

JOHN SLOMAN • DEAN GARRATT
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ECONOMICS FOR BUSINESS

SEVENTH EDITION



ECONOMICS FOR BUSINESS

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ECONOMICS FOR BUSINESS

Seventh edition

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About the authors



John Sloman was Director of the Economics Network (www.economicnetwork.ac.uk) from 1999 to 2012. The Economics Network is a UK-wide organisation based at the University of Bristol and provides a range of services designed to promote and share good practice in learning and teaching economics. John is now a Visiting Fellow at Bristol

and a Senior Associate with the Economics Network.

John is also Visiting Professor at the University of the West of England, Bristol, where, from 1992 to 1999, he was Head of School of Economics. He taught at UWE until 2007. John has taught a range of courses, including economic principles on social science and business studies degrees, development economics, comparative economic systems, intermediate macroeconomics and managerial economics. He has also taught economics on various professional courses.

He is also the co-author with Alison Wride and Dean Garratt of *Economics* (Pearson Education, 9th edition 2015), with Dean Garratt of *Essentials of Economics* (Pearson Education, 7th edition 2016) and with Elizabeth Jones of



Dean Garratt is a Principal Lecturer in Economics at Nottingham Business School (NBS), Assistant Head of Economics and the course leader for the School's MSc Economics programme. In 2014/15 Dean worked as a Principal Teaching Fellow in Economics at the University of Warwick having previously been at NBS from

2001, including a period as course leader for the undergraduate economics courses.

Dean teaches economics at a variety of levels to students both on economics courses and non-economics courses. He is passionate about encouraging students to communicate economics more intuitively, to deepen their interest in economics and to apply economics to a range of issues.

Earlier in his career Dean worked as an economic assistant at both HM Treasury and at the Council of Mortgage Lenders. While at these institutions Dean was researching

Essential Economics for Business (4th edition 2014). Translations or editions of the various books are available for a number of different countries with the help of co-authors around the world.

John is very interested in promoting new methods of teaching economics, including group exercises, experiments, role playing, computer-aided learning and the use of audience response systems and podcasting in teaching. He has organised and spoken at conferences for both lecturers and students of economics throughout the UK and in many other countries.

As part of his work with the Economics Network he has contributed to its two sites for students and prospective students of economics: *Studying Economics* (www.studyingeconomics.ac.uk) and *Why Study Economics?* (www.whystudyeconomics.ac.uk)

From March to June 1997, John was a visiting lecturer at the University of Western Australia. In July and August 2000, he was again a visiting lecturer at the University of Western Australia and also at Murdoch University in Perth.

In 2007, John received a Lifetime Achievement Award as 'outstanding teacher and ambassador of economics' presented jointly by the Higher Education Academy, the Government Economic Service and the Scottish Economic Society.

and briefing on a variety of issues relating to the household sector and to the housing and mortgage markets.

Dean is a Senior Fellow of the Higher Education Academy and an Associate of the Economics Network helping to promote high-quality teaching practice. Dean has been involved in several projects promoting a problem-based approach in the teaching of economics.

In 2006 Dean was awarded the Outstanding Teaching Prize by the Economics Network. The award recognises exemplary teaching practice that deepens and inspires interest in economics. In 2013, Dean won the student-nominated Nottingham Business School teacher of the year award.

Dean is an academic assessor for the Government Economic Service (GES). In this role he helps to assess potential recruits to the GES with particular focus on the ability of candidates to articulate their understanding of economics and its applications.

Outside of work, Dean is an avid watcher of most sports. Having been born in Leicester, he is a season ticket holder at both Leicester City Football Club and Leicestershire County Cricket Club.



Jon Guest is a Principal Teaching Fellow in economics at Warwick Business School. He joined the University of Warwick in 2015 having previously spent over 20 years as a Lecturer, Senior Lecturer and Principal Lecturer in the Economics Department at Coventry University.

Jon has taught a range of courses including Principles of Microeconomics, Intermediate Microeconomics, Economics of Human Resource Management and Behavioural Economics. He has also taught economics on various professional courses for the Government Economic Service and HM-Treasury.

His approach towards teaching is one that tries to convey his own enthusiasm for the subject combined with material that presents abstract economics concepts in the context of the everyday life of the student. Questions such as ‘Why do I never stick to my revision timetable?’ help to create lively discussions and develop students’ ability to think like an economist. He has also published chapters in textbooks on the economics of professional team sports and is an editor and regular contributor for the Economic Review.



Elizabeth Jones is a Principal Teaching Fellow in the Economics Department at the University of Warwick. She joined the University of Warwick in 2012 and was the Deputy Director of Undergraduate Studies for 2 years. Since 2014, she has been the Director of Undergraduate Studies, with overall responsibility

for all Undergraduate Degree programmes within the Economics Department. She is also a Fellow for the Warwick International Higher Education Academy and through this, she is involved in developing and sharing best practice in teaching and learning within Higher Education.

She is also the Academic Co-ordinator for the Warwick Economics Summer School and teaches on the Microeconomics and Principles of Economics Courses. She has also been involved in delivering the Warwick Economics Summer School in New Delhi, India, which delivers introductory courses in Economics to 16-18 year olds and has delivered taster events to schools in Asia about studying Economics at University.

Prior to being at Warwick, Elizabeth was a Lecturer at the University of Exeter within the Business School and was in this position for 5 years, following the completion of her MSc in Economics. She also taught A level Economics and Business Studies at Exeter Tutorial College and continues to work as an Examiner in Economics for AQA. She is also a

member of the OCR Consultative Forum and has previously been involved in reviewing A level syllabi for the main Examining bodies.

Jon has worked on developing teaching methods that promote a more active learning environment in the classroom. In particular, he has published journal articles and carried out a number of funded research projects on the impact of games and experiments on student learning. These include an on-line version of the TV show ‘Deal No Deal’ and games that involve students acting as buyers and sellers in the classroom. He has also recently created a series of short videos and implemented elements of the flipped classroom into his teaching.

Through his work as an Associate of the Economics Network, Jon has run sessions on innovative pedagogic practices at a number of universities and major national events. He is also an academic assessor for the Economic Assessment Centres run by the Government Economic Service. This involves interviewing candidates and evaluating their ability to apply economic reasoning to a range of policy issues.

The quality of his teaching was formally recognised when he became the first Government Economic Service Approved Tutor in 2005 and won the student nominated award from the Economics Network in the same year. In 2011 Jon was awarded a National Teaching Fellowship by the Higher Education Academy.

Outside of work Jon is a keen runner and has completed the London Marathon. He is also a long suffering supporter of Portsmouth Football Club.

Elizabeth has taught a range of courses including Principles of Economics; Economics for Business; Intermediate Microeconomics; Economics of Social Policy; Economics of Education and Applied Economics. She has won multiple student-nominated awards for teaching at Warwick and Exeter University and loves interacting with students in the classroom. She has a passion for teaching Economics and particularly enjoys teaching Economics to non-economists and spends much of her time at Warwick investing in innovative approaches to teaching and learning. She is also a contributor to the Sloman Economics News Site and uses the blogs within her teaching.

Elizabeth has taught on a number of professional courses, with EML Learning Ltd, where she teaches Economics for Non-economists and Intermediate Microeconomics to the public sector. She has delivered courses across all government Departments, including BIS, Department for Transport, HM-Treasury and the Department for Health. She has also been involved in teaching on the induction programme for new HM-Treasury employees, looking at economics, the role of policy, analysing and using evidence and the implementation of policy.

