JOHN SLOMAN • ELIZABETH JONES

ESSENTIAL ECONOMICS FOR BUSINESS

FIFTH EDITION

Pearson

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John Sloman

Economics Network
Visiting Professor, University of the West of England

Elizabeth Jones

Principal Teaching Fellow and Dean of Students,
University of Warwick

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Preface

TO THE STUDENT

Welcome to the fifth edition of *Essentials Economics for Business* (previously called *Economics and the Business Environment*). If you are a student on a business or management degree or diploma course and taking a module which includes economics, then this text is written for you. Such modules may go under the title of Business Environment or Business Context, or they may simply be called Introduction to Economics or Introduction to Business Economics. Alternatively, you may be studying for an MBA and need a grounding in basic economic concepts and how they apply to the business environment.

The text covers the core economics that you will need as a business student, but it also covers various business-related topics not typically covered in an introductory economics textbook. These topics include elements of business organisation and business strategy.

As well as making considerable use of business examples throughout the text, we have included many case studies in boxes (62 in all). These illustrate how economics can be used to understand particular business problems or aspects of the business environment. Many of these case studies cover issues that you are likely to read about in the newspapers. Some cover general business issues; others look at specific companies. There are also an additional 107 case studies on the text's companion website. These, along with references to various useful websites, are listed at the end of each of the four parts of the text.

We hope that, in using this text, you will share our fascination for economics. It is a subject that is highly relevant to the world in which we live. You only have to look at global events and the news since the onset of the financial crisis of 2008 to see its importance. Many of our needs are served by business – whether as employers or as producers of the goods and services we buy. After graduating, you will probably take up employment in business. A grounding in economic principles and how they relate to the world of business should prove invaluable in the business decisions you may well have to make.

The aim throughout the text is to make this intriguing subject clear for you to understand and as relevant as possible to you as a student of business.

The written style is direct and straightforward, with short paragraphs to aid rapid comprehension. Definitions of all key terms are given in the margin, with defined terms appearing in bold. We have highlighted 29 Key Ideas, which are fundamental to 'thinking like an economist'. We refer back to these every time they recur throughout the text. This helps you to see how the subject ties together, and also helps you to develop a toolkit of concepts that can be used in a whole host of different contexts.

Summaries ('Recaps') are given at the end of each section of each chapter. These should help you in reviewing the material you have just covered and in revising for exams. Each chapter finishes with a series of questions, as does each of the boxes. These can be used to check your understanding of the chapter and help you to see how its material can be applied to various business problems.

There are also questions interspersed throughout the text in 'Pause for Thought' panels. These encourage you to reflect on what you are learning and to see how the various ideas and theories relate to different issues. Answers to these questions are given on the companion website.

We hope you enjoy the text and come to appreciate the crucial role that economics plays in all our lives and, in particular, in the practice of business.

Good luck and enjoy. Perhaps this will be just the beginning of a life-long interest in economic issues and how they apply to the world of business – and in your own personal life too!

TO LECTURERS AND TUTORS

The aim of this text is to provide a short course in economic principles as they apply to the business environment. It is designed to be used by first-year undergraduates on business studies degrees and students on diplomas where economics is taught from the business perspective, either as a separate one-semester module or as part of a business environment module. It is also suitable for students studying economics on MBA, CMS, DMS and various professional courses.

In addition to covering core economic principles, various specialist business topics are also covered that do not appear in conventional introductory economics textbooks. The following are some examples of these additional topics:

- Business organisations
- Industrial structure
- STEEPLE analysis (as an extension of PEST analysis)
- The structure–conduct–performance paradigm and its limitations
- The control of prices (new to this edition)
- The multinational corporation
- Globalisation and business
- Marketing the product
- Strategic analysis and choice
- Principal–agent analysis and the problem of asymmetric information as applied to various business situations
- The problems of adverse selection and moral hazard
- Application of game theory to business situations
- Porter's five forces model
- Growth strategy
- Business strategy in a recession
- Transactions cost analysis
- Ratio analysis to measure firms' success (new to this edition)
- Alternative aims of firms
- Pricing in practice
- The product life cycle
- The small-firm sector
- Flexible labour markets and firms
- The economics of entrepreneurship
- Business ethics and corporate social responsibility
- Government and the firm, including competition policy and regulation
- The macroeconomic environment of business, including the impact of macroeconomic policy on business
- Analysis of global policy responses to the credit crunch and the impact on business (new to this edition)
- The competitive advantage of nations
- Trading blocs including the effect of the single European market on business
- Monetary union, the crisis in the eurozone and its impact on business
- The implications of exchange rate movements and international capital flows for business.

The text is split into four parts containing a total of 13 chapters. Each chapter could be covered in a week, giving enough material for a semester. Each chapter is divided into discrete sections, each with its own summary, providing ideal coverage for a single study session for a student. Chapters finish with review questions, which can be used for seminars or discussion sessions.

The first nine chapters cover microeconomics and its relation to business. The final four cover the macroeconomic environment of business, both national and international. This higher weighting for microeconomics reflects the structure of many economics for business or business environment modules.

