

PART 1

THE ECONOMIC AND BUSINESS ENVIRONMENT

1

WHAT IS BUSINESS ECONOMICS?

LEARNING OUTCOMES

After reading this chapter you should be able to:

- Explain what businesses do and what economics studies.
- Provide a definition and example of business activity in the public and private sectors.
- Define scarcity.
- Explain the idea of a trade-off and provide at least one example.
- Give a definition of opportunity cost and provide at least three examples relating to individual and business decision making.
- Explain the difference between capitalist and communist economic systems in how they answer the fundamental questions of society.
- Outline how prices direct resources to different economic activities.
- Explain why specialization and trade can improve people's choices.

WHAT IS BUSINESS ECONOMICS?

Business studies and economics are invariably taught as separate subjects in many schools prior to university. Business studies focuses on issues and problems related to business organizations of different types and includes business objectives, marketing, business organization, human resources management, accounting and finance, operations management and the influence of external factors including management of change. Economics focuses on the workings of markets, firm behaviour, market structures, factor markets (such as the market for labour and capital), international trade and the workings of the economy as a whole including growth, unemployment, inflation and exchange rates.

There is one thing, however, which connects the two discipline areas and that is decision making. People in businesses have to make decisions every day and the way in which they make these decisions and the outcome of those decisions can be informed by using the models, methods and tools of economics.

In addition, an understanding of the key concepts of economics is essential. The purpose of this book is to help you begin to think as an economist and to apply that thinking to business contexts to set you on the way to being a better decision maker. Businesses need people who understand the basic principles of business, who are flexible, can think in different ways and who are problem solvers who can cope with and confront change in a positive way. Having an understanding of the basic principles of economics will help in developing these skills.

What Is Business?

Business is an activity. It involves using inputs, which are broadly described as land, labour and capital, and turning them into some output which is then sold to customers. These outputs could be goods such as TVs, food, books, clothes, furniture, bricks, cars, glass and so on or services such as banking, insurance, accounting, tourism, repairs, medical care, entertainment, transportation, hotels, restaurants, etc. The customers who buy these outputs could be private individuals, other businesses or government bodies both from the domestic economy and from overseas. In the process of exchange of outputs, buyers pay a price to acquire the outputs and the money received by the seller represents the income of the business.

Business activity is carried out for different reasons. In some cases, the primary aim of a business is to ensure that the money received from selling outputs is greater than the cost of producing these outputs. In other words, the business is focused on making a profit and **profit** is the reward for the risk taken in carrying out business activity. Some business activity will be carried out with the primary intention of fulfilling a need, and while in most cases it is expected that the costs of providing the output must at the very least be covered by the income generated, any surplus that is generated is put back into the business or used for a good cause.

profit the reward for taking risk in carrying out business activity

Because business activity has different aims, the organizations that provide outputs are different. The **private sector** is made up of different types of businesses. Some are very small, one-person organizations and some are giants with operations in many different countries employing many thousands of people. The main aim of these businesses is to generate profit, but they will also have many other aims which might also include a recognition of their moral and ethical responsibilities to society as a whole. Other businesses in the private sector are set up with the primary aim of providing outputs or a service which meet a particular need. These businesses will include charitable organizations, carrying out voluntary work, fundraising and activities which have wider social and community benefits. This is referred to as the **third sector** or not-for-profit business.

private sector business activity which is owned, financed and organized by private individuals

third sector business activity owned, financed and organized by private individuals, but with the primary aim of providing needs and not making profit

In many countries a large amount of business activity is carried out by the government on behalf of the population as a whole. This is referred to as the **public sector**. The finance for public sector activity comes from tax payers, from government borrowing and from the income that can be generated from the activity itself. Public sector activity is focused on providing goods and services to the public as a whole, and in doing so maximizing the opportunities for access. Balancing the cost of providing education, health, legal, welfare, emergency services, roads and transport and so on with the demand for these services is a considerable challenge to any government but, fundamentally, it might be expected that the cost of provision is at least met by the funds available.

public sector business activity owned, financed and organized by the state on behalf of the population as a whole

One of the main decisions facing businesses is what the aims of the business should be. If the primary aim is to make profit, decisions made may be different, but related to those which are made if the primary aim of the business is to provide a perceived social benefit. Public sector organizations have to make difficult decisions about the provision of services because funds may be limited.

In most business activity, decisions might include any or all of the following:

- How many people to employ.
- What each of those people will do to contribute to the business.
- How much employees get in return for their labour.
- Who should receive a bonus scheme and who should not.
- How to increase output per worker.
- How best to manage costs.
- When to invest.
- How much to invest and where best to get the funds to invest from.
- What products to produce.
- What products not to produce.
- When to stop producing products.
- When to expand.
- When to contract.
- How best to manage the sales process and customer relations.
- Whether to be environmentally friendly or whether to give the impression of being so.
- How to deal with competitors.
- Whether to charge a high price or a low price (or one in-between).

It is important to note at the outset that there are rarely simple and identifiable 'right' and 'wrong' answers in business. However meticulous the analysis carried out and data collected, ultimately judgements have to be made. When the judgements lead to positive outcomes, the decision makers are praised and may be lauded as having some special skill or insight, but when the judgement leads to negative outcomes decision makers are criticized and may find themselves out of a job.

Decision makers will seek to use many different techniques and methods to help them make better decisions, that lead to the positive outcomes desired. A knowledge of the methods, tools and models of economics may be one way in which decision makers can understand the problems and issues they face and be in a better position to make decisions as a result. It is important to emphasize, however, that having a good understanding of economics is not going to automatically lead to business success, however that success is defined.

Types of Economic System Businesses operate as part of society. Typically, business activity forms part of a society that is based on capitalist principles where resources are owned by private individuals, and trade and exchange is carried out largely for the purposes of making a profit. In some societies, resources are owned by the state and business activity is carried out for social, economic and political reasons, which may include a fundamental belief that society ought to be organized along more egalitarian lines than those which exist in capitalist societies. These are referred to as **communist economies** (and more generally as 'command economies'). Inequality is an outcome of **capitalist economies** and the gaps between the rich and poor and those who have and have not form fundamental areas of disagreement in decision making.

communist economies systems where resource inputs are largely owned by the state, and exchange and trade are based on social, political and economic motives which may be primarily based on a belief of greater equality
capitalist economies systems where resource inputs are largely owned by private individuals and where the motive for exchange takes place primarily for profit

The Fundamental Questions of Society

Regardless of the economic system in place, any country has some fundamental questions to answer. These questions are:

- What products will be produced?
- How will products be produced?
- Who will get the products that are produced?

These are profound questions and have equally profound implications. In any society, human beings have wants and needs; at the most basic level these wants and needs are food, clothing and shelter. To provide for these needs, resources, which we have classified as land, labour and capital, have to be organized to generate the products that society needs to answer the first question, 'What is to be produced?'

There are many different ways in which products can be produced, and who gets access is determined by the economic system that is adopted in a country. In a capitalist system, those who own resources may get access to a far greater proportion of the products produced than those who do not, whereas in a non-capitalist system resources are owned by the state, and the state may determine a far greater degree of equality of access. Decisions made in capitalist economies will be based on different beliefs and priorities to those made in communist or command economies.

What Is Economics?

At its simplest, **economics** is the study of how society manages its resources. The management of society's resources is important because resources are scarce. **Scarcity** means that society has limited resources and therefore cannot produce all the products people desire. Just as a household cannot give every member everything they want, a society cannot give every individual the highest standard of living to which they might aspire.

economics the study of how society makes decisions in managing scarce resources
scarcity the limited nature of society's resources in relation to wants and needs

In capitalist societies, the fundamental questions of what is to be produced, how products are to be produced, and who gets access to the products produced are answered through the combined actions of millions of households and firms. Economists therefore study how people make decisions: how much they work, what they buy, how much they save and how they invest their savings. Economists also study how people and people in businesses interact with one another. Economists analyze forces and trends that affect the economy as a whole, including the growth in average income, the fraction of the population that cannot find work and the rate at which prices change.

In communist societies, the fundamental questions are answered by the state making judgements about resource use. These judgements will be based on different belief systems from those in capitalist societies. Economists study how decisions are made in these societies and the implications of these decisions. In many countries, private individuals and the state operate together in answering the fundamental questions. These are referred to as **mixed economies**. The proportion of economic activity that is carried out by the private sector and public sector varies, but there are few instances of countries where the private and public sector do not coexist in addressing the fundamental questions.

mixed economies economic systems that include elements of both private and public ownership of resources to answer the fundamental questions

In a sense, economics can be described as the science of decision making. In thinking as an economist in the context of business, there are particular concepts, models and methods that have developed within the discipline of economics. These can be applied and help in the analysis of business problems and issues.

