ECONOMICS

for Management and the Professions

Graham Donnelly

ECONOMICS FOR MANAGEMENT AND THE PROFESSIONS

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PREFACE

In introducing this text I am aware of the need to explain why yet another introductory book on economics is thought necessary. For some time I have felt that the needs of two groups of students were not adequately recognised and I have referred to them in the title. Both groups have a number of common elements to their studies. Firstly they are required to study economics as part of their examination programme even though they may have little interest in the subject and often see it as peripheral to their vocational employment. Secondly they are often studying on a day-release or evening basis and therefore have little time to spend on reading. Thirdly they are frequently maturer in years than many other groups reading the subject for the first time, and may find many introductory texts a little patronising. Finally they are more likely to approach the subject from a practical perspective rather than seeing it as an academic discipline to be studied out of interest alone. It is hoped that this text, with its questioning approach and emphasis on the relationship of economic problems to practical business situations, will appeal to these two groups. All the main areas of economics are examined and, while not every element of all professional and management syllabuses is guaranteed to be included, the book should be suitable for all the principal examining bodies' Foundation examinations, and beyond in some cases. In addition it is hoped that some topics will be of interest to 'A' Level and other students seeking an alternative approach to their primary text.

Where, in the text, reference is made to either manager or professional these terms are not intended to be mutually exclusive since it is anticipated that most able professional students will eventually be performing managerial functions while good management requires, by definition, a professional attitude. The case studies and questions at the end of each chapter are not intended to be representative of the sort of questions to be encountered by students in their examinations but to provide a variety of exercises to provoke thought, comment and argument. Individual groups of students will, no doubt, obtain guidance from tutors on their own examination requirements.

Finally a word of thanks for all those people who made helpful comments and suggestions in the preparation of the manuscript and especially to Stuart Wall who read the manuscript in its entirety and pointed to a number of improvements. Special thanks, too, for the typing, proof-reading and other support I was lucky to receive from a very able assistant.

Graham Donnelly, 1985.

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CONTENTS

Chapter 1

THE SCOPE OF ECONOMICS

It is customary when introducing an academic discipline to begin by examining the scope and nature of the discipline. In the case of economics this is especially necessary; not because of the reader's ignorance of the existence of the major economic problems but rather the reverse. All but the very young are aware of the major economic problems which confront society and the effect these have on their own lives and it is this awareness, coupled with the frequent failures of society to deal with these problems, which has contributed to the formation of attitudes towards the study and application of economics which are often hostile or cynical. These attitudes themselves discourage people engaged in practical business situations from studying economics. It is the aim of this opening chapter, therefore, to examine the nature and purpose of economics and the extent to which it can be useful to the manager, either as a tool of management or as an indicator of the framework within which he takes his decisions.

Economics as a social science

Economics is one of a group of disciplines, which also includes Sociology and Political Science, which used the scientific methods of observation, experimentation and research in studying the behaviour of society. While the social sciences may to some extent be able to predict behaviour and the results of various courses of action there are limitations on this ability far greater than those imposed on the natural sciences like physics and chemistry where a given experiment will always yield similar results provided the conditions are identical each time. This is because the social sciences do not work within situations where the conditions are identical each time but instead are engaged in the field of human behaviour where circumstances are constantly changing and behaviour patterns are never entirely predictable. Thus the social sciences are concerned more with predicting trends and likelihoods rather than exact results and even these predictions may have to be altered over time with evolving circumstances.

The area of social activity with which economics is concerned is the allocation of scarce resources between the various demands made upon them. How individuals or societies decide on the allocative process will clearly depend on the nature of the individual and of society, the influence of cultural, historical and sociological factors and the nature of the prevailing political system. This interrelationship of economics with other fields of human behaviour and attitudes not only makes the study of economics in isolation a fruitless task, it also gives a clue to the sources of the critical attitudes encountered by economists. Economists are frequently accused of being unable to agree among themselves. In fact all economists are agreed as to the basic issues and problems of economics; where they differ is in the matter of solutions, priorities and methods. Such differences are inevitable given that economists, like the society from which they have emerged, are subject to political, historical and cultural influences in the formation of their own attitudes. Because he is concerned with an area of study directly related to the quality of human existence it is difficult to envisage an economist achieving the same degree of detached observation exhibited by the geologist or astronomer dealing with natural phenomena. The second major criticism levelled at economists is their inability to provide solutions to the problems they encounter. In fact it is more likely to be the implementation of a solution that presents the bigger difficulty. If an economist by research or observation were able to provide a potential solution to a particular economic problem this solution would not be adopted if it were found to be politically or socially unacceptable. In the final analysis only society itself can solve its economic problems.

