Business Environment Notes

Types of Organisations

A major aspect of human social development is the organisation or group - whether clan or family, community or city, or international body such as the European Union (E.U.) - which human beings have found necessary to join. There are a multitude of different kinds of groups to which individuals subscribe - whether political, social, religious, cultural, or economic. Individuals receive rights and benefits from their membership, but also have responsibilities to fulfil.

Just like individuals, organisations and groups share an interdependent existence. In other words each organisation is aware of others, and generally the actions of one organisation or group will affect others.

Politically, groups tend to form alliances with others in order to promote or protect a common interest. ***Political parties*** aim to ***make national policies***. In a democracy, the political party which gains a majority of the MP's elected by a national vote in a General Election can form the government; whereas smaller parties form their opposition. The government assumes the role of political decision-maker and national manager, using the apparatus of the State to govern. Some political groups act as ***interest groups*** or ***pressure groups***, their aim being to ***influence public policy in some area***. This type of political system is known as a ***pluralist democracy*** in which no one group obtains total control, because of the need to bargain in forming alliances and gaining support. Since any policy is likely to result in winners and losers, political decisions and policies tend to reflect the outcome of bargaining or conflict between interested groups.

Groups engage in political activity at all levels of society - community, regional, national and international. A major change in the 1980's occurred when pressure groups tended to be more successful as ***cause groups*** (e.g. Greenpeace) than ***interest groups*** (i.e. those promoting the welfare of members - e.g. trade unions). Environmental groups and consumer groups have been particularly active and effective in promoting their causes, and question the validity of the notion that some groups will inevitably be more powerful and effective than others.

In terms of social relationships there have been significant changes since 1945. The position and roles of women in society have changed, with women becoming an important market segment as income earners pursuing careers; the decision to delay having children until later in life has had a clear effect on the shape of the UK population. Similarly children have matured earlier, prompting marketers to coin phrases such as ***KGOY*** (i.e. kids getting older younger).

Families have become much more fragile as the ***extended family*** has been replaced by the ***nuclear family***, divorce rates have risen, and the economic future for individuals has become less certain and more risky (e.g. house repossession by mortgage lenders has

grown significantly). The UK has developed an ***ageing population*** as people live to a much older age, presenting a problem for those younger generations, which may be unable to support a large mass of dependants. The population of the UK has also shifted from urban to more rural areas, leaving the inner cities to be populated by what Frank Field has labelled an ***underclass***. The social role of the State has been hotly debated since the late 1970's, with the whole idea of a Welfare State being challenged.

The economic relationships between groups and organisations have also undergone change. The UK has retained largely a system of competitive markets in which firms conduct a mass of transactions with other firms and with customers. However, electronic cash and credit have dramatically changed the conduct of transactions. Although companies still obtain their equity from the sale of shares, shareholders have shown preferences for ***ethical conduct*** by firms. Many large firms have adopted socially responsible behaviour, seeking to become involved in ethical projects (e.g. Whitbread's community schemes). Since the 1980's the notion of State intervention in the economy has been criticised, and ***privatisation policy*** resulted in many of the State's industrial interests being transferred to the private sector (e.g. the utilities, welfare provision, provision of housing).

In the sphere of international relations, membership of the European Union has led to the loss of some British sovereignty and recent debates over the adoption of a common European Union currency and economic strategy. European Union laws have gained precedence in the British legal system; and economic changes such as the ***Single European Market*** have resulted in creating new opportunities and challenges. Changes in communication have reduced the time taken to conduct business (e.g. internet, satellite communications), yet have raised the questions of privacy and security of personal information stored in data form. Resource depletion and environmental concerns have begun to prompt international anxiety, sharpening the dialogue between developed and developing economies over the future of the planet itself.

Types of Business Organisations

In common with other western developed market economies, it is possible to classify the types of business organisation in Britain in several ways.

In terms of ***production*** we can distinguish between those firms producing ***goods*** and others producing ***services***. Even the types of goods and services produced can be broken down further. Indeed much also depends on what we think the term ***production*** means. If we employ the term in its widest sense to mean the ***transformation of resources to produce commodities to satisfy wants***, then non-profit making charities are also producers and can have business-oriented concerns.

We can identify the following types of commercial activities:

1. Goods:

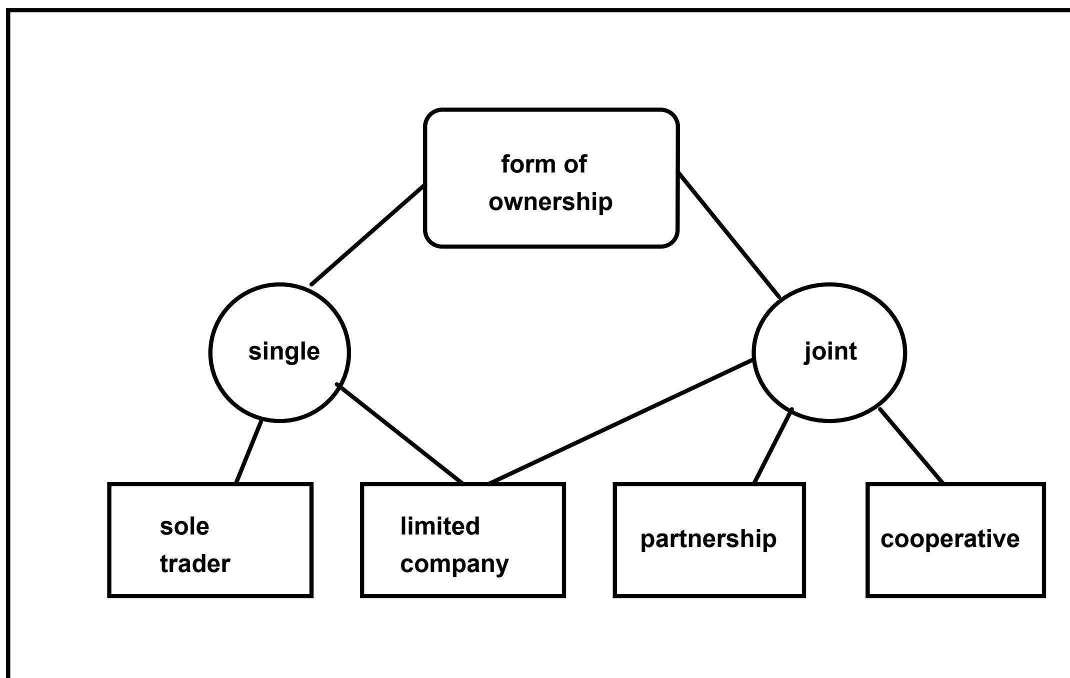
- consumer goods : those which are intended for use by a final consumer. These can be *durables*, e.g. washing machines, motor cars; or *non-durables*, e.g. beer, chocolate biscuits.
- producer goods : those which are intended for use by *other businesses* in making consumer goods, e.g. lathes, tractors.

2. Services:

- public services : services provided by state agencies (e.g. police), emergency services (e.g. fire brigade), welfare services (e.g. NHS, Benefits Agency)
- commercial services : marketing agencies, accountants, insurance companies, banks and other sources of finance.
- personal services : hairdressing, beauty treatments, hotel and accommodation, entertainment and recreation, catering
- distribution services : transport, warehousing , shipping, retailing, postal and communications services

In terms of ***ownership***, we can identify different types of organisational relationships.

Forms of Ownership of Firms



Limited Company

This is incorporated under the Companies Act and has a ***separate legal status*** from the owners - it can be bought/sold in part/whole and does not involve owners in bankruptcy because of ***limited liability*** **-** shareholders responsibility for company debts are limited to their shareholding and more funds cannot be called for. Directors are empowered to act for the shareholders and must do so honestly, financially responsibly, with regard to

employees' interests, and in compliance with the Companies Act; shareholders are not necessarily directors but in a very small company directors and shareholders are usually the same people.

The Company must have a Memorandum of Association or company charter and an Article of Association, which contains details about the management of the company. It can take time to form and requires documents to be lodged with the Registrar General in order to obtain a Certificate of Incorporation - ready made companies that have not traded but whose names can be changed can often be bought "off the shelf".

Partnership

This is Regulated under the **Partnership Act (1890).** Partners do not receive salaries or interest on capital invested. They have an equal vote in management decisions, have an equal investment in the business and an equal share of the profits. Partners are ***severally and jointly liable*** for the debts and actions of the firm and partnerships automatically dissolve on the death, retirement or bankruptcy of one of the partners. Partnerships are simple to set up like a sole proprietorship, but require Partners' names on letterheads. Partners are expected in law to act in good faith and fairly - all partners can act on behalf of the firm and incur liabilities as a result.

A **Partnership Agreement** can prevent the dissolution of the firm and alter the application of the 1890 Partnership Act in respect of profit-sharing, duration of the business, management and control of the business (e.g. in the case of junior or sleeping partners), and any agreements on interest payments for sums of money introduced by partners. Partners can still be liable for debts of the business when retired unless they have taken public leave by notifying their retirement to business contacts (e.g. by advertising in the "Business Gazette").

Sole Proprietor

The sole trader has ***unlimited liability*** because there is no legal separation between the assets/debts of the business and those of the owner .A business name can be chosen and trading begun immediately although any letterheads should show business names other than the owner's name. Setting up requires notification to the local Tax and DDSs offices of status as self-employed - VAT registration only applies if the business turnover is at or above the registration level.

Co-operatives

Are governed by the **Industrial & Provident Societies Acts (1965-75)** which require that members control the assets and management of the business. Members have an equal vote in the running of the business and share of profits; membership is open to all who satisfy the qualifications laid down .Share capital remains at the original value and interest on loans or share capital is limited .UN-registered co-operatives are regarded as partnerships with unlimited liability ; registered co-operatives have limited liability but must file accounts and have at least seven members. The United Kingdom Co-operative Council has developed a resource pack to guide small firms and business advisers through lesser-known forms of business such as co-operatives. Co-operatives account for 20% of agricultural production, and London's biggest taxi service is a co-operative.

In terms of ***economic sector*** we can also classify different kinds of organisations:

1. the ***private sector*** - privately owned organisations ranging from multinational corporations to small businesses, operating in a vast network of markets, all of which to some extent interact within an economic system . This interaction can be categorised in two basic ways:

- ***substitute goods*** are usually those rival goods existing in the same market and produced by ***competitors*** . There can be ***inferior substitutes,*** which tend to be bought when consumer incomes fall.

