure 1 Corporate strategy



Source: Adapted from Andrews, K. (1980) *The Concept of Corporate Strategy* © McGraw-Hill Education.

conditions and trends as a necessary first stage in the generation of organisational strategies. The external environment is examined with the objective of identifying opportunities and risks (commonly termed threats). At the same time, the organisation should also identify its strengths and weaknesses, which result from analysing its internal resources. The organisation may then bring together these two forms of analysis, external and internal, and seek to identify an optimal 'fit' or 'best match' between the two. This process led to the development of the popular SWOT tool, which we will explore later in this chapter.

The need to monitor environmental change

Every organisation, from the smallest sole trader to the largest multinational firm, whether public or private sector, ought ideally to continually monitor its environment in order to identify potential changes or the development of long-term trends that could affect the enterprise. For some organisations, the environment is likely to be relatively stable during the mid-term, as in the case of civil service departments, the emergency services and heavy manufacturing. That said, there will always exist the possibility of environmental shocks that can destabilise the status quo, such as acts of terrorism, financial scandals, environmental disasters and, more recently, the effects of the global financial crisis.

In other organisations and industries, the environment may prove to be far more turbulent. The retail sector, especially the fast moving consumer goods sector (FMCG) and consumer electronics, experiences continual innovation in product development that both shapes and reflects changing consumer demand patterns as well as increasing competition through the bewildering proliferation of product choices and condensing of product life cycles. The markets for mobile phones and portable MP3 players are just two such examples, and of course, technological developments and technology transfer now permit the boundaries of these previously distinct markets to become blurred.

The nature of the environment, or at least the way it may be perceived by each organisation in terms of stability versus dynamism, may then reflect the actions and efforts of organisations with regard to engaging in external analysis.

For organisations that perceive their environment as turbulent, the impetus for thorough and formal external analysis may be high and efforts towards such analysis might be afforded a prominent role in formulating strategies. This, however, is sometimes not sufficient. Some organisations may see their environment as so chaotic and complex that they simply do not know where to start or what to consider. With an absence of direction and clarity, organisations may inadvertently enter into a phase of soporific stupor or inertia. Alternatively, for many organisations undertaking external analysis may seem too resource intensive, in terms of money, time and people, and hence may not be an attractive proposition. The act of external analysis *per se* will not confer a competitive advantage for the organisation and therefore it can sometime become difficult to justify the initial resource commitment when the returns or rewards for doing so may be unknown or uncertain.

Equally, for organisations that may perceive their environment as relatively stable, the act of continual monitoring may seem inappropriate or even illogical. If the organisation believes that the external environment in the future is likely to share the same

or broadly similar characteristics as the environment it has operated within in the past, then there is little incentive to engage in external analysis.

This attitude can be likened to the simple parable of the 'boiled frog syndrome'. A frog that is placed into a pot of boiling water will immediately jump out. If the frog is placed into a tepid pot of water, it will sit there contentedly. If that pot is then slowly heated up, the frog will continue to stay in the water, until it becomes too late. The frog is unable to identify incremental changes in its environment, given that its internal apparatus is geared towards sensing sudden changes instead.

An example of this 'boiled frog syndrome' can be seen with the American giant car manufacturer General Motors (GM). In 1998, GM bought the Hummer brand name, and the off-road vehicle became an icon for GM during the early part of the millennium as it was favoured by the celebrity and Hollywood set, including high-publicity owners such as David Beckham and Governor of California and former movie star Arnold Schwarzenegger. With rising fuel prices and concern over its impact on the natural environment, the vehicle subsequently became increasingly unpopular and sales of the Hummer SUV fell dramatically. As a result, GM eventually decided to sell the brand, with China the likeliest destination. In February 2010, the company announced its intention of closing the Hummer plant after a deal to sell it to a Chinese manufacturer collapsed. The last Hummer rolled off the production line in May of that year, much to the delight of environmentalists.

Analysing the environment is therefore important for all organisations. To do nothing is at best foolish and at worst potentially disastrous.

Analysing the business environment: broad approaches

Environmental analysis is the process of scanning the environment to identify changes or trends that have the potential to generate opportunities and threats to the organisation's current or future intended strategies. The form and means by which this **environmental scanning** may be operationalised within an organisation will vary from firm to firm and can be undertaken informally or using quite sophisticated analytical tools and techniques that may require significant employment of an organisation's resources.

Informal scanning may take the form of getting information about, and from, the organisation's customers, suppliers, rivals, consultants and pressure groups. Such information from customers could, for instance, be gathered through questionnaires, sample interviewing or from feedback from the organisation's own sales and customer service staff. In retail, it is not uncommon for shop staff within a town or shopping centre to visit local rival stores and shops to get information about the prices being charged and promotional activities of competitors. All such informal activities, while relatively low cost to implement and generally lacking structure, should not be undervalued. While neither elaborate nor sophisticated, for smaller organisations especially, such informal techniques can provide necessary local market information.

An example of such informal scanning is where a local independent music store sends out a staff member from its small team at the beginning of each week to check up on the prices the large music chain retailers within the town are charging for popular CD albums. This ensures that the small independent record shop is able to price its products competitively and react quickly to any price changes or promotional activities by its competitors.

Many larger organisations, however, may prefer a more systematic and formal means for scanning and analysing the environment. In broad terms, these more deliberate approaches to environmental analysis tend to focus on the firm's societal and task environments.

As discussed in Chapter 1, the societal and general environment (often termed the macroenvironment) is typically analysed through the lens of **PESTLE** analysis, which focuses attention on political, economic, socio-cultural, technological, legal and environmental and/or ethical issues. A further development of this approach is the concept of **LoNGPEST** or **LoNGPESTLE**, which formally incorporates the spatial dimension into any analysis of an organisation's external environment. The basic argument is that any examination of the macroenvironmental influences on the firm needs to recognise that these can operate at all spatial levels: local (Lo), national (N), global (G). Hence the acronym LoNGPEST(LE). To take one example, a local business may be subject to political changes in its immediate vicinity (e.g. new by-laws on trading) and/or at the national level (e.g. changes to employment regulations) and/or at the global level (e.g. new agreed global standards on greenhouse gas emissions). The same approach can be adopted for all the other influences in an organisation's general environment.

At this point for the organisation a distinction can be drawn between environmental scanning and environmental analysis. The process of scanning is the identification of trends and changes, while analysis is the consideration of which trends and environmental changes will, or are likely to, impact on the organisation in terms of presenting new challenges and also opportunities. For example, a period of relatively high or rising interest rates may be of general concern, but it is how increases in interest rates may directly affect a firm's borrowing capacity, expansion or plans for further investment that is really of relevance to the organisation.

Mini case Multinational inward investment: a PESTLE analysis

In highly competitive markets businesses must be constantly alert to the challenges they face and ideally should attempt to gain some form of advantage over their main rivals. For some organisations this might mean investing in production and/or service facilities in other countries, either as a means of reducing costs (e.g. by exploiting cheaper sources of labour) or as a strategy for boosting demand (e.g. by developing new markets). Given that many industries could be described as 'footloose' (i.e. relatively free to locate anywhere), one key question facing organisational decision-makers is where to invest: what are the relative merits of one country over another? One way of beginning to answer this question is to undertake a PESTLE analysis in order to provide useful information about the broad macroenvironmental context against which the final decision has to be taken.

To illustrate how this might occur, the hypothetical example in this mini case looks at how a major car manufacturer considering investing in a new greenfield facility in eastern Europe might identify some of the key influences on the locational decision. Given that there is no definitive way in which to undertake an analysis of this kind, the approach adopted here is to highlight some of the key questions that are likely to be considered by those charged with the final decision on where to invest. For convenience these questions are presented in tabular form (Table 1). You should note that the allocation of questions

to categories can be a matter of personal choice (e.g. is a government tax law political or legal or economic?); the important point is that the questions are asked, not which category they go in.

As Table 1 illustrates, a PESTLE analysis can provide a valuable insight into some of the potential risks and uncertainties of a locational decision and can encourage corporate decision-makers to examine future as well as current circumstances in each of the alternative locations. By adding weightings to reflect the relative importance of the different factors to the final decision and building in some allowance for the perceived degree of risk, the analysis can become more sophisticated and hence a more useful tool that can be used by the organisation.

While it is likely that an approach of this kind will often be used negatively (i.e. to rule out certain locations), the fact that a particular country looks a less favourable location than the alternatives does not necessarily mean it will not be chosen. It could be, for example, that other factors weigh heavily in the final choice of location and that the PESTLE analysis has more influence on the level and nature of the investment undertaken (e.g. a joint venture might be seen as preferable to a direct commitment of funds) rather than where it occurs.

Table 1 Locating a car plant: a PESTLE approach

Political	*Economic*
• How stable is the government now and in the future? • Is the political regime favourable to foreign investment? • Is membership of the EU planned and likely in the near future?	• Is there a favourable economic framework within which to engage in business? • Is the economy likely to remain stable over the longer term? • Is there a favourable business infrastructure?
Social	*Technological*
• How will the structure of the population impact upon the demand for the product and/or the supply of labour? • Are economic conditions likely to provide increased market opportunities? • What skills currently exist within the labour force? • Are the welfare and educational systems supportive of the planned investment?	• What is the current state of technological advance? • Is technology transfer feasible? • Will the current (or future) infrastructure help or hinder the investment process? • What facilities exist for technological training?
Legal	*Ethical*
• Is the current legal framework likely to support or hinder business operations? • Do the current (or planned) employment laws provide an advantage or disadvantage to the business? • Do the current tax laws favour the organisation?	• Are the ethical standards in a chosen location likely to affect the operations of the business favourably or unfavourably and/or the company's image? • How will the organisation be affected by current (or planned) environmental standards and regulations?

Organisations can also analyse their task or competitive environment (frequently termed the microenvironment). Analysis of this kind focuses attention on external factors that are most proximal to the organisation, typically residing at the industry level. A number of models and frameworks have been designed that explore how industry-level factors influence organisational performance, with the best known being Harvard Professor Michael **Porter's five-forces model** (1980).

You will recall that Porter argued that average industry profitability and therefore organisational performance was predominantly determined by five key industry characteristics:

- the intensity of incumbent rivalry;
- the threat of new entrants;
- the threat of substitutes;
- the power of buyers;
- the power of suppliers.

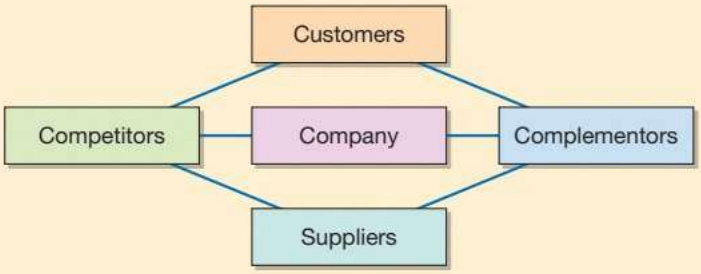
In very broad terms, the greater the power of each of these forces, the lower the profitability for competing organisations within the industry. The influence or power of each force will vary from industry to industry and therefore explains why some industries (e.g. pharmaceuticals) are inherently more profitable than others (e.g. airlines). An important additional component of Porter's work was his application of 'barriers to entry'. While barriers to entry was not a new concept, Porter used it to demonstrate how their existence would determine the extent to which the stability of average profitability could be maintained. With barriers to entry high, the threat of new entrants would remain low, while low barriers to entry would encourage new firms to enter the industry and increase the level of rivalry and therefore reduce profitability. These barriers to entry have already been described in the chapter on market structure, but what is of relevance here is to recognise that an organisation's external analysis should not just be restricted to the consideration of the five forces but also needs to incorporate environmental factors that might influence the height of these barriers to entry.

An example of this was in the United States during October 2001. During that month there had been a series of terrorist attacks using the US postal system to deliver letters containing anthrax spores to American citizens. The government, assuming the worst and unaware of the potential scale of the threat, wished to procure treatments for exposure to anthrax for up to 12 million people. Treatment against anthrax was a patented drug called ciprofloxacin, which was sold under the brand name Cipro by the German pharmaceutical firm Bayer. The US government had significant concerns as to Bayer's ability to supply such large volumes of Cipro in an extremely short period of time and at a relatively high cost. Congress indicated its intention to disregard Bayer's patent and buy ciprofloxacin cheaper elsewhere. After a series of talks between US officials and Bayer, the pharmaceutical firm eventually maintained its patent but had to agree to a reduction in the contracted price from $1.83 to less than $1 a tablet.

The five-forces framework remains perhaps the most influential method for analysing an industry and understanding a firm's performance. Underpinning the framework is an acceptance that value and, ultimately, profit are distributed between these five forces, and the extent to which the firm can capture an increasing share of the profit is determined by its ability to reduce the power of these forces. Inherent within the framework is the notion that relationships between the five forces are competitive, with all organisations competing in what may be considered a 'zero-sum' game.

While the five-forces framework therefore provides a useful means of exploring industry characteristics, it has not been beyond criticism. Brandenburger and Nalebuff, for example, in 1995 introduced their 'value net' framework. In many ways it is similar to Porter's five forces, in that it also identifies competitors, suppliers and customers as key industry characteristics, but it introduced a further component, that of 'complementors' (see Figure 2).

