ECONOMICS FOR MANAGERS

A PROFESSIONALS' GUIDE

PHILLIP CROWSON

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Preface

An earlier version of this book – *Economics for Managers* – was written in 1975 for both the practising manager and the management student. Indeed, since the diploma in management studies was introduced in 1961 it has become increasingly the case that the practising manager is also a management student. Accordingly, this book, like its predecessor, is designed to meet the needs of the manager in the daily process of decision making, and those of the management student taking Part I of the diploma in management studies, for those reading for a degree or professional qualification with a management-economics content, or as an introductory text for students taking business studies courses at advanced level. Even students of economics at advanced level should not be put off by the title; they may find the book a helpful guide through the fog of technical description that has increasingly descended on many textbooks and lecture courses.

Today's economic environment is changing increasingly rapidly and the manager's task of adapting his company to such change becomes progressively more difficult. He is concerned not just with the traditional business decisions of finance, production and marketing. His decisions, if they are to be effective, must be based on an understanding of the economic concepts which underlie all business activity, and a knowledge of the economic environment in which the firm operates. He must also be capable of applying such understanding and knowledge through modern management techniques. A major object of this book is to provide the basic groundwork for a wider understanding of the economic aspects of management.

Throughout the aim has been to present sufficient of the theory to satisfy academic requirements, and sufficient of the practice to make it realistic for working managers.

The original book was written by myself and Tony Richards, who has recently retired as a lecturer from the Polytechnic of Central London. It has now been extensively revised and updated to take account of the numerous changes of the past decade. The full magnitude of recent economic developments is perhaps only fully appreciated when a book such as this is updated.

Meadvale PHILLIP CROWSON

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THE CHANGING ENVIRONMENT

Had this book been published some fifteen years ago it would have been relatively simple to describe accepted views and practices concerning company objectives and corporate planning. Today the political, economic, sociological, and technological framework within which companies must operate is changing so rapidly that it is perhaps appropriate to identify at the outset some of the more critical factors which may affect the setting of company objectives and the planning required for their realisation. The manager's first step should be to identify the characteristics of the real world in which he must operate.

One of the most profound changes, particularly in the United States, has been in public attitudes to business generally, and to large-scale industry in particular. Leading industrialists were highly regarded as pillars of society, and their companies were looked on with favour. Today, however, industry is often held in low esteem, and the brightest graduates seldom wish to enter it. The pursuit of profit is widely regarded with suspicion, irrespective of political affiliation. Improvements in material standards of living, and economic growth, once thought the greatest of virtues, have been toppled from their lofty pedestals. A less materialistic youth is rediscovering the beauties of nature, and emphasis has shifted to environmental protection, the prevention of pollution and conservation. Science and technology have been the mainsprings of modern industrial development, but science is now widely considered to be a false god. It is not the purpose of this book to explore in any depth these sociological and moral changes, which may easily represent a fashion rather than a dramatic change in trend, but all managers must be aware of them.

Rapid technical change, particularly since 1945, has profoundly influenced every aspect of industry. Complete new industries such as petrochemicals and electronics have developed, the techniques of production in all industries have been transformed, and new transport and communication techniques have made possible a revolution in industrial organisation and management. A general feature has been the great increase in the most economic technical scale of plant which has involved an increase in capital intensity. Rapid air travel and telecommunications advances have enabled far off managements to exert close control over subsidiaries at opposite sides of the earth. The world has truly become a 'global village', with a vast increase in the interdependence of all economies. This growing interdependence has especially affected the advanced industrial nations of Europe, North America and Japan. The development of faster data-processing equipment and computer systems has enabled individual firms to grow even more rapidly than the most efficient scale of plants. Whereas management was formerly believed to be a bottleneck inhibiting the growth of firms, technical change has greatly eased this constraint and raised it much higher up the size range in many, but not all, industries. Today's barriers are the problems of stagnant or limited markets and of difficulties in raising finance.

OWNERSHIP AND CONTROL

Public policy and economic theory have not always kept pace with technical and economic changes. Company law especially has lagged markedly behind economic reality. Although new UK company laws were passed in 1976 and 1981 these merely tinkered with the systems and still failed to adapt organisational forms to present day realities.