- ***complementary goods*** are those which are associated with other goods or services in consumption (e.g. fish and chips) or production (e.g. hammer and nails) - an increase in demand for a good normally results in an increase in ***derived demand for a complement*** (e.g. greater car mileage and increased petrol consumption).

2. the ***public sector*** - State run agencies providing ***public goods and services***. ***Public*** goods are those provided on a ***collective basis*** - they are characterised by two major characteristics:
   - ***non-rivalry in consumption*** - once provided they benefit everyone, and one person cannot prevent another from enjoying those benefits - unlike a chocolate bar, which if eaten by me cannot be eaten by you too ;
   - ***non-excludability*** - enjoyment of the benefits cannot be confined to those who pay for the provision of the good or service - so private firms would not provide such goods since they cannot identify who should pay for them - even the State suffers from a ***free-rider effect*** and must ***enforce payment through taxation***.

3. the ***voluntary or charity sector*** - non profit organisations which have altruistic social goals (e.g. drug rehabilitation programmes, Church societies) - probably better known for their names (e.g. Shelter, Oxfam, Salvation Army, Mencap, etc.) These organisations rely on sponsorship and fund-raising events, and available State grants. They have been affected by the establishment of the State Lottery, insofar as the public charity donation in non-Lottery events has fallen.

Changes affecting organisations

Long term trends in the economic environment have altered the character of public and private sector organisations; correspondingly the structure of employment and the nature of economic activity have also changed.

The process of ***de-industrialisation*** represents a major change in UK industry and employment. In historical terms the Industrial Revolution saw a shift in emphasis away from the production of ***primary*** products (e.g. forestry, fishing, mining) towards ***manufacturing***. A later shift in emphasis took place in the 1950's towards ***service sector*** dominance. The extent of the shift can be seen by the contribution towards ***Gross Domestic Product*** (the total value of goods and services produced in one year) of the respective sectors: ***services*** contribute approximately 70%, whereas ***manufacturing*** contributes approximately 20%, to GDP. In terms of employment, job losses to import penetration and such structural changes have been significant. There is a heated debate among economists about the importance of the two sectors to the future prosperity of the UK. Manufacturing, it has been argued, is most capable of creating prosperity because of

the greater potential to develop ***value-added*** in production, especially in high technology areas.

The UK economy has also been subjected to ***cyclical*** pressures. It has experienced major periods of boom and slump in economic activity, creating respectively, inflationary and recessionary problems. Attempts by governments to control the economy and prevent such fluctuations have not been that successful, apart from the period during World War II. Many economists argue that cyclical problems are ***characteristic of a market economy*** and point to ***speculation*** as a major cause. Others note the international character of trade and trace influences to major trading partners - "when the USA sneezes the UK catches a cold" is a common phrase used to describe such problems, and at present similar effects are attending Japan's financial predicament.

A major debate surrounds the economic role of the State itself. Political support has at one time favoured a large State-controlled economic sector and State economic intervention; at other times a minimal State presence with as little State "interference" as possible. The Atlee government of 1945-51 represents the first position, while the Thatcher administrations in the 1980's are the best example of the latter. Changes in the economic scope and activity of the State affect non-profit organisations or charities, and obviously private sector firms. It has also affected the objectives of public sector organisations.

Aims of Organisations

Profit

When we ask questions about what firms really want to achieve the usual answer is ***profit.*** When economists first constructed the ***Theory of the Firm*** to try and predict the behaviour of firms in particular circumstances, they assumed that the main goal of a firm is ***profit maximisation***. There was a good theoretical reason for this. Since people were supposed to be ***rational***, the owners of the firm would want to gain a return for their investment in setting up and running the firm in the first place. The argument follows that if that is the case, the best investment is the one that yields the highest profit return for the initial outlay. So logically the best firms would be the most profitable ones, and the owners would wish to ***maximise those profits***. There would be several key behaviours shown by the managers of such firms: these would be linked to:

- the relationship between profit, cost, sales volume, and pricing policy
- the desire to make profits as big as possible

Problems With Profit Maximisation Theory?

There are major problems with the traditional ***Theory of the Firm***. The theory has its merits of course. It is logical and has elegant mathematical techniques. Its predictions

make sense and it is linked to other major ***micro-economic theories.*** ***In*** fact, when we hear much of the political and economic arguments for the ***free market system***, we are listening to a series of propositions grounded partly in the ***Theory of the Firm*** .We will return to many of these problems later. However, the main objections are as follows:

- Could firms profit ***maximise?*** It would be difficult to use the complex mathematics used in the Theory of the Firm to find the efficient amount of output to produce in order to maximise profits. In the theory, ***marginal cost pricing*** methods are used; in practice firms use much easier ***rule of thumb techniques*** in which a ***profit margin*** is added to the cost of production, and the ***resulting price*** is checked to ensure that it is ***competitive*** - this is known as ***cost-plus pricing***.

- Do firms ***wish to profit maximise?*** Other theories of the behaviour of firms introduce competing objectives - all of which are plausible. For example, ***survival***, ***growth, increasing market share.*** The point is that there is a consensus that although ***profit*** might be a serious goal, it is not the ***only goal***; taking this further it can be suggested that a firm's objectives might well ***change*** when circumstances alter.

Financial objectives

The various accounting ratios and targets are all linked to the assumption of profitability being the main objective of the firm. They are closely linked to the ideas displayed in the traditional ***Theory of the Firm***. Financial techniques are employed as guides to ***decision-making*** but essentially concern the following aspects:

- ***Cost efficiency***: basically whether productive resources are being used efficiently by the firm - if not then various ratios (e.g. ***liquidity ratios***) will indicate ***financial stability*** or otherwise. Some ***costing techniques*** extend the idea to very large firms (e.g. cost centres) while others identify movements in costs (e.g. variances).

- ***Financial performance***: these usually bring in a time element to recognise that costs and returns arrive over various time periods, and often in different amounts. ***Investment appraisal techniques*** attempt to compare the present cost of investment (e.g. in new plant, machinery, product development) with the expected value of future benefits.

- ***Profitability techniques***: tend to concern themselves with the short-run period (usually the present financial year) in order to assess ***financial viability*** - for example the ***prime ratios*** indicate the relationship between profit, cost, sales volume, and pricing policy that the ***Theory of the Firm*** suggests businesses should be concerned about.

Long Run Vs Short Run Objectives

Although the firm might seek profitable opportunities in the ***short run***, it is likely that such objectives will change. This is because firms don't exist in isolation but have independent relationships with others serving the same market, and with customers in that market. The firm's goals are likely to change because of external influences in its political, social, legal and economic environment. Adaptive strategies might switch objectives from profitability to market share, or to cost restructuring, as such influences change. The prime objective might well be survival in one time period, and expansion in another. Thus the firm will tend to have ***multiple objectives*** .In the ***long run*** these could be equivalent to ***maximising a profit return.***

Public Sector organisations

A major expansion of State involvement in society and the economy occurred after World War 2. State ***intervention*** has a fairly long history. For example, the 17th century saw regulated state monopolies like the Hudson Bay Company; the 19th century witnessed state abolition of the slave trade, and control of working conditions through successive Factory Acts; whereas the 19th century introduced local councils as public health authorities. Before World War 2, Lloyd George's Liberal government had introduced National Insurance schemes. Indeed, ***Peacock and Wiseman,*** in their ***displacement thesis,*** argued that significant shifts in public expenditure occurred after the World Wars as responses to crises. These periods represent ***rebuilding phases*** in which the already upward trend for state taxation and expenditure was exceeded - and significantly there was a public willingness to accept ***higher taxation to support welfare***.

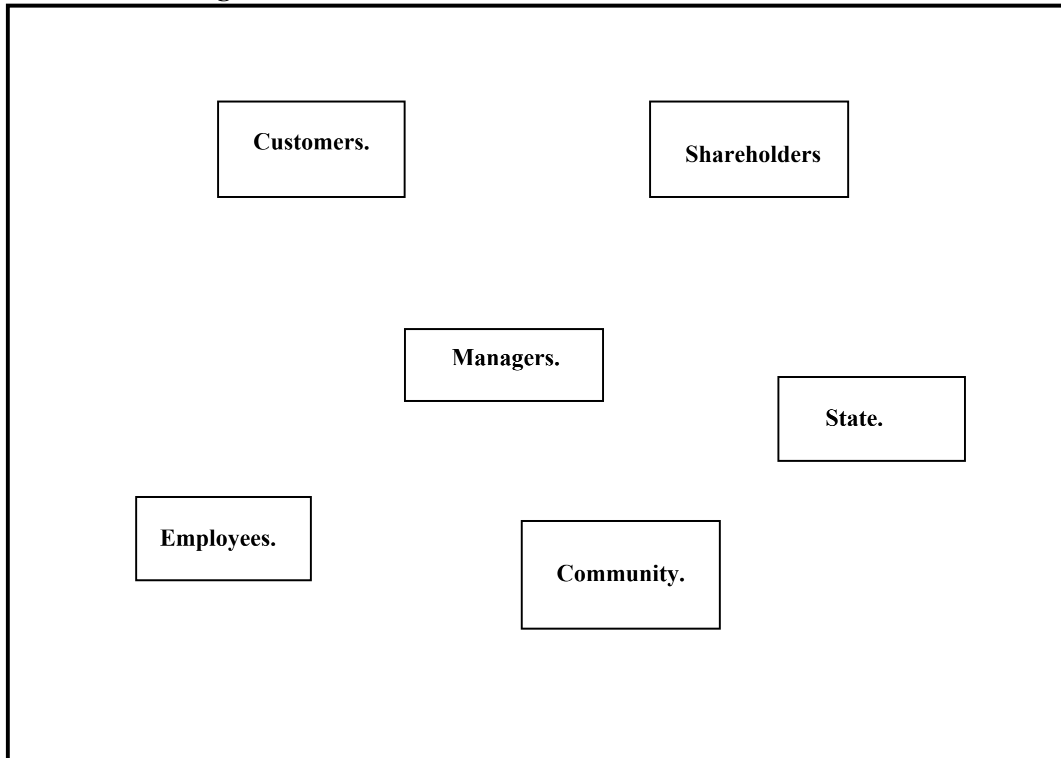
The construction of the post-war Welfare State between 1944 and 1948 is treated as a time of social and political consensus - an agreement across all political parties on a commitment to provide social welfare. There are several explanations for the construction of the Welfare State in the 1944-48 period.