SOME KEY IDEAS IN ECONOMICS

We use the term 'the economy' on a regular basis, but have you ever stopped to think about what the term really means? Whether we are talking about the economy of a group of countries, such as the European Union (EU) or the Middle East, or the economy of one particular country, such as South Africa or the United Kingdom (UK), or of the whole world, an economy is just a group of people interacting with one another as they go about their lives. This interaction is invariably through a process of exchange.

Whether it be an individual buying a coffee, a business buying several hundred tonnes of steel for a construction project or a government funding a higher education institution, the interaction consists of millions of individuals all making decisions and together we describe these interactions as **the economy**.

the economy the collective interaction between individuals in the process of production and exchange in a defined area

There are some fundamental ideas that are associated with economics which will appear consistently throughout our analysis in this book. These are introduced below.

Idea 1: Decision Making Involves Trade-Offs

When individuals, businesses or governments make decisions, they have to make a judgement between two or more courses of action. Each course of action will have certain benefits. If one course of action is chosen, the benefits of that action can be gained, but usually making that decision involves having to give up the benefits of the other courses of action. The benefits that have to be given up are said to be the **trade-offs** of a decision. Making decisions requires trading off the benefits of one action against the benefits of another.

trade-off the loss of the benefits from a decision to forego or sacrifice one option, balanced against the benefits incurred from the choice made

Consider a business manager who must decide how to allocate their most valuable resource: their time. They can spend all of their time reflecting on strategy in their office which, if implemented successfully, could bring benefits to the business. Equally, they could spend all of their time walking around the premises talking to staff, gaining a better understanding of the business and motivating workers, which may bring benefits of improved productivity and efficiency; or they can divide their time between the two fields. For every hour they spend reflecting and strategizing, they give up the benefits that could be gained for an hour they could have used talking to staff.

Similarly, consider employees of this business deciding how to spend the income they receive from working at the business. They can buy food, clothing or a family holiday, each of which bring certain benefits. Or they can save some of the family income for retirement, which brings benefits in the future. If the family decides to save an extra €100 a month for retirement, then they have to trade-off the benefits this brings in the future for the benefits incurred by spending that €100 on products today.

When people are grouped into societies, they face different kinds of trade-offs. Resources devoted to consumer goods such as clothing, food, cars, washing machines and so on could also be used for producing capital goods, equipment and machinery that is used for the production of other goods. The more society spends on consumer goods that bring benefits to people, the less we can spend on capital goods that bring the benefits of raising standards of living at some point in the future.

Also important in modern society is the trade-off between a clean environment and a high level of income. Laws that require firms to reduce pollution might raise the cost of production but bring the benefit to society as a whole (and possibly to the firm in the form of good publicity). Because of the higher costs, these firms may end up earning smaller profits, paying lower wages, charging higher prices or some combination of these three. Thus, while pollution regulations give us the benefit of a cleaner environment and the improved levels of health that come with it, they reduce the benefits that higher incomes would bring to firms' owners, workers and customers.

Recognizing that people and businesses face trade-offs does not by itself tell us what decisions they will or should make. A chief executive officer (CEO) should not abandon time set aside for reflection and thinking just because doing so would increase the time available to talk to workers. Society should not stop protecting the environment just because environmental regulations reduce our material standard of living. Nevertheless, acknowledging trade-offs is important because people and businesses are likely to make good decisions only if they understand the options that they have available and can quantify them in some way to make informed decisions.

Idea 2: The Cost of Something Is What You Give Up to Get It

Because people and businesses face trade-offs, making decisions requires comparing not only the benefits but also the costs of alternative courses of action. In many cases, however, these costs and benefits are not as obvious as might first appear.

Consider the decision by a business to cease production of a product that is not selling very well. The benefit is that resources can be made available to invest in other parts of the business that are more successful. But what is the cost? To answer this question, you might be tempted to add up the money the business has to pay in redundancy to workers who may no longer be needed, to close down the plant and get rid of defunct machinery and equipment. Yet this total does not truly represent what the business gives up when it ceases production of a product. First, it ignores many wider issues that the business might face as a result of its decision. How do competitors view the decision? Will they seek to use it as an example of the decline of the business? What about customers? Will they be disappointed that the product has disappeared? A number of businesses have found themselves under pressure to bring back much loved products that may not have been financially viable and have incurred disappointment from customers and possible loss of loyalty as a result. Then there is the attitude among workers. Is this closure the first of others? Does it send negative signals to the rest of the workforce resulting in a decline in motivation and increases in staff turnover as workers seek to get out before they are pushed out? Second, it does not include the lost revenue from sales of the product. It may be that sales were low and not very profitable, rather than it was not viable to continue with production, i.e. that the business was making a loss. Assuming that sales were not zero, there will have been some revenue being generated and this will now be lost. This has to be taken into consideration.

The decision, therefore, has costs far greater than pure money costs. The cost of loss of goodwill, worker and customer loyalty and bad publicity also has to be taken into consideration in assessing the costs of the decision and these may not be immediately obvious and sometimes not easy to work out.

The **opportunity cost** of an action is what you give up to pursue that course of action. When making any decision, such as whether to close down production of a product, decision makers should be aware of the opportunity costs that accompany each possible action.

opportunity cost the cost expressed in terms of the benefits sacrificed of the next best alternative

SELF TEST You may have heard the adage 'There is no such thing as a free lunch'. What do you think this means in the context of trade-offs and opportunity cost?

Idea 3: Rational People and Businesses Think at the Margin

There are many aspects of economics which are based on assumptions. One such assumption is that people behave rationally. In this context, behaving rationally means doing the best you can given the circumstances. The extent to which this is indeed the case is debatable but, in some cases, businesses and individuals do make decisions based on a rational assessment (as far as is possible) of different options. The decision by a company worker of whether to put in the extra hour at the end of the working day might be based on the perceived costs and benefits of completing a task before going home. A publisher may have to make a decision about whether to print an extra 1,000 copies of a textbook when it is not certain that all these extra books will sell. Economists use the term **marginal changes** to describe small incremental adjustments to an existing plan of action. Keep in mind that 'margin' means 'edge', so marginal changes are adjustments around the edges of what you are doing. In many situations, people can make sensible decisions by thinking at the margin.

marginal changes small incremental adjustments to a plan of action

Consider an airline company deciding how much to charge passengers. Suppose that flying a 200-seat aeroplane from London to Warsaw costs the airline €50,000. In this case, the average cost of each seat is

€50,000/200, which is €250. You might be tempted to conclude that the airline should never sell a ticket for less than €250. If the airline thinks at the margin, it could raise its profits. Imagine that 24 hours before the plane is due to depart, there are still ten empty seats. Last-minute passengers accessing the booking area on the airline's website might be willing to pay €200 for a seat. Should the airline sell it to them? If the plane has empty seats, the cost of adding one more passenger is minuscule. Although the *average* cost of flying a passenger is €250, the *marginal* cost is merely the cost of the airline meal that the extra passenger will consume (which may have gone to waste in any case if it was provided) and possibly a slight increase in the amount of aircraft fuel used. As long as the late booking passengers pay more than the marginal cost, selling them a ticket can be profitable. We assume that a rational decision maker takes an action if the marginal benefit of the action exceeds the marginal cost.

Idea 4: People and Businesses Respond to Incentives

If people and businesses make decisions by comparing costs and benefits, their behaviour may change when the costs or benefits change. That is, people respond to incentives. When the price of an apple rises, for instance, some people decide to eat more pears and fewer apples because the price paid to buy an apple is higher. At the same time, apple orchards decide to hire more workers and harvest more apples, because the benefit of selling an apple is also higher. The effect of price on the behaviour of buyers and sellers in a market is crucial for understanding how the economy works.

Public policy makers should never forget about incentives, because many policies change the costs or benefits that people face and, therefore, alter behaviour. Concerns over the environment and climate change have led some governments to pass legislation around the future production of vehicles using internal combustion engines. This, along with other business related factors, has encouraged manufacturers to invest more in the production of electric vehicles and for consumers to consider going electric when changing their vehicles. This in turn has led to new firms developing around the provision of the infrastructure needed, which includes more widespread and accessible public charging points and the provision of charging points in private homes.