Economics as a study of the problems of resource allocation

Every economic society is confronted with the fundamental problem of how to allocate the scarce resources available to it in the face of unlimited demands for those resources. Scarcity in the economic sense means that however plentiful the resource in question it is sufficiently limited in supply that, if it were free, total demand could not be satisfied, and thus the resource is able to command a price. In this sense all resources, whether human, capital or natural, are scarce, with the exception of air. In allocating its scarce resources society must solve three fundamental problems:

1. What shall be produced – what goods and services and in what quantity shall society choose to produce with the limited resources at its disposal?
2. How shall these goods be produced – what combinations of the available resources and what technological processes shall be employed in producing these goods and services?
3. For whom shall they be produced – how is society to allocate the goods and services produced when the supply can never satisfy the demand?

These problems are common to all economic decision-takers whether they be the individual deciding his own pattern of consumption, the firm planning and executing its production activities or the government taking collective decisions for society as a whole. Each decision taken involves a choice and in making a choice in favour of one alternative another is lost. The individual may choose to buy a refrigerator and abandon plans for a new television, the firm may opt for the installation of new machinery and cut back on its advertising budget, the government may increase expenditure on defence and reduce its funding of local authorities. In each case a choice made results in a cost – the cost of the alternative next best use to which the resources so used could have been put. This cost is known as *opportunity cost* and all economic decisions must contain an element of this cost. Because the economist assumes that human behaviour is rational (however strong the evidence to the contrary) a particular economic decision is regarded as being at the time when it is made the decision entailing the least opportunity cost. If an individual buys a refrigerator instead of a new television it must be assumed that at the time this choice involved a smaller opportunity cost and therefore greater satisfaction than if he had decided in favour of the television. While at times the behaviour patterns of individuals, firms or governments may seem to the observer quite irrational it must be assumed that the decisions taken were in fact rational, partly because different individuals and groups have different views of what constitutes the best use of their resources and partly because to attempt to base any study of human behaviour on its irrationalities would be impossible.

Collectively individuals, firms and the government make up the economic society which is moulded in its aims and ambitions by the other values and goals of society with which it comes into contact. Thus the prevailing economic system in any society is the result of the mixture of the social, political and ethical values of that society in addition to the customary practices through which economic decisions as to the use of resources are made. Comparisons between different economic systems, therefore, must be made not only in terms of their relative efficiency but also in terms of the costs incurred in relation to the other aims of society. The proponent of a particular economic system may argue that within that system the economic benefits more than compensate for any detrimental effects on society or even that the system actually increases the likelihood that other aims in society will be met. Attempts to identify particular economic systems encounter the familiar problem of distinguishing between the economic as opposed to the political system. All the great political theorists have recognised that political power rests with those groups in society which possess economic power. So the economic system may be the foundation on which the political system rests or it may be manipulated to produce a distribution of economic resources appropriate to the balance of political power, rather than be regarded as the means by which society's resources may be used most effectively. In the Middle Ages the feudal system consciously aimed to harmonise economic, political and social objectives to ensure the maintenance of the status quo and tried to achieve this through a formalised social structure and established patterns of economic behaviour. Ultimately the feudal system could no longer restrain the development of new economic practices and the growth of the merchant classes and it gradually fell apart to be replaced by the rudimentary capitalist ethic of Mercantilism in the sixteenth and seventeenth centuries. The decline of state control over economic activity from this period on opened the way for the political economists of the late eighteenth century and after to adopt new approaches to evaluating the economic system. This culminated in the formulation of 'ideal' economic societies which, though much altered since then, remain the main forms of economic society recognised in modern times.

Economic systems

'Laissez-faire' or free enterprise system

Within a pure *laissez-faire* or free enterprise economic system the problems of resource allocation are solved by the price mechanism. Thus resources go to those who can afford to pay for them, whether they want them for use in production or for consumption. Those early political economists who saw the *laissez-faire* system as an ideal, notably the French physiocrats and also Adam Smith, believed that such an economic system represented a return to a system of natural harmonies and that each man, by pursuing his own best interest, unconsciously worked for the good of all. Therefore there was no role whatever for the state in the economy since government regulations directed the economy from its natural course and inhibited economic growth and encouraged the self-interest of privileged groups to the detriment of society as a whole. Left to itself the natural economic order would promote an environment to stimulate competition and counter the natural tendency of businessmen to act against the public interest.