There was a "rebuilding" response to crisis in the aftermath of World War II, shown by a public willingness to accept higher tax burdens to finance the reforms. The growth of collectivist ideas and concern for equality was expressed in an acceptance by politicians that the State had a duty to provide welfare for its citizens; Keynesian economics (i.e. the ideas of J.M.Keynes) had demonstrated that State intervention, planning, and economic policies could tackle the problem of mass unemployment. The Coalition government in 1940-45 had fostered close links between the leaders of the political parties and had reduced party differences between them; although the 1945 landslide majority that elected the Labour Government of Atlee meant that Socialist ideas and policies were difficult to oppose in Parliament .Until the 1970's there was rapid UK economic growth - in common with the more affluent states the UK tended to spend a greater proportion of National Income on welfare .

Stakeholders

Stakeholders are individuals or groups who are affected by the actions or performance of a firm or organisation. These groups can be identified using a ***stakeholder diagram.*** Some groups like managers and employees are ***internal stakeholders;*** others such as customers are ***external stakeholders.***

Stakeholder Diagram



Shareholders

Shareholders provide capital in the *present* in return for a share of resulting *future* profits; in so doing they become risk-bearers, since the future is *uncertain*. In a well-managed business shareholders can expect the directors to declare dividend payments from profits; share values will also tend to rise as a result of the company's record of profitability and dividend payments.

Retained profits are a major source of company finance and rather than declare dividend payments, directors may prefer to finance particular company strategies. From the shareholders' point of view, this reduces their expected rate of return on their investment in the short term; prolonged dividend restraint or disappointing profit declarations may reduce both shareholder confidence and earnings per share.

A major issue is the extent to which shareholders can *internally* hold the directors accountable for their performance. An *external* option is the sale of shareholdings . A company that is basically sound but losing competitiveness in its markets is a ripe target for merger or take-over activity, especially since any aggressive bid will tend to both raise the company's share price and induce the sale of its shares. However, the issue of

corporate governance raises questions about the relative power of shareholders and directors, and the debate over the appropriate distribution of created wealth between stakeholders.

Communities and social issues

How desirable is economic growth compared to environmental conservation? The Earth Summit at Rio de Janeiro in 1992 placed conservation and pollution on a global agenda. Should businesses that create environmental pollution be responsible for reversing the effects? *Business ethics* - the principles guiding business conduct, and the social consequences of business activities, have become increasingly significant.

Businesses bring great benefits to the local communities in which they are located. They provide employment, not merely in terms of requiring a workforce, but also for other local supplying firms; the wages created provides customers for local consumer markets. The income generated in this way is taxable, and goes some way to providing social capital within the community. Some firms are also famous for their community involvement, providing sports facilities, charity sponsorship, and welfare schemes for their employees; a good example, perhaps, is the reputation of Pilkington Bothers PLC**.** located in St.Helens in Merseyside.

On the other hand, businesses add to local pollution. There is often a tension between the use of land for business development and its other possible uses, whether to provide housing, to support farming, or to provide recreational or conservation areas. Theoretically we could resolve this tension by applying ***cost-benefit analysis*** (CBA). This technique can be used to aid decision-making at local planning office or even Department of the Environment level. The technique involves comparing the cost of a project with its forecasted future benefits; if benefits outweigh the costs, the rule is that the project should go ahead. This conclusion is based on a theoretical proposition from ***welfare economics*** - simply the idea that if one person is better off and no-one is worse off as a result, a net increase in welfare has occurred. The CBA technique represents a conversion of this principle, through the ***Hicks Compensation Test***, where the argument is made that net increases in welfare can occur if those made better off can ***compensate those who are worse off as a result of a policy change, and more are made better off than worse off.***

However, the focus is on the impact of such projects on society. For that reason, both ***private*** and ***social*** costs and benefits are estimated and compared. Some costs or benefits are ***intangible***, and difficult to estimate or value; for example, how do you measure the value of a natural beauty spot, where the concept of beauty is obviously debatable itself? Other costs and benefits are more amenable to measurement; for example we can estimate the possible income generated by an additional 2,000 jobs created in an area.

Regulation and Self-regulation

Should organisations ought to be *regulated* by the State or allowed to *self-regulate*, establishing internal codes of conduct and accountability systems? For example, the

legal and medical professions, the advertising industry, and the press, are cases where self-regulation applies.

In response to the political pressure exerted by consumer and environmental interest groups, there has been a marked expansion of regulation; notably in consumer protection, environmental pollution, and health and safety at work.

Privatisation policy has led to the growth of *franchising* where private firms may be granted a *license* to operate in what amounts to near monopoly market conditions under the supervision of a regulatory body, such as *OFFWAT* .

According to traditional economic theory customer welfare is best served by a *competitive* system of *free markets*. Consumer sovereignty arises because customers have freedom of choice, satisfying their wants at the lowest possible prices; the efficient competitive firms survive. In a monopoly market structure firms earn *supernormal profits* from an ability to charge above the competitive price, absorbing higher costs due to inefficiencies in production. This forms the rationale of regulation by the *Monopolies and Mergers Commission*.

Schumpeter argues that *monopoly profits* are the *rewards of business success*; they finance the means of developing products in the long run, so that customers gain price, choice and quality benefits. The issue is how much should be passed back to customers, or distributed elsewhere as salary bonuses, dividends, or tax contributions.

Employees

The process of *de-industrialisation* altered the industrial structure of Britain, with declining employment in primary and manufacturing industries, and a rise in services. **Kotler** sees the 1980's as a period where adaptation to changes in global markets required a *marketing concept* . The main problems lay in foreign competition from Japan and the Pacific Rim *Tiger Economies*; allied to this was a series of economic recessions coupled with inflationary pressures and markets were oversupplied and increasingly competitive. The *marketing concept* required companies to "create value-rich offers for target customer groups that competitors can't match".
This implies the production of superior products, in which costs remain at a competitive level, and customers receive a commitment to improvement in quality and service; rather than emphasising price discounting strategies.

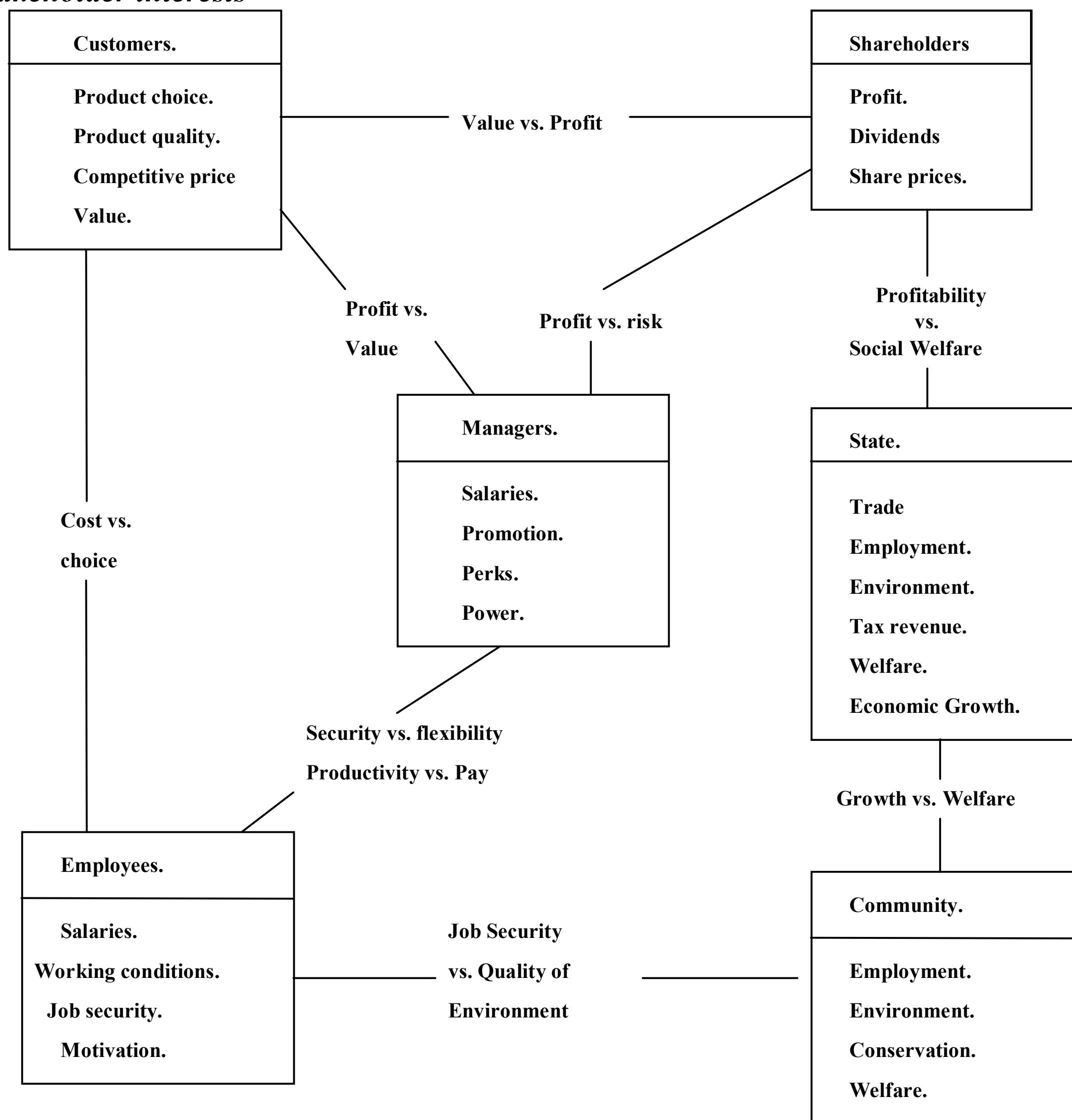
The adoption of such principles has meant that employees have been affected by considerable organisational changes at work. "To an increasing degree large employers are dividing their work force into a 'core' and a 'periphery'. The 'core' consists of workers in secure, long-term employment...(with) ...the best pay and fringe benefits. The periphery consists of a shifting group of temporary employees who can be taken on, and laid off, according to demand. There is a tendency for these workers to be disproportionately women, to be doing less skilled jobs and to be comparatively poorly rewarded."