Economic theory has tended to lag even more. The dominant model of the firm in many elementary textbooks is based on the small, owner-managed business which emerged in modern industry in the early and mid-nineteenth century. The entrepreneur, combining the functions of management, risk taking, and provision of capital, remains the ideal. Yet even in the nineteenth century rapid growth of demand often led to a need for much more capital for expansion than the owner and his immediate associates could supply.

The joint stock company, whose prototype was the chartered companies of Elizabethan days and earlier, was adapted to the needs of nineteenth-century industry and commerce. The device of limited liability enabled outside investors to sink their savings in industry, secure in the knowledge that the rewards might be unlimited whilst their losses would be restricted to their initial subscription. Originally the privilege of limited liability required a special Act of Parliament for each case, a restriction which became increasingly cumbersome and was eventually repealed.

As industry developed, the stock exchange traded in shares of limited liability companies, and ownership and control became increasingly divorced from management. The owners of the shares might have no connection with the firm apart from their annual dividend. Even up to 1945, however, ownership of most firms was concentrated in relatively few hands, and the scale of firms was such that the dominant owners could still effectively manage their investments. Dramatic growth in the next decades, however, with tremendous needs for capital, severed close links between original shareholders and management in all but a handful of companies. Increasing organisational complexity, and the need to keep abreast of rapid technological changes and market developments, increased the demand for specialist managers with particular skills. Professionally trained managers were widely recruited to supplement firms' existing pools of entrepreneurial talent. As companies have become larger and more complex these hired managers have increasingly displaced those with shareholdings in the firm. At the same time, growing capital needs have increased the number of shares issued by large firms, and ownership has become very widely spread both in private hands and also in large institutions, such as pension funds, insurance companies and banks. The issue of loans and debentures has further increased corporate capital. Today even the largest shareholders in leading companies may control a negligible proportion of the voting powers.

The situation has thus developed whereby the functions of ownership and effective control have become separated. The balance of power has shifted markedly in favour of the professional manager, or board of directors, and the shareholder has become emasculated. His only effective weapon is moral pressure, which can admittedly be important. If he dislikes a company's policies he can always sell his shares on the stock exchange. Company law has not kept pace with this organisational change and scarcely recognises the place of the professional manager. Companies must be run in the interests of their members, i.e. shareholders, yet the possibility of conflicts between the interests of shareholders and managers is almost completely ignored.

Even though the directors of the largest US public corporations tend to have large shareholdings, this is not generally true of the United Kingdom. The average shareholdings of directors and senior managers in the main British public companies tend to be very low. Mergers have often diluted family interests and widened the gap between ownership and control. Also stock option schemes for senior executives are not regarded by the tax authorities as favourably as in the United States, and their introduction has frequently been delayed by prices and incomes restraint. Such schemes do, of course, give senior managers a direct interest in their companies, but it is highly debatable whether even senior managers should be unduly encouraged to invest their savings as well as their livelihoods in their employing company.

Quite apart from the possibility of their own interests conflicting with those of the shareholders which the law enjoins them to pursue, directors of large companies face increasing pressures from other interests. Whereas shareholders can transfer their investments relatively easily, most employees cannot readily change their jobs. Strong social and economic ties bind them to a particular locality in which the opportunities for transfer between employers may be strictly limited. Often firms owe as much to the professional skills or contributions of their employees as to the providers of capital. This reaches an extreme in the professions and service industries, such as advertising, where the expertise of the staff is all-important and capital needs are minimal. Although employees have a strong interest in working for a prosperous and efficient employer, decisions which may conflict with their interests are frequently made by directors. Such conflicts of interests are most likely to be acute when large capital projects, mergers, or redundancies are being considered Yet, according to the law, all employees are merely servants of a company and directors must not have regard to employees' interests if they conflict with those of the shareholders. In practice, directors of public companies pay considerable attention to employees' interests.

Companies must maintain harmonious relationships with their customers if they are to remain profitably in business over the long term. They must ensure that they give their customers a 'fair deal' and this might occasionally conflict, at least in a narrow legal sense, with the interests of the shareholders. Another interest directors must consider is the wider public interest. This is expressed through such vague phrases as the need to be 'good corporate citizens', or have a 'sense of social responsibility'. In recent years companies have fallen over themselves, particularly in the United States, to show that their activities are beneficial to mankind and are having a positive effect on the environment. At the local level, firms may finance social facilities, or set up scholarships in the cause of public relations, or they may subscribe to charities. Yet these activities are peripheral to their central activities and might be overruled in the courts. The main point is that companies often see a need to do more to meet the vaguely defined public interest than is strictly required by the law.

