James Bates and J. R. Parkinson

BUSINESS ECONOMICS

Third Edition

Revised for this edition by

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Basil Blackwell · Oxford

First published 1963
Second edition 1969
Reprinted 1971, 1978
Third edition revised by John Bates, Brian Chiplin and
Mike Wright 1982

Basil Blackwell Publisher Limited
108 Cowley Road, Oxford OX4 1JF, England

British Library Cataloguing in Publication Data

Bates, James
Business economics. - Rev. ed.
1. Managerial economics
I. Title II. Parkinson, J. R.
III. Bates, John IV. Chiplin, Brian
V. Wright, Mike
330'.024658 HD58.5

ISBN 0-631-13146-9
ISBN 0-631-13147-7 Pbk

Typesetting by Unicus Graphics Ltd, Horsham.
Printed and bound in Great Britain by Billings, Worcester.

Preface to the Third Edition

We found the prospect of writing a third edition of *Business Economics* daunting and we were not able to bring ourselves to do it. Yet we felt that a textbook that had run for 20 years on two editions might justify a further effort to bring it up-to-date. Faced with this dilemma we found an answer in the energy, expertise and enthusiasm of our colleagues, the new authors, who have taken the burden off our shoulders. Mr John Bates has prepared chapters 2 and 3; Mr Brian Chiplin chapters 1, 4, 5, 6 and 11; and Mr Mike Wright chapters 7, 8, 9 and 10. All of them are at the University of Nottingham. In extending our thanks to them we derive a perhaps undeserved satisfaction in realizing that what we set out to do so long ago has gained a new lease of life in a completely new setting.

In the Preface to the first edition of *Business Economics* we wrote:

> Those who have attempted to teach short courses in economics to students in industrial administration will appreciate how necessary it is to be selective in choosing material. Economics as it is taught is concerned largely with the economy as a whole and its organization and management; the theory of the firm is scarcely more than a step in this process; and much of what is taught in economics seems to have small relevance to the problems of those in business - particularly those in small business. A knowledge of the factors making for a high level of demand, an efficient exchange of commodities in international trade and the organization of world finance are sometimes relevant to the success of large businesses and can be considered by expert economic sections in relation to the general policy of the firm; but the small firm can seldom rise to these refinements and to a young general manager economics often seems to be either obvious in elementary exposition inapplicable to real-life situations in its more sophisticated forms, or just plainly irrelevant. It is not easy to defend economics against these criticisms by arguing that the best form of education for management is general education, and that relevance is a secondary matter. Education for management covers a wide field and some, at least, of the matter imparted must be of use in a narrow technical sense in addition to contributing to general education.

In this book we have attempted to extract from the general body of economic thought some parts that seem to us to be particularly relevant to taking decisions in business. We do not, of course, think that we have covered every aspect of economics with relevance to business decisions; and we have deliberately abstained from treating some subjects of importance, for example, wages and industrial relations.

The theme of the book is that while the economic situation is always changing, and the businessman is therefore operating in an uncertain world, it is nevertheless possible to take business decisions in a systematic fashion, and by using appropriate techniques and ways of thought to reduce the uncertainties involved.

Although *Business Economics* has been almost completely rewritten, what we wrote 20 years ago about our aims still remains valid in this up-to-date treatment of the subject.

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The Rules of the Game

Business economics is concerned with the factors that operate in determining business decisions and with the effects of those decisions. It provides a useful framework of analysis through which the implications of any particular decision can be traced. It can therefore suggest whether the course of action proposed is likely to result in the achievement of the objectives. The operation of a business essentially involves three key elements: the generation of a plan; the actions taken to put the plan into effect; and an assessment of the success of the actions in meeting the plan. For any business, these three elements will be complex and will involve considerations of production, sales and marketing, and finance, which are all interrelated. In order to generate plans that are likely to be successful, it is important to have an understanding of these major factors.

Consequently, in this book we examine first, the principles involved in production; aspects of the market; and finance (chapters 2–7). This provides a basis for the discussion of assessing performance (chapter 8); investment (chapter 9); control (chapter 10); and corporate strategy (chapter 11). The chapters have been arranged in this way as an aid to exposition. Although corporate strategy (the plan) should come first in the determination of actual business decisions, the complex factors involved cannot be fully understood without a basic analysis of the key areas of the operations of a business. We also place considerable emphasis on assessment of performance both in terms of financial and accounting data and in relation to control. It seems to us essential that any treatment of business economics should pay due attention to performance indicators and any manager should have at least a working knowledge of the main issues.