The significance for employees rests in the *job insecurity* that may result from changes in working methods. Although companies might adopt a *human capital approach* where employees are seen as a key resource, investing in staff training and motivation programmes, a major dilemma is the possible resistance to changes in work patterns.

Stakeholder conflicts

The stakeholder diagram suggests that the interests, values, and expectations of stakeholders are likely to differ. In order to influence the objectives and behaviour of an organisation, stakeholder groups may form *coalitions of interest* with other groups that share similar values or goals; the objectives of the organisation tend to reflect the interests of dominant coalitions as the outcome of bargaining processes.

Stakeholder interests



From this perspective the role of management lies in the formation of strategies designed to fulfil the interests of dominant stakeholder groups. Since strategic decisions are likely

to affect stakeholder groups in different ways, some groups are likely to benefit while perspective the role of management lies in the formation of strategies designed to fulfil the interests of dominant stakeholder groups. Since strategic decisions are likely to affect stakeholder groups in different ways, some groups are likely to benefit while others become disadvantaged. The management of change is a skill, which requires both the resolution of conflict and attainment of improved business performance.

Responsibilities of Organisations

Responsibilities to Shareholders

Shareholders provide capital in the *present* in return for a share of resulting *future* profits; in so doing they become risk-bearers, since the future is *uncertain*. In a well-managed business shareholders can expect the directors to declare dividend payments from profits; share values will also tend to rise as a result of the company's record of profitability and dividend payments.

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Corporate Governance

Corporate Governance **refers to the relationship between shareholders and company directors. In terms of *company law*, "shareholders are both the owners and members of public companies, and directors are responsible to them."**

The Influence of Company Directors

The power of company directors has grown largely through the separation of ownership and control functions in large complex organisations. Ownership tends to be in the hands of a multitude of small investors concerned "..mainly with short term gains rather than with the detailed strategic and operational issues facing the company"; although financial institutions tend to own the bulk of shareholdings "..there is a tendency for fund

managers to be less interested in the day-to-day running of companies than in developing a balanced portfolio of investments.."

Non-executive directors, who are supposed to act independently of the board "are likely to be selected by the chairman and the board with the support of proxy voting." "Given the disinterest shown by many shareholders...the reality is that it is the executive directors who fix the pay of the non-executive directors...the non-executive directors then fix the pay of the executive directors." This may explain cases where company financial performance and directors' remuneration have been disproportionate ; the "fat cat" issues, for example involving Graeme Bowler at *Kwik Save*, who took a bonus of £ 162,000 despite a fall in company profits and a 1,600 cut in staff jobs.

As a result investors are "..at a disadvantage against an expert and entrenched management." The case of Wolverhampton and Dudley Breweries, where a finance director had failed to obtain a £100 shareholding in the company to qualify for his post and was in breach of the company's articles of association, is an example of both management power and the often inadequate information given to shareholders; but this argument can be over stretched where significant minority shareholdings allow heated conflict over resolutions proposing policy changes.

Responsibilities to Consumers

Kotler argues that faced by a series of economic recessions, high quality and low cost competition from *Tiger economies* such as Japan and Korea, and over-supply in markets, companies seeking success need to concentrate on developing a ***marketing concept*** - " defining customer targets and the best way to satisfy their needs and wants competitively and profitably."

Customer orientation has become more important with the rise of *consumerism*: " ..an organised movement of citizens and government to strengthen the rights and power of buyers in relation to sellers". Kotler cites examples of rights secured by consumer pressure: product ingredient labelling, product nutritional information, truth in advertising, product freshness dating, and so on. These rights were gained in the USA due to the efforts of Ralph Nader, who shocked America with the contents of his book about the U.S. motor vehicle industry, *Unsafe at Any Speed* (1965).

The argument promoted by consumer organisations is that the consumer needs at least the information required to make a choice between products; in competitive markets there is usually a wide range to choose from, and advertising information is likely to be more persuasive than informative. In terms of product pricing, large purchases may be funded by credit, and the true cost of the product should account for the interest paid in such circumstances; customers need to know about the interest charges in advance. The Consumers' Association take this further by testing products in magazines such as *"Which"*; and for durable goods there are now a host of similar magazines - e.g. *"What Car?"* Similarly television programmes are strongly represented by those with a consumer rights focus - e.g. *"Right to Reply", "Watchdog"*. Often the focus of features in

such media is on product safety, fraudulent practices, consumer complaints, or misrepresentation, as much as product performance.

In itself this trend has made firms supplying products and services more conscious of the potential implications of customer dissatisfaction. The independent consumer organisations exert pressure on businesses by acting as advocates for customers (e.g. Citizens' Advice Bureau) or publishing the results of product and service tests (e.g. "Which" published by the Consumers' Association; the National Federation of Consumer Groups). The British Standards Institute (BSI) awards *kitemarks* which signal that products conform to tested quality or performance criteria.

Trade associations, where businesses accept voluntary codes of practice, represent a further response to consumerism: for example the Association of British Travel Agents (ABTA) bond. Firms which act in demonstrably questionable ways may arouse not merely bad publicity from heightened media attention, but also criticisms from competitors in the market who stand to gain disaffected customers.

Within the British legal system, legislation such as the Trades Descriptions and Sale of Goods Acts, serve to protect consumer interests. Local authority trading standards and environmental health agencies investigate consumer complaints; at the national level, the Office of Fair Trading encourages industry codes of practice and applies discipline, while regulatory bodies scrutinise privatised utilities, licenses and franchises.

Responsibilities to Employees

We have emphasised that changes in the economic environment has influenced alterations in the relationship between companies and their stakeholders; revising in turn the conduct and strategies companies adopt in order to achieve competitive advantage. As a core strategy, we have identified achieving *value added* objectives through product differentiation and development, focused by customer orientation.

There are different ways in which to regard the role of employees in an organisation. From a profit-maximising perspective, labour is a factor of production; if it is possible to substitute labour and capital machinery, the relative costs of these factors will determine manpower planning. In the past, trade union strategies were often directed towards restrictive practices aimed at reducing the supply of labour in order to maintain wage rates; although it has become increasingly possible to replace labour in undertaking routine repetitive tasks through ***mechanisation***.

Taylor's ***scientific management*** in the 1890's involved ***de-skilling*** - basically reducing the skill requirements of tasks and developing specialised machinery to cope with repeated functions. "The economic dynamic to this continued re-division of labour is labour cheapening, a process which is assisted by the reduction in learning time for jobs and by weakening the bargaining power of workers." On the other hand, the employer obtained *control* over the production process and *productivity gains* from such arrangements. In mass production industries, ***Fordism*** enhanced these gains: "..the effects of the introduction of the assembly line at Fords on productivity and profits is

indicated by the fact that it reduced the time of chassis assembly from 121 hours to 2 hours 40 minutes."

The problem with ***Taylorism*** or ***Fordism*** is that its benefits largely apply where firms serve mass markets with price-sensitive products. "If price ceases to be the predominant factor in exchange, and non-price factors, such as reliability, quality and design, assume a larger significance, then this places a heavier emphasis on worker co-operation and worker commitment." In service industries, for example, the human interface is paramount, especially where transactional relationships require problem-solving, creativity, discretion, interpersonal, and communication skills. Moreover, there is evidence that *Taylorism* or *Fordism* can lead to industrial relations problems that are displayed in alienation, inflexibility, negative work attitudes, and poor quality performance.

As we have seen, rapid changes in markets and the economic environment require more flexible work organisation in which a committed work force produces quality products and services at a competitive cost. It is precisely because non-price factors are significant that the role of employees becomes important, requiring strategies that maximise their contribution.

Responsibilities to the global community

Pollution

Should businesses that create environmental pollution be responsible for reversing the effects? In 1992 the European Union proposed carbon taxes being placed on fuels. Businesses can claim that their activities create social wealth: employment, taxation sustaining social welfare programmes, exports, development and regeneration projects.

Pollution of the environment by the production or consumption of products is a standard example of an ***externality***. The general argument is that the ***costs to society*** of restoring environmental damage so caused are not accounted for in **the** ***market price*** of products. Consider the private motor-car as an example. Neither the motorist or the car manufacturer contributes any direct payment in the production or purchase of the vehicle towards its environmental costs - social costs arising from traffic congestion, health hazards, air pollution, and so on. In this case there may be a ***negative social effect***, since the ***benefits to society*** of using the product are *less* than the ***social costs*** that are generated.

One method of resolving the question of ***who pays*** for environmental costs is to apply a ***compensation principle*** . This assumes that ***economic growth*** in the production and consumption of goods and services equates to an ***increase in social welfare*** and wealth, and that the question about *whether* resources should be used has already been solved. The notion is that an ***improvement in welfare*** takes place when ***someone is better off*** as the result of an action, and ***no-one is made worse off***. A weaker condition suggests that the same result can occur if ***compensation*** takes place - i.e. those who benefit *compensate*

those who lose. This is the theoretical rationale behind policies based on ***cost-benefit analysis*** and ***polluter-pays*** principles.

Types of Economic System

The Free Market Economy

The UK economy is built on a system of markets, where buyers and sellers exchange money for goods and services through a ***price mechanism*.** In a ***Free Market*** *or* ***Laissez Faire*** system the following features are present:

1. ***competition***: firms compete for customers ; no one is powerful enough to control the market;

2. ***freedom of choice***: customers can choose how and where to spend ; firms can enter or exit the market;

3. ***self interest***: firms act in ways to maximise profits ; customers maximise satisfaction ; workers maximise pay and conditions;

4. ***private ownership***: individuals have a right to own, use, hire or sell, natural and man-made resources or assets. Ownership confers the right to earn income from such activities.

5. ***price mechanism***: this is a method of allocating scarce resources in society. Basically buyers signal their purchasing preferences by being prepared to pay a price for the goods and services they want (demand); sellers signal the amounts they are willing to supply at given prices. The ***market price*** is a ***market clearing price*** - it is that price which satisfies ***both*** buyer and seller.

6. ***differences in rewards***: differences in ***income*** act as ***incentives towards efficiency within the system***. Profits are the reward for efficient firms, bankruptcy the penalty for failure. Similarly ***high incomes*** are the rewards for ***effort*** or for possessing a desired personal and marketable quality (e.g. talent, skill, qualification).