Outside of work, Elizabeth loves any and all sports. She is an avid fan of Formula 1, tennis and football and provides ongoing support to her father’s beloved Kilmarnock FC.

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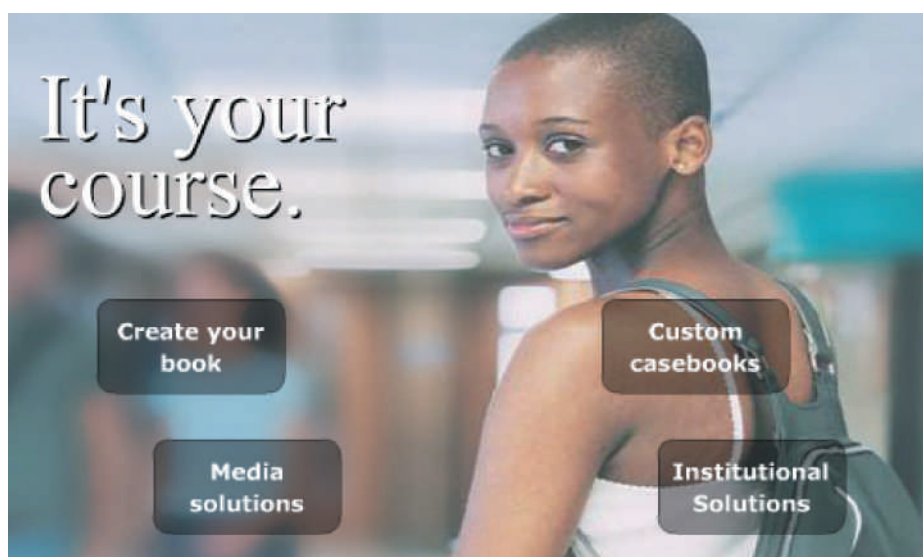
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Preface

TO THE STUDENT

If you are studying economics on a business degree or diploma, then this book is written for you. Although we cover all the major principles of economics, the focus throughout is on the world of business. For this reason we also cover several topics that do not appear in traditional economics textbooks.

As well as making considerable use of business examples throughout the text, we have included many case studies (in boxes). These illustrate how economics can be used to understand particular business problems or aspects of the business environment. Many of these case studies cover issues that you are likely to read about in the newspapers. Some cover general business issues; others look at specific companies. Nearly all of them cover topical issues including, the rise of online business, the video gaming market, entrepreneurship, competition and growth strategy, the banking crisis of the late 2000s, the sluggish recovery from recession, quantitative easing, the role of global trade and increased competition from newly industrialised countries.

The style of writing is direct and straightforward, with short paragraphs to aid rapid comprehension. There are also questions interspersed throughout the text in 'Pause for thought' panels. These encourage you to reflect on what you are learning and to see how the various ideas and theories relate to different issues. Definitions of all key terms are given in definition boxes, with defined terms appearing in bold. Also we have highlighted 44 'Key ideas', which are fundamental to 'thinking like an economist'. We refer back to these every time they recur in the book. This helps you to see how the subject ties together, and also helps you to develop a toolkit of concepts that can be used in a host of different contexts.

Summaries are given at the end of each chapter, with points numbered according to the section in which they appeared. These summaries should help you in reviewing the material you have covered and in revising for exams. Each chapter finishes with a series of questions. These can be used to check your understanding of the chapter and help you to see how its material can be applied to various business problems. References to various useful websites are listed at the end of each Part of the book.

The book also has a blog, The Sloman Economics News Site, with several postings each week by the authors. The blog discusses topical issues, links to relevant articles, videos and data and asks questions for you to think about.

In addition to the blog, the book is accompanied by an interactive website, MyEconLab. This is a personalised and innovative online study and testing resource. It also contains an online version of the book, 145 additional case studies, answers to 'Pause for Thought' questions, animations of key models in the book with audio explanations, a set of videoed interviews with businesspeople about decision-making and the relevance of economics to their businesses, hotlinks to 278 websites, plus other materials to improve your understanding of concepts and techniques used in economics.

We hope that, in using this book, you will share some of our fascination for economics. It is a subject that is highly relevant to the world in which we live. And it is a world where many of our needs are served by business – whether as employers or as producers of the goods and services we buy. After graduating, you will probably take up employment in business. A thorough grounding in economic principles should prove invaluable in the business decisions you may well have to make.

TO LECTURERS AND TUTORS

The aim of this book is to provide a course in economic principles as they apply to the business environment. It is designed to be used by first-year undergraduates on business studies degrees and diplomas where economics is taught from the business perspective. It is also suitable for students studying economics on postgraduate courses in

management, including the MBA, and various professional courses.

Being essentially a book on economics, we cover all the major topics found in standard economics texts – indeed, some of the material in the principles sections is drawn directly from *Economics* (9th edition). But in addition there

are several specialist business chapters and sections to build upon and enliven the subject for business studies students. These have been fully updated and revised for this new edition. The following are some examples of these additional topics:

- The business environment
- Business organisations
- Characteristics theory
- Advertising and marketing of products
- Business strategy
- Alternative aims of firms
- Growth strategy
- Strategic alliances and various other forms of co-operation between firms
- The small-firm sector
- Pricing in practice, including topics such as mark-up pricing, an extended analysis of first-, second- and third-degree price discrimination in various contexts, multiple product pricing, transfer pricing and pricing over the product life cycle
- Government and the firm, including policies towards research and development (R&D) and policies towards training
- Government and the market, including environmental policy and transport policy
- Financial markets and the funding of business investment
- The financial well-being of firms, households and governments and its impact on the business environment
- The multinational corporation
- Globalisation and business
- Trading blocs and their development
- Monetary union, the future of the eurozone and implications for business

The text is split into 32 chapters. Each chapter is kept relatively short to enable the material to be covered in a single lecture or class. Each chapter finishes with a summary and review questions, which can be used for seminars or discussion sessions.

The chapters are grouped into 11 Parts:

- Part A Business and economics (Chapters 1–3) establishes the place of business within the economy and the relevance of economics to business decision making.
- Part B Business and markets (Chapters 4 and 5) looks at the operation of markets. It covers supply and demand analysis and examines the importance of the concept of elasticity for business decisions.
- Part C Background to demand (Chapters 6–8) considers the consumer – how consumer behaviour can be predicted and how, via advertising and marketing, consumer demand can be influenced.
- Part D Background to supply (Chapters 9 and 10) focuses on the relationship between the quantity that businesses produce and their costs, revenue and profits.
- Part E Supply: short-run profit maximisation (Chapters 11 and 12) presents the traditional analysis of market structures and the implications that such structures have for business conduct and performance.
- Part F Supply: alternative strategies (Chapters 13–17) starts by looking at business strategy. It then considers various alternative theories of the firm. It also examines how business size can influence business actions, and why pricing strategies differ from one firm to another and how these strategies are influenced by the market conditions in which firms operate.
- Part G The firm in the factor market (Chapters 18 and 19) focuses on the market for labour and the market for capital. It examines what determines the factor proportions that firms use and how factor prices are determined.
- Part H The relationship between government and business (Chapters 20–22) establishes the theoretical rationale behind government intervention in the economy, and then assesses the relationship between the government and the individual firm and the government and the market.
- Part I Business in the international environment (Chapters 23–25) starts by examining the process of globalisation and the growth of the multinational business. It then turns to international trade and the benefits that accrue from it. It also examines the issue of protection and international moves to advance free trade. Finally it examines the expansion of regional trading agreements.
- Part J The macroeconomic environment (Chapters 26–29) considers the macroeconomic framework in which firms operate. We focus on the principal macroeconomic variables, investigate the role of money in the economy, and briefly outline the theoretical models underpinning the relationships between these variables.
- Part K Macroeconomic policy (Chapters 30–32) examines the mechanics of government intervention at a macro level as well as its impact on business and its potential benefits and drawbacks. Demand-side and supply-side policy and economic policy co-ordination between countries are all considered.