SPECIAL FEATURES

The text contains the following special features:

- *A direct and straightforward written style*, with short paragraphs to aid rapid comprehension. The aim all the time is to provide maximum clarity.
- *Attractive full-colour design*. The careful and consistent use of colour and shading makes the text more attractive to students and easier to use by giving clear signals as to the structure.
- *Figures with captions*. Most diagrams have captions to explain their properties and to highlight key features.
- *Key Ideas* are highlighted and explained where they first appear. There are 29 of these ideas, which are fundamental to the study of economics on business courses. Students can see them recurring throughout the text. Showing how ideas can be used in a variety of contexts helps students to 'think like an economist' and to relate the different parts of the subject together. All 29 Key Ideas are defined in a special section at the end of the text.
- *Pause for Thought* questions integrated throughout the text. These encourage students to reflect on what they have just read and make the learning process a more active one. Answers to these questions appear on the companion website. This new edition contains additional Pause for Thought questions.
- *Part opening sections* for each of the four parts of the text, setting the scene and introducing the material to be covered.
- *Chapter opening sections* that identify key business issues to be covered in that chapter.
- *All technical terms are highlighted and clearly defined in the margin* on the page they appear. This feature is especially useful for students when revising.
- *A comprehensive index*, including reference to all defined terms. This enables students to look up a definition as required and to see it used in context.
- *Many boxes with additional applied material*. All boxes include questions so as to relate the material back to the chapter in which the box is located. The extensive use of applied material makes learning much more interesting for students and helps to bring the subject alive. This is particularly important for business students who need to

relate economic theory to their other subjects and to the world of business generally. There are many new and updated boxes in this edition to provide additional case study material.

- *Additional case studies appearing on the companion website.* These are referred to at the end of each of the four Parts of the text. Most of these cases contain questions for the students to reflect on and answers can be found on the lecturer site.
- *Detailed summaries appear at the end of each section*. These allow students not only to check their comprehension of a section's contents, but also to get a clear overview of the material they have been studying.
- *Review questions at the end of each chapter*. These are designed to test students' understanding of the chapter's salient points. These questions can be used for seminars or as set work to be completed in the students' own time. Answers can be found on the lecturer site.
- *A list of relevant websites given at the end of each part.* Details of these websites can be found in the Web Appendix at the end of the text. You can easily access any of these sites from the Economics News website (at **www.pearsoned.co.uk/sloman**). When you enter the site, click on Hotlinks. You will find all the sites from the Web Appendix listed. Click on the one you want and the 'hotlink' will take you straight to it.

SUPPLEMENTS

Economics News Site

- Search 'Sloman Economics News' and visit the news blog site. This contains around 10 new posts per month. Each post considers a topic in the news that relates to economics, with an introduction to and description of the news item, links to newspaper articles from around the world, videos, podcasts and data. There are questions on each item and references to the relevant chapter(s) of the text.
- There are also hotlinks to a range of websites, including each of those referred to at the end of each of the four Parts of the text.

Student Website

The text's companion website provides a comprehensive set of online resources **at www.pearsoned.co.uk/sloman.** Access is provided with every new purchase of this text. Resources on the website include

- Animations of key models with audio explanations ('audio animations').
- 107 case studies with questions for self-study, ordered part-by-part and referred to in the text.
- Updated list of over 250 hotlinks to sites of use for economics.
- Answers to all in-chapter (pause for thought) questions.
- Hotlinks to the websites referred to at the end of each Part of the text.
- Glossary.
- Flashcards of key terms.
- Access to articles from the News site relevant to any given chapter.

Instructor Resources

There are many resources for lecturers and tutors that can be downloaded from the Instructor Resource Centre. These have been thoroughly revised for the fifth edition. These include:

- *PowerPoint® slide shows* in full colour for use with a data projector in lectures and classes. These can also be made available to students by loading them on to a local network. There are several types of slideshows:
  - All figures from the text and most of the tables. Each figure is built up in a logical sequence, thereby allowing tutors to show them in lectures in an animated form. There is also a static version for printing onto acetate for use with a conventional OHP.
  - Customisable lecture plans. These are a series of bullet-point lecture plans. There is one for each chapter. Each one can be easily edited, with points added, deleted or moved, so as to suit particular lectures. A consistent use of colour is made to show how the points tie together. They come in various versions:
    - Lecture plans with integrated diagrams. These lecture plans include animated diagrams, charts and tables at the appropriate points.
    - Lecture plans with integrated diagrams and questions. These are like the above but also include multiple-choice questions, allowing lectures to become more interactive. They can be used with or without an audience response system (ARS). ARS versions are available for InterWrite PRS® and TurningPoint® and are ready to use with appropriate 'clickers'. There is also a 'show of hands' version for use without clickers.
    - Lecture plans without the diagrams. These allow you to construct your own diagrams on the blackboard or whiteboard or use an OHP.

- *Case studies.* These, also available on the companion website for students, can be reproduced and used for classroom exercises or for student assignments. Answers are also provided (not available on the student site).
- *Workshops*. There are 13 of these – one per chapter. They are in Word® and can be reproduced for use with large groups (up to 200 students) in a lecture theatre or large classroom. Suggestions for use are given in an accompanying file. Answers to all workshops are given in separate Word® files.
- *Economic experiments.* These are simulations that can be used in class and cover topics such as markets, price controls, taxes and public goods.
- *Business videos:* interviews with senior managers in a number of firms and other organisations discussing various economic issues that affect them. Accompanying questions test students' understanding of the topics covered.
- *Teaching/learning case studies.* There are 20 of these. They examine various approaches to teaching introductory economics and ways to improve student learning of introductory economics.
- *Answers to:*
  - all end-of-chapter questions
  - pause for thought questions
  - questions in boxes
  - questions in the case studies
  - the 13 workshops.