Market forces are the forces of demand and supply. ***Demand*** refers to the amount of a commodity ***wanted in a market at a particular price***; ***supply*** refers to the amount of a commodity ***producers want to offer for sale*** in a market at ***a particular price***. The ***market price*** is determined where the amount demanded equals the amount supplied.

The Planned Economy

A major criticism of the ***free market system*** lies in the emphasis placed on ***consumer wants***. ***Do consumers know what is best for them, or for society?***

" *Unconventional economists, such as Galbraith, Mishan and Myrdal, and sociologists and psychiatrists, such as Ellul and Fromm, severely criticise the primacy accorded to*

material acquisition ('growth mania' and 'consumerism'), and the environmental deterioration caused by rapid and uncontrolled technological change." This begs the question of ***who should decide what kind of society we live in and the kinds of economic activities we engage in***.

Although there are different political philosophies underlying the notion of ***central economic planning***, the common theme in all centrally planned systems is the proposition that the State itself is the only institution capable of making decisions that reflect the welfare of its citizens, since private individuals and firms are ***self-interested***. Only the State has the power to enforce policies that, while unpopular, may be necessary for the good of society. Whether these propositions stand up to scrutiny is another matter: the point here is whether such central planning of the economy can work in practice. The answer is mixed.

In centrally planned economies the State decides on the combinations of goods and services that will be produced, and informs its agencies with a set of targets that such agencies are expected to reach. Resource allocation, the production by firms, and all other necessary arrangements are tied together by the use of ***input-output matrices.*** These input-output tables identify the pattern of resources needed in the countless production processes, which are involved in delivering the specified final combinations of goods and services thought to be desirable in the production plan.

In the ***Soviet centrally planned economies*** of the period from 1920-1990 the emphasis was placed on rapid economic growth and self-sufficiency. Quite simply the USSR, and later its satellite states, felt threatened and isolated; its response was an attempt to rapidly produce the weaponry and materials necessary to survive. An emphasis was placed on ***investment*** rather than ***consumption***, on ***producer goods and military equipment*** rather than on ***consumer goods***. Its workforce was given basic rights to employment, housing, and state welfare.

By 1990 it was apparent that the system had failed drastically - there were periodic shortages of food, poor quality production was endemic, the workforce lacked incentives or motivation, and production technology was far behind that achieved with superior technical knowledge in Western democratic market systems. In the early 1990's the policies of Gorbachov and Yeltsin led to the ***privatisation*** of state industries, with many concerns being bought by Western business corporations; this was mirrored in the former soviet satellite states.

As the new Russia emerges as a freer market system there is increased resentment from old Communists that western consumer goods are available for the few who can afford them, while national economic problems remain unresolved. There is evidence that a new ***economic elite*** of the Russian middle class has grown recently; these are the new entrepreneurs importing western consumer goods, whom many argue are little more than a Mafia operating a "get rich quick" black-market approach to new opportunities. In the CSFR (Russia) unemployment has risen, inflation has soared, and economic output has fallen.

The French planned economy on the other hand achieved a fast growth rate after World War 2. This was an economic and social rebuilding programme under largely socialist governments. Protection of key industries such as Renault motors allowed the French government to raise output and real incomes. The E.U. Common Agricultural Policy helped to solve problems of low farming incomes in many French regions. The Single European Market is bringing an end to protectionist policies in the E.U., but by now France appears strong enough to join the European Monetary System as a founder member. Similarly the Chinese planned economy has had its successes, although the growth rates achieved appear to be caused more by the privatisation of Chinese industries following the repossession of Hong Kong and stimulation of new entrepots such as Shanghai. In social terms, economic planning has led to a fairly effective population control programme, although the methods used to secure compliance may be questionable.

The Role of the State

The UK is a ***mixed economy*** in which some degree of ***state intervention*** is used to ***correct*** the disadvantages produced by a market system:

- ***the growth of monopoly power*:** tendency for large firms to control markets and exploit customers;

- ***unrestrained pursuit of profit***: tendency for firms to use any means to obtain profits;

- ***externalities***: firms or their customers imposing costs on society as a result of their actions - pollution, environmental damage ;

- ***wide gap in incomes and welfare***: a free market system tends to result in wide gaps in income and wealth, since incomes act as incentives to effort and enterprise.

Whether the state should intervene in this way is arguable. Some economists such as ***Friedman or Hayeck*** argue that this is ***unwarranted interference*** which leads to ***economic inefficiencies*** in the system and prevent firms being successful by imposing extra costs on them. Indeed Schumpeter argues that argue that in a market economy, *monopoly power* is the result of firms being *successful*.

In the 1970's the policies associated with the Consensus seemed to have failed. Keynesian demand-management had not cured the problems of unemployment and inflation, both of which were rising; Governments seemed incapable of controlling trade union activities and power. There were criticisms that the Welfare State was too costly and had failed to reduce inequality or promote equality of opportunity. Above all the idea that governments could successfully plan the economy was brought into question - as well as the efficiency of government agencies.

The landslide election victory of Thatcher in 1979 brought the philosophy of ***Thatcherism*** which was close to these ideas. The reduction of ***inflation*** was the ***priority*** - unemployment reached a peak of 3 million as inflation was reduced; government intervention was thought to distort and damage the free market system - the idea was to "roll back the frontiers of the State" (i.e. cut State influence).

Government spending was targeted for reductions and there was no commitment to equality - instead a "stimulating inequality" was fostered by reductions in income tax and attempts to cut State spending and benefits that were provided via the Welfare State.

The argument was ***capitalist*** - prosperity would eventually arrive when private enterprise had created the necessary wealth; state interference could only reduce wealth creation opportunities in the private sector. This view hinges on the idea that wealth creation occurs because of investment in the private sector by the owners of capital resources and the creation of profit; that profit is then distributed throughout the economic system in the form of wages, dividends, rents and interest payments. This creates income, and later wealth. Social wealth occurs from the taxation of profits and other incomes; but high taxation prevents growth by redistributing resources into the ***non-productive areas of the economy***. If we spend too much on welfare systems we encourage ***consumption today*** of resources which ***produce growth tomorrow***.

There is, however, a ***public good*** justification for economic activity undertaken by the State. This argument is based on the idea that ***markets may not exist*** for ***pure public goods***; since these would not be provided by private firms, the State has to provide them. There are few examples of such goods, but the cliché is the provision of light-houses; public goods will not be privately provided because firms cannot charge private individuals - this is because once provided, everyone benefits from such goods. A secondary problem is the free-rider effect; the fact that some would enjoy the benefits of such goods without having to pay for them - indeed only the State can enforce payment in the form of taxation. In reality many such goods are ***quasi-public goods*** provided by both private and public organisations - e.g. health care.

Government Policy

Microeconomic Policies

In a ***mixed economy*** some government intervention occurs, although the extent depends on the political and economic philosophy of the government of the day. ***Microeconomic policies*** are designed to affect the individual decision-maker, market, or firm, within the economic system.

Taxation policies

By using taxation instruments, a government can encourage or discourage the purchase or production of commodities. Increases in ***direct taxation*** e.g. income tax, national

insurance, company tax, affect the ***disposable income*** of customers and firms in the economy. Any reduction in disposable income will have an ***income effect***; in simple terms less will be bought because people and firms will have less income to support their purchasing patterns. It is likely that some products will be in greater demand when incomes fall - these are inferior substitutes e.g. DIY activities, second-hand purchases. On supply and demand diagrams this would be shown as a ***shift of the demand curve***.

Indirect taxation is usually targeted at individual products and once again can encourage or discourage consumption and production of such commodities. ***Subsidies*** encourage consumption and production. Production subsidies are cost reductions or guaranteed market prices paid for by government expenditure (e.g. the Common Agricultural Policy pricing system). Consumption subsidies refer to the price reductions consumers receive when public expenditure is used to give ***rebates*** on purchases, or to pay part of the purchase price in the market, e.g. in the 1950's cheap or free milk and orange juice in primary schools to encourage a healthier diet. Indirect taxes on fuels, alcohol and tobacco products are designed to discourage consumption of these products by pricing them way above their real market price.

Whether such policies are effective is open to question. The closure of tobacco factories in Britain might suggest so, although unemployment in the industry is the price of such success. Various research articles have suggested that the tax-price rises have had much less effect than anti-smoking advertising in changing smoking habits; smoking is particularly acute among the lower socio-economic groups despite the relatively high price of tobacco products. Similarly fuel and motor taxes have not reduced the number of vehicles on roads; two-car households are increasingly common in middle-class residential areas.

Regional policies

Taxation and subsidy policies have formed the central instruments of ***regional policy*** in the past. It is clear that there is a regional imbalance in prosperity and employment in the UK. The south-east tends to experience relatively higher prices, incomes, and labour shortages in key skill areas, than the rest of the UK. Apart from East Anglia and the East Midlands, the other ***standard regions*** of Britain suffer from problems characteristic of occupying a ***peripheral location***.

The older industrial areas such as the North West and North East have suffered from problems relating top their ***industrial structure***, dominated by industries that were heavily labour intensive such as coalmining and textiles, reliant on heavy civilian or military investment such as shipbuilding, and generally subject to the early ravages of ***recession*** or slump in the ***trade cycle***. Another important factor was that these industries experienced import penetration from cheaper foreign substitutes; textiles from the Asian area as early as the 1960's and coal from Poland in the 1980's.

Market Types

Perfect Competition

A ***market*** is merely a ***meeting place*** between buyers and sellers of a particular kind of good or service. The arrangements in the market allow buyers to choose which commodities to buy and from which seller. They also allow sellers to offer goods for sale and observe customer preferences. This means that there should be sources of information available for buyers and sellers, lines of communication between them, and methods of enabling transactions and payments to take place.

Market Structure

Market structure has several characteristics:

- the size and number of **buyers** in the market
- the size and number of **sellers** in the market
- the degree of **integration** in the production of products sold in the market
- **cost structures** of firms in the market
- the degree of **product differentiation** present in the market
- the importance of **barriers to entry** in the market

Perfect Competition as a market structure

Perfect Competition is a special kind of market structure. It is sometimes known as ***Pure Competition***. As can be seen from the table, the main ***structural characteristics*** are:

- an ***infinite number of tiny firms*** which supply the market
- a ***large number*** of ***independent customers*** buying from the market
- customers have ***perfect information*** about all offers in the market
- firms act ***independently***...as if they are unaware of any rivals
- ***homogeneous*** products - i.e. identical products
- an ***absence of barriers*** to exit or entry means that if the product becomes more fashionable or useful, new firms will enter the market , and this will reduce prices (temporarily higher due to increased demand) to the competitive level once more. In a perfectly competitive market the customer has the whip hand. Consumer sovereignty means that the welfare of customers is maximised. Firms supply what customers value, but at the least possible price. If firms attempt to put up their price to cover cost inefficiencies, customers can merely choose to go elsewhere. The entry of new firms into an expanding market ensures that in the long run prices are as low as possible, that inefficient or unresponsive firms are forced out of business, and that resources are used in their best possible way.