SPECIAL FEATURES

The book contains the following special features:

- A direct and straightforward written style, with short paragraphs to aid rapid comprehension. The aim all the time is to provide maximum clarity.
- Attractive full-colour design. The careful and consistent use of colour and shading makes the text more attractive to students and easier to use by giving clear signals as to the book's structure.

- Key ideas highlighted and explained where they first appear. There are 44 of these ideas, which are fundamental to the study of economics. Students can see them recurring throughout the book, and an icon appears in the margin to refer back to the page where the idea first appears. Showing how ideas can be used in a variety of contexts helps students to ‘think like an economist’ and to relate the different parts of the subject together. All 44 Key ideas are defined in a special section at the end of the book.
- Pause for thought’ questions integrated throughout the text. These encourage students to reflect on what they have just read and make the learning process a more active one. Answers to these questions appear in the student section of MyEconLab.
- Double-page opening spreads for each of the 11 Parts of the book. These contain an introduction to the material covered and an article from the *Financial Times* on one of the topics.
- All technical terms are highlighted and clearly defined in definition panels on the page on which they appear. This feature has proved very popular in previous editions and is especially useful for students when revising.
- A comprehensive glossary of all technical terms.
- Additional applied material to that found in the text can be found in the boxes within each chapter. All boxes include questions which relate the material back to the chapter in which the box is located. The extensive use of applied material makes learning much more interesting for students and helps to bring the subject alive. This is particularly important for business students who need to relate economic theory to their other subjects and to the world of business generally. The boxes are current and include discussion of a range of companies and business topics. They are ideal for use as case studies in class. Answers to the questions in boxes can be found in the lecturer part of MyEconLab, which you can make available to students if you choose.
- Additional case studies with questions appearing in MyEconLab are referred to at the end of each Part. Again, they can be used for class, with answers available on the lecturer part of MyEconLab.
- Detailed summaries appear at the end of each chapter with the points numbered by the chapter section in which they are made. These allow students not only to check their comprehension of the chapter’s contents, but also to get a clear overview of the material they have been studying.
- Each chapter concludes with a series of review questions to test students’ understanding of the chapter’s salient points. These questions can be used for seminars or as set work to be completed in the students’ own time. Again, answers are available to lecturers on MyEconLab.
- References at the end of each Part to a list of relevant websites, details of which can be found in the Web appendix at the end of the book. You can easily access any of these sites from the book’s own website (at www.pearsonblog.campaignserver.co.uk/). When you enter the site, click on ‘Hotlinks’. You will find all the sites from the Web appendix listed. Click on the one you want and the ‘hotlink’ will take you straight to it.
- A comprehensive index, including reference to all defined terms. This enables students to look up a definition as required and to see it used in context.

SUPPLEMENTS

Blog

Visit the book’s blog, *The Sloman Economics News Site*, at www.pearsonblog.campaignserver.co.uk/ This refers to topical issues in economics and relates them to particular chapters in the book. There are several postings per week, with each one providing an introduction to the topic, and then links to relevant articles, videos, podcasts, data and official documents, and then questions which students and lecturers will find relevant for homework or class discussion.

MyEconLab for students

MyEconLab provides a comprehensive set of online resources. A student access code card may have been included with this textbook at a reduced cost. If you do not have an access code, you can buy access to MyEconLab and the eText – an online version of the book – at www.myeconlab.com.

Central to MyEconLab is an interactive study plan with questions and answers. You will also find a variety of tools to enable you to assess your own learning. A personalised Study Plan identifies areas to concentrate on to improve grades, and specific tools are provided to enable you to direct your studies in a more efficient way. Other resources include:

- An eText version of the book to enable you to access it via the Internet
- Animations of key models with audio explanations
- 145 case studies with questions for self-study, ordered Part-by-Part and referred to in the text
- Updated list of 278 hot links to sites of use for economics
- Answers to all in-chapter (Pause for Thought) questions
- Videoed interviews with a number of businesspeople, where the discuss business decision-making and the relevance of economic concepts to them
- Glossary flashcards to test and check your knowledge of all technical concepts

MyEconLab for lecturers and tutors

MyEconLab can be set up by you as a complete virtual learning environment for your course or embedded into Blackboard, WebCT or Moodle. You can customise its look and feel and its availability to students. You can use it to provide support to your students in the following ways:

- My EconLab's gradebook automatically records each student's time spent and performance on the tests and Study Plan. It also generates reports you can use to monitor your students' progress.
- You can use MyEconLab to build your own test, quizzes and homework assignments from the question base provided to set your own students' assessment.
- Questions are generated algorithmically so they use different values each time they are used.
- You can create your own exercises by using the econ exercise builder.

Additional resources for lecturers and tutors

There are many additional resources for lecturers and tutors that can be downloaded from the lecturer site of MyEconLab. These have been thoroughly revised for the seventh edition. These include:

- PowerPoint® slide shows in full colour for use with a data projector in lectures and classes. These can also be made available to students by loading them on to a local network. There are several types of slideshows:
 - *All figures from the book and most of the tables.* Each figure is built up in a logical sequence, thereby allowing tutors to show them in lectures in an animated form.
 - *Customisable lecture slideshows.* There is one for each chapter of the book. Each one can be easily edited,

with points added, deleted or moved, so as to suit particular lectures. A consistent use of colour is made to show how the points tie together. They come in various versions:

- Lecture slideshows with integrated diagrams. These include animated diagrams, charts and tables at the appropriate points.
- Lecture slideshows with integrated diagrams and questions. These are like the above but also include multiple-choice questions, allowing lectures to become more interactive. They can be used with or without an audience response system (ARS). ARS versions are available for InterWrite PRS® and two versions of TurningPoint® and are ready to use with appropriate 'clickers'.
- Lecture plans without the diagrams. These allow you to construct your own diagrams on the blackboard or whiteboard, or use an OHP or visualiser.
- Case studies. These, also available in the student part of MyEconLab, can be reproduced and used for classroom exercises or for student assignments. Answers are also provided (not available on the student site).
- Workshops. There are 24 of these, each one covering one or more chapters. They are in Word® and can be reproduced for use with large groups (up to 200 students) in a lecture theatre or large classroom. Suggestions for use are given in an accompanying file. Answers to all workshops are given in separate Word® files.
- Teaching/learning case studies. There are 20 of these. They examine various approaches to teaching introductory economics and ways to improve student learning of introductory economics.
- Answers to all end-of-chapter questions, pause for thought questions, questions in boxes, questions in the case studies in MyEconLab, the 24 workshops.