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Elizabeth Jones

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Figures

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Text

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Part A

Introduction

In this text we will be looking at the economic environment in which firms operate and how economic analysis can be used in the process of business decision taking. In doing so, you will gain an insight into how economists think and the sorts of concepts they use to analyse business problems.

But what particular aspects of business does the economist study? Firms are essentially concerned with using inputs to make output. Inputs cost money and output earns money. The difference between the revenue earned and the costs incurred constitutes the firm's profit. Firms will normally want to make as much profit as possible, or at the very least to make satisfactory profits and certainly to avoid a decline in profits.

In order to meet these and other objectives, managers must make choices: choices of what types of output to produce, how much to produce and at what price; choices of what techniques of production to use; what types and how many workers to employ; what suppliers to use for raw materials, equipment, etc. In each case, when weighing up alternatives, managers will want to make the best choices for their firm. Business economists study these choices. They study economic decision making by firms.

All these choices will be affected by the environment in which the firm operates. If the firm is in a stable market with a well-established customer base, the choices may be relatively simple. The choices will be very different if firms are in a rapidly changing market, with lots of competition and new products and processes being developed.

The decisions of the firm are also affected by the much broader national and international environment. Is the economy expanding or contracting? What is happening to interest rates and taxes? Is there competition from other countries? Are there opportunities for expanding abroad? At the time of writing, the terms under which the UK will leave the EU are under discussion. The nature of Brexit and the UK's future relations with the EU will affect the choices that firms make.

The local, national and international economic and political environments all crucially influence a firm's decisions. We will be looking at these influences as the text progresses.

Chapter 1

Business and the economic environment

Business issues covered in this chapter

- Which factors influence a firm's behaviour and performance?
- How are businesses organised and structured?
- What are the various legal categories of business and how do different legal forms suit different types of business?
- What are the aims of business?
- Will owners, managers and other employees necessarily have the same aims? How can the decision makers in a firm be persuaded to achieve the objectives of the owners and hence their employers?
- How are businesses influenced by their national and global market environment?
- How are different types of industry classified in the official statistics?
- How do economists set about analysing business decision taking?

What are the core economic concepts that are necessary to understand the economic choices that businesses have to make, such as what to produce, what inputs and what technology to use, where to locate their production and how best to compete with other firms?

The business environment has been somewhat uncertain since the financial crisis of 2008/9. Uncertainty has come from many quarters: how much Chinese economic growth will slow; what will happen to the price of oil and various other commodities; the future of the EU and the euro; the UK's relationship with the EU; the ability of the global banking system to withstand various shocks. These uncertainties affect business confidence and business plans.

What is more, the world economy has undergone many other changes in recent decades, and these changes have had profound effects on businesses across the world.

For a start, most countries have increasingly embraced the 'market' as the means of boosting prosperity. You can see this in the abandonment of state planning in former communist countries, the privatisation of state industries around the world, the dismantling of barriers to international trade, the development of global financial markets, the use of government policies to promote competition and reductions in government regulation of business in order to attract inward investment. A consequence has been the growth of multinational businesses seeking the best market opportunities and the cheapest sources of supply. This has also contributed to increasing interdependence between nations, which has both good and bad consequences, as we will discuss in part D.

Other important influences on businesses around the world have included the development of computers and IT, improvements in transport and communications and, more recently, a rapid growth in the use of the Internet, including e-commerce and social media. These technological advances have provided both opportunities and threats to businesses. Firms have had to adapt to them to maintain their competitiveness, but these developments have also allowed businesses to take advantage of growing market opportunities.

Today, for many firms the world is their market. Their business environment is global. This is obviously the case with large multinational companies, such as McDonald's, Sony, VW, HSBC, Nestlé and Shell. But many small and medium-sized enterprises (SMEs) also have global reach, selling their products in various countries, often via the Internet, and buying their supplies from wherever in the world they get the best deal. Clearly the terms of access to such markets is crucial. For example, for companies based in the UK or trading with the UK, economic relations between the UK and the rest of the EU may be key to determining the success of their business.

For other firms, however, their market is much more local. Take a restaurant or firm of heating engineers – in fact, look in the Yellow Pages and you will see a host of companies serving a market whose radius is no more than a few miles. But these firms can also be affected by the global environment, either in terms of where their supplies are sourced and/or if they face competition from global companies. A local shop is likely to face competition from a supermarket, such as Tesco or Wal-Mart, both of which have shops around the world and source their supplies from across the globe.

In this chapter, we take an overview of the types of environment in which firms operate and of the role of the economist in business decision taking. We start by looking at the internal environment of the firm – the organisation and aims of the business. We then look at the external environment in which the firm operates – the nature of competition it faces, the type of industry in which it operates, the prices of its inputs, the general state of the economy (e.g. whether growing or in recession), the actions of the government and other authorities that might affect the firm (e.g. changes in taxes or interest rates, or changes in competition legislation) and the global environment (e.g. the extent to which the company operates internationally and how it is influenced by global market opportunities and the state of the world economy). Finally we look at the approach of the economist to analysing the business environment and business decision taking.