Figure 2 The concept of complementors



Source: Adapted from Brandenburger, A. and Nalebuff, B. (1995) 'The right game: use game theory to shape strategy', *Harvard Business Review*, July–August, pp. 57–71.

For Brandenburger and Nalebuff, competing firms could also at times be complementors and in so doing could further add value (and, ultimately, profitability) to the industry. They argued that a complementor existed if the customer were to value an organisation's product more when they had another organisation's product. This has led to a popular view that the five-forces framework should be extended to incorporate a sixth force, that of complementors. In short, in undertaking external analysis an organisation will need to consider both competition and cooperation, which have become known by the portmanteau term 'co-opetition'.

Techniques

Organisations may employ a range of techniques to assist them in analysing the external environment. Some of these techniques use statistical measures, such as the various forms of trend extrapolation and cross-impact matrices, while others, such as Delphi methods and scenario planning, use qualitative or narrative assessments. Some techniques for external analysis seek to predict likely future states or identify relationships between external variables, while others strive to illuminate possible future states. Furthermore, each tool presented below often focuses on different future time frames.

The value of the techniques will vary from organisation to organisation, and there is no hierarchy in terms of their quality. Each technique that will be explored within this chapter has both strengths and limitations. These methods of external analysis should not be considered as surrogates for each other, but rather on whether the merits of a particular technique or techniques can help illuminate understanding of the external environment and aid the organisation in its identification of environmental opportunities and threats. The various techniques presented here also have differing resource requirements in terms of cost, labour and time, and therefore the organisation needs to find a balance between its desire for understanding and gaining insight into the environment and its willingness to commit resources to achieve such understanding. There is also the danger of paralysis – achieved through analysis. The organisation can never gain a complete appreciation of all external issues, and nor should it attempt to. Analysis by itself has value only once it is acted upon by the organisation in terms of designing new strategies to either take advantage of opportunities or mitigate environmental threats.

A well-thought-through and considered strategy is desirable, but one that is well thought through, considered and implemented before those of the organisation's rivals is preferable.

web link

If you would like more details of the various techniques referred to in this section (e.g. SWOT, the cross-impact matrix, the Delphi technique), try typing these terms into a search engine.

Trend extrapolation

As its name suggests, **trend extrapolation** is essentially a technique for predicting the future based on an analysis of the past. Implicit in this is the assumption that, in the short run at least, most factors tend to remain fairly constant and critical changes in the key variables are unlikely to occur. Accordingly, extending present trends into the future is seen as a useful means of anticipating forthcoming events and tends to be one of the techniques most frequently used by business organisations seeking a relatively simple and inexpensive means of forecasting.

At its simplest level, trend analysis tends to be used to predict changes over time (e.g. in the likely demand for a product), a process which can sometimes prove relatively accurate where there are sufficient historical data to allow seasonal and cyclical fluctuations to be taken into consideration. The analysis can also be refined to examine an observed relationship between one factor (e.g. sales) and another (e.g. levels of disposable income) and can even be extended to the simultaneous consideration of several variables felt to influence the subject under consideration (e.g. by using multiple regression techniques). Techniques also exist to investigate causal or explanatory factors that link two or more time series (e.g. statistical modelling techniques) and to consider the likely impact on forecasted trends of a range of factors, identified by analysts as likely both to occur and to have an effect on the predicted outcome. The latter technique is generally known as **trend–impact analysis** and is sometimes used by large companies in conjunction with other methods of forecasting, including the Delphi approach and opinion canvassing (see below).

The fundamental drawback in the use of trend analysis as a forecasting tool is that there is no guarantee that the trends identified from historic patterns will continue in the future; sudden discontinuities – such as the United Kingdom's decision to leave the ERM in the 1990s – can invalidate or undermine the existing assumptions on which a trend was predicted. In a majority of cases, trends are based on a series of patterns or relationships among a wide range of variables, a change in any one of which can drastically alter the future course of events. These variables are not always easy to identify and the interactions between them are not necessarily fully understood. Attempts to link a simple cause with a simple effect run the danger of underestimating the complexities of the business environment.

Scenario planning

Scenario planning is about undertaking a disciplined method for imagining and examining possible futures. It is not an attempt to predict the future and indeed it would be typical for an organisation to generate between two and four generically different possible

futures as an outcome of the scenario planning process. This technique often focuses on 'best case' and 'worst case' scenarios, although Royal Dutch Shell – the company most renowned for the use of scenario planning as a core component of its environmental analysis activities for more than 30 years – has in its recent scenarios often expressed a preference for one particular scenario case (see the case study at the end of this chapter).

Scenario planning as a strategic tool can be traced back to the Rand Corporation in the early 1960s, and is often associated with the work of one of its employees, physicist and mathematician Herman Kahn. At the time of his research, the Cold War between the United States and the Soviet Union was at its peak. In 1962, the Cuban Missile Crisis brought the two Cold War superpowers perhaps within only a matter of days of nuclear war, when US air force reconnaissance planes took aerial photographs of Soviet installations of nuclear bases on the island of Cuba, which would provide a direct nuclear threat to American soil.

Herman Kahn, in conjunction with the Rand Corporation, in 1962 presented his text entitled 'On thermonuclear war', which argued against common views at the time that 'mutually assured destruction' would happen in a nuclear war. Instead, Kahn presented the view that, as with any other form of warfare, a nuclear war could be ultimately winnable and his text identified a range of scenarios by which this might be possible.

In business organisations, scenario planning seeks to consider the possible effects of, and interactions between, various external environmental forces on the future and to test the resiliency of specific strategies that the organisation may be considering, in such a scenario. Typically, scenario planning is most relevant to large organisations, as it is a resource-intensive technique and is most commonly found in industries considered to have highly dynamic, complex and uncertain environments and/or those industries that require heavy forward investment (e.g. energy companies).

The process of scenario planning normally begins with the organisation considering which key environmental trends to consider, and over what time period. Royal Dutch Shell has historically published scenarios on a three- to four-year cycle, projecting 20–25 years ahead. Its most recent scenarios consider the possible nature of global energy markets in the mid to late twenty-first century. General consensus, however, suggests that scenarios should ideally be looking at least ten years ahead. Once the key trends have been identified, organisational focus then moves to considering what external forces or developments are likely to have the greatest ability to shape the future, which could include such factors as regulatory policy and corporate social responsibility.

Mini case Bucking the trend

In April 2013, the bargain clothing retailer Primark – which is owned by Associated British Foods – announced a 24 per cent increase in sales and a 56 per cent rise in operating profits, figures that ran counter to the general gloom being felt by most high-street big brands. Unlike its rivals, which were moving towards multi-channel sales, smartphone apps and click-and-collect services, Primark's preferred strategy was to focus on the high street rather than the internet, opening new and bigger stores and investing in floor space in the form of upgrades and expansions. In the six months prior to its announcement, the company had opened 15 new stores (6 in Spain, 4 in the UK, 2 in Germany, 2 in Austria and 1 in the Netherlands) and was about to make its first foray

into the French market by the end of the year. It was also looking at other potential sites across all regions of the UK to add to its portfolio of more than 250 stores.

It is interesting to note that while retailers such as Tesco, B&Q and Debenhams have all predicted that future stores are likely to become smaller as shoppers turn to online retailing, Primark is heading in the opposite direction, increasing the size of its high street outlets. The company believes that many shoppers still like to experience purchasing their fashion items on the spot, rather than engaging in virtual browsing. Emulating its competitors' strategy, at least for the moment, does not appear to be on the agenda.

web link

Information on Primark is available at *www.primark.com*; its parent company's web address is *www.abf.co.uk*

Expert opinion: the Delphi method

To predict future developments or to build likely scenarios, some organisations turn to experts, an increasing number of whom work as consultants. These experts often operate as a group to produce an analysis which is presented to management in the form of a report or which emanates from a discursive technique known as **brainstorming**. Alternatively, the organisation may prefer to canvass the views of an anonymous panel of experts, using a technique known as the **Delphi method**, which was originally developed by the Rank Corporation in the United States to forecast likely military events.

In essence, the Delphi approach involves eliciting opinions from a group of experts who operate individually, and anonymously, unaware of the other members of the group. Each expert is asked to respond to an initial set of questions and the answers are clarified and tabulated by a neutral investigator, who uses them to generate a more refined set of questions that are then put to the experts. Following their replies, further revisions may occur and the respondents may be asked again to provide another set of predictions that take into account the information provided in the earlier replies. This process may continue for several rounds until a measure of convergence occurs between the views of the panel and a form of consensus is reached on likely future developments.

As a technique the Delphi method tends to be expensive and time-consuming and there is no guarantee that a clear view will emerge. It can, however, be used to investigate any aspect of a firm's environment and to identify not only the effects of predicted changes but also their causes, and this information may be incorporated into other forms of environmental analysis of both a qualitative and quantitative kind.

Cross-impact matrices

The **cross-impact matrix** provides a more complex means of assessing and forecasting environmental change than some of the other methods previously described. Under this approach, analysts identify a set of events that is forecast to occur within a given time period, and specify not only the expected timing of each event but also its probability of occurrence. Arranging these events in anticipated chronological order in rows

Figure 3 A simple cross-impact matrix

Probability and timing	Event 1	Event 2	Event 3	Event 4	Event 5
Event 1 (probability/ timing)					
Event 2 (probability/ timing)					
Event 3 (probability/ timing)					
Event 4 (probability/ timing)					
Event 5 (probability/ timing)					

and columns of a matrix (see Figure 3) permits attention to be focused on the interaction between the events and, in particular, on the extent to which one may influence the timing or likely occurrence of another.

As a means of predicting likely interactions between anticipated future developments, cross-impact analysis serves at least two significant purposes. First, it can be used to check the consistency of the various forecasts which go into it – such as the prediction of events and their relationships – given that inconsistencies will become apparent from an analysis of the results. Second, it provides a means of identifying events and trends that will have the greatest impact on subsequent developments, whether they be in individual segments of the environment or across a range of segments, as in the case of interactions between economic, technological, social and political factors.

Review and discussion questions

1 Discuss the costs and benefits to businesses of the introduction of a system for monitoring and analysing the changing external environment in which they operate.

2 To what extent do you agree with the proposition that only large firms should or can make use of the various techniques of environmental analysis?

Further reading

Brandenburger, A. and Nalebuff, B., 'The right game: use game theory to shape strategy', *Harvard Business Review,* July–August, 1995, pp. 57–71.

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Worthington, I., Britton, C. and Rees, A., *Business Economics: Blending Theory and Practice,* 2nd edition, Financial Times/Prentice Hall, 2005, esp. Chapter 15.

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8 SWOT analysis frameworks

Business organisations operate within a changing and often uncertain environment. To ensure that corporate resources are used effectively in pursuit of organisational objectives, firms ideally need to examine the external influences upon them and, where possible, to anticipate the nature and extent of environmental change. The study and practice of strategic management and decision-making have provided a number of useful approaches in this area and generated a variety of techniques for analysing the business environment. These techniques rely on the generation of data and information, much of which is in the public domain. Accessing this information has become significantly easier with improvements in computer technology and in collecting and collating material from both national and international sources.

Learning outcomes

Having read this chapter you should be able to:

- demonstrate the need to monitor the changing business environment
- explain broad approaches to environmental analysis
- analyse a range of qualitative and quantitative techniques used by business organisations as an aid to decision-making
- access a variety of national and international sources of information and data useful to both students and practitioners of business

Key terms

Brainstorming
Cross-impact matrix
Delphi method
Environmental analysis
Environmental scanning
LoNGPEST/LoNGPESTLE analysis
PESTLE analysis
Porter's five-forces model
Scenario planning
Strategic fit
Strategic management
SWOT (or TOWS) analysis
Trend extrapolation
Trend–impact analysis

SWOT or TOWS analysis

It is widely accepted that corporate performance is influenced by a combination of internal and external factors. These factors can be characterised as the organisation's internal 'strengths' and 'weaknesses' and its external 'opportunities' and 'threats'. Systematically analysing these factors as an aid to strategic decision-making represents a form of situational analysis known commonly by the acronym **SWOT** (or **TOWS**).

The starting point for a SWOT analysis is usually a review of the organisation's internal strengths and weaknesses, which may be undertaken by management or by external consultants brought in to provide a more objective view. The identified factors may then be given scores to indicate their importance, with the more significant issues receiving a larger score. This process is then repeated for the firm's external opportunities and threats in order to highlight those external factors that are likely to occur and are expected to have an impact on the organisation's future position. The resultant SWOT grid can then be used to focus attention on the key environmental influences faced by the organisation and to consider how far current strategy is relevant to the changes taking place in the business environment.

It is worth pointing out that the analysis of opportunities and threats cannot be absolute, since what might at first appear to be an opportunity may not be so when viewed against the organisation's resources or its culture or the expectations of its stakeholders.