Types of Market Structure

Pure Competition	Atomistic	Oligopoly	Duopoly	Pure Monopoly

Degree of Market Power

Insignificant	Low	Considerable	High	Extreme

Degree of Competition

High	Cut-throat	Some	Low	None

Barriers to entry

Insignificant	Low	Considerable	High	High

Size Distribution of firms

Infinite number of tiny firms	Many firms Some Market leaders	Small number of dominant firms	Two firms	One dominant firm

Types of Market Structure

The problem with the perfectly competitive model

Think for a moment how ***realistic*** the model is. Does this sound like the real world of business? The model may apply to wheat farmers in Nebraska, but has little practical example in goods and services markets. Galbraith has argued that an ***"approved***

contradiction" is accepted by theorists. "*The firm is not assumed to exercise any significant influence over purchase by the consumer or the state. That these remain sovereign is not argued; it is an article of faith*." However, the requirement for ***perfect information*** is also suspect: even though Lancaster has a vision of computerised price information being available in markets, perhaps pre-empting Internet possibilities; and consumer information is much more readily available via media consumer protection reviews. The whole emphasis in production and marketing is towards ***product differentiation.*** [1] Nevertheless this abstract theoretical model had become the basis of the argument towards greater ***competition*** in market structures, and the rationale for the criticism of ***monopoly structures***.

Monopoly structure

In the case of a *monopoly market* the customer has *little or no choice* about *where to obtain the product* from. A ***perfect monopoly*** exists when there is *one* large firm *supplying the whole market* . What is so bad about monopoly power? The case against monopolies has the following points:

- monopoly firms charge *prices* that *are above* the market price in *competitive* markets;
- monopoly firms are *inefficient* and *lazy* - they are *too secure* so they don't bother to *improve their products* or *service* to their customers;
- monopoly firms charge high prices because they *deliberately produce less* than *customers want and create a shortage in the market* - this also creates *unemployment* because *customers would buy more at lower prices.*

However, economists like Schumpeter argue that in a market economy, *monopoly power* is the result of firms being *successful* and the high profit margins that they enjoy are the rewards of doing their job well. Indeed Lispey argues along lines similar to Schumpeter that it is not necessarily the case that the monopoly firm is inefficient. Suppose that, because of ***actual physical size*** rather than ***size relative to the market***, the monopoly firm is able to gain ***economies of scale***; as a result the price of products may ***fall over time***, due to falling production costs. Similarly if the monopolist makes what would be regarded as a ***supernormal profit*** (i.e. well above the ***normal profit*** in perfect competition), and this is ploughed back into supporting R&D (research and development) and product or process innovation, then distinct customer welfare improvements are likely.

Nevertheless, the perfectly competitive model, used as a standard, underlies the distrust of monopolies. In the USA, for example, Anti-trust legislation makes monopoly ***illegal***. The UK Government *defines* a monopoly as existing when *one firm controls 25% of the UK market for a product*. Traditionally, *monopolies* are thought to *act against the national interest*. In the UK the ***Monopolies and Mergers Commission*** investigate

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[1] ***Differentiation***: the practice of making a product different from those of competitors. ***Image differentiation*** creates a psychological difference (e.g. advertising, brands); ***Real differentiation*** creates a physical difference (e.g. performance, specifications).

abuses of monopoly power (i.e. actions against the national interest) and act to *prevent mergers* or *take-over bids* that may result in medium-sized firms *joining together* into one large monopoly.

The UK government has welcomed the contribution of large-scale producers in earning foreign exports, creating employment, and through research and development, introducing product innovations or product development. [2]

[2] In the past some major British industries have been too small a scale to compete internationally - examples are in motor car manufacture and in aircraft production.

Workable Competition

This concept was developed by J.M.Clark who argued that ***perfect competition***: *" does not and cannot exist and has presumably never existed"*. J.Markham argued that an industry: *" ...may be judged to be workably competitive when....there is no clearly indicated change that can be affected through public policy measures that would result in greater social gains than social losses".*

Indeed Galbraith argues that if the ***profit maximisation assumption*** is held, the motivation of firms must be towards controlling market prices, although still regarding customer preferences: *" ...as consumer choice varies or the requirements of the state changes, the prices and levels of output at which profits are maximised also change. To these changes the firm responds."*

However, Galbraith also points out that such consumer responsiveness may not be *profit maximising at all* ...but a *desire to replace the market or control it. " So the firm controls the prices at which it buys materials, components and talent and takes steps to ensure the necessary supply at these prices. And it controls the prices at which it sells and takes steps to ensure that the public, other producers or the state take the planned quantities at these prices. So far from being controlled by the market, the firm.....has made the market subordinate to the goals of its planning".*

Taking the views of Marham and Galbraith, profit maximisation is not the motivator of the firm. It is one of numerous other goals, all aimed towards controlling the market and its uncertainty. Thus firms may seek ***monopoly power*** but not ***monopoly status***; the impetus is towards ***dominating markets*** ...to establish ***market leadership and competitive advantage***, rather than maximise profits; in this respect the firm with monopoly power may exercise social conscience, customer-oriented marketing techniques, and ethical actions. But these are all instruments aimed at establishing market leadership, market share, and a satisfactory profit level.

Market power and competition

Clearly *market power* is the *direct opposite of competition*. In order to gain *market power* or monopoly power firms have to reduce the number of competitors in the market. This presents customers with fewer substitution possibilities (i.e. less choice), and allows suppliers to reduce their output to the market, pushing up prices and profit margins. Enjoying *monopoly power* is not necessarily the same thing as occupying a *monopoly position*; monopoly *power* refers to the power of large firms in an *oligopolistic* market to *influence prices* rather than being *influenced by market prices*. Realistically then, markets will *typically* fall into one of two categories:

atomistic markets: where the are a large number of small firms engaged in *cut-throat competition* - highly competitive markets relying heavily on advertising and imitation, or price competition.

oligopolistic markets: where a small number of large firms dominate a fringe of smaller firms in the market. Less competition in terms of price warfare or advertising, but heavily defensive in preventing imitation and seeking market leadership largely through establishing a technological or cost leadership over rivals.

Market power is the power to set prices. It has also been called "monopoly power". According to F.M.Scherer, the *degree of monopoly power* enjoyed by firms in markets *depends on the structure of the market* itself. We can concentrate on two-market structure characteristics to explain the link between market structure and market power. The key features involve:

the *size distribution* of firms (i.e. : size and number)
the significance of *barriers to entry* (i.e. whether it is easy for new firms to enter the market).

Measuring the size distribution of firms: concentration ratios

The ***more concentrated*** the market, the greater the influence of dominant firms, and the ***less competition*** present. Markets are ***concentrated*** when they are dominated by a small number of large firms that account for a large percentage of the economic activity in the market.

Concentration ratios are a measure of the ***size distribution of firms in the market***; specifically they measure the amount of economic activity accounted for by the largest firms.

Calculating concentration ratios is quite simple, which is why they are favoured by researchers. More complicated measures exist.

Calculating Concentration Ratios

Market A		Market B	
Firms	**Market share [%]**	**Firms**	**Market share [%]**
A	20	P	10
B	15	Q	7
C	12	R	5
D	8	S	4
E	3	T	3
F	2	U	2
G	1	V	1
3CR=	47	**3CR=**	22
5CR=	58	**5CR=**	29

A ***concentration ratio*** measures the ***economic activity*** (influence) of the ***biggest firms in the market***. A 3CR measures the influence (market share) of the three largest firms in the market, for example. To calculate a 3CR, simply ***add up*** the market share accounted for by the 3 largest firms.

Notice that in Market A the 3 largest firms dominate 47% of the market while the figure is 22% in Market B. In a pure monopoly a 1CR = 100%. The ***higher*** the CR figure

- the **greater** the degree of **concentration**
- the **greater** the **market (monopoly) power** of the dominant firms
- the **lower** the amount of **competition**

If we wish to calculate CR's we hit the problem of what we mean by size. In this sense the size is ***relative*** to the market, since a fairly small firm could have monopoly power. Researchers commonly use several dimensions of "size".[3]

Barriers to Entry

Barriers to entry are ***the cost disadvantages faced by new entrants into a market***. They can be divided into:

- ***Absolute cost barriers***: reputation; sources of information; experience; established sources of supply and distribution channels; "know-how". All these things ***cost money for new entrants*** - perhaps the most obvious is experience, with inexperience ("mistakes or trial and error decisions") leading to costly errors.

- ***Scale barriers*** - the new entrant is likely to be smaller than the established firms in the market. Large-scale firms can obtain ***scale economies*** - i.e. cost reductions due to the size of the firm.

Where there is a large number of small firms in a market competition will be fiercer and the power of individual firms to affect the supply, price and quality of goods offered to customers will diminish. This assumes, of course, that firms do not act jointly to form a cartel agreement (i.e. adopt a common price and quality standard, sharing out customers and profits between them).

As more firms enter the market and challenge the dominant firms (perhaps lured by the high profits available) the amount of competition increases and this may manifest itself in various competitive strategies (e.g. price cutting wars; product development; quality improvements) since customers can go elsewhere if not satisfied.