The modern manager has to balance the interests of all his constituents – himself, his employees, his customers, his shareholders, and the general public whether at local or national level – with little help from an outdated company law. The legal view is that the law sets the ground rules and constraints within which industry must operate, but the manager is then on his own. Such ground rules might include regulations governing working hours and conditions of work, safety, permissible effluent levels, or air-purity standards, or required product quality controls, apart from the more general framework of the tax and company-law system. Increasingly this legal view is being regarded as insufficient, and managers will face new pressures in the 1980s. One of the strongest will be a growing demand by employees for a more secure role and for a much greater degree of participation in management's decisions, on the general direction of the business as well as on more narrowly defined employment questions. This demand affects all organisations and is not confined to companies in the private sector.

In this respect British company law has not only lagged behind industrial developments, but also behind movements on the European mainland. In Germany and the Netherlands, for example, company law requires directors to have regard to the interests of employees and the general public in addition to those of shareholders. A company is regarded as rather more than a collection of property rights. There has been a tendency throughout Europe for employees to be officially represented in the company's organs of government, as well as in works or company councils. In Germany, as is well known, employee representatives sit on the Supervisory Board, the company's policy-making body concerned with long term strategy. Employees also have an important role in the Netherlands and the Scandinavian countries. Whilst due account must be taken of the different pattern of development of employer–employee relations in the UK and mainland Europe – a strong voluntary tradition versus legal restraints, for example, and strong and widespread unionism versus relatively weak and narrowly based unions – European trends do have some lessons for the UK. Developments within the EEC have already occasioned some adaptations of UK company law (in 1981) and in due course could mean some profound changes in company organisation. This does not mean that the UK will or should slavishly adopt existing European patterns, but that these patterns will be modified to fit UK traditions and circumstances.

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In 1977 a government committee chaired by Lord Bullock recommended that boards of directors should have equal numbers of shareholders' and employees' representatives plus one independent member agreed by the two interest groups. This $2x+y$ formula and the accompanying proposals were widely criticised; the committee was not asked whether workers' representation was a good idea but to advise on the best means of achieving it. The majority accepted the official TUC line that worker directors could only be elected by unionists, irrespective of the extent of a company's union membership. The principle of worker directors was not fully accepted by all unions, and many union leaders as well as employers were bitterly opposed to the Bullock Committee's recommendations. The employers' views were set out in a minority report which argued that worker directors were an irrelevance without fundamental changes in industrial relations lower down. The political situation in 1976–9 prevented quick legislation, and, with the election of a Conservative government in 1979, the chances of any speedy introduction of worker directors. Proposed directives by the European Commission none the less keep the issue alive.

In some European countries there is pressure for direct representation of the public interest on company boards through state or local government appointment of a proportion of directors. The great danger is that boards of directors will end up as collections of representatives of widely disparate interests. Either their decisions will be reduced to the lowest common denominator, or their functions will be usurped by the company's executive organs. An alternative, and more likely development is the extension of *social audits,* which are spreading in the United States. The idea is that the company should not only subject its books to annual scrutiny by external auditors, but that it should also analyse its impact, for good or ill, on the environment considered in its widest sense. Although social audits are not backed by any legal sanctions they are undoubtedly a possible development. Another common trend is the appointment in large companies of advisers on environmental affairs to acquaint management with the external impact of their actions and to seek means of minimising any adverse effects. The 1981 Companies Act requires companies to publish information about their activities that go beyond the financial interests of shareholders, on, for example, their environmental expenditure and research and development.

COMPANY OBJECTIVES

The above and similar developments cloud the simple position of company law that a board of directors' sole and overriding duty is to further the interests of shareholders. Management's need to balance a wide range of apparently diverse interests raises in an increasingly acute form the question of company objectives. On the one hand it might be argued that commercial managements are not competent to balance all the interests. Such a balancing role can only be performed by the state, and managements should be left to concentrate on their primary role. Management's view of the public interest, for example, may not be the same as that held by the mass of the electorate. This means that the state should require industry to operate within defined guidelines and constraints. This is merely a continuation of the present legal view already set out above. The main objection is that society's priorities and objectives are continually changing, and that the law is too inflexible in response to such changes. It is, in another guise the argument for Britain's unwritten constitution rather than the precise written document of the United States. There is, however, a general presumption that industry should concentrate its energies on fairly narrowly defined objectives. Unless a company has clearly defined goals and targets, or at the very least some generally accepted criteria of success, management will have no yardstick against which to judge its effectiveness.