Figure 1 A SWOT matrix

INTERNAL ASPECTS / EXTERNAL ASPECTS	**Strengths (S)** List major organisational strengths (e.g. quality products)	**Weaknesses (W)** List major organisational weaknesses (e.g. poor distribution)
Opportunities (O) List major organisational opportunities (e.g. new markets)	**SO strategies**	**WO strategies**
Threats (T) List major organisational threats (e.g. competition)	**ST strategies**	**WT strategies**

Moreover, the true value of the SWOT approach lies not in the listing of influences but in their contribution to the formulation of appropriate organisation strategies. One means of focusing attention on the latter is to produce a SWOT (TOWS) matrix, which matches the firm's opportunities and threats against its internal strengths and weak-nesses (see Figure 1). The result is four sets of possible strategic alternatives – termed SO, ST, WO and WT strategies – which range from the positive exploitation of strengths in order to take advantage of opportunities to the essentially defensive strategy of minimising weaknesses and avoiding anticipated threats.

Limitations to environmental analysis

The techniques described above represent some of the ways in which organisations can examine the changing business environment in an attempt to understand what changes are likely to occur, how these may affect the organisation and what responses would be appropriate in the circumstances. In short, the value of such analysis lies not only in the information provided but also in the process of gathering and evaluating it and in applying it to the task of **strategic management**.

Despite its potential value as a tool of decision-making, environmental analysis is not without its limitations and these need to be taken into account. For a start, analysing the business environment is not a precise science and does not eliminate uncertainty for an organisation, caused, for instance, by unanticipated events which do not follow the normal pattern. Nor should it be regarded by managers as a means of foretelling the future, allowing them to avoid their responsibilities as strategic planners and decision-makers by blaming problems on a deficiency in the application of a particular technique or on inaccuracies in the data provided.

Added to this, environmental analysis of itself is by no means a guarantee of organisational effectiveness, and can sometimes complicate the decision-making process by providing information that calls into question the intuitive feeling of experienced managers. The danger is that the analysis may become an end in itself and may obscure information and data coming from other sources, rather than being used in conjunction with them. As a consequence, its value in strategic thinking and strategic decision-making may not be exploited to its full potential and this may represent a lost opportunity to the organisation, as well as an inefficient and ineffective use of resources.

Sources of information

Researching the business environment can be a daunting task, given the extensive amount of information and statistical data available. To help in this direction the final section of this chapter outlines some of the key national and international information sources which are readily accessible to both students and businesses. While the list is by no means exhaustive, it gives a good indication of the wide range of assistance available to researchers and of the different formats in which information is published by government and non-government sources for different purposes. There has been a decided

move away from publishing statistical data in print, although the print format is not yet completely redundant. The internet is an invaluable resource and is now usually the starting point for anyone needing business information.

Statistical sources

Statistical information is an important component of business research and students need to be aware of what is available, particularly as some data turn up in the most unexpected places. Key guides in locating statistical information are:

1 *National Statistics – the official UK statistics site,* a portal to UK officially produced statistics. The Office for National Statistics is the UK national statistics institute responsible for collating and disseminating government statistics. Most information is available online as downloadable datasets (*www.ons.gov.uk*). Data is disseminated in publications (discussed below) and can be browsed in the Publications Hub (*www.statistics.gov.uk*); this can be an easier way to access the vast amount of data produced by, and for, the UK government.
2 The *World Directory of Business Information Sources,* published by Euromonitor, now in its second edition. A two-volume set listing 22,000 providers of business information across a range of industries in 82 countries, this is a useful guide for hard-to-find, obscure business data.
3 Business information on the internet. A gateway maintained by Karen Blakeman, including links to websites covering most aspects of business (see *www.rba.co.uk/sources/index.htm*).

Some of the main statistical sources are discussed below:

1 *Annual Abstract of Statistics*. Published by the ONS, this is an authoritative source of official statistics arranged under various headings, which include population, production, energy, transport, trade and public services. Figures usually cover a ten-year period and are presented in tabulated form. There is a detailed alphabetical index at the end. It is available to download at no charge from the National Statistics website (*www.statistics.gov.uk*).
2 *Consumer Europe*. Produced by Euromonitor, Consumer Europe is a pan-European source of marketing statistics, with the emphasis on consumer goods and consumer trends. The information pertains to market sizes for consumer products in 27 countries for the previous 6 years and includes predictions on future levels of consumption.
3 *Datastream*. A finance and economics online database, produced by Thomson Reuters. Accounts for public companies around the world, as well as share prices and stock market indices, are available. The economics databases cover a vast range of current and historical international economic series, including money supply, inflation and interest rates for 150 countries. Data are taken from many statistical sources, including OECD and the UK government, central banks and unofficial statistical sources.
4 *United Nations Economic Commission for Europe (UNECE)*. Another source of European economic data can be found on the UNECE website (*www.unece.org/stats/stats_h.html*). Data on national accounts, labour figures, gender and transport statistics can be accessed for individual countries and compared with other European, North American or central Asian countries.

5 *Economic Review*. Since January 2012 the *Economic & Labour Market Review* has divided to become the *Economic Review* and *Labour Market Statistics*. Both are monthly releases by the ONS and a key guide to the current economic indicators (e.g. prices, unemployment, trade interest rates and exchange rates) and labour market data.

6 *Economist Intelligence Unit*. Reviewing the business environment for selected countries, the EIU produces Country Reports for around 195 countries. Demographic data, risk analysis, political, regulatory and economic indicators, forecasts and analysis are given. More in-depth analysis is provided on a subscription basis. This is a useful online resource for PEST/PRESTCOM analysis (see *www.eiu.com*).

7 *Employment and Social Developments in Europe*. Combining the Social Situation Report and the Employment in Europe report, this publication contains an excellent overview of employment issues in Europe. Published annually online by the European Commission (see *http://ec.europa.eu/social/home.jsp*).

8 *Europa World Year Book*. A Routledge publication available in print and online. An annual publication covering political and economic information in more than 250 countries, not just European countries as the title suggests (see *www.europaworld.com/pub*).

9 *Europe in Figures: Eurostat Yearbook*. A comprehensive and useful introduction to statistical data on the European Union and its member states. The yearbook is also a useful alternative if you are overwhelmed by the Eurostat website. Background data and more than 500 statistical tables, graphs and maps are presented. Areas covered include the economy, education, the labour market, industry and services, international trade, transport and the environment. The yearbook is available online only and is free to download from the Eurostat website (*http://epp.eurostat.ec.europa.eu*) where the most up-to-date statistical tables can also be found.

10 *European Marketing Data and Statistics*. An annual publication by Euromonitor providing statistical information on the countries of western and eastern Europe. The data cover a wide range of market aspects – including demographic trends, economic indicators, trade, consumer expenditure, retailing – and often show trends over a 30-year period. The information is provided primarily in a spreadsheet format and there is an alphabetical index.

11 *Family Spending*. The Living Costs and Food Survey (LCF) is conducted annually by the Office for National Statistics. Primarily collecting information on expenditure of goods and services for private households, the survey also captures data about the income of household members. It also collects specialist food data, which is used and sponsored by the Department for Environment, Food and Rural Affairs (DEFRA). The results of the survey form the ONS annual publication 'Family Spending', available online (*www.ons.gov.uk*). The LCF is primarily used to provide information for the Retail Prices Index. Historically in 2008 the Expenditure and Food Survey became part of the Integrated Household Survey (IHS), which itself was renamed as the Living Costs and Food Survey. Much of the General Household Survey was integrated into the IHS after its cessation in January 2012.

12 *International Marketing Data and Statistics (IMDAS)*. An international compendium of statistical information on the Americas, Asia, Africa and Oceania, published annually by Euromonitor. Information on demographics, economic trends, finance, trade, consumer expenditure and many other areas usually covers a 30-year trend period, and an alphabetical index is provided (see *www.euromonitor.com*).

13 *Annual Survey of Hours and Earnings*. Replacing the *New Earnings* Survey in 2004, ASHE presents detailed data in tables on earnings and hours paid for employees within industries, occupations and regions. It is free to download from the ONS website (*www.statistics.gov.uk*).

14 *United Kingdom National Accounts*. Also known as the 'Blue Book', this annual ONS publication contains data on domestic and national output, income and expenditure, and includes a sector-by-sector analysis. Figures often cover ten years or more and an alphabetical index is provided. Best accessed through the Publications Hub if the whole publication is to be viewed (see *www.statistics.gov.uk*).

15 *OECD Economic Outlook*. A bi-annual assessment of economic trends, policies and prospects in OECD and non-member countries, the Outlook includes articles as well as figures, tables, charts and short-term projections, and looks at developments on a country-by-country basis. Available for subscribers to download or alternatively free to read online on the internet.

16 *OECD Economic Surveys*. Surveys are presented as country reviews containing comprehensive analysis of developments in the subject country, along with individual chapters covering key economic challenges being faced and recommendations for dealing with the challenges. The member country reviews are updated every 18 months, while non-member reviews are done on an ad-hoc basis. Available for subscribers to download or alternatively free to read online on the internet.

17 *Regional Trends*. An annual ONS publication providing a wide range of information on social, demographic and economic aspects of the UK's standard planning regions, together with some data on the sub-regions and on the EU. The guide includes a subject index. Available on the internet via *www.statistics.gov.uk*.

18 *Social Trends*. Another annual ONS publication, in this case looking at different aspects of British society, including population, education, environment, housing, leisure and transport. It provides a more detailed analysis of data produced for the Annual Abstract of Statistics and includes a large number of charts and diagrams. Information often spans a 15–20-year period and an alphabetical subject index is included. Available on the internet via *www.statistics.gov.uk*

19 *United Kingdom Balance of Payments*. Known as the 'Pink Book'. It is a comprehensive guide to the UK's external trade performance and contains a wide range of statistics covering a ten-year period. Available on the ONS website (see *www.ons.gov.uk*).

20 *United Nations Statistical Yearbook*. Written in both English and French, the Yearbook is a detailed international comparative analysis of UN member countries. Data cover a wide variety of topics, including international finance, transport and communications, population, trade and wages, and a World Statistical Summary is provided at the beginning. Particularly helpful if finding the statistics section of the UN website overwhelming. More useful to look at historical trends and data rather than the latest statistics. Available to purchase in print, chapters are also available to view online (see *http://unstats.un.org/unsd/syb/default.htm*).

21 *World Economic Outlook*. Usually published twice a year by the International Monetary Fund (IMF); the focus is on the analysis and projections of global economic developments in the short and medium terms. It also considers current world economic policy issues. It is available in print and also as a free download from the IMF website (*www.imf.org*), where other useful statistics can be found, including the World Economic Outlook interactive database.

Other useful statistical sources

1 Most government departments publish statistics on their own websites. Of particular interest are:
   (a) *Department for Business, Innovation and Skills*. This is the government department to peruse for statistics on a wide variety of information, including SME statistics, UK competitiveness indicators, construction and energy statistics and regional data, such as economic performance indicators. The Statistics tab gives access to this data (see *www.gov.uk/government/organisations/department-for-business-innovation-skills*).
   (b) *HM Treasury*. HM Treasury has control over public spending, setting the direction of the UK's economic policy. It is the government economic and finance department and a good source of statistics on the UK economy, freely accessible from its website (see *www.gov.uk/government/organisations/hm-treasury*).
2 *Eurostat*. The Statistical Office of the European Communities (Eurostat) is responsible for producing data for the European Union. There are numerous links to information on areas including general and regional statistics, demography, economic development and trade statistics. All are available to view on the Eurostat website (*http://epp.eurostat.ec.europa.eu*).
3 *UK Data Archive*. The UK Data Archive (University of Essex) is a specialist national resource containing the largest collection of accessible data in the social sciences and humanities in the UK. Most universities are members of the UK Access Management Federation (UKAMF), meaning students and staff gain free access to the data after completing a short registration form; other users must register. Some data, including UK census and international databanks, can be used only by HE/FE authenticated users (see *www.data-archive.ac.uk*).
4 *Bank of England*. For the very latest information on the UK interest rates and inflation the Bank of England website is invaluable (*www.bankofengland.co.uk*). Other financial data are available as well as full text publications on surveys and working papers.
5 Sources of further information. By selecting a gateway site, you will often find links to just the information you need much more quickly than by simply using Google.
   (a) *Useful UK Statistics sites from the University of Glasgow Library*. Very thorough summary (see *www.gla.ac.uk/services/library/collections/mapsofficialpublicationsandstatisticsunit/statisticscollection/internetsitesforstatistics*).
   (b) *Business information on the internet*. A gateway maintained by Karen Blakeman, including links to websites covering most aspects of business (see *www.rba.co.uk/sources/index.htm*).

Information sources

Information on the different aspects of the business environment can be found in a variety of sources, including books, newspapers and periodicals. These often provide a wealth of contemporary data and commentary which can be located relatively easily in most cases, using specialist databases designed to assist the researcher. While an increasing amount of information is available on the internet, the fastest and most reliable way

of finding what you want tends to be to use newspapers and magazines, which are often available electronically.

In the last few years more and more abstracting databases have moved over to the Web and now also offer the full text of articles, thereby reducing the amount of time it takes to research a topic. ProQuest (see below) can be used to trace information, but there are other alternatives (e.g. LexisLibrary). It is even possible to customise your business databases to cover the most popular titles in a particular library. But remember, the situation tends to change on a regular basis, so you need to keep up to date. Some key sources in this area are discussed below:

1 *RDS Business Suite*. Covers worldwide trade and business news, sourcing information from journals, national and international newspapers and industry newsletters. Useful when searching for broad profiling information about companies or industries. It is available as an online subscription database.
2 *Ebsco*. Has a range of business databases, including the Business Source range that offers full text articles and abstracts in the areas of business, economics and management.
3 *Emerald*. An internet version of all the journals published by MCB University Press; includes some keys titles like the *European Journal of Marketing*. Also includes abstracts from many other journals in the Emerald reviews section.
4 *FT.com*. Online subscription database combining a rolling archive of the *Financial Times* and *Europe Intelligence Wire*. Especially good for European financial and economic news, it is a good starting point when researching current events.
5 *ProQuest*. Has a series of databases useful for business students. Particularly noteworthy is ABI/Inform Global. ProQuest databases are noted for the quality of their abstracting and information retrieval.