Box 1.1 introduces many of the topics that you will be covering in this book by taking the case of John Lewis and seeing how it is affected by its environment.

BOX 1.1 **A PERFECT PARTNERSHIP**

Making the best of your business environment

John Spedan Lewis created John Lewis in 1864 with the opening of a single shop on Oxford Street, London. In 1937, it bought Waitrose, which at the time had 10 shops. However, prior to this, in 1929, the first Trust Settlement was created making the John Lewis Partnership legal. Since then the Partnership has grown to include 46 John Lewis shops across the UK, 32 department stores, 12 John Lewis at home, shops at Heathrow Airport Terminal 2 and at St Pancras International and Birmingham New Street stations, 346 Waitrose supermarkets, an online and catalogue business, a production unit and a farm.[1]

The John Lewis Partnership has over 91 000 permanent staff and it is they who own the business. The interests of these employees are the first priority of the John Lewis Partnership and they benefit if the company does well. They share in the profits and their opinions are taken into account in decision making, creating a democratic and transparent business. The Partnership has annual gross sales of £11.0 billion and provides a wide range of goods and services. John Lewis itself has over 350 000 lines available in store and more than 280 000 lines available online. In addition, it offers other services, such as credit cards, insurance and broadband, to name a few.

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

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

The market environment

To be successful, it is important for the John Lewis Partnership to get its product right. This means understanding the markets that it operates in and how consumer demand responds to changes in prices and to the other services being offered. For example, in 2008, John Lewis responded to challenging conditions by increasing the number of products available for national delivery, prioritising customer service and introducing free delivery across the UK. Its investment in customer service clearly achieved its goal, helping John Lewis to rank as the best company in the 2009 UK Customer Satisfaction Survey.

[1] All figures refer to the financial year 2015/16.

It has maintained good customer service since then and in the 2014 Verdict Customer Satisfaction Awards it won various awards, including Best Overall Retailer. It continued its success in the 2015 Awards, winning Best Retailer for Electricals, Homewares and Clothing. Waitrose was also recognised in these 2015 Awards, being awarded the Best Food & Grocery Retailer. Waitrose also won 'Favourite Supermarket' in the Which? 2015 Customer Survey, with John Lewis placed second in the 'best shops' category.[2]

John Lewis also enforced its commitment to being 'Never Knowingly Undersold', which helped the company to maintain its market share. It also added lines such as Jigsaw to its fashion ranges to continue to meet customer demand and keep up with the fast-moving women's fashion industry.

We look at how markets work in general in Chapter 2 and then look specifically at consumer demand and methods of stimulating it in Chapter 3.

To stay successful, the Partnership must respond to changes in the global economic environment, to changing tastes and fashions and must, to some extent, set fashion. Given the legal structure of its business, it must also balance its competitive position with its objective of 'giving every Partner a voice in the business they co-own'. To quote from the John Lewis Partnership website, 'We build relationships with our customers, suppliers and each other based on honesty, respect and encouragement.'[3]

The store 'John Lewis' operates in a highly competitive market, facing competition in its fashion departments from firms such as Debenhams, Selfridges and Next, and in other departments from firms such as Currys and DFS. The products it sells are crucial for its success, but the prices charged are equally important. Consumers will not be willing to pay any price, especially if they can buy similar products from other stores. Thus, when setting prices and designing products, consideration must be given to what rival companies are doing. John Lewis' prices must be competitive to maintain its sales, profitability and position in the global market.

With the emergence of the Internet and online shopping, John Lewis has had to adapt its strategy and consider which markets to target. Back in 2011, John Lewis expanded its online market to continental Europe, as part of a £250 million investment programme. This decision to expand was partly influenced by record Christmas sales in 2010/11, which were up by 8.9 per cent to £545 million in the five weeks to 1 January compared to the previous year. Online sales were also significantly higher in 2010, justifying this online investment.

Over the past few years, John Lewis has added to its online presence and online sales have expanded rapidly, recorded at £1.5 billion for 2015/16, with Click & collect overtaking home delivery.[4] Reflecting the changing national and global market environment, where consumers are increasingly shopping online, John Lewis has invested more money to improve its online experience through Oracle Commerce. This new platform produces more relevant results and makes it easier for customers to search, which has led to improved conversion rates. David Hunn, Director of IT Delivery at John Lewis said:

> Our on-going customer commitment includes adopting new technology to enable us to better serve customer needs and meet their expectations for convenience, choice and experience . . . This latest Oracle deployment is driving growth online and supporting our aim to deliver a true omni-channel experience.[5]

The John Lewis Partnership has typically been UK based, but Waitrose ventured into the Channel Islands in 2011, following approval by the Jersey Competition Regulatory Authority (JCRA) in August 2010 for it to purchase five Channel Island supermarkets.[6] If the Partnership were to think about expanding further into the global marketplace, such as into the USA and Asia, careful consideration would need to be given to the competitors in these nations and to the tastes of consumers. Tesco, for example, had little success in its foray into the United States. The factors behind this would be something that the Partnership would need to consider before making any significant global move.