The overriding objective of companies in traditional economic theory, as set out in subsequent chapters, was maximisation of profits. The sole aim of economic man in business was to expand his output until profits were maximised. Obviously this had to be considered over a sufficiently long period, as short-term profit maximisation might spell long-term ruin. Short-term maximisation might, for example, mean pushing workers so hard for such low wages that they eventually strike, or selling shoddily made goods at such exorbitant prices in periods of shortage that new entrants come in with better-quality products sold at lower prices. The need for long-run, as opposed to short-run, profit maximisation is often used to justify the legal view that company directors should have regard solely to the shareholders' interests. If long-run profit maximisation meets the shareholders' interests it will only be achieved by ensuring that other interests are appeased, if not completely satisfied. Up to a point this may be true, but the public interest may often lose out, because it may often have no direct impact on profits. The annual accounts do not, for example, reflect costs of damage to the environment, nor the beneficial multiplier effects on regional employment of siting a factory in a development area. Consideration of the public interest would require some acknowledgement of such external effects. Yet companies in the private sector are unable to take full account of any external effects of their actions lest they lose out to competitors who might be less socially conscious. Although it is by no means clear that simple profit maximisation is the only or most important goal of modern industry, it is not certain that it should be jettisoned as a guide to corporate behaviour. Even if it were decided that managers should no longer solely consider the shareholders' interests, the pursuit of profit might still remain the most appropriate objective. This is examined below.

The profit-maximisation goal of traditional economic theory was a device for determining the scale of output once a firm had decided on its product scope in market conditions where price was given. The firm would expand output until the marginal cost of producing and selling an additional unit equalled the marginal revenue obtained from selling that unit. At this output, and this output alone, profits would be at a maximum, because any increase in output would add more to costs than to revenue, and any reduction in output would mean that profits were less than they could be. The assumptions made of perfect competition in the supply of labour and capital meant that the optimum output would also give the highest return on capital.

Profits are the difference between a firm's total receipts and its total expenses. Not only do they reward the equity, risk-bearing capital put into the business, but they also encourage entrepreneurship. In the conditions of perfect competition that characterised economic theory, all moderately efficient firms would earn some 'normal' rate of profit, which might vary between industries according to the degree of risk or uncertainty involved. The difference between the rate of interest on government funds and the average rate of profit would be the reward for risk and entrepreneurial skill. Where there were imperfections in the market, profits might additionally include a scarcity element, which competitive pressures would usually prevent emerging. Even in imperfectly competitive industries, firms would still fix their output or prices at levels ensuring maximum profits.

The development of modern capitalism with its divorce of ownership and control, and the growth of a managerial class within industry, has severely damaged the view that pursuit of maximum profits, even in the longer term, is a firm's main objective. Classical theory had always recognised other motives such as the pursuit of power, both economic and political, and of social status, but these were always considered as subsidiary goals that could best be achieved by profit maximisation itself. Most large companies appear to pursue a hierarchy of objectives in which proft maximisation, suitably defined, is but one element. These objectives may not always be mutually consistent.

In the classical firm making few products and selling in a restricted market, and where the owner and manager were the same person, profit maximisation was a relatively straightforward goal. Maximum profits for the shareholders may, however, conflict with the needs of management in modern firms, and in any case need translating into operationally useful objectives for transmission throughout the various levels of the organisation.

The personal goals of managers are more likely to be directed towards personal security, and status, both within the firm and in the wider community, than to maximum profits for their firm. These goals are likely to be achieved if the manager's company earns a profit consistently above a level likely to be regarded by shareholders as an acceptable minimum, but below a level which might involve excessive risks of failure or is likely to attract new entrants into the industry. Above all, the goal of security will ensure that the firm earns sufficient profits to pay an acceptable dividend, that it at least maintains its place in the market, and that it remains secure from a take-over which would adversely affect the incumbent managers. The goal of an 'acceptable level of profits' implied by security is less easy to define than profit maximisation. Possible criteria, which can be used operationally within the company, are a rate of return on capital employed at least as good as the average of all firms in the industry, and a rate of return no worse than the firm has earned in the past. The firm needs to earn sufficient to pay an acceptable dividend, both to satisfy shareholders and, if necessary, to attract new capital, whilst earning sufficient to finance expansion schemes from internal sources. Such a pursuit of 'satisfactory' profits is known as *satisficing*. The reasons advanced for limiting profits are management's goal of security, its strong desire to maintain the goodwill of customers by earning only a 'fair return', a wish to limit trade union demands for a greater share of high profits, a need to discourage competitors from encroaching on the firm's geographical or product territory, and a desire not to attract the attention of civil servants responsible for anti-monopoly regulations.