Other useful sources

1 *Bank of England Quarterly Bulletin*. An assessment of economic developments in the UK and the rest of the world. It includes articles and speeches, together with general commentary on the economy, and is available from the Bank of England website (*www.bankofengland.co.uk*).
2 *Bank reviews*. Quarterly publications by some of the leading clearing banks and often available free on request. These include the *Lloyds Bank UK Economic Quarterly Bulletin*.
3 *CBI Business Surveys*. The CBI states that its quarterly surveys are the longest-running UK private sector qualitative business tendency surveys, the first being in 1958. The surveys are a comprehensive look at industrial trends, service sector, financial services, distributive trades and investment intentions. They provide a useful insight into business prospects and an indicator to future changes. They are available in full on a subscription basis, but the key findings are available on the CBI website (see *www.cbi.org.uk/business-issues/economic-intelligence*).
4 *Company Annual Reports*. An annual report is a description of a company's activities and financial performance for a particular period of time, usually the previous calendar year. Libraries used to hold vast collections of print annual reports, but since the Companies Act 2006 allows for the provision of an electronic rather

than printed report, accessing them online has become the norm. For those conducting historical research, The Guildhall Library, City of London (see *www.cityoflondon.gov.uk/things-to-do/visiting-the-city/archives-and-city-history/guildhall-library/Pages/default.aspx*) holds a range of historical business sources, including annual reports of companies listed on the London Stock Exchange 1880–1965. For current annual reports there are various options. First, the company's own website should be consulted; second, various databases such as Mergent Online and Proquest's ABI/Inform Global contain annual reports to browse; finally, online directories compile annual reports for perusal in one accessible place. Three such services are recommended:

(a) *Annual Reports.com* offers free access to companies listed on UK and US stock exchanges. Companies are searchable by exchange, industry sector or company name. Though you are unlikely to find some of the more obscure, unlisted companies, this is still a useful resource (*www.annualreports.com*).

(b) *Financial Times Company Content Hub*. The Company Content Hub is an interactive tool from FT.com that allows you to search for UK and global companies by country, sector, exchange or company name. Where available, an archive of annual reports is offered along with interim reports. Older annual reports can sometimes be difficult to find on company websites, making this feature particularly useful (*http://markets.ft.com/research/Markets/Company-Content*). Basic information is also given about the company as well as the major shareholders, details of directors and forecasts.

(c) *The Annual Reports Service*. London Stock Exchange listed companies are presented in an alphabetical list or by industry. Compiled by PrecisionIR, they will deliver small numbers by post or forward electronic reports to a supplied email (*www.orderannualreports.com*).

5 *Wright Investors' Service*. This site includes information on 31,000 companies in more than 50 countries. The information provided is just a 'snapshot' but is current and is usually sufficient to form the basis of a company profile (see *www.wisi.com/ramainnew.htm*). The site includes *Corporate Information,* a subscription service with full reports on the listed companies, giving further details on industry sectors, economic data and country and regional-specific searches.

6 *Accountancy firms*. Many accountancy and audit firms produce their own reports and research, much of which is freely available from their websites. These can be written from a UK or global perspective covering the state of industry and any likely changes that may impact upon that industry. Three firms that produce particularly good reports and research are Ernst & Young (*www.ey.com*), PricewaterhouseCoopers (*www.pwc.com*) and Deloitte (*www.deloitte.com*). The reports are often categorised on their websites as industries, insights or issues.

7 *Newspaper Index*. A very useful website (*www.newspaperindex.com*) giving online access to newspapers from around the world. The main international quality newspapers are available here, as well as the Sunday papers. Where an English translated website is available, this is indicated.

8 *Income Data Services*. A regular series of studies and reports on pay and other labour-market issues (e.g. teamworking, child care, redundancy), containing valuable up-to-date information and some statistical analysis. Available on the internet via *www.incomesdata.co.uk*

9 *Key British Enterprises*. A multi-volume compendium from Dun & Bradstreet giving details of Britain's top 50,000 companies. Companies are listed alphabetically and are also indexed by trade, product and geographical location. Available in print and online (see *www.dnb.co.uk*).

10 *Kompass (United Kingdom)*. A multi-volume directory with details on companies including products and services, industrial trade names and employee numbers. The Kompass website (*www.kompass.com*) allows a product or company search in 66 countries worldwide. Basic information is free.

11 *Haymarket Media.* Haymarket Media produces a range of magazines on various aspects of the business environment, for example *Marketing* and *PR Week*. They are an accessible source of facts and articles presented in a journalistic style. Details available on the internet via *www.haymarket.com/home.aspx*

12 *Market research*. Market research reports cover market factors, trends, market share, the supply structure and consumer characteristics, and frequently include forecasts of future prospects. Sometimes dismissed by non-marketing students, these are very useful sources of information placing companies in their market context. Sometimes available freely online, most current market research is accessible only on a subscription basis. Major UK suppliers of market research include Mintel and Key Note; there are also providers of international market research including Euromonitor's Passport database.

13 *Retail Price Index – Headline Rate*. A site maintained by Devon County Council giving a table with the RPI (headline rate), month by month, for the last 40 years. Available to download as a spreadsheet at *www.devon.gov.uk/economyrpi.htm*

14 *The Economist*. A standard reference source published weekly and examining economic and political events throughout the world. It is an invaluable publication for business students and regularly contains features on specific business-related topics. It has a useful update on basic economic indicators. Available on the internet via *www.economist.co.uk* or *www.economist.com*

15 *WARC Advertising and Marketing Knowledge*. The World Advertising Research Center's Advertising and Marketing Knowledge database is a vast collection of case studies and articles from authoritative sources. It covers all areas of advertising, marketing and media activity. Available at *www.warc.com*

16 *Who Owns Whom*. An annual publication which identifies parent companies and their subsidiaries. It is a useful source of information for examining the pattern of corporate ownership in the UK. There is no size criteria for entry; however companies and organisations are included only if ownership is greater than 51 per cent by other companies or organisations. Companion volumes are also available covering other parts of the world. Available in print and online (see *www.dnb.co.uk*).

A final comment

When researching a business topic you are particularly recommended to use library catalogue sites, especially the British Library catalogue (*www.bl.uk*) and COPAC (*http://copac.ac.uk*), which is the combined catalogue of major British academic libraries. WorldCat (*www.worldcat.org*) is an integration of more than 10,000 library catalogues from across the world, so could be useful when searching for more obscure international business information. You might also want to check references on

internet bookshop sites such as Blackwell's (*http://bookshop.blackwell.co.uk*) or Amazon (*www.amazon.co.uk*). For older material AbeBooks (*www.abebooks.co.uk*) is useful as it specialises in older, out-of-print books.

Synopsis

As the chapter has demonstrated, there is a need for business organisations to monitor the environment in which they exist and operate and, where possible, to anticipate changes that are likely to affect the enterprise. Rather than being an optional extra, environmental analysis and scanning should be seen as an intrinsic part of strategic management and should ideally provide data and information that are used to guide the decision-making process. Many of these data and much of the information already exist in published form and/or can be easily gathered from both literary and electronic sources on a national and international basis. Analysing them is also possible, using a range of techniques which has been developed by businesses and academics over a considerable number of years.

Summary of key points

- A firm's business environment changes over time.
- Firms need to consider and anticipate potential changes in their general and operational environments in order to take advantage of opportunities and/or minimise possible threats.
- Environmental analysis should be seen as a key part of the strategic management process; ideally it should form part of the basis on which corporate decisions are taken.
- Such analysis can occur at both a societal level (e.g. through PESTLE analysis) and at a task level (e.g. through industry-based approaches) and can involve the use of a wide variety of established techniques.
- Key techniques include trend extrapolation, scenario planning, the Delphi approach, cross-impact matrices and SWOT analysis.
- In researching the business environment, students and practitioners can utilise a wide range of information sources, many of which are relatively inexpensive and readily accessible.
- Accessing this information has been made considerably easier with improvements in information technology, especially the internet.

Case study

Scenario planning at Shell

Royal Dutch Shell has utilised scenario planning as an integral part of its range of techniques for undertaking external analysis since the early 1970s. Its first scenarios were developed in 1972 and were narrow in scope, concentrating on forecasts for economic growth and the impacts of a discontinuity or shortage of supply of oil on prices. Until this point, both economic growth and oil supply had shown high levels of consistent and predictable growth, and Royal Dutch Shell was interested in exploring a 'what if' scenario should oil supply become destabilised. This scenario became realised in October 1974, following the Yom Kippur War and subsequent Arab oil embargo on supply of oil to the United States and supporting governments of the state of Israel.

The realisation of Shell's first scenarios acted as a powerful argument for the continued investment in scenario planning, and Shell has continued to produce scenarios, typically on a three-year cycle, to the present day.

Initially, Shell's scenarios tended to focus narrowly on economic perspectives of oil demand and supply over a relatively short time horizon (3–5 years). The scenarios were presented as 'in-house' publications only, having been produced by the organisation's own strategic analysts. As Shell's experience, willingness to invest increasing resources and scenario planning skills matured, the scenarios gradually became more complex and broader in scope, incorporating both geo-political and geo-societal trends. The decade of the 1980s was characterised by Shell as being driven by what it termed 'transition', trends that would see the end of the Cold War, the beginning of the collapse of the former Soviet bloc and increasing market liberalisation. The 1990s would be one of continuing liberalisation, underpinned by powerful forces for globalisation and technological innovation. So pervasive and dominant were these trends considered to be that Shell coined the expression 'TINA' (there is no alternative) to describe them.

In 2005, Shell introduced three new scenarios that were looking ahead to 2025. These scenarios questioned for the first time the assumptions of its 'TINA' trends. The scenarios published – named 'Open Doors', 'Low Trust Globalisation' and 'Flags' – suggested that there might be a break on globalisation and market liberalisation. Shell drew upon the events of 9–11 and the financial scandal of Enron as examples of geo-political crises of security and trust. These environmental shocks could foreshadow a period of slowing international trade, as governments became more protective in their policies towards their own domestic industries and, specifically, energy resources. Additionally, there would be increased pressure on all organisations to be far more transparent and accountable towards society in all their business activities and disclosure of performance.

In early 2008, Shell published further scenarios, which looked at plausible future developments in global energy markets up to 2050. In the foreword of its published report, Shell's Chief Executive, Jeroen van der Veer stated:

'Never before has humanity faced such a challenging outlook for energy and the planet. This can be summed up in five words: "more energy, less carbon dioxide."'

The company identified three key trends that were likely to significantly alter the energy landscape. It termed these its 'three hard truths':

- There will be a surge in energy demand (global requirements are predicted to double by 2050), especially resulting from the growth in economic activity from both China and India.
- Traditional energy sources are struggling to keep up with demand.
- Current and future projected uses of energy will continue to raise carbon dioxide emissions and other greenhouse gases, with adverse effects on the environment.

Given the above trends – which when compared can be seen to create obvious tensions – Shell characterised the possible future energy landscape as 'TANIA' (there are no ideal answers).

From these trends, two scenarios were developed, one entitled 'Scramble', the other 'Blueprints'.

In the scenario of 'Scramble', Shell suggested that events will continue to outpace action. For the next decade, people from all walks of life will join the debate about energy and climate change, but for governments, security of energy supply and fears of

losing economic ground will shape decision-making and policy. The primary focus will be on meeting the needs of global demand and there will be little in the way of consideration of investing in more efficient means of providing energy until traditional sources become critically depleted. In a 'Scramble' future, focus on addressing greenhouse gas emissions would receive scant attention much before around 2020, by when an increasing frequency of climate shocks would force governments to belatedly respond to the needs of the natural environment. Even then, Shell believed that such responses would be localised, with both governments and firms taking individual action, with little framework for a coordinated, considered global response. Although by 2050 greenhouse gas emissions would have been reduced, it argued that the efforts may be seen as too little too late.

In 'Blueprints', groups of seemingly disconnected people (e.g. politicians, environmentalists, venture capitalists, farmers and businesses) all begin to recognise the profitable potential of finding solutions to the challenges of economic development, energy security and environmental pollution at the same time. These seemingly disparate groups would begin to collaborate together in localised and regionalised areas, motivated by recognising the need to take action before it was forced upon them by circumstance.

These actions would receive public support, which then would transfer into public pressure on governments for change. Buildings would become more energy efficient, and government efforts to reduce greenhouse gas emissions and improve air quality would occur. Participating governments would use a range of individualised, local initiatives and policy investments, from tax breaks to subsidies, mandates, and investment and support for new 'cleaner' technologies. While governments would begin to take a holistic view of the challenges posed, multinational firms could find international investment decisions and strategies difficult to implement given the patchwork of government initiatives. These firms would therefore begin to pressure local, national and international authorities to harmonise approaches towards energy consumption, supply and environmental management.