In the book we concentrate on the general principles of business operations while seeking to relate the concepts closely to real-world illustrations. The book is designed not as an exercise in abstract economic reasoning, but rather as a guide to the practical advantages of analysing decisions in economic terms. We emphasize that business problems cannot be solved with economic analysis alone, but we would like to suggest that a familiarity with economic principles is important if a business is to achieve success in the long term. There are many examples of businesses that have been started on the basis of a good idea, only to founder on the neglect of economic factors. The collapse of the Laker business early in 1982 illustrates no more than the surface of this phenomenon.

The principles we expound in this text are of relevance to all types of business enterprise. They apply equally to the large state-owned enterprise, the large private-sector firm, the small owner-managed business, partnership, worker co-operative and 'one-man band'. The precise circumstances, the range of decisions and the objectives pursued will differ from case to case, but all enterprises are affected by general economic and market forces whether they are 'free' or controlled by the state. In order to set the decisions in context, we consider in this chapter the broad 'rules of the game' under which businesses operate.

THE OBJECTIVES OF THE BUSINESS

If a business is to formulate a plan, the first necessity is to determine the objective that the plan is designed to achieve. These objectives may vary according to the type of business, its organizational structure and the type of markets in which it operates. Thus, for example, the objectives of a workers' co-operative are likely to be different from those of a firm that is owned by a single entrepreneur. Whether, in fact, market forces will lead to the same outcome independent of the original objectives is a matter of some contention.[1] In both these cases there is a clear relationship between ownership and control of the business. But in the larger businesses in a country such as Britain, the owners may be totally distinct from those who have day-to-day control (the managers).

This divorce between ownership and control and its effects has been central to much of the discussion of business economics. In large-scale private enterprises, the controls that owners can impose on managers are fairly limited in practice. Thus, for example, the annual general meeting of most companies tends to be rather short and attendance by shareholders sparse.[2] The facts that the ownership of a typical large company is diffused and that any one shareholder has a limited impact both serve to reduce the element of control. The institutional shareholders (insurance companies, pension funds, unit trusts, banks, etc.) now own a substantial proportion of the ordinary shares in UK companies, but traditionally they have been rather reluctant to interfere in the day-to-day management of the companies in which they have a stake. One important threat to managerial autonomy that remains is that the company might be taken over by another enterprise, and it is frequently presumed that managers wish to preserve their independence. However, as we note in chapter 11, there are good reasons why a company might wish to become part of a larger enterprise and, in addition, it does not seem as if poor performance is necessarily penalized by a takeover bid.[3]

There is a further important point in relation to objectives: except for some small firms, most companies are not run by a single person. The objectives of a business will, therefore, be determined as some combination of the differing objectives of the individuals concerned, and the more individuals there are, the more difficult will be the process of formulating the agreed objectives for the organization as a whole. The outcome is similar, therefore to a coalition among managers.[4]

In most treatments of business economics, the role of profit is regarded as central to the aims of the business. The enterprise will not survive if it is unable to make a profit for any length of time; the necessary finance for both working and physical capital (see chapter 7) will be forthcoming only if the firm can demonstrate that it has a profitable future. There is no denying that profit is a major factor in business decisions, but there is some dispute between business economists as to whether firms predominantly seek, or are forced to seek, the maximization of these profits, or whether the need to earn some minimum level of profit acts as a constraint on other objectives that the firm might wish to pursue. For our purposes, it is not necessary to come down firmly on one side or the other but merely to recognize that profit will be important to businessmen in reaching their decisions. Profit is, however, a complex concept, which is frequently misunderstood. It is therefore appropriate in this section to reflect on the nature and purpose of profits.

Put at its simplest, profit arises when there is a surplus of revenue over costs in a period of trading. In a limited sense this is a definition, but it does not say anything about how or why profits arise, or about their function and relation to other economic concepts. Moreover, the concept of profit is open to dispute over the meaning of the terms 'cost' and 'revenue'. As we shall discuss in detail in chapter 7, there is a crucial difference between the business economist and the accountant over the valid items to be included in calculating profit, particularly on the cost side.