ACKNOWLEDGEMENTS

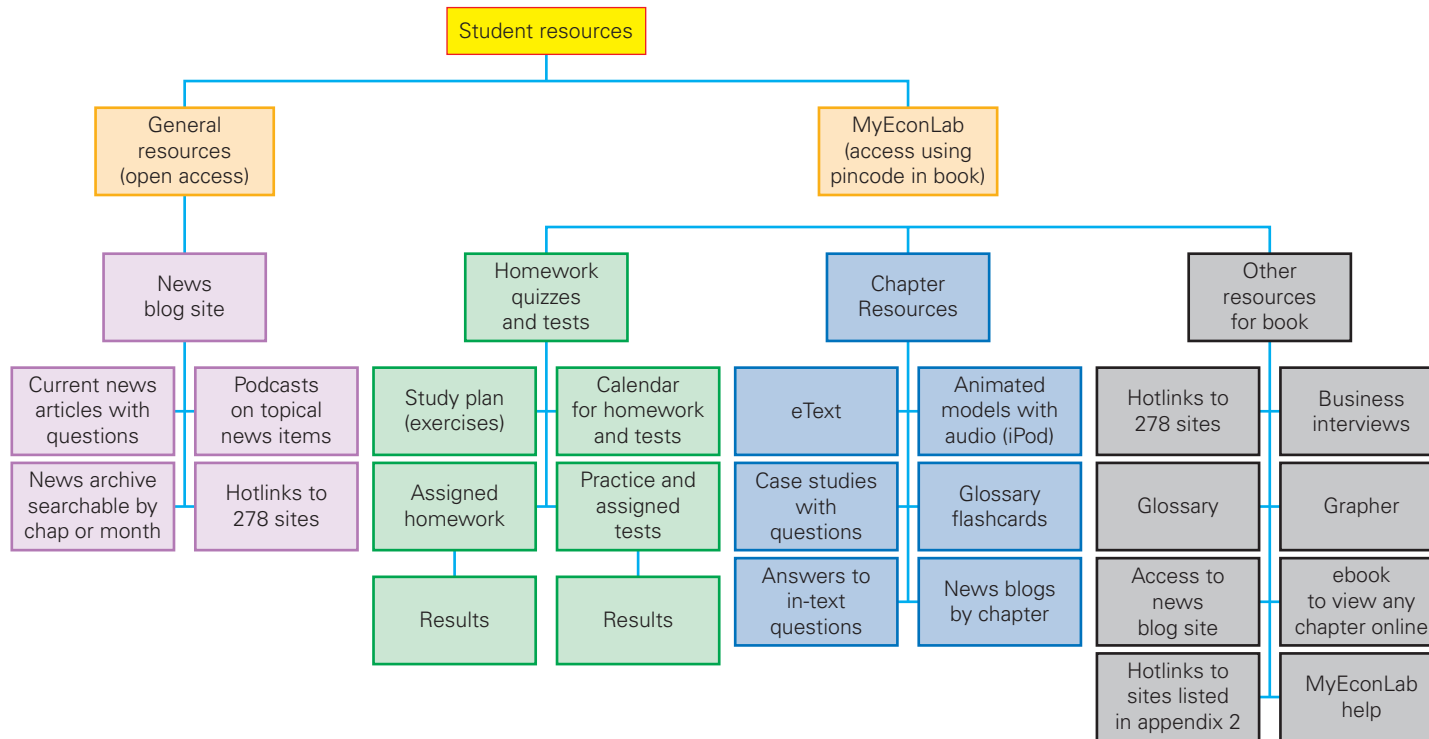
As with previous editions, we've had great support from the team at Pearson, including Kate Brewin, Caitlin Lisle, Louise Hammond, Tim Parker, Zoe Smith and Melanie Beard. We'd like to thank all of them for their hard work and encouragement. Thanks too to the many users of the book who have given us feedback. We always value their comments. Please continue to send us your views.

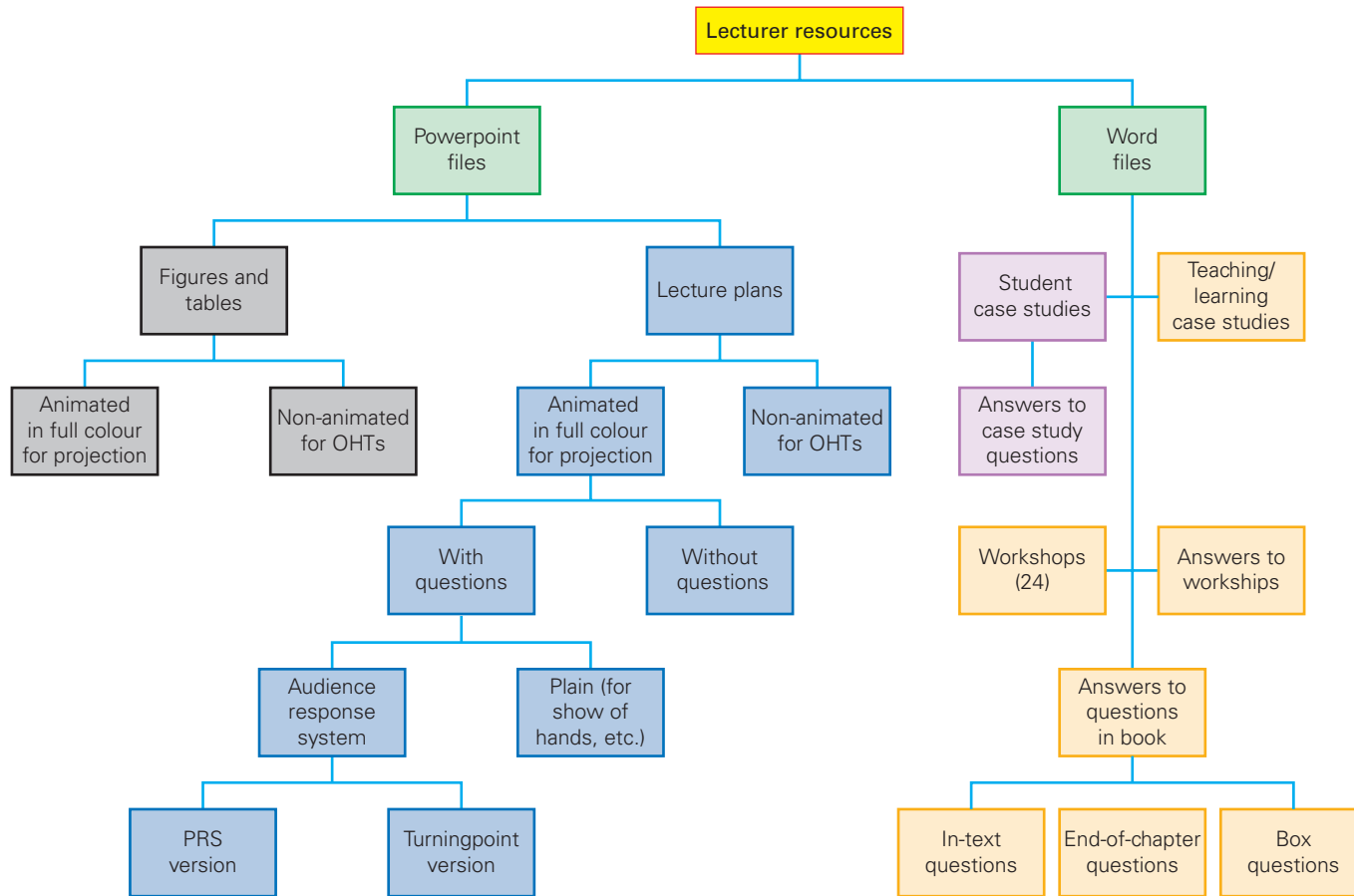
Kevin Hinde and Mark Sutcliffe, co-authors with John on previous editions, have moved on to new ventures. However,

many of their wise words and ideas are still embedded in this edition and, for that, we offer a huge thanks.