With harmonisation would come widespread adoption of good efficiency practices. Trading schemes for carbon dioxide emissions' rights would begin to cover a critical mass of industry sectors in a critical mass of countries and transport would become 'greener' through growth in vehicle engine hybrids and, later, full-electric vehicles.

In its latest iteration (2013) of what it calls its 'new lens scenarios', Shell has proposed two further visions of future worlds which it terms 'Mountains' and 'Oceans'. These are based on the expectation that demand for critical resources such as water, energy and food – referred to as the 'Stress Nexus' – will rise by 40–50 per cent as the global population heads towards 9 billion by mid-century and poverty declines. 'Mountains' is essentially a world in which those at the top generally work to create a stable environment in ways which ensure the maintenance of the status quo. Rigid power structures and institutions will tend to hamper economic development, but enable established sectors to gain an advantage by unlocking resources that require significant capital and new technology. Under this view of the future, there is a strong role for government and for the introduction of policy measures that will help to create more compact cities and transform the global transport network. The expectation is that natural gas resources will become the largest global energy source by the 2030s and that policy will drive the introduction of carbon capture and storage technology, thereby supporting a cleaner energy system.

'Oceans' by way of contrast is a world which is both more prosperous and volatile, one in which competing economic and political interests are accommodated intermittently. As those at the top recognise that their future success depends on compromise, reform of existing economic and financial structures is likely to occur and this will increase aspirations for further reform by empowered constituencies. Given the wider distribution of power, the expectation is that governments will take longer to agree major decisions and that consequently market forces rather than policy will shape the development of the energy system. Liquid fuel and coal will continue to hold a key role in the energy mix until solar becomes the world's largest energy source by the 2070s.

Case study questions

1 In what ways might scenario planning be useful to a firm?

2 Why is scenario planning not more widely used in business?

The Shell website at *www.shell.com* contains a wealth of information on the company's involvement with scenario planning.

Review and discussion questions

1 Using a firm or organisation of your choice, attempt a 'SWOT' analysis. For example, can you apply such an analysis to the organisation in which you work or study?

2 Using the information sources discussed in the text, and any others with which you are familiar, provide a comparative analysis of consumer markets in at least eight leading European countries (including eastern Europe).

Further reading

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9 Market structure

All businesses operate in a market that will be peculiar to that industry. Each market will have its own particular characteristics which depend upon many factors, and although it is not possible to have a model that describes every market, there are some economic models that provide some guidance to the kinds of characteristics and behaviour that will be found in individual markets.

Learning outcomes

Having read this chapter you should be able to:

- explain the market structures of perfect competition, monopoly, oligopoly and monopolistic competition and indicate their implications for the behaviour of firms
- demonstrate the applicability of these predictions to the real world
- apply Porter's five-forces model to an analysis of the structure of industries
- understand the measurement of competition by concentration ratios
- survey differences in industrial concentration between industries, countries and over time
- indicate what determines market structure and what determines the behaviour of firms

Key terms

Abnormal profits
Average cost of production
Barriers to entry
Barriers to exit
Cartel
Collusion
Concentration ratio
Contestable market
Differentiation
Economies of scale
Five-forces model
Homogeneous products
Interdependence
Market structure
Minimum efficient scale of production (MES)
Monopolistic competition
Monopoly
Monopsony
Natural monopoly
Non-price competition
Normal profits
Oligopoly
Perfect competition
Perfect knowledge
Perfect mobility
Price competition
Price discrimination
Price leadership
Price maker
Price taker
Price war
Sticky prices
Structure–conduct–performance model
Transaction cost economics

Introduction

In economics the behaviour and the performance of firms in an industry are thought to depend upon some basic structural characteristics. This view is exemplified by the **structure–conduct–performance model**, where structure determines conduct, which in turn determines performance. The basic elements included under these headings are given in Table 1.

The structure–conduct–performance model provides a good framework for classifying and analysing an industry. A simple example of the process can be seen in the soap powder industry. Here the market is dominated by two large producers, Unilever and Procter & Gamble. This apparent lack of competition gives rise to certain behavioural characteristics, such as the massive amount of advertising, the existence of many brand names and fairly uniform prices. This process will be considered in more detail later in the chapter, but the example serves to indicate the relationship between the structure of the market and the behaviour and ultimately the performance of firms in an industry.

web link

For more information on these companies see *www.unilever.com* and *www.pg.com*

Market structure refers to the amount of competition that exists in a market between producers. The degree of competition can be thought of as lying along a continuum with very competitive markets at one end and markets in which no competition exists at all at the other end. This chapter looks at the two extremes (perfect competition and monopoly), and the market structures that exist between. The theory predicts the effects of market structure on behaviour and performance in those markets. However, as with the working of the market mechanism, the real world is often different from the theory and therefore this chapter will look at real markets and the relevance of the theory to the real world. The structure–conduct–performance model is open to criticism[1] since it says little about what determines structure in the first place. It also tends to view the firm as passive in the face of market structure, accepting the implications for conduct and performance, rather than actively trying to change and mould market structure. Michael Porter's **five-forces model**[2] will be used to broaden out the analysis.

Table 1 Structure–conduct–performance model

Structural factors
Amount of actual competition: (a) seller concentration and (b) buyer concentration
Existence of potential competition
Cost conditions
Demand conditions
Existence of barriers to entry
Conduct factors
Pricing policy
Amount of advertising
Merger behaviour
Product differentiation
Performance factors
Profitability
Technological innovation

Market structure is important not only because of the implications it has for conduct and performance but also because it has an impact upon the strategic possibilities that face the organisation, its ability to act strategically and the likely effects of such strategic behaviour.

In addition, this chapter will examine how the level of competition is measured in a market, how the level of competition varies between industries and countries, and how and why this has changed over time.

Market structures – in theory and practice

As mentioned above, market structures can be thought of as lying along a continuum with perfect competition at one end and monopoly at the other (see Figure 1). Both of these market structures are unrealistic representations of the real world, but are useful as benchmarks in assessing the degree of competition in a market. Between these two extremes lie other market structures, which are more realistic. Two will be described: oligopoly and monopolistic competition.

Perfect competition

This is the most competitive market structure. A number of conditions need to be fulfilled before **perfect competition** is said to exist. These conditions are as follows:

1 There are so many buyers and sellers in the market that no *one* of them can influence price through its activities.
2 The good being sold in the market is **homogeneous** (i.e. all units of the good are identical).
3 **Perfect knowledge** exists in the market. This means that producers have perfect knowledge of prices and costs of other producers and that consumers know the prices charged by all firms.
4 There exists **perfect mobility** of both the factors of production and consumers. This means that people, machines and land can be used for any purpose, and that consumers are free to purchase the good from any of the producers.
5 There are no **barriers to entry or exit** in the industry. There is nothing to prevent a new firm setting up production in the industry.

Figure 1 Market structures

Naturally, this is a highly theoretical model and these conditions are unlikely to be all met in reality, but if they were, and the theory was followed through, the conclusion is that there would be only one price in the market for the good being sold. For example, if one firm is charging a higher price for the good than other firms, everyone in the market will know (because of perfect knowledge), and because the good is homogeneous and because of perfect mobility on the part of consumers, consumers will simply purchase the good from another firm. The firm that was charging a higher price would be forced to reduce the price of the good in order to sell it, or face mounting stocks of the good. There is therefore only one price for the good and this will be determined by market demand and supply – that is, total demand and total supply, no one consumer or producer having enough market power to influence the price. Accordingly, the firm is said to be a **price taker**.

Price determination in perfect competition

Firms need to cover costs of production and to earn a certain level of profits in order to stay in business. This minimum level of profits is called **normal profit**, and profits over and above this level are called **abnormal profits**. If the firm is trying to maximise its profits it will decide what level of output to produce by setting the cost of producing the last unit of the good equal to the revenue gained from selling the last unit: in economic terminology, where marginal cost equals marginal revenue. Included in cost would be elements of wages, rent, rates, interest, raw materials and normal profits. If these costs are not being covered, the firm will be making a loss.

As there is only one price in perfect competition, the revenue derived from selling the last unit must be equal to its price. Therefore, the price of the good depends on the level of marginal cost.

In the short run, individual firms can earn abnormal profits, but these are not sustainable in the longer term. If one firm is earning abnormal profits, given the assumption of perfect knowledge, everyone will know and, since freedom of entry exists, other firms will enter the market in order to earn abnormal profits. This means that there is an increase in market supply and price will fall back to a level where abnormal profits have been competed away. Similarly, when losses are being made, freedom of exit means that supply will be reduced and price will rise again until normal profits have been regained.

The implications of perfect competition for market behaviour and performance are summarised in Table 2. Perfect competition involves very restrictive assumptions,

Table 2 Implications of perfect competition for conduct and performance of firms in an industry

Extent of market power	The firm has no market power at all.
Price	There will be only one price for the good. The firm will be a 'price taker'.
Advertising	There will be no advertising, as all units of the good are the same and everyone knows this.
Profitability	There can be no abnormal profits, except possibly in the very short run if a producer reduces price and captures a larger share of the market.

which will rarely be fulfilled in the real world. The usefulness of the model lies in its role as an *ideal market* in which competition is at a maximum, rather than in its applicability to the real world.

An example of perfect competition?

The nearest example to perfect competition is probably the fruit and vegetable market in the centre of a large town. The goods will be fairly homogeneous, with perhaps slight variation in the quality. Knowledge will be almost perfect with respect to prices charged, as consumers could quickly walk around the market and ascertain the price of tomatoes, for example. Mobility of consumers is also high because the sellers are located in the same place. Thus, the conditions for perfect competition nearly hold. The prediction is that there will be only one price for a particular good. Again this prediction is nearly fulfilled; the price of tomatoes tends to be rather similar across such a market, and when one trader reduces the price towards the end of the day, others tend to follow suit.

Another market that is said to be close to perfect competition is the stock exchange, although with the increasing use of computers this is less likely to be true in the future.

Monopoly

Monopoly lies at the opposite end of the spectrum to competition. In its purest form a monopolistic market is one in which there is no competition at all; there is a single producer supplying the whole market. The monopolist has considerable market power and can determine price or quantity sold, but not both because he or she cannot control demand. The power of the monopolist depends on the availability of substitutes, and on the existence and height of barriers to entry. If there are no close substitutes for the good being produced, or if there are high barriers to entry, the power of the monopolist will be high and abnormal profits can be earned in the long run.

A monopolist could also be a group of producers acting together to control supply to the market: for example, a **cartel** such as OPEC (Organization of the Petroleum Exporting Countries).

For information on OPEC see *www.opec.org*

In monopolistic markets the producer might be able to charge different prices for the same good: for example, on an aeroplane it is quite likely that there will be passengers sitting in the same class of seat having paid very different prices, depending upon where and when the tickets were bought. Essentially they are paying different prices for the same service, and the producer is said to be exercising **price discrimination**. Why is this possible? There are certain conditions that must hold for this type of price discrimination to occur. First, the market must be monopolistic and the producer must be able to control supply. Second, there must be groups of consumers with different demand conditions. For example, the demand for train travel by the commuter who works in London will be more inelastic than the demand of a student going to London for the day, who could use alternative forms of transport or even not go. This means that the willingness to pay among consumers will vary. The final condition necessary is that it

must be possible to separate these groups in some way. For example, telephone companies are able to separate markets by time so that it is cheaper to phone after a certain time; British Rail used to separate groups by age for certain of its railcards.

The monopolist will maximise its profits by charging different prices in different markets. Price discrimination is often thought of as a bad thing as the monopolist is exploiting the consumer by charging different prices for the same good. But there are some advantages, in that it makes for better use of resources if cheap airline tickets are offered to fill an aeroplane that otherwise would have flown half-full. It can also lead to a more equitable solution in that higher-income users pay a higher price than lower-income users. The main problems with the notion of price discrimination is not that it is always a bad thing, but that it is the monopolist who has the power to decide who is charged what price.

Again the effects of monopoly on the behaviour and performance of the firm can be predicted (see Table 3). Like perfect competition, this is a highly theoretical model and is mainly used as a comparison with perfect competition to show the effects of the lack of competition.

Table 3 Implications of monopoly for conduct and performance of firms in an industry

Extent of market power	The firm has absolute market power.
Price	There will only be one price for the good, except in the case of price discrimination. The firm is a **'price maker'**.
Advertising	There will be no need for advertising, as there is only one firm producing the good.
Profitability	Abnormal profits can exist in the long run as there is no competition that might erode them away.

A comparison of perfect competition and monopoly

- It would be expected that price would be higher under monopoly than under perfect competition because of the absence of competition in the monopolistic market. It is argued, for example, that the large telephone companies (including BT) are overcharging the consumer. The benefits of the considerable technological advances that have been made in this area have not been passed on fully to the consumer. This can be sustained only by virtue of the monopolistic power of the companies. But to counter this, it could be argued that a monopolist is in a better position to reap the benefits of economies of scale, therefore it is possible that price might be lower.
- There might be less choice under monopoly since firms do not have to continually update their products in order to stay in business. But it is also possible to think of examples where monopolies provide greater choice (e.g. in the case of radio stations), where under perfect competition all radio stations would cater for the biggest market, which would be for pop music. A monopolist, however, would be able to cover all tastes with a variety of stations.
- There is less incentive to innovate under monopoly, since the monopolist is subject to less competition. But, equally, a monopolist might have more incentive to innovate as it can reap the benefits in terms of higher profits. It may also have more resources to devote to innovation.