For generations, theoretical economists have sought a consistent definition of profits. Wages, rent and interest may be looked on as a reward for the corresponding factors of production, labour, land and capital, but it has always proved difficult to isolate a specific factor of production to which profit may be said to accrue as a reward.

Several different theories have been advanced, and perhaps the best known of these is that profits are a reward for bearing risk and uncertainty.[5] There is no need to bear those risks of fire and other accidental damage to, or loss of, plant and stocks that can be covered by insurance, and they are not related to profit. But most of the risks of manufacture and trading are not insurable. Every businessman undertakes some risk when he manufactures a product in anticipation of demand, and the more specialized is a form of business activity, the more risk and uncertainty there may be. The successful salvage of gold from the wreck of HMS *Edinburgh* in 1981 is a good example of a high-risk activity which in the end resulted in substantial rewards. The reduction of risk may be one of the main motives for a policy of diversification, which we discuss in chapter 11. Anything new involves the risk that the public will not buy it, and the failure rate of new products is high. Certain trades are more susceptible to sudden swings in demand and are, therefore, likely to be more risky. Technological change can render whole sections of industry obsolete.

If profit is thought of purely as a reward for risk, however, it will not coincide with what most people would think of in a general way as profit. Certain wage-earning occupations, such as coal mining, diving in the North Sea, etc., carry physical risks, and increasingly many jobs carry the risk of redundancy. Nevertheless, it is rarely suggested that an appropriate part of the wages of such employment should be thought of as 'profit'. Even if the risk theory does not provide a complete explanation, there is little doubt that it would be difficult to justify economic risk-taking without some prospect of gain or profit, which in capitalistic countries would accrue to the entrepreneur and the providers of share capital.

Another theory regards profit as a reward for innovation and enterprise, for seeing the possibilities latent in various fields of action and in new technological development.[6] To some extent this view is a variant of the risk theory, but reward for risk is not a necessary part of the profit from innovations. The theory may also be looked on as a variant of that concerned with imperfections of the market or 'market failure', because it stresses that profit may come from the exploitation of a temporary advantage. This temporary advantage may arise by chance from unexpected events, which may vastly increase anticipated profits or turn them into losses ('windfall' gains or losses). For example, large changes in profits can occur through variations in the exchange rate, and the Laker Airways collapse in 1982 illustrates the problems that a substantial fall of the pound against the dollar causes when fixed payments have to be made in dollars.

On the other hand, temporary advantage may arise from the superior ability of some firms to recognize or create profitable opportunities. In this case, profit can be regarded as a reward to entrepreneurial ability. When innovations of technique or marketing, or indeed in any other aspect of business organization, are made, there will be a period when the successful innovator can make substantial profits. As long as there are no particular barriers preventing other firms from following the example, these profits will eventually be reduced and shared out by the forces of competition. For example, even where there is some barrier created by a patent on an invention, the latest research would indicate that imitation is fairly rapid and extensive.[7] Since innovation is almost always taking place, profit is always earned somewhere in the economy, and thus profit is linked to change and growth.

The economic literature distinguishes between 'normal' profit and 'super-normal' profit (or, in the case of sub-normal profit, losses). Normal profit is defined in opportunity cost terms (see chapter 2) usually in relation to capital, where it is recognized that the capital involved in any particular enterprise has an alternative use. If it is to be employed in any particular sector it must earn a profit at least as great as that which could be earned elsewhere with due allowance for any differences in risk. If an activity yields a return lower than this normal profit, it would be expected that some businesses will cease trading in that sector and use their capital elsewhere; although it should be noted that capital is not necessarily mobile between uses and there may be barriers to exit. We look at the problems of adjusting to declining demand in chapter 11. Similarly, if firms in a particular sector are earning above-normal profits, one would expect the entry of new participants. In a perfectly competitive economy (see chapter 6), in the long run the equilibrium would occur when no abnormal profits or losses were being made by any firm; i.e., all firms would be making only sufficient to keep them in that business. This is part of the difference between the accountant's and the economist's