When policy makers fail to consider how their policies affect incentives, they often end up with results they did not intend. These are referred to as **unintended consequences**. For example, if a government decided to make the wearing of safety helmets for cyclists a legal requirement, the primary focus of the law might be to help reduce the incidents of serious head injuries for cyclists. The unintended consequences might be that people decide not to cycle in the numbers they used to because wearing a cycle helmet is unfashionable. The number of people suffering head injuries might fall because fewer people are now cycling but, in addition, society loses the positive health benefits that cycling can bring, and businesses manufacturing and servicing bicycles might see demand fall. Public transport and roads may become busier because people switch to using buses and cars rather than cycling to work.

unintended consequences the outcomes of decision making or policy changes which are not anticipated and are unforeseen

This is an example of the general principle that people respond to incentives. When analysing any policy or business decision, we must consider not only the direct effects but also the indirect effects that work through incentives. If the decision changes incentives, it will cause people to alter their behaviour.

SELF TEST The emphasis on road safety throughout Europe has increased since the early 1990s. Not only are cars packed with safety technology and devices, but roads are also designed to be safer with the use of safety barriers and better road surfaces, for example. Is there a case for believing that if people feel they are safer in their cars there is an incentive to drive faster because the marginal cost is now outweighed by the marginal benefit?

CASE STUDY Technology and Decision Making

One of the major debating points in economics is around how humans make decisions. Economics has a history of assuming that humans make decisions based on the principle of rationality. This is highlighted in the ideas we have discussed in this chapter. Many models in economics are based around the assumption of rational behaviour, that is people making decisions to do the best they can given their circumstances. However, research has shown that humans can often make irrational decisions partly due to their inability to comprehend and process the amount of data needed to make better decisions.

Technology, however, is being developed to help humans, and in particular humans who work in businesses, to analyze and process data to improve decision making. Artificial intelligence (AI) is technology that enables machines to perform with human-like capabilities in solving problems and making decisions. AI covers a wide range of technologies but includes machine learning where systems can process information and establish patterns which enable the system to improve performance in the future. Many of us will have experience of AI through the use of smart speakers, digital assistants on websites, face recognition on smartphones, the personalized information we are fed through social media accounts, spell checks on computer devices, travel and weather apps, and banking services. Much of the time, AI is working in the background to process the data we provide and to understand us better to provide more personalized experiences in many areas of our lives.

In business, AI is becoming increasingly important. In manufacturing, AI can be used to monitor production processes and systems and to identify potential problems and rectify them before they happen.



AI can make decision-making more efficient but to what extent should it replace human judgement?

Many businesses now collect massive amounts of data which humans would not be able to process effectively but machines can. The analysis of data can provide information to help improve decision making, to better understand customers and their behaviour, to understand their operations more effectively and to make improvements which generate greater efficiency. At this stage in the development of the technology, AI is not replacing humans but working with humans to facilitate improved decision making.

Questions

- 1** Give an example of a 'rational' business decision. What is it about the decision that makes it 'rational'?
- 2** The case study provides a definition of AI. Do you think it is important for software developers working on AI to find ways to take into account opportunity costs in making decisions? Explain.
- 3** How important do you think it is that AI does not replace humans but that business decision making continues to rely on human judgement? Explain.

Idea 5: Trade Can Make Everyone Better Off

The United States, South Africa and Japan are often mentioned in the news as being competitors to Europe in the world economy. In some ways this is true, because US, South African and Japanese firms do produce many of the same goods as European firms. Airbus and Boeing compete for the same customers in the market for aircraft. Toyota and Citroën compete for the same customers in the market for cars. South African and US fruit growers compete in the same market as European fruit growers, and South African and US wine producers compete in the same market as French, Spanish and Italian wine makers.

Yet it is easy to be misled when thinking about competition among countries. Trade between Europe and South Africa or the United States, or between Europe and Japan, is not like a sports contest where one side wins and the other side loses (a zero-sum game). Trade between two economies can make each economy better off.

In the private sector in a capitalist system, when a business produces a product it competes against other businesses that are producing similar products. Despite this competition, a business would not be better off isolating itself from all other businesses. If it did, the business would have to supply all its own raw materials and components, find its own staff, arrange its own insurance, do its own banking, arrange its own security and so on. Businesses can benefit from their ability to trade with others. Trade allows each business to specialize in the activities it does best, whether it is farming, making clothes or home building. By trading with others, businesses can buy a greater variety of goods and services at lower cost and therefore (potentially) increase efficiency.

Countries as well as businesses benefit from the ability to trade with one another. Trade allows countries to specialize in production of certain goods and services which they have developed an efficiency in for some reason. This might be because of resource endowments, for example parts of the Arab world have significant reserves of oil. It could also be because they have developed experience, infrastructure and skill in finance, such as the City of London or Frankfurt. The production of these goods and services can be traded so that citizens are able to enjoy a greater variety of goods and services. The Japanese and Americans, as well as the Egyptians and Brazilians, are as much partners in the world economy as they are competitors. While trade can bring benefits it must be borne in mind that with any trade there can be winners and losers.

Idea 6: Markets Can Be a Good Way to Organize Economic Activity

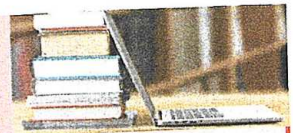
Communist economic systems have central planners in the government who guide economic activity. These planners decide what goods and services are produced, how much is produced and who produces and consumes these goods and services. Those who support central planning might argue that only the government can organize economic activity in a way that promotes economic well-being for the country as a whole.

In a capitalist system, the private ownership of resources means that individuals making millions of decisions every day determine economic activity. The interaction of buyers and sellers in markets allocates resources to different uses and addresses the fundamental economic questions. In a **market economy**, firms decide who to hire and what to make; individuals supplying labour decide which firms to work for and what to buy with their incomes. These individuals (collectively referred to as households) and firms interact in the marketplace, where prices and self-interest guide their decisions. The process of exchange in market economies is facilitated by prices that provide signals to consumers and producers, and lead to resources moving to different uses, all of which are based on the self-interests of firms and households. Prices reflect both the value of a good to society and the cost to society of making the good.

market economy an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services

In a pure market economy (one with no state involvement), no individual is considering the economic well-being of society as a whole. Yet, despite self-interested decision makers, market economies have proven remarkably successful in organizing economic activity, and the vast majority of countries around the world base their economies on a market system to a greater or lesser degree. Proponents of market economies argue that they are the most effective way yet devised in allocating resources and improving standards of living. However, note the caveat in this idea. Markets *can be* a good way to organize economic activity. We emphasize *can be* because markets are not devoid of problems. Events since 2019 have highlighted the fragility of market systems and how disruption to the flow of goods and services in market systems can cause widespread problems. We will look at the reasons why markets may not work properly in later chapters.

FYI



Adam Smith and the Invisible Hand

Adam Smith's *The Wealth of Nations* is a landmark in economics. It reflected a point of view that was typical of so-called 'enlightenment' writers at the end of the eighteenth century, that individuals are usually best left to their own devices, without government guiding their actions. This political philosophy provided the intellectual basis for the market economy summed up in the following description by Adam Smith of how people interact:

Man (sic) has almost constant occasion for the help of his brethren, and it is vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them... It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. ... Every individual... neither intends to promote the public interest, nor knows how much he is promoting it. ... He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.

The Wealth of Nations 1776

Economists have interpreted this as Smith arguing that participants in the economy are motivated by self-interest and that the 'invisible hand' of the marketplace guides this self-interest into promoting general economic well-being. For many years the 'invisible hand' has been cited as an example of the way in which markets are the most appropriate way yet devised to address the fundamental economic questions. Not everyone, however, believes this to be the case. Some economists argue that Smith was writing in the particular context of his day and that the world and economies are very different today and have different belief systems that may mean markets do not always lead to improvements in overall well-being.

Idea 7: Governments Can Sometimes Improve Market Outcomes

Markets only work if certain assumptions are upheld. One of these assumptions is that an effective system of property rights exists. **Property rights** are linked to the idea of ownership of resources, which forms the basis of the capitalist system. If an individual owns property, then there has to be some system in place to ensure that the rights associated with owning that property can be enforced. These rights might include the exclusive right to use and exploit the good to generate income and the right to transfer ownership to another individual or organization. A farmer will not grow food if they expect their crop to be stolen, and a restaurant will not serve meals unless it is assured that customers will pay before they leave. A market-based system has to rely on the legal system and police to enforce rights over the things we produce and these are provided by the state.

property rights the exclusive right of an individual, group or organization to determine how a resource is used

A pure market system can lead to outcomes that may not be deemed desirable. Specifically, market outcomes may be seen as being inefficient or inequitable. Governments step in to promote efficiency and equity by seeking to either enlarge the economic cake or change the way in which the cake is divided.