Our families have also been remarkably tolerant and supportive throughout the writing of this new edition. Thanks especially to Alison, Pat, and Helen, Elizabeth, Douglas and Harriet who seem to have perfected a subtle blend of encouragement, humour, patience and tolerance.

John, Dean, Elizabeth and Jon





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Figures

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Business and economics

The FT Reports . . .

The Financial Times, 26 October 2015

FT

Apple investors worry the iPhone is losing its shine

By Tim Bradshaw

When Apple reports its earnings this week, Wall Street wants to know just one thing: will iPhone sales keep growing?

Apple's smartphone has become one of the most profitable products the technology industry has ever produced. In the three months to December last year [2014], so lucrative was the iPhone that Apple reported the most profitable quarter of any US company on record.

But the euphoria of that achievement soon gave way to the daunting challenge of matching or even exceeding such a record profit.

Most analysts predict that iPhone unit growth . . . will slow from about 35 per cent over the past year to the low single-digits for the next few quarters. But given the strength of its performance a year ago, concerns remain that even that may be a stretch.

"Sentiment on Apple is a-changin", wrote analysts at Berenberg in a recent note . . . Tim Cook, Apple's Chief Executive, dismissed questioning by analysts three months ago about the impact of Chinese macroeconomic fluctuations on iPhone demand in its most important growth market.

Nonetheless, even Apple analysts who are normally more bullish have acknowledged the

concern that iPhone sales might soon see a year-on-year drop for the first time since its launch.

Gene Munster of Piper Jaffray predicts a 3 per cent rise in iPhone unit sales over the coming year, a sharp slowdown from its growth rate of 25 per cent in the three months to September, which Apple is expected to report this week. . . .

Worries about iPhone growth will put renewed focus on which new products may be able to take up some of the slack.

Mr Cook's comments a week ago that carmakers face "massive change" because of technology trends may bolster confidence among investors that Apple is serious about entering the automotive industry with a vehicle of its own in the coming years.

But in the near term, investor focus will be on Apple's Watch . . . and its TV box and larger iPads . . . Apple has not disclosed sales figures for the Watch but a software update in September has made modest improvements to the user experience, according to a recent study . . . Wristly found that 90 per cent of owners wear the Apple Watch every day, seen as a higher rate than other wearable devices such as fitness trackers, which are often abandoned a few months after purchase.

I dread admitting I am an economist. The cab driver quizzes you on what is going to happen to the economy, the dinner companion turns to talk to the person on the other side and the immigration officer says, with heavy sarcasm, that his country needs people like you.

John Kay, 'Everyday economics makes for good fun at parties', *Financial Times*, 2 May 2006



Businesses play a key role in all our lives. Whatever their size, and whatever the goods or services they provide, they depend on us as consumers to buy their products.

But just as businesses rely on us for their income, many of us also rely on them for our income. The wages we earn depend on our employer's success, and that success in turn depends on us as suppliers of labour.

And it is not just as customers and workers that we are affected by business. The success of business in general affects the health of the whole economy and thus the lives of us all.

The extract from the *Financial Times* takes the case of Apple and the iPhone. To be successful, firms must be capable of responding to changes in the market environment in which they operate. This requires a thorough understanding of economics. Developing a business strategy that simultaneously responds to technological changes, changes in consumer tastes and the activities of rival companies is not an easy task. Fortunately, economics provides frameworks for thinking about these issues, and many more.

In Part A of this text, we consider the relationship between business and economics.

In Chapter 1 we look at the structure of industry and its importance in determining firms' behaviour. We also look at a range of other factors that are likely to affect business decisions and how we can set about analysing the environment in which a firm operates in order to help it devise an appropriate business strategy.

Then, in Chapter 2 we ask what it is that economists do and, in particular, how economists set about analysing the world of business and the things businesses do. In particular, we focus on rational decision making – how to get the best outcome from limited resources.

Finally, in Chapter 3 we look at the different ways in which firms are organised: at their legal structure, at their internal organisation and at their goals.

Key terms

The business environment
PEST and STEEPLE analysis
Production
Firms
Industries
Industrial sectors
Standard Industrial Classification (SIC)
Industrial concentration
Structure–conduct–performance
Scarcity
Factors of production
Macroeconomics
Microeconomics
Opportunity cost
Marginal costs
Marginal benefits
Rational choices
Circular flow of income
Transaction costs
Principal and agent
Business organisation
Price taker
Perfectly competitive market
Price mechanism
Demand
Supply

The business environment and business economics

Business issues covered in this chapter

- What do business economists do?
- What is meant by the 'business environment'?
- How are businesses influenced by their national and global market environment?
- How are different types of industry classified in the official statistics?
- What things influence a firm's behaviour and performance?

What is business economics?

What is the role of *business economics*? What will you study in this text?

The global business environment has been rather uncertain since the start of the financial crisis in 2008/9. Furthermore, the world economy has experienced many changes in recent decades and they have had profound effects on businesses across the world. An economist's approach to the world of business requires that we examine *firms*: the environment in which they operate, the decisions they make, and the effects of these decisions – on themselves, on their customers, on their employees, on their business rivals, on the public at large and on the domestic and international economy.

All firms are different, but they are all essentially concerned with using inputs to make output. Inputs cost money and output earns money. The difference between the revenue earned and the costs incurred constitutes the firm's profit. Firms will normally want to make as much profit as possible, or at the very least avoid a decline in profits. In order to meet these and other objectives, managers will need to make choices: choices of what types of output to produce, how much to produce and at what price; choices of what techniques of production to use, how many workers to employ and of what type, what suppliers to use for raw materials, equipment, etc. In each case, when weighing up alternatives, managers will want to make the best choices. Business economists study these choices. They study economic decision making by firms.

The study of decision making can be broken down into three stages.

The external influences on the firm (the 'business environment'). Here we are referring to the various factors that affect the firm that are largely outside its direct control. Examples are the competition it faces, the prices its suppliers charge for raw materials, the state of the economy (e.g. whether growing or in recession) and the level of interest rates. Businesses need a clear understanding of their environment before they can set about making the right decisions.

Internal decisions of the firm. Given a firm's knowledge of these external factors, how will it then decide on prices, output, inputs, marketing, investment, etc.? Here the business economist can play a major role in helping firms achieve their business objectives.

The external effects of business decision making. When the firm has made its decisions and acted on them, how do the results affect the firm's rivals, its customers and the wider public? In other words, what is the impact of a firm's decision making on people outside the firm? Are firms' actions in the public interest, or is there a case for government intervention?

What do business economists do?