As we can see, there is not a clear set of arguments implying that perfect competition is better than monopoly, and this is taken into account in UK competition policy.

An example of monopoly?

Although it is easy to think of examples of industries where the dominant firm has a great deal of monopoly power, there is no such thing as a pure monopoly, as substitutes exist for most goods. For example, British Rail used to have monopoly power in the market for rail travel, but there are many alternative forms of travel. This point highlights the difficulties of defining markets and industries discussed in Chapter 10. The nearest examples of monopolies are the old public utilities, such as gas, electricity, water and so on, which have been privatised.

The government, in determining whether monopoly power exists in a market, has a working definition of what constitutes a monopoly: it is when 25 per cent of the market is accounted for by one firm or firms acting together. This would form grounds for investigation by the Competition Commission. The sources of monopoly power are the existence of barriers to entry and exit and the availability of substitutes (these will be discussed later in this chapter).

web link

For information on the operation of the Competition Commission see *www.competition-commission.org.uk*

Oligopoly

In both perfect competition and monopoly firms make independent decisions. In the case of monopoly there are no other firms in the industry to consider; in the case of perfect competition the firm has no power to affect the market at all. So for different reasons they act as though they have no rivals. This is not true in the case of oligopoly. **Oligopoly** is where a small number of producers supply a market in which the product is differentiated in some way (see Table 4). The characteristics of oligopoly are:

Table 4 Implications of oligopoly for conduct and performance of firms in an industry

Extent of market power	A great deal of market power.
Price	A stable price level. Prices set by price leadership or collusion.
Advertising	Much advertising and branding. Non-price competition is common.
Profitability	Abnormal profits can exist; their extent depends on the strength of competitors.

- a great deal of **interdependence** between the firms; each firm has to consider the likely actions of other firms when making its decisions;
- a lack of **price competition** in the market; firms are reluctant to increase their prices in case their competitors do not and they might lose market share. Firms are also reluctant to reduce their prices, in case other firms do the same and a price war

results that reduces prices but leaves market share unchanged and so everyone is left worse off;[3]

- this lack of price competition means that different forms of **non-price competition** take place, such as branding or advertising. Oligopolists will sell their products not by reducing the price but through heavy advertising, brand names or special offers. In the UK, Tesco has a reward scheme whereby customers accrue points on their grocery shopping and these can be used to get money off their next shop or can be doubled up to buy other products such as visits to theme parks or the cinema.

The way in which price is determined in an oligopolistic market is through either **price leadership** or some sort of **collusion**. Price leadership is where one firm takes the lead in setting prices and the others follow suit. The price leader is not necessarily the firm with the lowest cost, as it depends upon the power of the firm. So price could be set at a higher level than in a competitive market. Collusion is an explicit or implicit agreement between firms on price, which serves to reduce the amount of competition between firms. Collusion is illegal in most countries as it is seen as a form of restrictive practice, but this does not mean that collusion does not take place. A cartel is a form of collusion where firms come together to exercise joint market power. Cartels are outlawed in most states, but the most famous of all is OPEC, which has had a dramatic effect on the oil industry over the last 30 years. Collusive agreements, as well as possibly being harmful to the consumer, tend to be unstable as there is great temptation on the part of individual firms/countries to cheat. What is clear in the case of oligopoly is that once price is set, there is a reluctance to change it. Therefore price competition is replaced by non-price competition of the sort mentioned above.

The most often quoted examples of oligopoly are the markets for tobacco and soap powder, both of which are dominated by a very small number of producers and exhibit the predicted characteristics. There is little price competition and price is fairly uniform in both markets. There is a high degree of non-price competition in both markets – high advertising, strong brand names and images, and the use of special offers or gifts at times in order to sell the goods. Compared with monopoly and perfect competition, oligopoly is a much more realistic market structure, with many markets exhibiting the characteristics stated above. Table 5 gives a few examples.

Table 5 The top firms' share of the market in the UK (percentages)

Industry	*Percentages*
Cigarettes[a]	92*
Laundry detergents[b]	78**
Lager[b]	71*
Motor insurance[b]	60**
Greetings cards[b]	53***
Ice cream[b]	43*
Clothing retail[c]	29**

Note: *Top three firms in the industry; **Top five firms; ***Top two firms.
Source: [a] ASH.org.uk, 2012; [b] Mintel Reports, 2013; [c] Mintel Report, 2012.

web link

For information and reports on specific industries see *www.mintel.co.uk* and *www.keynote.co.uk*

Monopolistic competition

Monopolistic competition exists when all of the conditions for perfect competition are met except for the existence of a homogeneous good, so that each firm has a monopoly over its own good but there is a great deal of competition in the market from other suppliers producing very similar products. In **monopolistic competition** the good is slightly **differentiated** in some way, either by advertising and branding or by local production. There does not have to be a technical difference between the two goods, which could be identical in composition, but there must be an 'economic difference' – that is, a difference in the way the goods are perceived by consumers. There is also some degree of consumer loyalty, so that if one firm reduces price, consumers might not necessarily move to that firm if they believe that the difference between the brands justifies the higher price. Abnormal profits can exist in the short run but cannot persist since new firms are free to enter the industry and compete away abnormal profit (see Table 6).

Table 6 Implications of monopolistic competition for conduct and performance of firms in an industry

Extent of market power	The firm has little market power.
Price	There will be small differences in price.
Advertising	There will be heavy advertising and branding.
Profitability	Small abnormal profits can exist in the short run but will be competed away in the longer run.

An example of monopolistic competition?

There are many examples of this type of industry: for example, the paint industry, where ICI is the only producer of Dulux, but there are many other types of paint on the market.

How accurate is the theory?

The implications of the theory of market structures for the behaviour and performance of firms are summarised in Table 7.

Table 7 Implications of theory for behaviour of firms

	Market power	*Price*	*Advertising*	*Profitability*
Perfect competition	None	One price	None	Only normal profits
Monopoly	Absolute	Price discrimination possible	None	Abnormal profits
Oligopoly	High	One price	High	Abnormal profits
Monopolistic competition	Little	Small differences in price	High	Only normal profits in long run

As argued above, both perfect competition and pure monopoly tend to be based on assumptions that are somewhat unrealistic and should be regarded as 'ideal types' of market structure, in the sense that they establish the boundaries within which true markets exist and operate, and against which they can be analysed. In contrast, oligopoly

and monopolistic competition are much nearer to the types of market structure that can be found in the real world, and economic theory does appear to explain and predict behaviour in these markets to a certain extent. In oligopolistic markets, for example, price tends to be **sticky** and much of the competition between firms occurs in non-price ways, particularly branding, advertising and sales promotion (see Table 8). Occasionally, however, **price wars** do occur – as in the petrol market in the 1980s and more recently between the four biggest supermarkets in the UK.

Table 8 shows the top advertisers in the United Kingdom ranked for 2012; their ranks in 1994 are also given. The names in the list are familiar and largely expected from the predictions: for example, Procter & Gamble and Unilever account for around 90 per cent of the market for washing powder. A less familiar name is Reckitt Benckiser, which subsequently acquired Boots in 2007. It is interesting to note that many well-known brands do not appear in the top ten – Apple lies at number 54 (ad spend of £27.2 million) and Coca-Cola at number 24 (ad spend £44.1 million).

Table 8 Top advertisers in the UK, 2012

Rank			
2012	*1994*	*Advertiser*	*Total adspend (£mill)*
1	1	Procter & Gamble	203.9
2	48	British Sky Broadcasting	145.1
3	3	Unilever	125.5
4	19	Tesco	114.6
5	–	Asda	113.3
6	–	Central Office of Information Communication	105.4
7	–	DFS Furniture	94.3
8	32	Reckitt Benckiser	80.9
9	2	British Telecom	79.4
10	5	Kellogg's	76.9

Source: Adapted from *Advertising Statistics Yearbook*, 1995 and Adbrands.net 2012.

web link

For information on advertising see ***www.adassoc.org.uk***

It is much more difficult to judge how accurate the behavioural implications are. Lack of data is one problem, as is the fact that only one structural characteristic has been considered here – the level of competition between producers. The other structural factors listed in Table 1 will also have an effect, such as the level of demand, the degree of competition between the buyers and the degree of potential competition. Profitability, price and advertising, for instance, will be affected by the level of demand in the market.

Porter's five-forces model

Porter's model[4] says that the structure of an industry and the ability of firms in that industry to act strategically depend upon the relative strengths of five forces: current competition, potential competition, the threat of substitute products, the power of buyers and the power of suppliers. Each of these five forces will be examined in turn. The case study at the end of this chapter uses this model to analyse the tobacco industry.

Current competition

Current competition has already been considered under the heading of market structure, but the important point to remember is that by acting strategically firms can change the structure of the industry. Firms in a highly competitive market might be unhappy with the lack of power they have over various factors such as pricing and may, through their strategic actions, try to change the situation. If they are successful there will be a change in the level of current competition and therefore in market structure.

Potential competition (or threat of new entry)

It has been shown that market structure or current competition affects the behaviour of firms in an industry. However, looking at the number of firms in an industry does not provide the whole picture. It is possible that firms in an oligopolistic market might act in a way consistent with perfect competition because of the threat of potential competition. This threat can affect the behaviour of firms even if it does not happen. The degree of potential competition depends upon the existence and height of barriers to entry and exit.

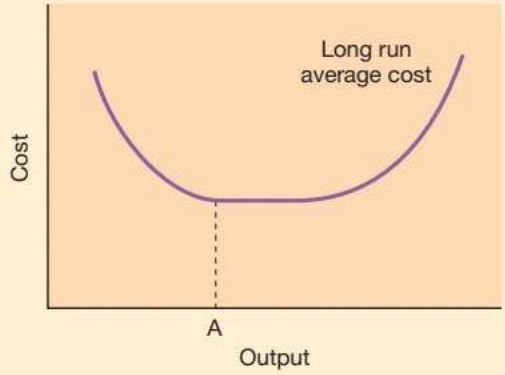
Barriers to entry

Barriers to entry are any barriers which prevent or inhibit the entry of firms into the industry. There are several sources of barriers to entry.

Some industries are what are called **natural monopolies** in that the production process is such that competition would be wasteful. The old public utilities are good examples of these, as it would be very wasteful for there to be two national grid systems in the electricity industry.

Some production processes are subject to **economies of scale**. As firms grow in size, or as the scale of production increases, certain economies occur that serve to reduce the **average cost of production**. The scale of production can be increased in many ways, for example by increasing the capacity of the existing plant, by increasing the number of plants or by increasing the product range. Figure 2 shows how the average *cost* of production changes as the *scale* of production changes.

Figure 2 A firm's average cost curve



The downward-sloping part of the curve shows falling average cost or economies of scale. The upward-sloping part shows rising average cost or diseconomies of scale. Economies of scale reduce average cost and therefore benefit the producer and also the consumer if they are passed on in lower prices.

The sources of economies of scale are usually classified under three headings: technical; marketing; and financial.

- *Technical economies* come from increased specialisation and indivisibilities. The larger the scale of production, the more the production process can be broken down into its component parts and the greater the gain from specialisation. There are certain indivisibilities involved in production, which only large firms can benefit from. For example, a small firm cannot have half a production line as that is meaningless, but might not be big enough to use a whole production line. Another type of indivisibility is involved in the notion of fixed costs. Fixed costs like the cost of rates or the fees of an accountant, for example, remain the same irrespective of the level of production. Therefore the greater the level of production, the lower will be the average cost of items as it is being spread over a larger output.
- *Marketing economies* come from spreading marketing costs over a larger output, so that average costs will be lower. The company can also take advantage of bulk buying, and will probably have a specialised department devoted to marketing.
- *Financial* economies come from the fact that larger companies find it easier and often cheaper to borrow capital.

Added to these is *risk diversification*, which is possible with larger companies as they may well have interests in other industries. All of these economies of scale give rise to falling average cost and therefore explain the downward-sloping part of the cost curve in Figure 2. Economies of scale are a very effective barrier to entry. If the incumbent firm in an industry has lower average cost as a result of economies of scale, it will be hard for a newcomer to compete effectively at a smaller scale of production. Gas, electricity and water are examples of this. The production processes of these goods are subject to economies of scale and it is therefore difficult for others to come into the market in competition with established firms. This is why such industries are called 'natural monopolies'.

Barriers to entry can be legal ones, as in the case of patents and franchises, which serve to restrict competition and prevent new firms from entering an industry. Advertising and branding can also be barriers, in that industries where brand names are well established are difficult to enter without massive expenditure on advertising. Some industries require a high initial capital investment to enter, for example dry cleaning, where the machinery is very expensive. Switching costs can also be regarded as a barrier to entry. If the consumer has to bear a cost in switching from one good to another, that might be enough to deter the consumer from doing so and therefore serve as a barrier to entry. The recent practice of the building societies and banks of offering low fixed-rate mortgages with penalties for early withdrawal can be seen as an example of the introduction of switching costs into the market.