When market outcomes fail to lead to an efficient allocation of resources, economists call this **market failure**. One possible cause of market failure is an **externality**, which is the uncompensated impact of one person's actions on the well-being of a bystander or third party. For instance, the classic

example of an external cost is pollution. Another possible cause of market failure is **market power**, which refers to the ability of a single person (or small group) to unduly influence market prices. For example, if everyone in a remote village in the Scottish Highlands needs water but there is only one well, the owner of the well may act in their own self-interest and in doing so make decisions that have wide social and economic implications.

market failure a situation in which a market left on its own fails to allocate resources efficiently
externality the uncompensated impact of one person's actions on the well-being of a bystander or third party
market power the ability of a single economic agent (or small group of agents) to have a substantial influence on market prices



WHAT IF... the intervention by government actually leads to a worse outcome than if it had not done anything in the first place? Does this mean government should never interfere in the market?

Market systems may also fail to ensure that economic prosperity is distributed equitably. A market economy rewards people according to their ability to produce things for which other people are willing to pay. The world's best footballer earns more than the world's best chess player simply because people are willing to pay more to watch football than chess. The invisible hand does not ensure that everyone has sufficient food, decent clothing and adequate health care. Many public policies, such as income tax and the social security system, aim to achieve a more equitable distribution of economic well-being.

To say that the government *can* improve on market outcomes at times does not mean that it always *will*. Public policy is made by a political process that is far from perfect. Sometimes policies are designed simply to reward the politically powerful (which might include business leaders). Sometimes they are made by well-intentioned leaders who are not fully informed or who are unduly swayed by lobbying from businesses with a great deal of influence and power. Well-intentioned policies can have unintended consequences. Thinking as an economist helps you to judge when a government policy is justifiable to promote efficiency or equity, and when it is not.

The Economy as a Whole As noted earlier, individuals make decisions and also interact with one another with these collective decisions and interactions making up 'the economy'. A key concept in Business Economics is **economic growth**: the percentage increase in the number of goods and services produced in an economy over a period of time, usually expressed over a quarter and annually.

economic growth the increase in the amount of goods and services in an economy over a period of time

Idea 8: An Economy's Standard of Living Depends on Its Ability to Produce Goods and Services

Economic growth is important because it relates to the amount of goods and services produced by a country in a period and can be used as a reflection of the **standard of living** that citizens of that country enjoy. Economic growth can be measured by looking at the change in the value of goods and services a country produces each year, its **gross domestic product (GDP)**. Citizens in countries with high levels of GDP tend to have more goods and services such as housing, TVs, internet access, cars, household white goods and so on, which can make life more comfortable, as well as access to better nutrition, better health care and longer life expectancy than citizens of low GDP countries. In addition, many of these high income countries have more robust legal systems which enforce the law and reduce the incidences of corruption, which is important in ensuring that businesses are governed appropriately and behave to high standards.

Taking the GDP of a country and dividing the figure by the population gives **gross domestic product (GDP) per head** or per capita. GDP per head is used as one measure of the standard of living of citizens in a country as it reflects the amount of goods and services people are able to access. It can be argued that countries with higher GDP per head tend to enjoy a higher standard of living compared to countries with low GDP per head, although there may be other measures of well-being that can be used rather than the amount of goods and services which can be bought.

standard of living a measure of welfare based on the amount of goods and services a person's income can buy
gross domestic product (GDP) the market value of all final goods and services produced within a country in a given period of time

gross domestic product (GDP) per head the market value of all final goods and services produced within a country in a given period of time divided by the population of a country to give a per capita figure

One of the main factors influencing the rate at which an economy grows over time is productivity. **Productivity** is the amount of goods and services produced from each hour of a worker's or another factor of production's time. In nations where workers or other factors can produce a large quantity of goods and services per unit of time, people tend to enjoy a high standard of living; in nations where workers or other factors are less productive, people tend to endure a more meagre existence. Similarly, the growth rate of a nation's productivity determines the growth rate of its average income. Productivity is not only important to a country's well-being but is also vital to that of businesses.

productivity the quantity of goods and services produced from each hour of a worker, or other factor of production's, time

The relationship between productivity and living standards has profound implications for public policy. When thinking about how any policy will affect living standards, the key question is how it will affect a country's ability to produce goods and services. To boost living standards, policy makers need to raise productivity by ensuring that workers are well educated, have the tools needed to produce goods and services, and have access to the best available technology. These policies are important in providing the resource infrastructure that businesses need to be able to thrive. Without well-educated workers with high levels of employability skills, business costs would be higher because they would have to pay to train workers in these skills themselves. Without an adequate transport and communications network, business activity is hampered and again costs are higher and productivity lower.

SUMMARY

- The fundamental lessons about individual decision making are that people and businesses face trade-offs among alternative goals, that the cost of any action is measured in terms of foregone opportunities, that rational people and businesses make decisions by comparing marginal costs and marginal benefits, and that people and businesses change their behaviour in response to the incentives they face.
- The fundamental lessons about interactions among people and businesses are that trade can be mutually beneficial, that markets are usually a good way of coordinating trade among people and businesses, and that the government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.
- The fundamental lesson about the economy as a whole is that productivity is the ultimate source of living standards.

IN THE NEWS

The Business of Music Festivals

Music festivals are big business. Like any business they have costs and must meet those costs by generating sales that provide revenue sufficient to cover the costs and make a profit. Where those profits go may be dependent on the business aims of the organizers, but regardless, if a festival has costs higher than revenues, then it is simply not viable.

Following the Covid-19 pandemic, 2022 was the year when things were supposed to get back to some sort of normality. Lockdowns and restrictions meant that many festivals were cancelled in 2020 and 2021. In June 2022, festival goers once again poured through the gates onto Worthy Farm for the Glastonbury festival and the Reading and Leeds festivals were both sold out. However, such a success story was not the case for all festivals and there were reports that many were struggling to survive as both micro and macroeconomic factors affected them.

The festival industry is reported to be worth around £1.76 billion (£2.04 billion) to the UK economy and around 85,000 jobs are related to the industry. The post-pandemic world was expected to see a rise in demand for certain hedonistic goods and services – holidays, social events and so on, but circumstances meant that many people faced having to make careful choices about how to allocate their income. The price of a number of goods and services rose sharply and supply chain problems, partly caused by the after-effects of the pandemic and conflict in Ukraine, meant that the cost of living rose for many people. Some festival organizers saw a drop-off in demand for tickets and with the cost of staging festivals rising some became commercially unviable and had to be cancelled. Cost pressures arose from shortages of raw materials such as wood and steel to build the stages and facilities that form the backbone of festivals, the cost of fuel increased affecting transport costs and some festivals say they experienced challenges in recruiting labour to help set up and stage their festivals. Some estimates put the increase in costs at around 30 per cent.

In addition to the challenges of staging an event, there have also been criticism of artists, especially those that are the bigger draws at such events, who have sought to make up for lost incomes during lockdowns by charging higher fees. There have been calls for artists and their agents to moderate their fees to help festivals remain viable. There is a question around what drives ticket sales; artists may argue that they are the ones that drive ticket

sales, but equally, festival organizers argue they provide the outlet for artists and provide them with considerable revenues.

It may also be the case that the festival market has outgrown itself. The popularity of major festivals like Glastonbury has seen the growth of this type of entertainment, and most weekends during the late spring and summer will see some festival or other taking place at a number of venues around the UK and also across Europe. Artists may travel around these different festivals, but ultimately, are there sufficient customers willing and able to pay to go to all of these events? According to some in the industry, that is clearly not the case and they fear for the future of the industry.



Festivals have become more popular in recent years but not all are guaranteed to be successful and financially viable.

(Continued)

Questions

- 1 Explain why the staging of a music festival can be described as a business. Are such businesses part of the public sector or the private sector?
- 2 Imagine a festival organizer is looking at artists to headline their event. What trade-offs might they have to consider in their decision making over who to book?
- 3 How is the concept of opportunity cost related to the decisions people make about going to a festival given the economic climate that existed in 2022?
- 4 Given the value of the festival industry and its impact on the economy as a whole, should government be more involved in supporting the industry? Explain your reasoning.
- 5 What might be the business arguments of asking artists and their agents to lower their fees, and how do these arguments highlight some of the key issues facing businesses in general?