Our study of business will involve three types of activity:

- *Description.* We will describe the objectives of businesses (e.g. making profit or increasing market share), the types of market in which firms operate (e.g. competitive or non-competitive) and the constraints on decision making (e.g. the costs of production, the level of consumer demand and the state of the economy).
- *Analysis.* We will analyse how a firm's costs might vary with the amount of output it produces and how its revenues will be affected by a change in consumer demand or a change in the price charged by rivals. We will also analyse the upswings and downswings in the economy: something that will have a crucial bearing on the profitability of many companies.
- *Recommendations.* Given the objectives of a firm, the business economist can help to show how those objectives can best be met. For example, if a firm wants to maximise its profits, the business economist can advise on what prices to charge, how much to invest, how much to advertise, etc. Of course, any such recommendations will only be as good as the data on which they are based. In an uncertain environment, recommendations will necessarily be more tentative.

In this chapter, as an introduction to the subject of business economics, we shall consider the place of the firm within its business environment, and assess how these external influences are likely to shape and determine its actions. In order to discuss the relationship between a business's actions and its environment, we first need to define what the business environment is.

1.1 THE BUSINESS ENVIRONMENT

It is normal to identify four dimensions to the business environment: political, economic, social/cultural and technological.

Political factors. Firms are directly affected by the actions of government and other political events. These might be major events affecting the whole of the business community, such as the collapse of communism, the problems in Syria and Iraq, the troubles between Russia and Ukraine or a change of government. Alternatively, they may be actions affecting just one part of the economy. For example, the ban on smoking in public places affects the tobacco industry; a minimum price on alcohol would affect breweries, pubs, supermarkets, etc.

Economic factors. There are numerous and diverse economic factors that affect businesses and these must be taken into account when businesses devise and act upon their strategy. Economic factors include the rising costs of raw materials; the market entry of a new rival; the latest Budget; changes

in policy abroad; the current availability of investment funds and the economic performance of the domestic and world economy.

It is normal to divide the economic environment in which the firm operates into two levels:

- *The microeconomic environment.* This includes all the economic factors that are *specific* to a particular firm operating in its own particular market. Thus one firm may be operating in a highly competitive market, whereas another may not; one firm may be faced by rapidly changing consumer tastes (e.g. a designer clothing manufacturer), while another may be faced with a virtually constant consumer demand (e.g. a potato merchant); one firm may face rapidly rising costs, whereas another may find that costs are constant or falling.
- *The macroeconomic environment.* This is the *national* and *international* economic situation in which business as a whole operates. Business in general will fare much better when the economy is growing, as opposed to when it is

BOX 1.1

A PERFECT PARTNERSHIP

Making the best of your business environment

John Spedan Lewis created John Lewis in 1864 with the opening of a single shop on Oxford Street, London. In 1937, it bought Waitrose, which at the time had 10 shops. However, prior to this, in 1929, the first Trust Settlement was created making the John Lewis Partnership legal. Since then the Partnership has grown to include 43 John Lewis shops across the UK, 31 department stores, 10 John Lewis At Home, shops at St Pancras International and Heathrow Terminal 2, 33 Waitrose supermarkets, and an online and catalogue business, a production unit and a farm.

The John Lewis Partnership has over 90 000 permanent staff and it is they who own the business. The interests of these employees are the first priority of the John Lewis Partnership and they benefit if the company does well. They share in the profits and their opinions are taken into account in decision making, creating a democratic and transparent business. The Partnership has annual gross sales of over £10 billion and provides a wide range of goods and services. John Lewis itself has over 350 000 lines available in store and more than 280 000 lines available online. In addition, it offers other services, such as credit cards, insurance and broadband, to name a few.

The John Lewis Partnership is a unique one, in particular due to its organisational structure that puts its employees at its heart. Despite this very different focus from most businesses, the Partnership has been a success, expanding its reach over the past century. But how has it continued to be successful? What lessons are there for other businesses? How has its performance been affected by its business environment – by consumer tastes, by the actions of its rivals, by the state of the national and world economies and by government policy?

In particular, how would an economist analyse the Partnership's performance so as to advise it on its best strategy for the future? This is the sort of thing that business economists do and the sort of thing we will be doing throughout this text. We will also look at the impact of the behaviour of businesses on their customers, on employees, on competitors and on society in general. So let's take a closer look at the John Lewis Partnership and relate its business in general to the topics covered in this text.

The market environment

To be successful, it is important for the John Lewis Partnership to get its product right. This means understanding the markets that it operates in and how consumer demand responds to changes in prices and to the other services being offered. For example, in 2008, John Lewis responded to challenging conditions by increasing the number of products available for national delivery, prioritising customer service and introducing free delivery across the UK. Its investment in customer service clearly achieved its goal, helping John Lewis to rank as the best company in the 2009 UK Customer Satisfaction Survey. It has maintained good quality customer service since then and in the 2014 Verdict Customer Satisfaction Awards, it won various awards including Best Overall Retailer. John Lewis also enforced its commitment to being 'Never Knowingly Undersold', which helped the company to maintain its market share. It added lines such as Jigsaw to its fashion ranges to continue to meet customer demand and keep up with the fast-moving women's fashion industry.

The John Lewis Partnership as a whole has clearly had success in meeting the needs of its customers, having performed exceptionally well in the Which? Surveys. John Lewis won Best Retailer in 2014 for the second year in a row and Waitrose took the top spot in the Which? Supermarket survey in 2014 and was awarded the Best Food & Grocery Retailer prize in Verdict's Customer Satisfaction Awards.¹

We look at how markets work in general in Chapters 4 and 5 and then look specifically at consumer demand and methods of stimulating it in Chapters 6 to 8.

The store 'John Lewis' operates in a highly competitive market, facing competition in its fashion departments from firms such as Debenhams, Selfridges, Next, etc., and in other departments from firms such as Currys and DFS.

The products it sells are crucial for its success, but the prices charged are equally important. Consumers will not be willing to pay any price, especially if they can buy similar products from other stores. Thus when setting prices and designing products, consideration must be given to what rival companies are doing. John Lewis's prices must be competitive to maintain its sales, profitability and its position in the global market. The same applies to Waitrose, as the supermarket industry is highly competitive and with growth in demand for the low-cost retailers, it has been a difficult time for Waitrose and its more high-end competitors, such as Marks & Spencer.

With the emergence of the Internet and online shopping, John Lewis has had to adapt its strategy and consider which markets to target. Back in 2011, John Lewis expanded its online market to continental Europe as part of a £250 million investment programme. Backed up by excellent customer service, online sales have expanded rapidly – for the half year to July 2014 they were up 25 per cent at £552 million.² This reflects a changing national and global market environment where consumers are increasingly shopping online.

The John Lewis Partnership has typically been UK based, but Waitrose ventured into the Channel Islands in 2011, following approval by the Jersey Competition Regulatory Authority (JCRA) in August 2010 for it to purchase five Channel Island supermarkets.³ If the Partnership were to think about expanding further into the global marketplace, such as into the USA and Asia, careful consideration would need to be given to the competitors in these nations and to the tastes of consumers. Tesco, for example, had little success with its foray into the United States. The factors behind this would be something that the Partnership would need to consider before making any significant global move.

Strategic decisions such as growth by expansion in the domestic and global economy are examined in Chapters 13, 16 and 23.

¹ www.johnlewispartnership.co.uk/about/john-lewis.html

² www.johnlewispartnership.co.uk/media/press/y2014/press-release-11-september-2014-john-lewis-partnership-plc-interim-results-for-the-half-year-ended-26-july-2014.html

³ John Whiteaker, 'Waitrose invades Channel Islands', *Retail Gazette*, 26 August 2010.