Whilst this view does not dethrone profits as an extremely important goal of modern companies, it moderates their influence. The other aims of security and status can best be achieved by ensuring long-run profitability and can best be expressed through some measure of profits. None the less these are still goals of the organisation, and will apply if management is considered as an entity, but they may not embody the aspirations of individual managers. It is strongly argued, notably by Professor J. K. Galbraith, that, in practice, professional managers will not subordinate their own personal and pecuniary interests to those of ineffectual shareholders. Self-interest will ensure a safe goal of prevention of losses rather than maximisation of profits. Whilst salaried managers do not receive any of the super profits associated with successful high-risk projects unless they earn a commission based on profits, their status and position would be seriously affected adversely if their actions caused a loss.

It is often a mistake to regard large companies as unified organisations working steadfastly towards common goals. They are living and changing entities in which individual managers and departments may be striving for status and power. As in all organisations there will normally be interdepartmental jealousies and rivalry. Perhaps the only method to subordinate these individual rivalries to the goals of the enterprise as a whole is to stress size and growth as corporate objectives. Many writers have pointed out that profitable growth serves the interests of both managers and shareholders in profits, security and status. Growth will create new opportunities for promotion and higher salaries within the organisation, and will nullify personal jealousies between managers.

Obviously the goal of growth must be subject to some constraint of minimum profits and dividends; otherwise it will offend against the objectives of security and company survival. The cheapest method of growth is through internally generated expansion, which requires healthy profits. The goal of growth is not therefore necessarily inconsistent with the pursuit of 'satisfactory' profits, suitably defined. Security also is interlinked with the other objectives through their impact on stock-market expectations and the company's share price. Provided the latter is maintained, and the company is not regarded as, in some sense, 'cheap', the company will be relatively safe from unwelcome takeovers.

Growth and profits need defining more narrowly to be of any value to management. The vague goals must be turned into precise, and preferably numerical, targets whose form will vary with each company. Given a growing industry and economy, the growth objective might be defined as a rate of growth of sales volume, the maintenance or increase of the firm's share of a product or geographical market, a defined annual extension of plant capacity, an expansion of the labour force, an annual percentage or absolute increase in profit, or a target increase in earnings per share. The last target is linked with the profit goal, which might variously be defined as a given rate of return on total capital employed or on shareholders' funds, or a given rate of profit retention. There may, therefore, be a whole range of interlocking targets and objectives which the company uses to plan its pursuit of its twin primary goals. To a marked extent, the initial size of the company and management's attitude to risk will qualify the various targets. A sleepy and highly security-conscious management will place greater emphasis on present day profits; a more adventurous team will push growth. Quite apart from deliberate targets, companies may set constraints for security reasons. These might include some minimum dividend distribution rate to satisfy shareholders' current income expectations, and perhaps some maximum gearing ratio. This is the ratio between loans and other debts bearing a fixed return and total capital employed. The higher the gearing ratio, the greater the volatility of rewards to shareholders because of the greater burden of fixed interest, and the more the risk. But a high gearing ratio allows a faster growth rate than a lower one.

The interrelationship of the various targets can be demonstrated through simplified schematic balance sheets and trading accounts as shown in Table 1.1 overleaf. This table also brings out the relationship between the various definitions of capital and profits.

CORPORATE STRATEGY AND THE ENVIRONMENT

In one sense the discussion of targets and objectives in the previous section has put the cart before the horse. Even before defining their pecuniary and non-pecuniary goals and targets, companies must determine their overall strategy in relation to their environment. They must decide on the products they wish to make, the markets they intend to serve, and the geographical areas they wish to sell in. The type of process and raw materials they will use and the location of their plants are also important strategic questions. We have already touched on the dramatic sociological changes in attitudes to business that have taken place in recent years. It is now worth emphasising the equally profound organisational and political changes.

Nowhere has change in business been more manifest than in the post-war growth of the international company. Increasing economies

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