References: <https://accessaa.co.uk/artist-fees-the-elephant-in-the-room/> (accessed 6 June 2023).
www.theguardian.com/music/2022/jun/04/uk-summer-music-festivals-forced-to-close-as-cost-of-living-crisis-hits-home (accessed 6 June 2023).

QUESTIONS FOR REVIEW

- 1 Give three examples of trade-offs that a business manufacturing washing machines might have to face.
- 2 What is the opportunity cost to a business of purchasing a new IT system to manage its accounting at a cost of €55,000?
- 3 A business in the construction industry is considering investing in building ten new houses on the edge of a small town. How might it use thinking at the margin to make a decision whether to go ahead with the investment?
- 4 Why should policy makers think about incentives?
- 5 If trade is beneficial, why do some countries seek to put up barriers to trade?
- 6 Why might trade among countries have some winners but also some losers?
- 7 What is it claimed the 'invisible hand' of the marketplace does?
- 8 Explain the two main causes of market failure and give an example of each.
- 9 How can an increase in productivity reduce business costs?
- 10 Why is an increase in productivity important in helping to improve the standard of living in a country?

PROBLEMS AND APPLICATIONS

- 1 Describe some of the trade-offs faced by each of the following:
 - a. An entrepreneur starting a small business deciding to borrow some start-up capital from a bank or raise the funds through borrowing from friends and relations.
 - b. A member of the government deciding how much to spend on some new military hardware for the defence industry.
 - c. A CEO deciding whether to invest in a new more efficient heating system for the company's headquarters.
 - d. A worker in a hotel deciding whether to accept the offer by their manager of extra shifts in the restaurant.
- 2 You work in a bank and were planning to spend Saturday going to watch your local football team with some friends. However, your boss has asked you if you would help prepare some important financial data for some new regulations that are being introduced by the government. It is not compulsory to come in over the weekend but it is made clear it would be looked upon favourably.
 - a. If you decide to go to the football match, what is the true cost to you of that decision?
 - b. If you decide to go into work for the weekend to help out your boss, what is the true cost of that decision?

- 3 A business operated by a sole trader generates €20,000 in profits and has the option of retaining the amount to reinvest into the business or putting the sum into a bank which would generate 2 per cent interest a year. What would your decision be, why, and what is the opportunity cost of your decision?
- 4 A smartphone manufacturer has invested €20 million in developing a new phone design and interface, but the development is not quite finished. At a recent meeting, your sales people report that a rival has just released a new phone which is estimated to reduce the expected sales of your new product to €12 million. If it would cost €4 million to finish development and make the product, should you go ahead and do so? What is the most that you should pay to complete development? Explain your answer.
- 5 Three members of the operations management team at a plant manufacturing steel tubing for construction projects are discussing a possible increase in production. Each suggests a way to make this decision.
 - a. Team member 1: We should base the decision on whether labour productivity would rise if we increased output.
 - b. Team member 2: We need to focus more on cutting our average cost per tube. This will help us to be more competitive against our rivals.
 - c. Team member 3: We should only increase output if the extra revenue from selling the additional tubes would be greater than the extra costs.

Who do you think is right? Why?

- 6 The Covid-19 pandemic caused a significant disruption to economies across the world and impacted millions of people. Does this experience mean that governments should take a more active role in managing economic activity?
- 7 Suppose the EU adopted central planning for its economy, and you became the chief planner. Among the millions of decisions that you need to make for next year are: how much food to produce, what land to use, who should receive the food produced and in what quantities.
 - a. To make these decisions intelligently, what information would you need about the food industry?
 - b. What information would you need about each of the people in the countries making up the EU?
 - c. How would your decisions about food affect some of your other decisions, such as how much farm equipment to produce, how much labour to employ on farms and how much fertilizer to use? How might some of your other decisions about the economy change your views about food?
- 8 Explain whether each of the following government activities is motivated by a concern about equity or a concern about efficiency. In the case of efficiency, discuss the type of market failure involved.
 - a. Regulating gas prices.
 - b. Regulating advertising.
 - c. Providing students with vouchers that can be used to buy university education.
- 9 Discuss each of the following statements from the standpoints of equity and efficiency.
 - a. 'All students should have free access to higher education.'
 - b. 'Businesses making workers redundant should be made to provide at least six months' pay as a redundancy payment to enable those affected time to find a new job.'
 - c. 'Businesses should be made to pay more into workers' pension schemes to ensure that people have a decent standard of living when they retire.'
- 10 Countries have to address the fundamental economic questions and in doing so must have a role for the public sector and a role for the private sector. In some countries the public sector plays a larger role in determining what is produced, how it is produced and who gets what is produced.
 - a. How do you think the extent of the division between the role the public sector and the private sector plays has come about?
 - b. What role might belief systems play in determining the division?
 - c. Do you think business operates more effectively under private ownership than public ownership? Justify your reasoning.

2

ECONOMICS AND BUSINESS DECISION MAKING

LEARNING OUTCOMES

After reading this chapter you should be able to:

- Give examples of unconscious and conscious decisions by consumers and businesses.
- Explain the basic economic problem of scarce resources and unlimited wants.
- Give examples about how informed decision making can be based on assumptions about weighing up the value of costs and benefits.
- State at least two examples of the difficulties businesses face in accurately valuing costs and benefits.
- Explain the importance to businesses of decisions on investment, growth and expansion, using appropriate examples.
- Show why acquiring and keeping customers are important decisions for a business.
- Give an example to show how making decisions on keeping customers needs to be assessed carefully.

ECONOMICS: THE SCIENCE (OR ART) OF DECISION MAKING

In every walk of life humans have to make decisions. In business, this is no different. Every day millions of people working in businesses at many different levels make decisions. Decisions arise because there is a choice of different actions. A business might have to make a decision about whether and how far to change price, whether to invest in new technology, hire or release workers, spend money on an advertising campaign and so on. In each case, it will have to weigh up the costs and benefits of making the decision and in doing so consider other possible options as part of the decision making process. These decisions between alternatives arise because resources are usually scarce relative to the demand. This is the heart of the economic problem.

The Economic Problem: Scarce Resources and Unlimited Wants and Needs

The central economic problem is one of scarce resources for unlimited wants and needs. The Earth is blessed with resources of all kinds: some we know about and some we still do not know exist. Oil, metals, land, minerals, plants, animals and so on all provide humans with the means to satisfy our needs; the essentials of life such as food, water, clothing and shelter, without which it would be difficult to survive, and our wants, all the things we would like to have which we believe make our lives more comfortable and happy.

However, these resources are scarce. By scarce resources we mean that they are insufficient in quantity relative to the demand for them. Few businesses have so much money that they can afford to

satisfy all their wants and needs. As a result, businesses have to make decisions about how they allocate income and scarce resources to different uses.



WHAT IF... you are living inside the Arctic Circle and are having some guests round to your house for a party. You go to a store which is selling packaged ice cubes in its freezer. Would you buy them? If so why and if not, why not?

When consumers choose between buying one product or another they undertake both conscious and subconscious processing. Understanding how consumers behave is important for businesses. Economists attempt to model decision making behaviour and in building these models have to make assumptions. One such assumption is that humans weigh up the value of the costs and benefits of a decision. If the value of the benefits of a decision is greater than the value of the costs, then this can be a reasonable basis on which to make a purchasing decision.

This assumption of rational behaviour, that is individuals and businesses doing the best they can given their circumstances, may be relevant in many cases; it could be argued that businesses in particular have developed sophisticated ways of making rational decisions by identifying and quantifying costs and benefits to help them make decisions. Management accounting techniques, in particular, have been developed with the primary intention of assisting in decision making. Since the early 1990s, advances in technology and research in the field of neuroscience and psychology have opened up new information as to how and why humans make decisions. The developments in the analysis of 'big data' is also revealing consumer behavioural traits and habits in increasingly sophisticated ways. This information is being used by businesses to help understand consumer behaviour and this can help in the design and development of new products as well as in the way in which existing products are marketed.