The events of the nineteenth century in which the faith of the early economists in the natural harmony of the *laissez-faire* system was shown to be unfounded led to a more cynical reappraisal of the worth of the system. Confronted by the poverty and misery endured by the economically weak under a system of virtually unbridled free enterprise, later liberal economists had to admit that the *laissez-faire* system did not guarantee a better economic condition for the whole of society. They maintained, however, that its worth in terms of the promotion of economic growth justified its existence. Indeed the economically weak were held to be partly to blame for their own suffering since the fruits of economic growth were bound to go to those, like the capitalist and the entrepreneur, who contributed the most to economic growth, and thus those who could not or would not take a decisive economic role had inevitably to enjoy a return on their labours commensurate with their contribution. This later *laissez-faire* liberalism with its acceptance of economic hardship as a fact of life still represents the modern, if muted, view of those who support minimal interference by government in the economic affairs of the nation.

The centrally-controlled economy

The modern centrally-planned economy is loosely based on the Marxist reaction to the evils of nineteenth-century *laissez-faire* economies. The view of Marx that the state acting as the will of the people could achieve a just and prosperous economic society and then itself become unnecessary has been distorted to justify the rise of all-powerful state economies which determine the allocation of resources ostensibly on behalf of the people but frequently without reference to their views. The questions of What, How and For Whom are settled by the Central Planning Committee with reference to the current National Plan and its stated priorities. The individual retains some control over his expenditure patterns but is subject to the availability of the goods he wishes to purchase. The inevitable problem of excess demand is not solved by market forces acting through the price mechanism but by rationing and waiting lists. By extolling the virtues of co-operation against the wasteful tendencies of competition the centrally-planned economy aims at self-sufficiency and is suspicious of foreign trade where overseas competition may pose a threat to its own industries.

The mixed economy

The mixed economy differs from the *laissez-faire* and centrally-planned economies in that it is not based on a theoretical model devised as a perfect economic system and it cannot therefore be compared against a theoretical ideal. Furthermore the absence of an absolute standard means that it is possible for the mixed economy to take many different forms. Thus while all mixed economies contain elements, substantial elements, of both individual and collective decision-making, the precise balance between the two sectors may vary substantially from one country to another and, over a period, may vary considerably within one country. In practice all economies have elements of both free enterprise and state direction. There is no evidence that there has ever been a pure free-enterprise society and even during the peak period of *laissez-faire* economics in the middle of the nineteenth century the state still exerted considerable influence over certain sectors of economic activity and found itself intervening, albeit unwillingly, in those areas where there were acute resource allocation problems. Similarly all modern state-directed economies tolerate a degree of private enterprise on a small scale and much more occurs unofficially. What distinguishes the mixed economy from the other types of economic system is that it is the only one in which the presence of private enterprise alongside a substantial public sector is regarded as both necessary and desirable. The nature of the mixed economy will be examined further in the next chapter when the British mixed economy will be discussed.

Economics as a managerial tool

So far economics has been examined both as a social science and as a study of the problems of resource allocation. These two areas expose economics as a discipline which can neither give exact answers concerning human behaviour in the allocation of scarce resources nor predict without error the exact response of society to a given economic occurrence. Furthermore the interrelationship of economics with politics and other social phenomena means that no economic event is capable of repeating exactly previous similar events. Thus in any given economic problem a number of possible solutions will present themselves and all will have some validity. The precise solution proposed by an economist will depend on his own personal views as to the optimum least-cost alternative taking into account the society within which the problem has presented itself, the political and social conditions impinging on any solution offered and his own informed estimate as to the likely outcome of adopting that solution. Clearly there will be many different interpretations to be placed on any given evidence and when this is combined with variations as to attitude and the precise goal to be achieved there will be a whole range of possible solutions. What therefore is the use of economics to the business manager or professional consultant when it can produce a bewildering range of problems and solutions any, or none of which, may be relevant to the success of his business?

Economics is capable of being a valuable aid to the manager on three levels. Firstly, the manager who understands how the economy works will be better placed to interpret the information he receives as to economic trends and forecasts and how this will affect his company and its activities. Secondly, on an active level he will be able to adapt his company's overall policy with all that this entails for the changing economic climate. Thirdly, within the company he can use economics as a tool in helping to make the best use of its resources. On each of these levels economics impinges on the decision-making of the manager because all firms are concerned directly with the three basic economic questions of what to produce, how to produce it and for whom to produce. Thus economics interrelates with such areas as the production function, costing, accounting and marketing and provides at the same time an overview of the economic environment within which decisions in these areas must be taken.