Strategic decisions such as growth by expansion in the domestic and global economy are examined in Chapters 6 and 7, respectively.

Production and employment

Being a profitable business depends not just on being able to sell a product, but on how efficiently the product can be produced. This means choosing the most appropriate technology and deploying the labour force in the best way. John Lewis and Waitrose, as with other companies, must decide on how many workers to employ, what wage rates to pay and what the conditions of employment should be. We explore production and costs in Chapter 4 and the employment of labour in Chapter 8.

Despite rising sales in difficult trading conditions, in 2013 John Lewis cut over 300 managerial positions, the biggest cut seen since 2009 when hundreds of call-centre workers lost their jobs. Workers typically have involvement in decisions due to the nature of the organisational structure, but these enforced job cuts came as a shock, especially given the good Christmas trading when sales were 13 per cent up on the same period the previous year. However, it appears as though much of these sales came from its online trading, further suggesting a change in the way we shop and a need for companies to adapt. This is reinforced by the collapse of companies such as HMV, which are facing increased competition from online companies, including Amazon.

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

> To support that growth we've had to change the way we work . . . We need to expand our output in every area but our factory is very tight for space . . . We have to be flexible to handle the peaks and troughs of demand, and many Partners have been cross-trained so they can help out in different areas of the factory.[7]

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[2] www.johnlewispartnership.co.uk/about/john-lewis.html
[3] www.johnlewispartnership.co.uk/about/the-partnership-spirit.html
[4] www.johnlewispartnership.co.uk/content/dam/cws/pdfs/financials/interim%20reports/john_lewis_partnership_interim_report_2015.pdf
[5] 'John Lewis improves online customer experience with Oracle Commerce', press release
[6] John Whiteaker, 'Waitrose invades Channel Islands', *Retail Gazette*, 26 August 2010.
[7] Katy Perceval, 'Material world', JLP e-Zine, 21 May 2010.

In addition to selling its own-brand items in both John Lewis and Waitrose, numerous other brands are sold. As an organisation which prides itself on its ethical stance, this does create a need for an awareness of how its suppliers treat the environment, their employees, their own suppliers and their customers. This is an example of a more general point about the Partnership's 'corporate social responsibility'. We examine these broader social issues in Chapter 9, along with government policies to encourage, persuade or force firms to behave in the public interest.

The Partnership has been active in diversifying its suppliers and creating opportunities for small and medium-sized enterprises (SMEs) to access its supply chain, creating wider social benefits. In addition, Waitrose became the first supermarket to commit to stocking 100 per cent own-label British dairy and, as stated on the website, Waitrose 'looks to buy local with buyers seeking out the finest local and regional products, helping to boost the economy in many rural areas and enabling customers to sample the very best foods made locally.'[8]

Its championing of British produce and its position as a farmer helped Waitrose win the 'Best Buy' Award in 2015, with almost 50 per cent of the tested products being worthy of the Best Buy award, ahead of all other competitors.[9] Given the growing awareness of the sources of products and their ingredients, being able to advertise the local side of its business has big benefits.

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

The economy

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

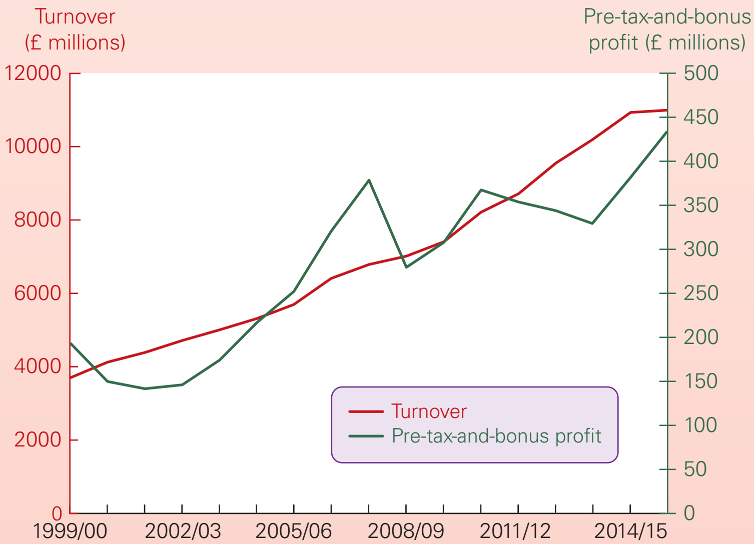
In the Annual Report by the John Lewis Partnership from 2009, its Chairman said:

> As the economic downturn gained momentum, the focus of the Partnership has been to achieve the right balance between continuing to meet the needs and expectations of our customers and Partners while making sufficient profit to support our growth plans, by controlling our costs tightly and managing our cash efficiently.[10]

John Lewis experienced a slowdown in its sales of large purchases in its home market as the financial crisis began to spread. This decline in sales was largely driven by the collapse of the housing market, which has remained weak ever since. Operating profit for the Partnership (excluding property profits) was down 17.7 per cent in April 2009 (compared to the same time the year before) at £316.8 million. For John Lewis itself, gross sales fell by 0.1 per cent and this pushed its operating profit down by £54.6 million from April 2008 to April 2009. Like-for-like sales were also down 3.4 per cent. Due to the nature of the products being sold, Waitrose was somewhat more insulated against the financial crisis and in the same tax year experienced a 5.2 per cent increase in gross sales; a like-for-like sales growth of 0.4 per cent, but a fall in operating profit (excluding property profits) of 3.4 per cent.