The Effect of Human Decision Making on Businesses

When consumers go to the supermarket, many will fill up the shopping trolley with similar products to those purchased on the last visit, almost on autopilot. Some might be tempted by the end-of-aisle or point-of-sale offers that seek to persuade consumers to give up hard earned cash in order to acquire the good in question, but this involves a little bit more mental computation than simply buying on autopilot. Does the consumer really need (or want) the item concerned and does the amount of money being asked for the product (the price) represent value for money; in other words, will buying the product bring adequate benefits? Every time an individual makes a decision about the purchase of a product it has an effect on a business.

Consider the following example.

A new student walks into a university bookshop and looks at the copy of Mankiw, Taylor and Ashwin, which has been recommended by their lecturer. The student looks at the book, thinks it looks impressive but when they look at the price they think it is a little high. Giving up €60 at that moment in time makes them think twice. They think about the freshers' welcome party for new members of the sports team which they are planning on going to, not to mention the freshers' ball at the end of the week. They put the book back on the shelf and decide they will try their luck in the library instead.

The effect of this decision is that the bookshop will not receive €60 from the sale of the book. This is just another in a long line of decisions being made by students which has seen sales at the bookshop declining. At the end of the month the bookshop returns the unsold stock back to the publisher, Cengage Learning. The publisher has to adjust its inventories (stocks) and now has more stock of the book than it had anticipated. The bookshop may find that if it cannot encourage more students to use its facilities rather than spending their money on other things, or even buying their books second hand or online, then it may not be able to cover the costs of stock, staffing, lighting and heating, administrative costs and rent for the premises. It may have to close down as a result. Indeed, this story is a familiar one for campus bookshops, many of which have now closed down.

For the publisher, the increase in stock means that it will not have to reprint the book at the time it planned to do so. The printing company finds that the reprint order it was expecting does

not arrive and as a result it cuts back on the amount of paper and ink it orders from its suppliers. For paper manufacturers the fall in the order for paper means that they now do not need to hire as many workers and so some workers are made redundant.

These workers find their incomes are now much lower and so have to cut back on the family spending. They used to eat out at least once every two weeks but now decide they have to cut that out altogether. The restaurant where they used to eat notices a drop in the number of people walking through the door to eat and so does not need to order as many supplies of ingredients as previously...

And so on.

The simple decision by the student on its own may not seem to be that important, but the combined effect of millions of decisions made every day by millions of people around the world does have significant effects on businesses. These decisions are important in other ways too.

Value for Money

A decision to buy this book is a message to the publisher and the authors that the book has some value. It helps with study, it makes the subject easier to understand, the support resources are helpful in getting through assessments, and ultimately the students can get the grade they are looking for. In other words, a decision to buy this book implies the buyer feels it will give value for money. We can define **value for money** as a situation where the satisfaction gained from using the book (however we choose to measure that satisfaction) is at least equal to or greater than the amount of money the individual had to hand over to acquire it (the price).

value for money a situation (mostly subjective) where the satisfaction gained from purchasing and consuming a product is equal to or greater than the amount of money the individual had to hand over to acquire it (the price)

If enough students make such a decision this book will be very successful. The authors will be pleased because they will get royalties from the sale of each book and the publisher will be pleased because each sale represents revenue. If enough books are sold to more than cover the total costs of producing and selling the book, it will make a profit.

However, the decision to buy this book has an effect on other books which could have been bought for a Business Economics course. When you are in a book shop or looking at the choices on a website, choosing one book is an endorsement for the producer of that book, but what about the one you decide not to buy? If enough people make the choice to buy this book and not another, then the rival publisher may decide that its book does not have a market and declares the book out of print. The author is likely to get very few, if any, royalties and those people that worked hard to help produce the book may find their jobs in jeopardy if something similar happens to other books they are involved with.

This is why economists spend a great deal of time looking at the working of markets. A market is made up of two parties, buyers (consumers) and sellers (producers), coming together to agree on exchange. Businesses make products available and consumers make decisions about whether to buy these products. Every individual consumer decision is important in its own right, but in order to get an understanding of the market as a whole we look at the effects of the aggregation of those decisions.

Why consumers make the decisions they do is the subject of continued debate and academic research. The developments in imaging technologies have revealed in part (there is still much we do not know) how the brain functions when we make decisions. It is opening up fascinating new lines of enquiry and understanding. Neuroscience and developments in psychology are playing their part in helping economists to understand human behaviour in a variety of contexts, including how they make purchasing decisions. Behavioural economics is becoming an increasingly important branch of the discipline and is being utilized not only by academic economists but also by businesses in a bid to understand decision making and human behaviour.

BUSINESS DECISION MAKING

Businesses are also interested in how they, themselves, make decisions about a whole host of things such as who to hire, when to hire, what to invest in, what not to invest in, how to improve productivity, whether to pursue an acquisition or not, whether to conduct an advertising campaign and if so how much to spend on it and when, among others. There are stakeholder decisions that affect the business and need to be understood, for example why some employees may be less committed to their work or to the principles and values of the business. How do governments make decisions and what impact will they have on businesses? What decision making processes take place at suppliers? Are the decisions managers and owners make compatible, and if so how will these decisions affect local communities and the environment?

SELF TEST Think about a recent purchase decision you made. What were the other options you could have chosen instead? Articulate the reasons why you eventually made the decision to purchase the product you did.

There are three important areas for business where decision making has to be considered carefully.

Investment

One of the key decisions that has to be made relates to investment. **Investment**, in this context, is about a business making money available to develop a project that will generate future returns, including increasing future productive capacity. Examples of business investment might include:

- A chemical engineering firm deciding to hire a specialist chemist to work on the development of a particular process for a client.
- A tool-making firm investing in a new piece of machinery which helps make the firm more productive.
- A food manufacturing plant buying a new oven which helps improve temperature regulation of the cooking process or helps to increase the volume of ingredients being processed at any one time.
- A farmer considering whether to install a new milking parlour to replace an existing facility. The new parlour might provide the farmer with more information about the volume and quality of the milk being given by the herd, as well as automating some procedures which mean that more cows can be milked in a shorter amount of time. This might then free up the farmer to do other important jobs around the farm.
- A Chinese restaurant owner having to make a decision about which insurance company to use to renew its insurance policies to cover it for fire, theft, loss of profits, public liability (in case any customer or member of the public is injured or suffers in some way as a result of the business's actions), employers' liability (injury to employees), damage or loss to machinery and equipment and many other possible risks. Does it stick with its existing insurer who has provided good service but is quite expensive, or go with a new insurer with an unknown reputation but which is much cheaper?
- A road haulage company considering investing in a computerized monitoring system for all its fleet of vehicles which travel around Europe to help it improve its logistical planning, adherence to health and safety regulations and help improve tracking in the event of theft.

investment making money available to develop a project which will generate future returns including increasing future productive capacity

There are some key characteristics which are common to this sort of investment decision. Any decision will bring with it some costs, both financial and otherwise, and will also bring with it benefits. These benefits could be to the business itself and to those who have an interest in the business (**stakeholders**) and wider society. These costs and benefits have to be weighed up and we assume that a decision is worth taking if the value of the accrued benefits to the business outweighs the value of the total costs of the decision.

stakeholders groups or individuals with an interest in a business, such as workers, managers, suppliers, the local community, customers and owners

? WHAT IF... a business values two options equally? How might it make a decision which to invest in if it can only afford one of them?

Economists would argue that in order to make any informed decision we have to have some idea of the value of the relative costs and benefits. Calculating the financial cost of building and operating a new assembly plant for a manufacturing firm, and estimating the financial benefits from the resulting expansion in production, might be relatively straightforward. What is not so easy is calculating the cost of the new plant on the ecosystem, or the damage to the visual amenity of the area around which the plant will be built. The more accurately these sorts of costs can be calculated the more informed the decision. Economists try to find effective ways of calculating costs and benefits more accurately, but ultimately there is always going to be some error term and a lack of information which will make the calculations and estimates less than perfect.

JEOPARDY PROBLEM In the UK, there is a fierce ongoing debate about the building of a new high-speed rail route connecting London with towns and cities further north. Phase one of the project from London to the West Midlands has begun, but there is still debate around subsequent phases, in particular the connections to Leeds. The decisions will affect many businesses in different ways. What factors would businesses take into account in agreeing with the decision to invest in extending HS2 to places like Derby and Leeds? How and why might other stakeholders view the decision to go ahead differently?

Growth and Expansion

At some point in time, a business will have to make a decision about growth and expansion. It could be argued that a new business start-up is as much a part of growth and expansion as a decision by a large multinational business to acquire a new business by merger or takeover.