A **contestable market**[5] is one in which there are no barriers to entry or exit. This means that all firms (even potential entrants) have access to the same technology and there are therefore no cost barriers to entry. It also means that there are no sunk or unrecoverable costs that would prevent a firm leaving the industry. It follows that it is possible to ensure that firms behave in a competitive way, even if the market structure they operate in is imperfectly competitive, by ensuring that the market is contestable. What is regulating market behaviour, then, is not *actual* competition but *potential* competition.

Mini case Open Skies and contestability

The 'Open Skies' agreement between the USA and the EU, which was introduced in 2008, is a policy that was designed to make markets more contestable. It eased restrictions on air travel between the USA and the EU so that any airline could fly to US destinations and not necessarily from its home nation, as was previously the case. British Airways could now fly from Paris to New York, whereas previously it could only fly from London Heathrow to New York. Similarly, any US airline could do the same for European destinations. The second phase of this agreement was put into place in 2010.

This policy was not designed to break up existing companies or to introduce more competition into the market directly. It makes the market more contestable – it opens up the market for the possibility of competition. The stated aims are to increase free market competition, allow price to be determined by the market, allow fair and equal opportunity to compete, cooperative marketing arrangements and the provision of a mechanism for dispute resolution. The agreement has led to structural changes in the market. For example, as a direct result of this deal:

- British Airways launched a new airline called OpenSkies, which flew between Paris and Newark, New York. It has since been renamed Elysair.
- In December 2012 Delta Airlines purchased a 49 per cent stake in Virgin Atlantic in order to launch a joint venture in January 2014 – by March 2014 there should be daily flights between Seattle and London.

Theory predicts that more competition will lead to lower prices. Unfortunately this agreement came into force at a time of rapidly rising oil prices so this was unlikely to happen – Virgin Atlantic declared that prices could not be any lower. It is possible that lower prices will come in the future as Michael O'Leary of Ryanair has claimed that he could have $10 flights running from the UK to the USA by 2017. Whether this will happen or not will have to be seen. EU airlines also argue that the agreement is unbalanced: US airlines can fly between EU destinations (from Paris to London, for example) but EU airlines cannot do the same within the USA. In addition to this, US carriers are allowed to buy up their EU rivals but foreign ownership of US airlines is not allowed. The second stage of the agreement, which came into place in 2010, has done nothing to dispel this view as there was still no indication that European carriers would be allowed to carry inter-US routes and there was no further progress on ownership, only a 'commitment to engage in a process towards reforming airline ownership'. This, then, is not true contestability.

Barriers to exit

Exit barriers are those that prevent or deter exit from an industry; they are mainly related to the cost of leaving the industry. The cost of exit depends upon how industry-specific the assets of the firm are. If we take physical assets as an example, a printing press is highly specific to the printing industry and could not be used for anything other than printing. There will be a second-hand market for printing presses, but the press would probably have to be sold at a loss, therefore incurring a high cost. A van, however, would be different, as it is still a physical asset but one that would not be specific to a particular industry, therefore the loss involved in selling would be less. Generally speaking, the more industry-specific an asset is, the lower will be the second-hand value and the higher the cost of exit. An intangible asset such as knowledge of the market or expenditure on research and development cannot be resold and must be left in the market, and therefore is a sunk cost – a non-recoverable cost.

Barriers to entry and exit can be 'innocent' or can be deliberately erected. Economies of scale can be regarded as innocent barriers to entry since they are inherent in the production process. Advertising and branding can be thought of as deliberately erected barriers to entry since they increase the expense of any firm entering the market. Similarly, the introduction of penalty clauses on mortgages is a deliberately erected barrier since it incurs switching costs for the consumer.

Where innocent barriers to entry or exit are low, potential competition will be high and firms within such a market are faced with the choice of accepting the situation or deliberately erecting some barriers. This is an example of strategic behaviour on the part of firms; whether it is attempted or not depends on the likelihood of success and the relative costs and benefits. It is another area where game theory is used to formulate strategic possibilities.[6]

The threat of substitute products

The threat from substitute products largely depends upon the nature of the good being traded in the market and the extent of product differentiation. It has a clear impact upon market structure, because if there are no substitutes for a good the producer of that good will face little competition and have a great deal of market power. However, as we saw earlier, even industries that appear to be pure monopolies (the former British Rail, for instance) can face competition from substitutes since there are other ways to travel. Much of the expenditure by firms to differentiate their products is designed to reduce the threat from substitute products.

The power of buyers

So far this chapter has concentrated on the competition between producers in a market, but the amount of competition between buyers will also have an impact on an industry. Markets will range from those where there are many buyers, as in the case of retailing, through markets where there are a small number of buyers, as in the case of car and parts manufacturers, to markets where there is only one buyer. This latter type of market is called a **monopsony**, and it is the buyer who has a great deal of market power rather than the seller. An example of this is the coal industry, where the majority of output goes to the electricity producers. Increasingly in retailing the giant retailers are exerting a great deal of power over the manufacturers. TOYS 'R' US, the world's largest toy retailer, is involved very early on by manufacturers in the design process for new toys and as a result gets many exclusives that are not available in other toy shops.

The level of buyer power could be measured in the same way as seller power (see later in this chapter), but no data are collected centrally on the level of buyer concentration. It is clear, however, that there are many markets in which powerful buyers can and do exert a great deal of control over suppliers, and this power is an important source of marketing economies of scale. It is possible to put together the level of competition between producers and consumers in order to predict behaviour. For example, a market that consists of a single buyer and a single seller will have quite different characteristics from a market that has many buyers and sellers. The existence of strong buyers might have beneficial effects on the market as they could offset the power of strong producers

or it could lead to higher seller concentration as sellers come together to counteract the power of the buyer.

In markets where there are strong sellers and weak buyers the producers' power can be offset by, for example, consumer advice centres or regulatory bodies, as in the case of the former public utilities.

A distinction can be made between existing and potential customers. Existing customers are particularly significant to firms in industries where repeat orders are important or where goods are supplied on a regular basis, as in grocery retailing. It is no surprise that the large grocery retailers are using loyalty cards to increase the loyalty of existing customers. The power of existing customers is much lower where the firm supplies goods on a one-off basis, although the firm cannot disregard existing customers as this will affect its reputation and the ability to attract potential customers. Potential customers might be new to the market or can be buying from an existing competitor at present.

The power of suppliers

The power of suppliers over the firm is likely to be extremely important in certain markets, depending upon the nature of the product being supplied. For example: is the product highly specialised? Is the same or similar product available from elsewhere? How important is the product in the production process? The importance of good and reliable supplies has assumed greater significance since firms have started to adopt just-in-time production methods. Reducing stock levels to reduce costs can be effective only if firms can depend upon their suppliers; hence there has been the development of partnership sourcing as firms nurture long-term relationships with their suppliers.

Another important factor here is whether or not the firm itself can produce the components it needs in the production process. If it can, the power of suppliers is greatly reduced. The decision as to whether to produce or to buy from a supplier is the subject of an interesting area of economics called **transaction cost economics**.[7]

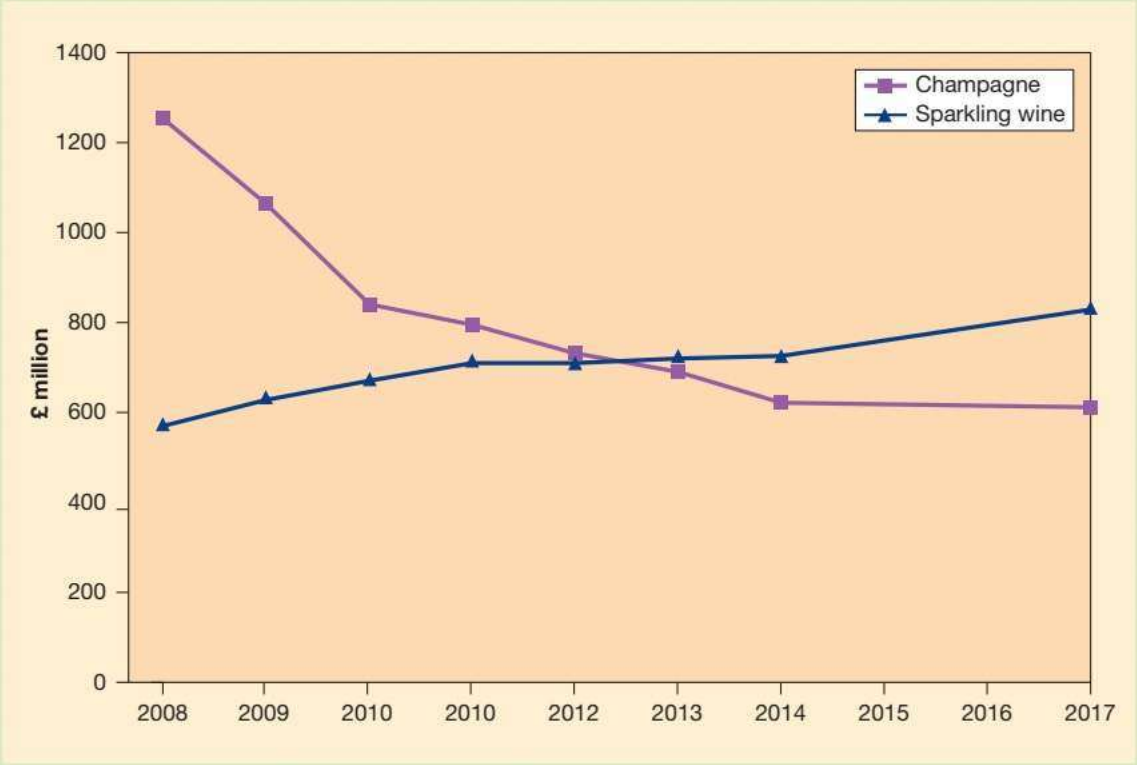
Porter's five-forces model provides a good structure for looking at market structures. The case study at the end of the chapter uses the framework to analyse the market for cigarettes in the UK, while the mini case study on Prosecco uses Porter's model to identify which of the forces are important.

Mini case The success story of Prosecco

Wine sales in the UK have averaged a growth rate of around 3 per cent per annum since 2008. Sales were badly affected by the economic downturn – there was a fall in the sales of wine of 4 per cent in 2009, but there were big differences between market segments. The sales of still wine and Champagne both fell in 2009 by 3.8 per cent and 22 per cent respectively, while sales of non-Champagne sparkling wine rose by 11.3 per cent in 2009. As Figure 3 shows, annual sales of sparkling wine overtook Champagne in 2011, and the trend is forecast to continue into the foreseeable future. According to Mintel, sales of Champagne in the UK are forecast to fall to £609 million by 2017, while sales of other sparkling wine are forecast to rise to £835 million.

In the non-Champagne sparkling wine market, Cava accounts for half of the market and Prosecco around one third, but sales of Prosecco have been growing fast. The Cooperative's own-brand Prosecco won a *Which?* best value award in 2013 and as a result the sales of this wine rose

Figure 3 Annual sales, £ million, 2012 prices



Source: Adapted from Figures 29 and 30, Mintel Report, Still, Sparkling and Fortified Wine, 2013.

by 875 per cent over the Christmas 2013 period. Similar success can be seen from other wine sellers: Sainsbury's own-brand Prosecco increased its sales by 41 per cent in volume between 18 and 31 December 2013, its Prosecco magnums rose in sales by 291 per cent; Prosecco was the fourth most popular wine at Majestic in 2013 and sales rose by 39 per cent in the summer of 2013. Majestic Wine has attributed at least part of a rise in profits for the second half of 2013 to sales of Prosecco.

Why has it been so successful? Clearly there is a price difference between Champagne and sparkling wine and in times of economic downturn, price will be very important. In addition to this there has been clever promotion – while Champagne is the drink of celebration and special occasions, Prosecco has been marketed and accepted as the drink of every day. The sales figures above show that Prosecco is seen as a drink for summer days as well as at Christmas time. In addition, Prosecco is scoring well on flavour, it is much lighter than Champagne and often lower in alcohol, and this makes it popular among its demographic, which (according to Mintel) is female and aged between 18 and 35 years old. One limitation to this growth is that, under EU law, only wines produced in the Prosecco region of Italy (north of Venice), which includes Conegliano and Valdobbiadene, can use the name Prosecco, which limits the output. This means it might not be able to continue to grow at the present rate, but there are other sparkling wines waiting to fill any gaps in the market – English sparkling wines and wines from other parts of the world, including Chile and Australia.

From this brief analysis, it can be seen that of Porter's five forces, the most important one is buyer behaviour – the impact of economic downturn on demand and the characteristics of buyers. In addition, producers have cleverly marketed the wine as an everyday drink (current competition), although there may be limitations to the growth of the market (suppliers).

Measuring the degree of actual competition in the market

In industrial economics the level of competition in a market is measured by concentration ratios. These measure the percentage of value added, total output or employment that is produced by a stated number of the largest firms in the industry. The common numbers are three or five. The five-firm concentration ratio measures the percentage of employment or output accounted for by the five largest firms in the industry.

Table 9 shows the five-firm concentration ratios for a selection of industries in 2004 as measured by output. These data are no longer collected or collated by the UK government, but given the nature of these industries, concentration levels are likely to be very similar.