In the past few years, the supermarket industry has become increasingly competitive, with low-cost retailers such as Aldi

John Lewis Partnership plc sales and profit



Note: Financial years run from beginning February to end January
Source: Company Annual Reports and Accounts

[8] www.johnlewispartnership.co.uk/about/waitrose/products-and-services.html
[9] 'Waitrose is the 2015 supermarket best buy champion'; 28 December 2015.
[10] 'The John Lewis Partnership Annual Report and Accounts 2009'.

and Lidl posing a very real threat to the major supermarkets. Consumers have tended to become more willing to shop around, getting different products in different supermarkets. Thus, people who previously would do all their shopping in Waitrose may now just use it for more speciality products and buy the more basic lines in a cheaper supermarket.

As more difficult conditions have prevailed in the economy, the Partnership has nevertheless continued to increase its market share and deliver healthy profits.[11]

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

Gross sales have continued to grow over the years, as the chart shows. Pre-tax-and-bonus profits too have generally risen, but dipped in the direct aftermath of the financial crisis.[12] However, they fell in 2011/12, 2012/13 and 2013/14 as Waitrose responded to competition by cutting prices on many of its more basic lines. Nevertheless, in 2014/15 and 2015/16 pre-tax-and-bonus profits grew once more.[13]

So, there are perhaps signs that companies like the John Lewis Partnership, which are responsive to consumer demand and to the changing economic environment, can record healthy growth and profit despite challenging trading conditions. Whether this continues will depend on the Partnership's internal organisation and, crucially, on the external environment.

We examine the national and international business environment in Part D. We also examine the impact on business of government policies to affect the economy – policies such as changes in taxation, interest rates, exchange rates and customs duties. We also look at the impact of the UK's decision to leave the EU.

?

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

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

[12] 'The John Lewis Partnership Annual Report and Accounts 2011'.

[13] www.johnlewispartnership.co.uk/media/press/y2015/press-release-10-september-2015-john-lewis-partnership-plc-interim-results-for-the-half-year-ended-1-August-2015.html

1.1 THE BUSINESS ORGANISATION

There are many factors that affect the behaviour of firms, and here we focus on three key things:

- the legal status of the business;
- the way in which the firm is organised – whether as a simple top-down organisation or as a more complex multi-department or multi-division organisation;
- the aims of the firm – is profit maximisation the objective of the firm, or are there other aims?

The firm as a legal entity

In a small firm, the owner or owners are likely to play a major part in running the business. Such businesses will normally be one of two types.

The sole proprietor. Here, the business is owned by just one person. Owners of small shops, builders and farmers are typical examples. Such businesses are easy to set up and may require only a relatively small initial capital investment. However, they suffer two main disadvantages:

- *Limited scope for expansion.* Finance is limited to what the owner can raise personally, for example through savings or a bank loan. Also there is a limit to the size of an organisation that one person can effectively control.
- *Unlimited liability.* The owner is personally liable for any losses that the business might make. This could result in the owner's house, car and other assets being seized to pay off any outstanding debts, should the business fail.

The partnership. This is where two or more people own the business. In most partnerships there is a legal limit of 20 partners. Partnerships are common structures for solicitors, accountants, surveyors, etc. Whilst partnerships do mean a loss of control, as decision making is now shared, with more owners there is scope for expansion. Extra finance can usually be raised and as partners can specialise in and control different areas of the business, a larger organisation can become more viable.

Since 2001 limited liability partnerships have been possible. However, many firms still retain unlimited liability. This problem could be very serious, as the mistakes of one partner could jeopardise the personal assets of all the other partners.

Where large amounts of capital are required and/or when the risks of business failure are relatively high, partnerships are not generally an appropriate form of organisation. In such cases it is best to form a company (or ***joint-stock company***, to give it its full title).

Definition

Joint-stock company A company where ownership is distributed between shareholders.

Companies

A company is legally separate from its owners. This means that it can enter into contracts and own property. Any debts are its debts, not the owners'.

The owners are the shareholders. Each shareholder receives his or her share of the company's distributed profit: these payments are called 'dividends'. The owners have only ***limited liability***. This means that, if the company goes bankrupt, the owners will lose the amount of money they have invested in the company, but no more – their cars, houses, etc. belong to them and not to the company. This has the advantage of encouraging people to become shareholders, thereby providing more finance to businesses and creating greater scope for expansion.

Shareholders often take no part in the running of the firm. They may elect a board of directors which decides broad issues of company policy. The board of directors in turn appoints managers who make the day-to-day decisions. This can create problems in terms of the divorce of ownership (by shareholders) from control (by managers), as we will see on page 9.

There are two types of company: public and private.

Public limited companies (plc). These are companies that can offer new shares publicly: by issuing a prospectus, they can invite the public to subscribe to a new share issue. In addition, many public limited companies are quoted on the Stock Exchange (see section 6.4), where existing shares can be bought and sold. A public limited company must hold an annual shareholders' meeting. Examples of well-known UK public limited companies are Marks & Spencer, BP, Barclays, BSkyB and Tesco.