These decisions involve considerable risk to a business. **Risk** is the extent to which a decision leading to a course of action will result in some loss, damage, adverse effect or otherwise undesirable outcome to the decision maker. One of the first questions many businesses may ask themselves when making a decision is 'What could go wrong?' and decisions relating to growth and expansion are no different.

risk the extent to which a decision leading to a course of action will result in some loss, damage, adverse effect or otherwise undesirable outcome to the decision maker

A business might grow through internal or external means. Internal growth comes from the business generating sufficient profits to be able to reinvest back into the business. This reinvestment might be in buying new premises, new plant and equipment, taking on more staff, more efficient computer systems or hiring a consultant to help identify new systems and processes of working which allow the business to sell more.

External growth by contrast is generally much quicker. A firm can grow by either taking over or merging with another business. Merger and acquisition activity (M&A) tends to fluctuate with the swings in economic activity; when the economy is growing, M&A activity tends to be higher and vice versa. There are often grand claims made by business leaders about the benefits to the business of any such external growth. The word 'synergies' is used to describe how anticipated benefits will accrue to the business. **Synergy** refers to a situation where the combination of two or more businesses or business operations brings total benefits which are greater than those that would arise from the separate business entities. The idea of $2 + 2 = 5$ is often used to exemplify the principle.

synergy a situation where the combination of two or more businesses or business operations brings total benefits which are greater than those which would arise from the separate business entities

The reality tends to be less spectacular. There have been a number of very high-profile mergers and takeovers which have promised huge benefits to shareholders and customers alike which have proved to be illusory. Some estimates put the success rate of M&A at between 20 and 45 per cent. If we take the lower end of these estimates, then only one in five M&As are successful. This, of course, depends on what we mean by 'success'. If the M&A did not bring the benefits promised at the outset, then the process could be classed as not being successful, although the business might still be in a better position than it was prior to the M&A.

PITFALL PREVENTION Terms such as 'success' or 'failure' are relative. This means that we have to be careful how we make judgements in relation to these terms. If a business tells its shareholders that a merger will yield a 40 per cent increase in efficiency within five years, but in the event efficiency only increases by 20 per cent, should this be classed as a failure? Always make sure that you are clear in your definition of what is meant by 'success' or 'failure' when discussing business activity.

Acquiring and Keeping Customers

For any business to survive it must have customers, whether these customers are other businesses or final consumers. Acquiring customers involves some cost: marketing, advertising, promotion, putting in place appropriate services, having the right product in the right place at the right time and ensuring that the product meets the expectations of customers in terms of quality. It will also involve making decisions about how much money should be devoted to acquiring new customers. How much budget should a new advertising or promotion campaign be given? What is the best and most efficient way in which customers can be reached and persuaded to try the business's products?

Once a business has acquired customers, there are also decisions to be made about how these customers can be retained and at what cost. What emphasis should the business put on keeping customers in relation to acquiring new ones? Should it be 80:20, 70:30, 60:40, 50:50 or some other proportion?

At what point is it appropriate to lose a customer? In principle, the answer can be given by reference to thinking at the margin. It might be worth losing a customer if the cost of retaining that customer becomes higher than the benefits that the customer brings. In other words, the revenue being generated by the customer is less than the cost of retaining that customer.

The balance between the cost of acquiring and keeping customers changes, depending in part on the wider economic environment. It is often said that it is much cheaper to keep existing customers than find new ones. The Chartered Institute of Marketing notes that the cost of acquiring a new customer depends on the industry or market sector, but that in general it is between four and ten times the cost of keeping an existing one. There are a number of factors that can affect the cost of both these things, including the rate at which new competitors enter the industry, the extent to which existing competitors bring out new products and how close a substitute they are, pricing tactics being adopted and levels of customer service. The latter can be important in retaining customers and includes such things as the expectations of customers not being met, the quality of the product in terms of how easy it is to use and how resilient it is, errors in billing customers and general customer service issues like the length of time customers have to wait to speak to someone, how knowledgeable customer service operatives are, the ease of accessing technical help, and how easy a website is to navigate.

All these factors are affected to a greater and lesser extent by the decisions a firm makes. Someone in the organization, for example, makes a decision about what telephone system to use, how many people there are to staff the system, where it is located and what its perceived role is. On the basis of this decision, the company could win and lose customers. Giving customers a frustrating time at the end of a phone but at low unit cost could be false economy.

CASE STUDY Decision Making and the Pandemic

Perhaps one of the things we take for granted is the extent of business interdependency. The Covid-19 pandemic helped to highlight the importance of this interdependency. When governments across Europe introduced lockdowns to try to control the spread of the virus, many coffee shops and sandwich bars suffered. Decisions around where to locate these types of businesses are often dependent on the availability of customers, so it is no surprise to see such businesses located in and around busy town and city centre areas. Many rely on office workers and the travelling public for their business. The existence of other businesses and how they operate, therefore, is an essential prerequisite for other businesses. Coffee shops, for example, might rely on workers commuting to their offices and places of work for passing trade. Once lockdown happened, many found their revenues dried up. The British Coffee Association, for example, noted that revenue from sales fell from around £363 million in March 2020 to £51 million in April of that year. A Covid-19 impact study by the World Coffee Portal suggested that 87 per cent of coffee shop operators interviewed said that the pandemic negatively impacted their business and 72 per cent believed that changes in consumer behaviour as a result of the pandemic will impact their business in some way. Sandwich shops fared little better. Sales prior to the pandemic were estimated at around £7.85 billion a year but estimates suggest sales fell by around 60 per cent in 2020 compared to equivalent periods in 2019.

Some sandwich bars and coffee shops are one and the same thing and many are small, independent businesses. Some of the larger branded coffee shops may have been in a better position to cope with the effects of the pandemic and some were able to move some of their business online. This was partly designed to take advantage of the decision by consumers to purchase coffee making machines for the home and thus required supplies of coffee beans, ground coffee and pods. Some retailers offered a delivery service, and some sought to retain customers through a subscription service – pay a monthly subscription and get access to a certain number of drinks each day.

As lockdowns ended and life began to return to some sort of normality, many coffee shops and sandwich bars may have been hoping for customers and sales to return. This has not always been the case, however. Many businesses have changed their working practices following the pandemic and an increasing number



Many businesses rely on others for their business and the pandemic highlighted the extent of business interdependency.

of people now work from home permanently or have far greater flexibility as to when they go into the office. This will undoubtedly have an effect on retailers, not just coffee shops and sandwich bars but other businesses that rely on footfall through towns and cities for their business. In September 2022, the cake and pastries retailer Patisserie Valerie announced that it was closing nine sites across the UK, including sites in Belfast, Victoria Station in London, Windsor, Dundee, Glasgow, Eastbourne and Exeter because the sites had not been able to recover sufficiently from the pandemic. In 2017, Patisserie Valerie had almost 200 sites; by 2023 this had fallen to just 30. Some businesses did not survive the pandemic and some have had to think very hard about how they structure and run their business post-pandemic.

Questions

- 1** What do you understand by the term 'business interdependency' and why is it important for the potential success or failure of a business (you might also want to include a clear definition about what you mean by 'success' and 'failure' in this context).
- 2** How do the decisions made by businesses post-pandemic about how to organize their operations highlight the importance of human decision making on business?
- 3** Consider some of the strategies being used by coffee shops and sandwich bars to capture and retain customers outlined in the article and consider the possible factors they may be taking into account when making decisions around these strategies.

References: <https://britishcoffeeassociation.org/covids-impact-on-coffee-sales/> (accessed 6 June 2023).
www.wired.co.uk/article/coronavirus-sad-sandwich (accessed 6 June 2023).
www.worldcoffeeportal.com/Latest/InsightAnalysis/2020/UK-coffee-shops-The-Coronavirus-Impact-Study (accessed 6 June 2023).
www.bighospitality.co.uk/Article/2022/09/02/patisserie-valerie-to-close-nine-sites (accessed 6 June 2023).
www.mylondon.news/whats-on/food-drink-news/starbucks-costa-pret-manger-pure-20247635 (accessed 6 June 2023).

SELF TEST What factors might a business have to consider in making a decision to outsource customer service operations to a low labour cost economy?

CONCLUSION

Economics can be seen as being a science of decision making. Because we are all affected in some way by scarce resources and unlimited wants and needs, we have to allocate resources to different uses and thus make choices. In making these choices we have to make decisions. There are increasingly more sophisticated ways of looking at how individuals and businesses make decisions, but in order to analyze how economies work we make basic assumptions about behaviour. In making these assumptions we can then observe deviations and seek to develop more sophisticated models to understand why, which lead to better theories to help make predictions.