In a “tight oligopoly” situation (that is, where there are a few very large firms surrounded by a fringe of much smaller ones) the dominant firms have a high degree of monopoly

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[3] The ***market share*** enjoyed by the firm (i.e. % of market sales); the ***share of employment*** accounted for by the firm (i.e. % employees); the ***share of capital*** accounted for by the firm (i.e. % value of capital); the ***share of value-added*** (i.e. % of **total profits**) accounted for by the firm.

power; consequently they enjoy significant profit margins. However, the greater the profit margin, the more attractive the market for new entrants. Since these profit margins are based on restricting supply to the market a new entrant is always a threat, since any expansion in supply will reduce prices. From one point of view the dominant oligopolist has a distinct advantage - the existing height of barriers to entry - over the interloper. The new entrant faces a cost disadvantage which if high enough might wipe out the expected profits from operating in that market, in other words, the costs may outweigh the expected advantages. Some barriers may be technical as well as cost-based; if the dominant firm obtains significant scale economies, entrants have to operate at a large scale from the start - rather like sink or swim but by jumping into the deepest end of the swimming pool. Some barriers may stem from the fact that the new entrant has to become established in the market, find suppliers and outlets, launch costly promotion programmes, but above all face the costs of making the mistakes the established firms have already learned from.

Barriers to entry are important because they cut down the number of rival firms that could challenge the dominant firms in the market. Technically they reduce the ***substitution possibilities*** for the firms' products. Since ***substitutability*** is the key ***determinant***[4] of the ***slope of the demand curve*** of a product, the effect is to make the product more ***price inelastic*** (i.e. a higher price can be possible, hence a higher profit margin can be obtained).

At this point we can nail the market power vs. competition relationship to a simple set of propositions:

1. firms gain market power when they reduce the number of substitute products (or rival competitor firms inside or outside the market);

2. the profit margin obtained as a result will be higher because of the effect on the price elasticity of demand of the firm's products - certainly higher than the competitive market price (where price elasticity is completely elastic);

3. the competitive strategies undertaken by firms will tend to be aimed towards reducing the substitution possibilities for the firms' products;

4. thus the competition which characterises a ***competitive market structure*** is ***not perfectly competitive behaviour at all*** - indeed it is the ***antithesis*** of it - with rival firms defending their power or seeking to attain more market power, seeking to influence the market, and eventually ***reduce competition*** as a result;

5. the ***consumer*** only gets a better deal in this situation in markets where exit and entry are relatively easy, and where barriers to entry are low, for here the cut and thrust of business might be expected to be more acute, since substitution threats are greater;

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[4] A *determinant* is a *determining* or most important factor in the association between two variables. It is held to *explain* the association or relationship.

6. ***oligopoly markets*** may reduce ***consumer welfare*** if some kind of ***collusion*** is present - i.e. firms in the market agree to fix prices and share the market profits out between them, however, it is just as likely that markets dominated by a few large firms ***prevent the attainment of a full monopoly position by one of their number*** by their competitive behaviour - a kind of "checks and balances" operates;

7. whether ***oligopoly behaviour*** actually ***reduces*** or ***enhances*** consumer welfare is indeterminate - there is neither the theoretical nor the empirical wealth available to make such a judgement: the best that can be done is to look at the instances of ***anti-competitive behaviour*** that may take place (e.g. price-fixing agreements)[5] and whether consumer welfare suffers or not, or whether public policy could enhance the consumer's position

Market Forces and Organisational Responses

Competitive Strategies again...reducing the substitutability of the firm's product

Large firms can become market leaders and dominant firms in the market through various forms of business conduct or behaviour:

- through ***product innovation*** : using research and development to design and develop products that *out-perform* those of rival firms or to produce *new* products that give a ***market lead*** (a good example is Halloid, which developed the Xerox photocopier);

- through ***predatory pricing or price wars*** : possessing the ability to prevent new entry and threaten existing rivals;

- by ***patents*** on products which prevent ***imitation*** undercutting prices or threatening customer loyalties to existing brands;

- by ***merger or take-over*** activities which can remove rivals by purchasing them;

- by ***image differentiation*** or the conscious development of a unique image for the product so that customers ***think it is different*** from the products produced by rivals, usually through ***publicity and advertising techniques*** e.g. the development of Coca-Cola as a national American drink and international consumer product icon even though it is little more than coloured carbonated sugar-water;

- by attempts to develop ***customer loyalty and brand recognition*** so that the product develops a strong reputation and tops customer preference lists - probably the best

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[5] We are back to the burden of proof here: ***prices*** in markets may be ***similar*** because ***cost structures are similar***, not necessarily because the member firms act in a determined way to ***make*** it so.

example of product recognition is Hoover, whose ***brand-name*** came to refer to a ***product type***;

- by ***product differentiation*** - making the product visibly outperform rivals on selected product characteristics (e.g. taste, performance, after-sales service).

Price warfare and price stability in imperfect markets

Price warfare may be effective when the dominant firm uses this strategy to force smaller rivals out of business, but is far riskier when the larger firms in the market are concerned. With smaller rivals the dominant firm can use ***limit pricing or predatory pricing*** strategies. Basically this involves cutting prices near to the ***break-even position*** - such prices can be carried by the large firm over the short-run, and may result increased ***market share***, while clearly the smaller firm could not match these prices and would become bankrupted eventually if it tried to.

With larger rivals the dominant firm may attempt to win a price war - they are quite frequent in the petroleum supply industry, e.g. between Shell and Esso. However, the ***kinked oligopoly theory*** suggests that price warfare is probably unlikely. It predicts fairly stable and general prices in markets dominated by large firms because of the destructive effects of price warfare. It is more likely that large rival firms will compete on ***product*** characteristics instead of price - i.e. on strategies focused on differentiation. If so the ***marketing function*** becomes crucial in order to allow fast responses to the changing needs, perceptions, and wants of customers.

There are of cause many ***anti-competitive practices*** which firms could engage in to compete against rivals. For example, ***resale price maintenance*** is aimed at maximising revenue from sales at the expense of the competitiveness of retail outlets. Other examples might be ***exclusive dealership*** or ***industrial espionage***. Perhaps the most wasteful is ***defensive patenting*** where firms develop new techniques which may never be employed, but the discovery of which ***prevent rivals from introducing them***.

Competition Policy

UK ***competition policy*** involves the participation of several state institutions:

- the ***Office of Fair Trading (OFT)*** , headed by a Director General - responsible for initial investigation of all competition issues, and capable of acting formally or informally to seek solutions under the authority of the Secretary of State for Trade and Industry before referring cases for further investigation by the

- ***Monopolies and Mergers Commission (MMC)*** - an independent tribunal which carries out investigations at the request of OFT and the Trade and Industry Secretary concerned with breaches of the Fair Trading Act and Competition Act : the MMC investigates cases and produces a report with recommended remedies for the attention of

- ***The Secretary of State for Trade and Industry*** - a Cabinet Minister who decides on the enforcement of the Acts and what remedies to take - especially in terms of whether a firm's activities should be allowed to continue or not on the basis of its effects on the ***public interest***. Not all monopoly practices are deliberate breaches of competition policy, but may be inevitable given the state of the market, and indeed the most efficient way of serving that market.

European Dimension

Organisations

The European Community was set up formally by the ***Treaty of Rome (1958)***. The object was to group together member states and to obtain joint benefits from political, economic, and social interaction. The Treaty set up a system of common institutions that could override the domestic governments and parliaments of member states, in matters covered in the Treaty itself. The U.K. did not join the Community until 1973, after the Conservative government of Edward Heath had won a narrow majority in support of the ***European Communities Act, 1973***.

There are five major institutions:

- ***The Council of Ministers***: this is the highest decision-making body; it is composed of ministers from member states, which act as representatives (e.g. agriculture ministers discuss E.U. agricultural policy). The General Council is composed of the Foreign Ministers of member states, whereas the Technical Councils act as ministerial forums. It is the ***Council of Ministers*** where members agree to binding regulations on member states or on E.U. Directives.

- ***The Commission:*** the EC Commissioners are nominees of member states, usually experienced and respected politicians without party political affiliations; each Commissioner has responsibility for a specific policy area and prepares draft initiatives for consideration by the Council of Ministers. The ***Commission*** is backed by a large "civil service" and headed by the President of the Commission.

- ***The European Council:*** this is a forum of heads of member governments where major issues affecting member governments or the relationship between the E.U. and the rest of the world can be discussed.

- ***The European Parliament:*** unlike the British Parliament, this body does not have a legislative function, since this role is taken by the ***Commission*** and ***Council of Ministers***. The ***European Parliament*** has the power to reject the budget for the institutions proposed by the ***Commission*** and to ***dismiss the Commission***. Its ***MEPs*** carry on the party political battle and can amend the legislation proposed by the ***Commission*** under provisions of the ***Single European Act***.

- ***The European Court of Justice:*** has the power to interpret and enforce the legal obligations in treaties binding the member states to the E.U. Its decisions can override those of the domestic courts and parliaments of member states.

The Economies of Europe

The E.U. represents a huge international trading bloc in a world where such activities are becoming common (for example, USA has established its own Pan-American trading block including states like Mexico and Canada). There are of course advantages and disadvantages involved:

- a huge domestic market is available for the most efficient businesses to use as a customer base;
- political stability is increased, especially where states form solid alliances;
- the bloc has a greater prospect of countering import penetration, especially dumping practices;
- internal security can be increased if police forces operate closer co-operation policies and receive facilitation through international treaties (e.g. border arrangements, repatriation, immigration controls);
- if greater political integration is the aim, the price may be the giving up of member states' national sovereignty and specific national interests;
- economic convergence may be necessary before economic co-operation is beneficial to all member states, but this may place strains on individual member economies; if economic integration is the aim this is even more important;
- economic co-operation and stability can reduce business risks, especially if markets can be integrated or a common method of settling transactions and debts is established;
- cultural differences or protectionism by national member states may present considerable problems in promoting internal trade or economic efficiency.

Treaty of Rome, 1958 - the customs union

The original six member states, West Germany , Italy, France, Luxembourg , Belgium and the Netherlands, decided to apply a ***common external tariff*** on imports from non-member states and ***abolish internal customs duties***. The effect would be to reduce internal costs of production and present a common international trading policy.

The Common Agricultural Policy (CAP)

The ***Common Agricultural Policy*** (C.A.P.) was designed to stabilise agricultural prices and incomes. Basically it was an ***interventionist scheme*** in which the EEC bought and stored agricultural foods when their market prices were low, removing the surplus on the market and artificially shoring up the market price in the process. When prices were high the EEC sold surpluses of agricultural foods in order to increase the supply to the market and drive prices down to a competitive level.