Private limited companies (Ltd). Private limited companies cannot offer their shares publicly. Shares have to be sold privately. This makes it more difficult for private limited companies to raise finance, and consequently they tend to be smaller than public companies. However, they are easier to set up than public companies. One of the most famous examples of a private limited company is Manchester United Football Club, which, until it was bought out by the Glazer family in 2005, was a public limited company. It then became a public limited company again in August 2012 when 10 per cent of its shares were floated on the New York Stock Exchange.

Co-operatives

There are also two types of co-operatives.

Consumer co-operatives. These are officially owned by the consumers, although they play no part in running the business.

Producer co-operatives. These are owned by the firm's workers, who share in the firm's profits. John Lewis is a prime example of such an organisation, as we discussed in Box 1.1.

The internal organisation of the firm

The internal operating structures of firms are frequently governed by their size. Small firms tend to be centrally managed, with decision making operating through a clear managerial hierarchy. In large firms, however, the organisational structure tends to be more complex, although technological change is forcing many organisations to reassess the most suitable organisational structure for their business.

U form

In small to medium-sized firms, the managers of the various departments – marketing, finance, production, etc. – are normally directly responsible to a chief executive, whose function is to co-ordinate their activities: relaying the firm's overall strategy to them and being responsible for interdepartmental communication. We call this type of structure ***U (unitary) form*** (see Figure 1.1).

When firms expand beyond a certain size, a U-form structure is likely to become inefficient. This inefficiency arises from difficulties in communication, co-ordination and control, as the Chief Executive's office receives too much information to make efficient decisions and so it becomes too difficult to manage the whole organisation from the centre.

> **Definitions**
>
> **Limited liability** Where the liability of the owners for the debts of a company is limited to the amount they have invested in it.
>
> **U-form business organisation** One in which the central organisation of the firm (the chief executive or a managerial team) is responsible both for the firm's day-to-day administration and for formulating its business strategy.

Figure 1.1 U-form business organisation

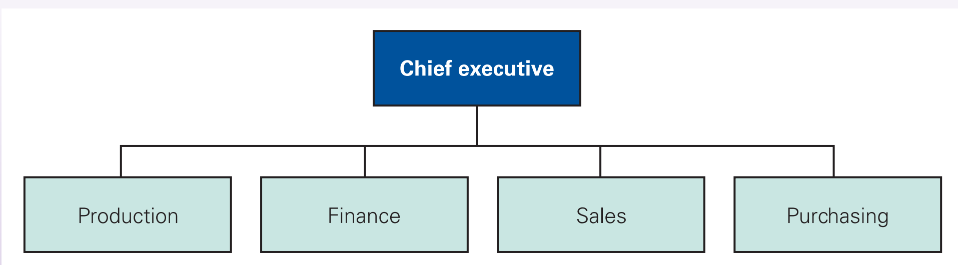
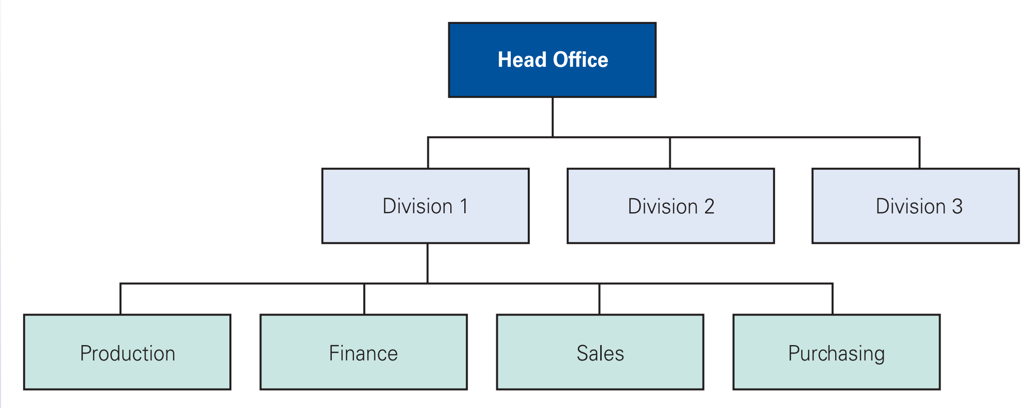


Figure 1.2 M-form business organisation



M form

To overcome these organisational problems, the firm can adopt an ***M (multi-divisional) form*** of managerial structure (see Figure 1.2).

This suits larger firms. The firm is divided into a number of 'divisions'. Each division could be responsible for a particular stage of production, a particular product or group of products, or a particular market (e.g. a specific country). The day-to-day running and even certain long-term decisions of each division would be the responsibility of the divisional manager(s). This leads to the following benefits:

- reduced length of information flows;
- the chief executive being able to concentrate on overall strategic planning;
- an enhanced level of control, with each division being run as a mini 'firm', competing with other divisions for the limited amount of company resources available.

The flat organisation

One of the major problems with M-form organisations is that they can become very bureaucratic with many layers of management. Recent technological innovations, however, especially in respect to computer systems such as e-mail and management information systems, have enabled senior managers to communicate easily and directly with those lower in the organisational structure. As a result, some companies have moved back towards simpler structures. These ***flat organisations***, as they are called, dispense with various layers of middle management and so can speed up communication.