Every individual consumer decision is important in its own right because that decision sends messages to a business about how the consumer values the products on offer. A decision to purchase can be taken as a positive message while a decision to purchase another product is a message that somehow the rival product is more valuable to the consumer for some reason. This collective individual decision making has major effects on the extent to which businesses are successful or not.

Businesses have to understand these reasons in order to improve their offering. In responding to changes or to the messages they receive from consumers, businesses also make decisions every day. These decisions can range from seemingly mundane ones such as whether to order reams of paper from one supplier or another, right through to major decisions on new plant and equipment or whether to acquire another business to help meet consumer needs more effectively. Each is important in its own right.

We can look at business decision making in three main areas: decisions on investment in new productive capacity, on growth and expansion, and on acquiring and keeping customers. Collectively these decisions are related and will have knock-on effects on other decisions businesses have to make. For example, if a decision is taken to introduce an enterprise resource planning (ERP) system (a system that brings together management information from inside and outside the business to the whole organization, which helps improve flows of information within the business), this might then lead to decisions having to be taken on hiring new staff, maybe reducing staffing in some areas, decisions on training needs and how to manage some of the disruption that will occur during transition.

We work on the basic assumption that businesses will weigh up the costs and benefits of a decision, attempting to quantify as far as possible these costs and benefits, and then making a decision based on the assessment of the value of the benefits in relation to the value of the costs. One of the problems businesses face in making decisions based on this principle is accurately valuing all the costs and benefits.

SUMMARY

- Decision making is at the heart of economics.
- Millions of decisions are made every day by businesses and consumers and these decisions affect businesses in different ways.
- Businesses have to make decisions focused on three main areas:
 - investment
 - growth and expansion
 - acquiring and keeping customers.
- Assessing the value of the costs and benefits is a basis for making decisions.
- If the value of the benefits is greater than the value of the costs, then the decision can be justified.
- It is not always easy to quantify the value of all the costs and benefits in making a decision.
- Neuroscience and psychology are revealing new ways in which people and businesses make decisions which may not always reflect a rational decision based on the value of costs and benefits.

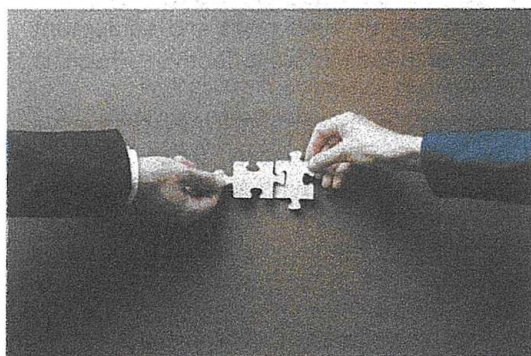
IN THE NEWS



Mergers

Mergers and acquisitions (M&A) are often touted as being the source of improved business performance, increased efficiency, better quality products, increased customer experience and, of course, more profits for the merged organization's owners and shareholders. These were some of the advantages put forward by publishers Cengage Learning and McGraw-Hill when they announced plans to merge in 2019. Both are global operators producing textbooks, digital products and other educational resources. According to Statista, Cengage's global revenue in 2021 was around \$1.24 billion (£1.03 billion, €1.21 billion) and McGraw-Hill's, around \$1.54 billion (£1.28 billion, €1.50 billion). The merged entity would have accounted for around 45 per cent of the market. Merging two such large organizations always carried risks not just in terms of whether the two companies could work together and whether the merger would result in synergies but also in arousing the concerns of competition authorities and other stakeholder groups opposed to the dominance of large publishers.

Both companies invested large sums of money in planning for how the merged entity would look and operate post-merger and also in providing information to the relevant competition authorities around the world. Around one year after the initial announcement of the plans to merge, the two companies issued a statement in May 2020 saying that they had agreed to call off the merger. Investigations into the merger by the Department of



Mergers are not always successful and there are numerous challenges to overcome.

Justice in the United States, the Competition and Markets Authority in the UK, and regulatory authorities in Australia and New Zealand raised concerns about the market power of the merged entity. It was reported that Cengage and McGraw-Hill had been requested to divest assets to avoid compromising competition in the industry. According to sources from the two companies, the amount of the assets to be sold off was too great and would have impacted on the economic viability of the merged entity. There were also consumer groups that opposed the merger and had campaigned against it arguing that the merger would reduce competition and lead to students having to pay higher prices. Both Cengage and McGraw-Hill had argued strongly that this would not be the case and that students would benefit from the merger.

Questions

- 1 Explain how and why mergers and/or acquisitions can result in improved performance for the resulting entity.
- 2 How do you think the proponents of the proposed merger between the two companies estimated and assessed the costs and benefits of the merger?
- 3 What do you think was the major reason for the proposed merger – growth and expansion or acquiring and keeping customers?
- 4 The cost of textbooks in the United States can be in excess of \$300 in some cases and across the UK and Europe a textbook for a first-year undergraduate module can be anything up to £100. How would you, as a student, assess the value for money provided by textbooks from publishers like Cengage and McGraw-Hill?
- 5 Given the relative sizes of Cengage and McGraw-Hill, do you think that the risk that the proposed merger would be blocked in some way by regulators should have been more obvious and taken into consideration by the leaders of the respective organizations?

References: www.insidehighered.com/news/2020/05/05/cengage-and-mcgraw-hill-cancel-merger-plans (accessed 6 June 2023).
www.statista.com/statistics/801199/cengage-revenue/ (accessed 6 June 2023).
www.statista.com/statistics/800771/mcgraw-hill-education-revenue/ (accessed 6 June 2023).
<https://sparcopen.org/news/2019/qa-cengage-mcgraw-hill-merger/> (accessed 6 June 2023).

QUESTIONS FOR REVIEW

- 1 Explain the difference between a conscious and a subconscious purchasing decision. Which do you think is more reliable and why?
- 2 Oil is a commodity and there are billions of barrels still waiting to be exploited. Why, then, do we refer to oil as a scarce resource?
- 3 Using some specific examples, explain the difference between wants and needs.
- 4 Explain what economists mean by 'making an informed, rational decision'.
- 5 Explain how a decision by a student to take a bus to a guest lecture by a famous economist at a nearby town hall, rather than a taxi, affects both transport businesses.
- 6 You buy a new t-shirt from Hollister and have to pay €25 for it. How would you measure the value for money of this t-shirt?
- 7 Why is it difficult to accurately assess the costs and benefits of a decision such as whether to grant permission to a leisure business to open a new theme park on the outskirts of a town?
- 8 What is risk in the context of decision making by a business?
- 9 Why do you think the cost to businesses of acquiring customers is generally much higher than retaining them?
- 10 Using an appropriate example, outline three factors which could lead to an increase in the cost of keeping customers.

PROBLEMS AND APPLICATIONS

- 1 When you go into a shop to buy a product, how often do you make decisions based on conscious and subconscious factors?
- 2 You have to arrange a flight from Amsterdam to Rome and look at a travel website for the choices available to you. List the range of factors you will want to consider in making your choice about which airline to choose to make the flight. To what extent is the decision you arrive at 'rational'?
- 3 Food is essential for human life. Does this mean that all food items should be classed as 'needs' and not 'wants'?
- 4 A customer of a mobile phone network contacts the provider to explain that they are changing to another provider. To what extent should the provider be concerned about this decision by the customer? Explain your answer.
- 5 Two student friends attend a gig showcasing a new band which has had rave reviews from music journalists. At the end of the evening they talk about their experience; one says they thought the band lived up to expectations and the €20 ticket was 'more than worth it'. The other thinks the evening was a 'waste of money'. Give some possible explanations about why each student had a different perception of value for money in this instance.
- 6 Some business leaders put faith in 'gut instinct' in making decisions. To what extent would you advise basing decisions on gut instincts rather than 'rational' analysis?
- 7 Explain how investment in new productive capacity can help a business grow internally.
- 8 Evaluate the case for a builders' merchant spending more money on retaining its existing customers rather than acquiring new ones.
- 9 A business calculates that the cost of acquiring a new customer is €250 and the average yearly revenue received from each customer is €260. Should the business go ahead with its customer acquisition spending on this basis? Explain using concepts covered in this chapter.
- 10 'There is a science to decision making and a business should take notice of this science in helping to make its own decisions.' To what extent do you agree with this statement?