Production and employment

Being a profitable business depends not just on being able to sell a product, but on how efficiently the product can be produced. This means choosing the most appropriate technology and deploying the labour force in the best way. John Lewis and Waitrose, as with other companies, must decide on how many workers to employ, what wage rates to pay and what the conditions of employment should be. We explore production and costs in Chapters 9 and 10 and the employment of labour in Chapter 18.

The John Lewis Partnership has over 90 000 permanent members of staff employed in a variety of areas. However, despite rising sales in difficult trading conditions, in 2013 John Lewis cut over 300 managerial positions, the biggest cut seen since 2009 when hundreds of call-centre workers lost their jobs. Workers typically have involvement in decisions given the nature of the organisational structure, but the enforced job cuts came as a shock, especially given the good Christmas trading when sales were 13 per cent up on the same period in the previous year. However, much of those sales came from its online trading, further suggesting a change in the way we shop and a need for companies to adapt. At the time, this was reinforced by the collapse of companies such as HMV, which was facing increased competition from online companies, such as Amazon. However in 2013, all 90 000 workers received a bonus of 17 per cent of their annual salary and this was backed up by a further 15 per cent bonus in 2014.⁴

On the production side, the Partnership is a vertically integrated company, with a production unit and a farm. John Lewis makes its own-brand textiles in Lancashire and also has a small fabric weaving operation creating thousands of products for its stores every week. Its efficient operations also allow John Lewis to operate a seven-day delivery system on orders of many types of product. However, the growth in this area did require changes, as the Managing Director, Ron Bartram pointed out:

To support that growth we've had to change the way we work . . . We need to expand our output in every area but our factory is very tight for space . . . We have to be flexible to handle the peaks and troughs of demand, and many Partners have been cross-trained so they can help out in different areas of the factory.⁵

In addition to selling its own-brand items in both John Lewis and Waitrose, numerous other brands are sold and this does create a need for awareness concerning the ethical nature of the business and what is known as 'corporate social responsibility'. We examine these broader social issues in Chapter 20, along with government policies to encourage, persuade or force firms to behave in the public interest.

The Partnership has been active in diversifying its suppliers and creating opportunities for small and medium-sized enterprises (SMEs) to access their supply chain, creating wider social benefits. In addition, Waitrose became the first supermarket to commit to stocking 100 per cent British in

its own-label dairy products and, as stated on the website, Waitrose 'looks to buy local with buyers seeking out the finest local and regional products, helping to boost the economy in many rural areas and enabling customers to sample the very best foods made locally'.⁶

The John Lewis Partnership remains a success story of Britain's high streets and it has been hailed by the government as a 'model of responsible capitalism'.

The economy

So do the fortunes of the John Lewis Partnership and other companies depend solely on their policies and those of their competitors? The answer is no. One important element of a company's business environment is largely beyond its control: the state of the national economy and, for internationally trading companies, of the global economy. When the world economy is booming, sales and profits are likely to grow without too much effort by the company. However, when the global economy declines, as we saw in the economic downturn from 2008, trading conditions will become much tougher. In the years after the financial crisis, the global economy remained in a vulnerable position and this led to many companies entering administration, such as Woolworths, Jessops, HMV, Comet, Blockbuster and Peacocks.

In the Annual Report by the John Lewis Partnership from 2009, its Chairman said:

As the economic downturn gained momentum, the focus of the Partnership has been to achieve the right balance between continuing to meet the needs and expectations of our customers and Partners while making sufficient profit to support our growth plans, by controlling our costs tightly and managing our cash efficiently.⁷

John Lewis experienced a slowdown in its sales of large value purchases in its home market, such as furnishings and electrical appliances, as the financial crisis began to spread. This decline in sales was largely driven by the collapse of the housing market, which remained weak for several years and has only recently begun to recover. Operating profit for the Partnership (excluding property profits) was down 17.7 per cent in April 2009 (compared to the same time the year before) at £316.8 million. For John Lewis itself, gross sales fell by 0.1 per cent and this pushed its operating profit down by £54.6 million from April 2008 to April 2009. Like-for-like sales were also down 3.4 per cent.

Due to the nature of the products being sold, Waitrose was somewhat more insulated against the financial crisis and in the same tax year experienced a 5.2 per cent increase in gross sales; a like-for-like sales growth of 0.4 per cent, but a fall in operating profit (excluding property profits) of 3.4 per cent. However, since then the supermarket industry has become more vulnerable, with low-cost retailers such as Aldi and Lidl posing a very real threat.

As difficult conditions prevailed in the economy, the Partnership turned things around, delivering 'market-beating

⁴John Lewis staff get 15% annual bonus', *BBC News*, 6 March 2014.

⁵Katy Perceval, 'Material world', *JLP e-Zine*, 21 May 2010.

⁶www.johnlewispartnership.co.uk/about/waitrose/products-and-services.html

⁷The John Lewis Partnership Annual Report and Accounts 2009.

sales growth' and healthy profits.⁸ Prior to 2009, John Lewis' advertising investment seemed largely ineffective and part of its strategy to boost demand since then has been the use of a new approach to advertising. Its highly emotive TV advertising campaigns stimulated interest in the brand and it led to increased numbers of shoppers visiting its stores and increased sales. According to the Institute of Practitioners in Advertising (IPA), the campaign generated £1074 million of extra sales and £261 million of extra profit in just over two years. In 2012, John Lewis was the Grand Prix winner, receiving the Gold Award in the IPA's Effectiveness Awards.

Gross sales in the 2011 to 2012 fiscal year rose by 9.1 per cent to £8.47 billion and the Group operating profit increased by 15.8 per cent to £409.6 million. This was the second year that both John Lewis and Waitrose saw significant growth in their sales and operating profit, suggesting a reversal of fortunes since the onset of the financial crisis.⁹ The positive trend has continued: gross sales for the Partnership were up

⁸www.johnlewispartnership.co.uk/content/dam/cws/pdfs/financials/annual%20reports/John_Lewis_plc_annual_report_and_accounts_2009.pdf

⁹The John Lewis Partnership Annual Report and Accounts 2011.

by 6 per cent in the half year to July 2014, with both Waitrose and John Lewis outperforming the industry. Profit before tax and exceptional items was 12 per cent up on 2013, recorded at £129.8 million. However, John Lewis' figures had to offset those from Waitrose, as the supermarket industry remains vulnerable. Waitrose saw its profits fall by 9.4 per cent in the six months to July 2014, despite its sales rising to £3.15 billion.¹⁰

We examine the national and international business environment in Chapters 23 to 29. We also examine the impact on business of government policies to affect the economy – policies such as changes in taxation, interest rates, exchange rates and customs duties in Chapters 30 to 32.



Choose a well-known company that trades globally and do a Web search to find out how well it has performed in recent years and how it has been influenced by various aspects of its business environment.

¹⁰'John Lewis' 62% profits soar off-sets poor Waitrose first half results', *The Drum*, 11 September 2014.

in recession, as we have seen since the onset of the financial crisis. In examining the macroeconomic environment, we will also be looking at the policies that governments adopt in their attempt to steer the economy, since these policies, by affecting things such as taxation, interest rates and exchange rates, will have a major impact on firms.