Table 9 Five-firm concentration ratios for selected industries in the UK, 2004

Industry	*Output (%)*
Sugar and sugar by-products	99
Tobacco	99
Iron and steel	61
Pharmaceutical products	57
Rubber products	45
Leather goods	30
Footwear	25
Legal service	9
Other business services	5

Source: Adapted from Appendix 1, 'Concentration ratios for businesses by industry in 2004', Sanjiv Mahajan, *Economic Trends*, ONS, October 2006.

Although Table 9 shows only a small selection of industries, it does illustrate that there is a wide variation in the degree of concentration across industries. Only two services industries are listed because there is a general lack of data on the service sector. Generally, services are less concentrated than manufacturing industries because of the nature of the production process and the fact there is less scope for economies of scale. The differences between the market shares of sugar and tobacco in Tables 5 and 9 are due to the fact that the large producers also produce the own-brand labels.

While it is relatively easy to compare the level of concentration in particular industries over time, it is more difficult to make any conclusion about the 'average' level of concentration (see mini case on concentration in last edition of this text). Table 10 gives an illustration of the percentage share of total employment and sales of the largest 100 private firms in the UK between 1979 and 1992. Although these are not concentration ratios as such, the data do provide an indication of how concentration has changed over time in aggregate. The change in the Standard Industrial Classification during this period has only a small impact on the figures. Note how the level of 'average' concentration decreased slightly during the first part of the period, reversing the trend of the first half of this century where industrial concentration increased. The reason for the decrease is largely the process of privatisation and the growth in the small-firm sector during the 1970s and 1980s. In the later part of the period concentration started to rise again, mainly due to the industrial restructuring taking place and the increased level of merger activity identified in Chapter 5. As the UK government ceased publication of these figures in 1992 it is difficult to assess what has happened to concentration more recently.

Table 10 100 largest private enterprise groups

Year	Percentage share of total Employment	Sales
SIC(68)		
1979	12	18
SIC(80)		
1980	13	15
1981	13	16
1982	12	15
1983	12	16
1984	15	19
1985	9.5	14
1986	9.7	15.4
1987	10.8	17.1
1988	9.8	17.6
1989	12.1	21.6
1990	14.6	23.6
1991	14.9	21.2
1992	16.9	24.9

Source: *Census of Production*, various. Crown copyright. Reproduced by permission of the Controller of HMSO and of the Office for National Statistics, UK.

Making comparisons between different countries tends to be difficult because of this problem of 'averaging' concentration and because of national differences in the way in which data are collected and reported. Moreover, official EU publications on industry have changed the way in which they report data, so comparisons over time are problematical. Despite the difficulties in comparing concentration ratios, the general view of industrial economists is that concentration is greater in the UK than in other member states.

Reasons for high concentration

Many industries in the United Kingdom are highly concentrated and it is believed that the UK has higher concentration ratios than other large industrial countries. Why are there different market structures between industries?

Referring back to Figure 2, the point at which the curve becomes horizontal (A in the figure) is called the **minimum efficient scale of production (MES)**. It is the point at which all economies of scale have been reaped by the firm, and the point at which firms that wish to maximise their efficiency must operate.

The higher the MES relative to the total output of the industry, the fewer will be the number of firms operating in an industry and therefore the higher will be the level of concentration. For example, if the MES in an industry is half of the industry output, the industry could support only two firms, as smaller firms could not achieve low enough costs to compete with the large firms.

As the scale of production continues to increase, average costs eventually start to rise. This is due to diseconomies of scale, which are mostly attributed to managerial inefficiencies. These are the difficulties faced by management in controlling, coordinating and communicating in a large organisation.

Firms in every industry will face differing average cost curves and therefore market structures will be different. In services, for example, because of the nature of the product, the scope for economies of scale is small and, accordingly, the MES is small relative to the size of the total market and the industries tend to be unconcentrated. The level of concentration in manufacturing tends to be much higher because of the nature of the production process and the scope for economies of scale.

The size of the MES is not the only explanation of why there are different market structures. If it was, one might expect that the same industry would have similar levels of concentration in different countries, but this is not the case, as indicated above. The strength of the five forces will differ greatly between industries and will therefore give many different structures. Obviously government policy can influence the type of market structure, and this will differ between countries. It is also true that the significance of barriers to entry varies between countries. Empirical results from Germany and the UK show that in both countries barriers to entry are high, but that in the UK advertising is the most important barrier, while in Germany it is economies of scale.

Synopsis

In this chapter, four different market structures were considered that embraced the whole spectrum of competition: perfect competition, monopoly, oligopoly and monopolistic competition. Each of these market structures gives predictions about the behaviour of firms in those markets. Generally, the more realistic of these market structures predict well what happens in the real world. This analysis was then incorporated into Porter's five-forces model, which includes further factors largely ignored by traditional economic theory. Nevertheless, these factors are particularly important in certain industries, like the power of the giant retailers as buyers and the importance of potential customers to industries where the level of repeat business is high.

The amount of competition in a market is measured using concentration ratios and evidence on concentration was examined both within the UK and between countries as far as that was possible.

Summary of key points

- There are four different market structures identified by business economists. These are (arranged with the most competitive first): perfect competition, monopolistic competition, oligopoly and monopoly.
- Perfect competition is a market structure which is very competitive and where the producers are 'price takers'.
- Pure monopoly is a market structure with a single producer that is a 'price maker'.
- Monopolistic competition is a market structure where there is a great deal of competition but where the product is slightly differentiated, so producers have a little market power.

- Oligopoly is a market structure where there is a small number of large producers, interdependent in their decision-making. This is a common market structure.
- The determinants of market structure include the existence and height of barriers to entry and exit and the existence of economies of scale.
- Knowledge of market structure gives some indication of likely behaviour of firms with respect to factors such as pricing and advertising.

Case study A Porter's five-forces analysis of the cigarette industry in the UK

Porter's five-forces model will be used to analyse the cigarette industry in the UK. Cigarette smoking has fallen since 1948, being 19.6 per cent of the adult population in 2012.

In 2012, smoking cigarettes was more prevalent among men (20 per cent) than women (19 per cent) and among manual workers (36 per cent) than non-manual workers (15 per cent).[8]

The UK government has specific objectives in place with respect to smoking – to reduce the total percentage among adults to 18.5 per cent by 2015, to reduce the percentage for the age group 16–19 years to 12 per cent and among pregnant women to 11 per cent by 2015. Although the percentage of smokers has fallen, the expenditure on cigarettes in the UK has risen since 2008, as Table 11 Shows. This is because of tax and price increases.

The incidence of smoking in other countries is much higher than in the UK, the top three are Greece (31.9 per cent), Chile (29.8 per cent) and Ireland (29 per cent).

Table 11 Percentage of total expenditure spent on cigarettes, UK

2008	1.8
2009	1.8
2010	1.9
2011	1.9
2012	1.9

Source: Adapted from Table 1.2, Keynote Report Cigarettes and Tobacco, 2013.

Current competition

The cigarette market is an oligopoly both globally and in the UK. Worldwide, four firms account for 50 per cent of the market – Philip Morris International, British American Tobacco (BAT), Imperial Tobacco and Japan Tobacco International (JTI).[9] In the UK, Imperial Tobacco accounts for 45 per cent of the market, JTI 39 per cent and BAT 8 per cent.[10]

The traditional tools available to firms to increase their market share, such as pricing and promotion, are severely curtailed in this industry by legislation. A large proportion (77 per cent) of the price of a packet of cigarettes is taxation and many countries have bans on smoking in public spaces in place. The extent of advertising that companies can do has been reduced by the government. The proposal (adopted in some countries) to enforce plain cigarette packaging has been postponed indefinitely by the UK government, but there is still pressure to introduce this.

Power of buyers

As Figure 4 shows, the rate of smoking in the UK has fallen over the last 50 years. This is mainly due to greater awareness of the health effects of smoking, government campaigns to reduce smoking and increased taxation. In 2013, the price of a packet was around £8 for 20 and the tax component of that was around £6.20. The demand for cigarettes is inelastic because it is habit forming and difficult to give up. This explains why, although the incidence of smoking has fallen, revenue to the tobacco companies has gone up. It would be expected that the economic downturn would have had a negative impact on the market for cigarettes in the UK as households tightened their belts; the inelastic nature of demand, however, would tend to negate this.

The availability of substitutes

Substitutes for cigarettes include hand-rolled tobacco, which is cheaper than ready-rolled. There is some evidence in the UK that substitution has taken place – in 2008, cigarettes made up 86.1 per cent of total spending on tobacco products; by 2013 this had gone down to 85.7 per cent.

A newer substitute is the electronic cigarette or e-cigarette. These enable smokers to consume nicotine but without the more harmful chemicals like carbon monoxide or tar. These were patented in 2003 and by 2013 more than 1 million people in the UK were using them.[10] There are some health issues with e-cigarettes: the World Health Organisation advised against them in 2013 because of the possibility of getting nicotine poisoning. In the UK, they will be licensed as a medicine by 2016. This means that they will be more controlled and could be prescribed by doctors.

The e-cigarette market is one that has seen rapid growth – the sales of e-cigarettes rose from £2.5 million in 2012 to £23.9 million in 2013. There are many brands of e-cigarettes that are widely available from supermarkets and online. Another substitute is e-shisha devices, which contain no nicotine. Although this is a competitive market at the moment, this is likely to change as the major cigarette producers are very active in the market. Imperial Tobacco bought Dragonite International in 2013, which produced the Ruyan brand, while BAT introduced its e-cigarette (Vype) in 2013 and JTI has diversified into shisha.

Potential competition

This industry is one with a small number of large producers globally and with high barriers to entry. It is also a declining market, so the level of potential competition is low. This is not true at present in the market for e-cigarettes, but this may change.

Power of suppliers

The main raw material needed for production of cigarettes is tobacco and the main sources of tobacco are Brazil and China. Tobacco is a product that can be stored for a considerable time, which gives the suppliers less power over the cigarette producers. Some cigarette producers have an involvement in tobacco growing to further protect themselves from seller power – BAT, for example – this is an example of vertical integration.

Case study questions

1 If e-cigarettes become licensed as a medicine, what is likely to be the impact on the market structure?

2 Given that cigarette smoking is a declining market which is predicted to continue to decline, use the life cycle model to show how e-cigarettes can rejuvenate the market.

web link

For information on smoking and e cigarettes, see *www.ash.org.uk*, *www.ecita.org.uk*; there was also a report on e-cigarettes due from Mintel in February 2014.

Review and discussion questions

1 Use Porter's five-forces model to analyse two industries of your choice. Try to choose industries which have contrasting market structures.

2 What economies of scale are likely to exist in retailing?

3 Think of examples of a market which is very competitive and a market which is not very competitive. Does the behaviour of the firms in these markets comply with the predictions in Table 7?

4 Why are goods such as washing powders and coffee advertised more heavily than goods like matches or bread?

Assignments

1 You are working in the strategic planning department of a large recorded music producer and have been asked to write a briefing document for a board meeting on the structure of the industry. Use either the structure–conduct–performance model or Porter's five-forces model as a framework for this briefing. (Sources of information: Competition Commission reports, the previous editions of this book, media and local libraries, Mintel and Key Note.)

2 You are working in the local consumer advice centre, which each week produces an information sheet giving the prices of a typical 'basket of goods' in local shops. Choose ten branded items (Nescafé, for example) to constitute your basket of goods and survey three types of retail outlet: a small corner shop, a mini-market on a local main road and a large supermarket. Design an information sheet and present the information you have gathered in the form of a table. Include a list of bullet points that might explain any differences in price.

Notes and references

1 See Hay, D. A. and Morris, D. J., *Industrial Economics: Theory and Evidence*, Oxford University Press, 1979, for a summary of the criticisms that are beyond the scope of this book.

2 Porter, M., *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, The Free Press, 1980.

3 For a full discussion of this, see Begg, D., Fischer, S. and Dornbusch, R., *Economics*, 10th edition, McGraw-Hill, 2011.

4 Porter, *op. cit*.

5 Baumol, W. J., Panzar, J. C. and Willig, R. D., *Contestable Markets and the Theory of Industry Structure*, Harcourt Brace Jovanovich, 1988.

6 In this context students should note the use of game theory to model and predict the behaviour of firms in oligopolistic markets. For a simple introduction to this area, see Griffiths, A. and Wall, S., *Applied Economics: An Introductory Course*, 12th edition, Financial Times/Prentice Hall, 2011.

7 Williamson, O. E., 'The economics of organisation: the transaction cost approach', *American Journal of Sociology*, 87 (3), 1981, pp. 548–577.

8 See Statistics on Smoking, 2013, Health & Social Care Information Centre, *www.hscic.gov.uk*

9 The other 50 per cent of the global market is almost completely accounted for by the China National Tobacco Corporation.

10 See Economics of Tobacco, Action on Smoking Health, *www.ash.org.uk*

Further reading

Begg, D., Fischer, S. and Dornbusch, R., *Economics*, 10th edition, McGraw-Hill, 2011.

Griffiths, A. and Wall, S., *Applied Economics: An Introductory Course*, 12th edition, Financial Times/Prentice Hall, 2012.

Worthington, I., Britton, C. and Rees, A., *Economics for Business: Blending Theory and Practice*, 2nd edition, Financial Times/Prentice Hall, 2005.