The scheme guaranteed stable prices and incomes for farmers and farm labourers; it was especially criticised by those member states that had a low concentration of the workforce in the agricultural industry and saw the scheme as a drain upon their incomes without providing benefits in return. The policy eventually drew criticism for creating "butter mountains" or "wine lakes" as the result of intervention in the market. The policy was later berated for incurring high administrative costs, especially the practice of rewarding farmers for over-production of agricultural produce, such as rapeseed. At the same time there were environmental concerns that farmers would over-work land and that agricultural products such as fertilisers, nitrates, and pesticides would contribute to a pollution problem.

The ***Common Agricultural Policy*** has created a burden for the E.U. itself, since left unchecked, there would be a continuing tendency for agricultural output to expand creating ever increasing taxation for member states to enforce. In 1992 the McSharry reforms cut the intervention price in markets by 29% - this is the minimum guaranteed price paid to farmers. Farmers will be able to claim income support if prices fall below a standard price averaged over past years, as long as they agree to set aside 15% of their land. Although the cut in production from this "set aside" policy would be more than matched by the impact of new technology on production methods within a 5-year period.

The effect of these reforms was to force small inefficient farmers out of production and lower E.U. agricultural prices closer to the world market price. However, by their introduction, the E.U. overcame a major criticism of the policy to reduce protectionism in World Trade. The major players in protectionist activities included the E.U., the USA, and Japan; by this reform the E.U. satisfied the GATT (General Agreement on Tariffs and Trade) conditions more closely. It was also a policy that would go some way to satisfying environmentalist demands that were displayed at the Rio Earth Summit of 1992.

The Single Market, 1992

In 1986 the ***Single European Act*** paved the way for greater economic integration of member states within the E.U. By agreeing to this the member states accepted several principles:

- that it is desirable to create a single internal market for the E.U. rather than independent markets - the barriers that gave national markets independence would be removed, including physical barriers, tariff barriers, regulations, and restrictions on movement of goods and people. A process of ***harmonisation*** would take place bringing member states into line with a single set of E.U. market conditions;

- that a process of ***harmonisation*** would require a ***regional development policy*** in which subsidies would allow less developed member state economies to resist protectionist strategies and play a significant part in contributing to economic activity in the single market system;

- that in order to live and work within a single market, workers would need an environment in which common E.U. regulations governed working conditions and rights, product standards, training and consumer law. Member states would need to move towards establishing common industrial policies;

- that in order to create a fully integrated free market there would need to be common financial institutions and a common currency shared by member states.

Why create a Single Market?

The justification lies in the objective to promote economic growth in the E.U. In order for economic growth to occur the firms within the member states need to become competitive in world terms. This means being able to compete in world markets against Japanese efficiency, American economic power, and the challenge of rapid technological development in emerging Pacific Rim economies.

Economic growth requires efficient production of goods and services. Inefficiencies in production are directly translated into higher than optimal costs, which in many circumstances firms might be attempted to pass on to their customers. High costs lead to further problems. If prices of E.U. goods rise the domestic market is tempted towards purchasing imports instead; but this reduces the confidence of domestic suppliers who may consider cutting back production and laying workers off. On the other hand, the removal of barrier costs to E.U. firms would result in the most efficient firms winning the markets of less efficient rivals, long run internal price stability with rising real incomes, and an increase in the competitive performance of the E.U. as a whole.

The existence of domestic closed markets in member states was held to represent a major source of higher costs in the E.U:

- distribution costs: delays at customs and border controls;

- tariffs: usually used to protect domestic firms against competition, since import taxes could be employed to artificially raise the prices of imported goods;

- currency conversion costs and the requirement to keep a "float" in foreign currency to facilitate the payment for imported orders of components, etc. This was compounded by the possibility of fluctuations in exchange rates, so that speculation was involved in dealing with firms in foreign member states. Quite simply, a firm might convert currency when the target country's exchange rate was high, but find that it had fallen *a few weeks after* a transaction had been paid;

- labour immobilities and shortages would threaten wage costs in a closed economy, but the ability to attract workers from the E.U. in a larger integrated market would keep wage costs and inflationary tendencies much lower in a time of output expansion;

- product regulation barriers can also be used to protect inefficient domestic producers by preventing penetration into the market by rival firms' products ; for example English snail farmers producing the same kind of edible snail as the French were told that the product failed to satisfy the criteria as *escargot*. Between E.U. member states there is still a variety of product standards, although the European *benchmarking* initiatives may introduce more widely accepted standards and tests;

- protection of national companies by member state government agencies is also removed by the requirement for compulsory tendering for public expenditure contracts.

The ERM and the ECU

In the 1990's membership of the ***ERM*** was based on the adoption of a ***common exchange rate for all E.U. states in Europe***. This was set in terms of the ***ECU*** (in 1990, £1 = DM 2.95). EU states were expected to keep within a ***narrow band of +/- 2.25%; the UK was allowed +/- 6%.*** EU states were expected to use foreign currency reserves and interest rates to keep within their band.

The ERM was supposed to allow member states to set common interest rates, adopt a common currency, and basically achieve Germany's economic success in controlling inflation and promoting competitiveness.

What are Exchange Rates?

Exchange Rates refer to the value of a currency abroad. The £ Sterling exchange rate is the spending power of UK currency in foreign markets. Foreign transactions require the ***conversion of currencies***: e.g. a UK buyer changes £'s into $'s in order to buy American goods and services. The ***supply and demand*** for the currency determines its value; e.g. if demand for £'s Sterling is greater than the supply of £'s Sterling available, then the Exchange value of Sterling rises. A fall in the exchange rate will occur if the demand for Sterling falls compared to the demand for other currencies (e.g. Francs).

Why should ***more*** £ Sterling be wanted? Several reasons are possible:

- to pay for UK goods and services (exports)

- to invest in UK firms (buy shareholdings)

- to invest in UK banks

- to **speculate** (gamble on a profit if the Sterling Exchange Rate is expected to rise in future).

Notice that the basic reasons are because people want to use £ Sterling more in transactions, because there is greater demand for British exports, or because they are optimistic and wish to invest in Britain. The ***opposite*** would occur if UK exports were not competitive, or investment in UK banks and firms would not appear to be profitable.

The ***ERM*** is a ***managed system*** rather than rely on a ***floating system totally governed by market forces.*** In a ***floating system*** exchange rates are free to move up or down ***without interference*** . Problems with this system are:

- business uncertainty or risk - firms trading abroad may find that if they pay in advance and the exchange rate rises, they could have obtained a cheaper deal by waiting; if they pay on delivery and the exchange rate falls they will be paying more . ***Spot and forward markets*** exist - firms can agree to pay a forward price based on an estimate of future exchange rates, or choose to pay a spot price now.

- Speculators buy currencies when their exchange rates are low if they expect a rise in the currency's rates later. Large-scale ***speculation*** can lead to ***instability*** - sudden large scale selling can lead to currency collapse.

- **foreign currency reserves** - to avoid **losses** when exchange rates alter, firms have to carry a **float** of foreign cash (usually profits from the same source in the past) - but this represents unused capital.

Up to 1973 most countries adopted ***managed systems***. A target value for the currency was selected. If the Exchange Rate was falling below this, the Government would buy surplus £'s by selling its foreign currency reserves (e.g. Francs, Yen, Dollars). But this quickly drained the reserves, so the government had to borrow to buy more reserves. To borrow, the Government would have to cut interest rates in order to allow banks to lend money. With easier credit facilities a consumer boom could occur - leading to inflation if firms tried to expand production quickly to meet the new consumer demand.

In a managed system government expenditure and resulting debt has to be reduced to a minimum in order to allow reserves to be built up. In turn the interest rate will cease to be artificially lower or higher than the market rate, since reductions in government debt will reduce the tendency for such artificiality. Price stability is also important - higher inflation rates promote higher import rates, as well as reducing real incomes and placing increased costs on firms. It calls for a strict economic regime when politicians would prefer to give pre-election "sweeteners" to the public.

A further underlying problem of poor exchange rate performance is the Balance of Payments. The Balance of Payments is an account that records the UK's trading profit and loss. The UK Balance of Payments has suffered from **crises** from time to time - the worst was in 1976 when an IMF loan was needed to "bail out" the UK Government. The causes of the UK’s problems lie in:

- domestic inflation - encouraging consumers and firms to buy cheaper imported goods

- import penetration and loss of export markets
- government borrowing (to support the Balance) fuelling domestic inflation and imports
- UK firms becoming less competitive due to higher costs, wage demands, strikes, poor quality or reputation
- government borrowing to support the falling exchange rate greater demand for UK exports (due to lower exchange rate) offset by poor competitiveness.

The UK government in 1979 decided to:

- increase interest rates to attract foreign cash
- increase interest rates to cut domestic spending and inflation
- cut public spending to reduce public borrowing and inflation
- allow firms that were not competitive to collapse
- allow resulting redundancies to depress spending and reduce trade union power
- allow UK firms to keep labour costs down and encourage investment in production technology

In 1993 the UK couldn't keep within the 6% band and was forced to devalue the exchange rate ("Black Wednesday "). After leaving the ERM the UK experienced:

- dearer foreign imports
- cheaper UK exports
- lower interest rates
- no major inflation
- more firms surviving but less competitiveness

More recently the decision made by the Blair Labour Government to place the determination of interest rates in the hands of the Bank of England and to set targets for the control of inflation has led to a strengthening of £ Sterling. The immediate impact of this has been company failures and job losses in exporting firms. This could set off a second round wave of closures and job losses in the firms that supply them. Coupled with the financial uncertainty facing Japanese firms and other Far Eastern countries, this may

lead into recession as foreign investments are pulled out; although it may be balanced later by inward flowing currency investments from speculation.

The ECU - a European Single Currency?

There are very good economic reasons for believing that a single European currency would benefit firms and the public throughout the E.U.

Firstly there would be no currency conversion costs, so firms wouldn't need to carry a foreign cash float for trading, attending trade fairs, or making business visits within the E.U. Cheaper prices should emerge if such lower costs are passed on to consumers rather than kept as profits, in a more competitive environment. A common currency should also enable faster transaction payments again because of eliminating conversion requirements.

A common currency would require a common interest rate throughout the E.U. This may be relatively high if aligned to produce a stronger dependable currency (since the highest % of the ECU would be based on the German mark, with weakest currencies such as Lire representing an insignificant amount of its value). However, it should lead to stable prices (due to currency design and criteria for membership) and increased real incomes. A common interest rate would also offer greater protection against speculators, and prevent fluctuations in the E.U. external exchange rate, providing greater predictability and reduced risk.