Social/cultural factors. This aspect of the business environment concerns social attitudes and values. These include attitudes towards working conditions and the length of the working day, equal opportunities for different groups of people (whether by ethnicity, gender, physical attributes, etc.), the nature and purity of products, the use and abuse of animals, and images portrayed in advertising. The social/cultural environment also includes social trends, such as an increase in the average age of the population, or changes in attitudes towards seeking paid employment while bringing up small children. In recent times, various ethical issues, especially concerning the protection of the environment, have had a big impact on the actions of business and the image that many firms seek to present.

Technological factors. Over the past 30 years there has been significant technological change, which has had a huge impact on how firms produce, advertise and sell their products. The growth in online shopping means that firms can compete in global markets, but it has created problems for high street retailers. It has also changed how business is organised, providing opportunities for smaller online retailers, many of which are yet to be realised. The use of robots and other forms of computer-controlled production has changed the nature of work for many workers. The informa-

tion-technology revolution has enabled much more rapid communication and has made it possible for firms across the world to work together more effectively. The working environment has become more flexible and efficient, with many workers able to do their job from home, while travelling or from another country.

The division of the factors affecting a firm into political, economic, social and technological is commonly known as a *PEST analysis*. However, we can add a further three factors to create *STEEPLE analysis*. The additional elements are:

Environmental (ecological) factors. This has become an increasingly important issue in politics and business, with many firms aiming to take a greener approach to business. Consumers are more environmentally aware and a green image can be useful in generating finance from investors and government. Business attitudes towards the environment are examined in section 22.1.

Legal factors. Businesses are affected by the legal framework in which they operate. Examples include industrial relations legislation, product safety standards, regulations

Definitions

PEST analysis Where the political, economic, social and technological factors shaping a business environment are assessed by a business so as to devise future business strategy.

STEEPLE analysis In addition to the four categories of factors considered in PEST analysis, STEEPLE analysis takes into account environmental, legal and ethical factors.

BOX 1.2

THE BIOTECHNOLOGY INDUSTRY

Its business environment

There are few areas of business that cause such controversy as biotechnology. It has generated new medicines, created pest-resistant crops, developed eco-friendly industrial processes and, through genetic mapping, is providing incalculable advances in gene therapy. These developments, however, have raised profound ethical issues. Many areas of biotechnology are uncontroversial, but genetic modification and cloning have met with considerable public hostility, colouring many people's views of biotechnology in general.

Biotechnology refers to the application of knowledge about living organisms and their components to make new products and develop new industrial processes. For many it is seen as the next wave in the development of the knowledge-based economy. The global biotechnology industry was worth some \$500 billion in 2015. The growth of the sector has made a significant contribution to job creation over the past 15 years.

The global structure of the industry

In global terms, the USA dominates this sector. According to the Organisation for Economic Co-operation and Development (OECD), out of a worldwide total of nearly 20 000 firms involved in biotechnology, the USA has 6862, of which 2178 are dedicated biotechnology firms, and between 2010 and 2012 these firms accounted for 41 per cent of all patent applications. Spain is the European leader in terms of biotechnology firms, with 3070, followed by France with 1950 firms, although France has more dedicated biotechnology firms than Spain. When compared to Europe as a whole, the US biotechnology sector spends over twice as much on research and development (R&D) – \$26 billion – and generates twice as much in revenues. The UK is seventh in the league table with some 614 biotech companies, 66 per cent of which are estimated to engage in R&D.

The industry is dominated by small and medium-sized businesses. Most biotechnology firms (approximately 80% in the UK) have fewer than 50 employees. However, the larger firms dominate the sector in terms of R&D. In the USA and France, the countries with the largest R&D expenditure, some 88 and 84 per cent of this was carried out by firms with over 50 employees. In most countries biotech firms are geographically clustered, forming industry networks around key universities and research institutes. In the UK, such clusters can be found in Cambridge, Oxford and London. The link with universities and research institutes taps into the UK's strong science base.

In addition to such clustering, the biotech industry is well supported by the UK government and charitable organisations such as the Wellcome Trust. Such support helps to fund what is a highly research-intensive sector. The UK government not only provides finance, but also encourages firms to form collaborative agreements, and through such collaboration hopes to encourage better management and use of the results that research generates. It also offers help for biotechnology business start-ups, and guidance on identifying and gaining financial support.

The EU too provides a range of resources to support business within the biotech sector. The EUREKA programme, founded in 1985, attempts to help create pan-EU partnerships. Now consisting of 40 members including the EU itself, it provides support for such collaborative ventures through a series of National Project Co-ordinators who help to secure national or EU funding. Successful projects are awarded the internationally recognised Eureka label.

Such support by governments is seen as a crucial requirement for the creation of a successful biotechnology sector, as product development within the industry can take up to 12 years.

Funding, growth and consolidation in the sector

The majority of funding for the industry comes from 'venture capital' (investment by individuals and firms in new and possibly risky sectors). Even though the UK is Europe's largest venture capital market, such funding is highly volatile. Following significant share price rises in 1999 and 2000, many of the biotech companies listed on the stock market saw their share prices collapse, along with those of various high-tech companies. With a depressed stock market, raising finance became much more difficult.

Then, after growth between 2000 and 2007, there was a collapse in investment in both the EU (–79%) and the US (–62%) biotechnology industry. This had a serious impact on the viability of some businesses in the sector. Some were forced to close and others had to scale back their activities. However, the sector as a whole weathered the downturn relatively well. Investment recovered quickly and by 2011 the amount of capital raised globally by biotechnology firms was higher than that for any year since 2000. Since 2012 biotechnology shares have soared, with many tripling in value in just three years.

Growth in research and development has also recovered and in 2013 industry R&D spending increased by 14 per cent; however, this included a 20 per cent increase in the USA, but a 4 per cent decline in Europe.¹¹ This is another indication of the impact of the financial crisis and indeed the more constrained finance faced across Europe. With the growth in R&D expenditure, there has been a decline in the industry's net income.

In recent years there has been considerable consolidation in the sector. Mergers and acquisitions (M&As) have increased, involving both public and private biotech companies. The EY Firepower Index, which measures biotech companies' ability to take over or merge with other companies based on the strength of its balance sheet, has suggested that since 2013 there have been more viable competitors for any particular transaction than in previous years.¹² 2014 was a record year for deal making, with worldwide biopharma M&As alone exceeding \$200 billion in value. And it was not just consolidation: there was a record number of new biotech companies, with 63 new US companies alone listed on the stock market.

High growth rates in coming years are expected. Forecasts indicate annual growth of the biotechnology sector of 10.8 per cent per year for the 10 years until 2019.¹³ Furthermore, Jonathon Porritt, a leading environmentalist in the UK, estimates that the global market for biotechnology could lie somewhere between £150 billion and £360 billion by 2025. The differential between these estimates is substantial, but nevertheless it gives some indication as to the likely trend for this industry and where significant job growth may arise.



From the brief outline above, identify the political, economic, social and technological dimensions shaping the biotechnology industry's business environment.

¹¹'Beyond borders: Biotechnology Industry Report 2014', Ernst & Young, 23 June 2014.

¹²Elton Licking, 'Firepower fireworks drive record M&A in 2014. What's ahead for 2015?', Ernst & Young, 7 January 2015.

¹³Global Technology Market Research Report, IBIS World, January 2015.