The holding company

As many businesses have expanded their operations, often on a global scale, more complex forms of business organisation have evolved. One such organisation is the ***H-form*** or ***holding company***. A holding company (or parent company) is one that owns a controlling interest in other subsidiary companies. These subsidiaries, in turn, may also have controlling interests in other companies. There may thus be a complex web of interlocking holdings. While the parent company has ultimate control over its various subsidiaries, typically both tactical and strategic decision making is left to the individual companies within the organisation. A good example of such an organisation would be the Walt Disney Company.

The aims of the firm

Economists have traditionally assumed that firms want to maximise profits. The 'traditional theory of the firm', as it is called, shows how much output firms should produce and at what price in order to make as much profit as possible. But do firms necessarily want to maximise profits?

One question arises over the time period in which they may want to maximise profits. For example, if a business adopts a strategy of growth, more must be spent on investment in machinery and advertising to increase both production and sales. These large expenditures will reduce the

Definitions

M-form business organisation One in which the business is organised into separate departments, such that responsibility for the day-to-day management of the enterprise is separated from the formulation of the business's strategic plan.

Flat organisation One in which technology enables senior managers to communicate directly with those lower in the organisational structure. Middle managers are bypassed.

H-form or holding company A business organisation in which the parent company holds interests in a number of other companies or subsidiaries.

profit in the short run, but profits in the long run may be maximised. In this case, what is inconsistent with short-run profit maximisation may be wholly consistent with long-run profit maximisation.

A more fundamental criticism of the assumption of profit maximisation, however, is that in large companies it is not the owners that make the decisions about how much to produce and at what price. In such cases other objectives may be pursued by these decision makers.

The divorce of ownership from control

As we saw in our discussion of public limited companies, the shareholders are the owners and they elect directors. Directors in turn employ professional managers who often have considerable discretion in making decisions on things such as pricing, advertising, costing, etc. There is therefore a separation between the ownership and control of a firm.

The owners (shareholders) may want to maximise profits to increase their dividends, but what are the objectives of the managers? They will probably want to pursue their own interests, such as a higher salary, greater power or prestige, greater sales, better working conditions or greater popularity with their subordinates. Indeed, different managers in the same firm may well pursue different aims. The point is that these aims may conflict with the aim of maximum profit.

> **Pause for thought**
>
> *Make a list of four possible aims that a manager of a McDonald's restaurant might have. Which of these might conflict with the interests of McDonald's shareholders?*

Managers will still have to ensure that *sufficient* profits are made to keep shareholders happy, but that may be very different from maximising profits. Alternative theories of the firm to those of profit maximisation, therefore, tend to assume that large firms are profit 'satisficers'. That is, managers strive hard for a minimum target level of profit, but are less interested in profits above this level.

The principal–agent relationship

Can the owners of a firm ever be sure that their managers will pursue the business strategy most appropriate to achieving the owners' goals (i.e. profit maximisation)? This is an example of the ***principal–agent problem***. One of the features of a complex modern economy is that people (principals) have to employ others (agents) to carry out their wishes. If you want to go on holiday, it is easier to go to a travel agent to sort out the arrangements than to do it all yourself. Likewise, if you want to sell a house, it is more convenient to go to an estate agent.

The crucial advantage that agents have over their principals is specialist knowledge and information. This is usually why we employ agents. For example, owners employ managers for their specialist knowledge of a market or their understanding of business practice. But this situation of ***asymmetric information*** – that one party (the agent) knows more than the other (the principal) – means that it will be very difficult for the principal to judge in whose interest the agent is operating. Are the managers pursuing their own goals, rather than the goals of the owner? It is the same in other walks of life. The estate agent may try to convince you that it is necessary to accept a lower price, while the real reason may be to save the agent time, effort and expense.

> **KEY IDEA 1**
>
> ***The principal–agent problem.*** **Where people (principals), as a result of a lack of knowledge (asymmetric information), cannot ensure that their best interests are served by their agents. Agents may take advantage of this situation to the disadvantage of the principals.**

Principals may attempt to reconcile the fact that they have imperfect information, and are thus in an inherently weak position, in the following ways.

- *Monitoring* the performance of the agent. Shareholders could monitor the performance of their senior managers through attending annual general meetings. The managers could be questioned by shareholders and ultimately replaced if their performance is unsatisfactory.
- Establishing a series of *incentives* to ensure that agents act in the principals' best interest. For example, managerial pay could be closely linked to business performance, through schemes such as profit sharing. Although this can be useful in encouraging managers (agents) to act in the owners' (principals') interests, this is likely to be more effective the larger the incentive: e.g. the larger the share in company profits. But this could prove costly from the owners' point of view.

Within any firm there will exist a complex chain of principal–agent relationships – between workers and managers, between junior managers and senior managers, between senior managers and directors, and between directors and shareholders. All groups will hold some

> **Definitions**
>
> **Principal–agent problem** One where people (principals), as a result of lack of knowledge, cannot ensure that their best interests are served by their agents.
>
> **Asymmetric information** A situation in which one party in an economic relationship knows more than another.