Edexcel Economics (A) A-level

Theme 3: Business Behaviour and the Labour Market

3.1 Business Growth

Summary Notes

3.1.1 Sizes and types of firms

Why some firms tend to remain small and why others grow

- The size of firms can be determined by:

    - **Economies of scale relative to market size:** Large firms might only experience small economies of scale compared to their size, since the extent of economies of scale might be limited in that industry. This could make their costs higher than firms which choose to stay smaller.
    - **Diseconomies of scale:** Larger firms could face high costs because they have grown too quickly. There could be poor organisation, x-inefficiency or because firms in large, formal markets tend to have to pay higher wages.
    - **Small firms as monopolists:** Small firms could hold some degree of monopoly power, since they provide a more personal, local service. Their opening hours might suit a small town, such as those of a corner shop, and some consumer might prefer making smaller purchases, than the larger ones expected at bigger stores. Small firms might also create a **niche market**, where they can use their relatively price inelastic demand to charge higher prices. An example could be a small café over a multinational corporation.
    - **Profit motive:** By growing, firms get the opportunity to earn higher profits. Growing also allows firms to take advantage of economies of scale, providing they do not grow so large that they experience diseconomies of scale.
    - **Market power:** large firms have more dominance over the market, which allows them to gain price setting powers and discourage the entrance of new firms. They might also gain monopsony power, which can allow them to buy their stock at a lower price.
    - **Diversification:** By growing and expanding the product range, firms reduce their risk of making huge losses, since they have areas of the market to fall back on.
    - **Owners:** Managers of the firm might have the motive of larger bonuses, more holidays or more leisure time, which encourages them to expand the firm.

Significance of the divorce of ownership from control: the principal-agent problem

- The **principal-agent problem** can be linked to the theory of asymmetric information. This is when the agent makes decisions for the principal, but the agent is inclined to act in their own interests, rather than those of the principal. For example, shareholders and managers have different objectives which might conflict. Managers might choose to make a personal gain, such as a bonus, rather than maximise the dividends of the shareholders.

- When an owner of a firm sells shares, they lose some of the control they had over the firm. This could result in conflicting objectives between different stakeholders in the firm. If the manager is particularly good, they might require higher wages to keep them in the firm. However, they also need to keep shareholders happy, since they are an important source of investment. It is not always possible to give both the manager a high salary and the shareholders large dividends, since funds are limited.

Distinction between public and private sector organisations

- **Public sector:**

- This is when the government has control of an industry, such as the NHS. The railway industry in the UK was nationalised after 1945, so it became part of the public sector.
- There could be natural monopolies in the public sector. For example, only one firm will provide water because it is inefficient to have multiple sets of water pipes.
- Some public sector industries yield strong positive externalities. For example, by using public transport, congestion and pollution are reduced.
- Public sector industries have different objectives to private sector industries, which are mainly profit driven. Social welfare might be a priority of a public sector industry. It could also lead to a fairer distribution of resources.

- **Private sector:**

- This is when a firm is left to the free market and private individuals. For example, British Airways is a private sector firm.
- Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. Firms have to produce the goods and services consumers want, which increases allocative efficiency and might mean goods and services are of a higher quality. Competition might also result in lower prices. This is because firms operating on the free market have a profit incentive, which public sector firms do not.

Distinction between profit and not-for-profit organisations

- A **profit** organisation aims to maximise the financial benefit of its shareholders and owners. The goal of the organisation is to earn maximum profits.

- A **not-for-profit** organisation has a goal which aims to maximise social welfare. They can make profits, but they cannot be used for anything apart from this goal and the operation of the organisation.

3.1.2 Business growth

How businesses grow

Organic growth (also called 'internal growth)

This is when firms grow by expanding their production through increasing output, widening their customer base, by developing a new product or by diversifying their range. Firms might use market penetration to sell more of their products to existing consumers. They might also invest in research and development, technology, or production capacity. This will allow sales to increase and the volume of output to expand.

For example, Apple has grown through creating new products such as iPads and iPhones.

Firms can grow **inorganically** through merging with, acquiring or taking over another firm.

Advantages and disadvantages:

- This is a long term strategy, and it is significantly slower than growing inorganically. This could mean competitors gain more market power by expanding in the meantime. It could also make shareholders unhappy if they want faster growth.
- Firms might rely on the strength of the market to grow, which could limit how much and how fast their can grow.
- It is less risky than inorganic growth.
- Firms grow by building upon their strengths and using their own funds, such as retained profits, to fund the growth. This means that the firm is not building up debt, and the growth is more sustainable.
- Moreover, existing shareholders retain their control over the firm, which might reduce conflicts in objectives that are possible when there is a takeover.

Forward and backward vertical integration

Vertical integration occurs when a firm merges with or takes over another firm in the same industry, but a different stage of production.

Forward vertical integration occurs when the firm integrates with another firm closer to the consumer. This involves taking over a distributor. For example, a coffee producer might buy the café where the coffee is sold.

Backward vertical integration occurs when a firm integrates with a firm closer to the producer. This involves gaining control of suppliers. For example, a coffee producer might buy a coffee farm.

Advantages and Disadvantages:

- Firms can increase their efficiency, through gaining economies of scale, which could reduce their average costs. This could result in lower prices for consumers.
- Firms can gain more control of the market. Backwards integration can mean that firms can control the price they pay for their supplies, and they could raise the price for other firms. This could give them a cost advantage over their competitors.
- Firms have more certainty over their production, with factors such as quality, quantity and price.
- The disadvantages associated with diseconomies of scale could be considered.
- Vertical integration can create barriers to entry, which might discourage or limit the entrance of new firms. This could lead to a less efficient market, since the firm has little incentive to reduce their average costs when their market share is high.

Horizontal integration

This is the merger of two firms in the same industry and the same stage of production. For example, if a car manufacturer merges with another car manufacturer, they will have horizontally integrated.

Advantages and disadvantages:

- Firms can grow quickly, which can give them a competitive edge over other firms in the market. However, this could lead to monopoly power and there is the potential of lower inefficiency as a result.
- There could be disagreements in the objectives of the two firms which merged.
- Firms can increase output quickly, so they can take advantage of economies of scale.
- The two firms will have expertise in the same industry, so the merged firm can gain advantages, such as in marketing.

Conglomerate integration

This is the combining of two firms with no common connection. For example, Associated British Foods owns Primark and Patak's, which produces curry pastes and pickles.

Advantages and disadvantages:

- It can help both firms become stronger in the market, than if they were individual.
- The conglomerate can reach out to a wider customer base, and market competition could be reduced.
- The advantages of economies of scale, and particularly risk bearing economies of scale, can be considered.
- There is a risk of spreading the product range too thinly, and there might not be sufficient focus on each range. This might reduce quality and increase production costs.

Constraints on business growth

Size of the market

A small market might only have limited opportunities for business expansion, since firms can only access a limited consumer market and there might be limited opportunities for innovation and expansion. Larger markets, such as the market for mobile phones, have a much wider scope for innovation, and firms can take advantage of huge selling opportunities.

Access to finance

Smaller and newer firms tend to be less able to get access to finance than larger, more established firms. This is because they are deemed riskier than established firms. Moreover, banks have become more risk averse since the global financial crisis, which has limited the number and size of loans on the market. Without sufficient access to credit, firms cannot invest and grow, and firms cannot innovate as much.

Owner objectives

Owners might have different objectives. Philanthropic owners might aim to maximise social welfare, or have a strong Corporate Social Responsibility (CSR) with objectives for the environment in mind. Some owners might aim to maximise profits, whilst others might a bigger personal gain in the form of bonuses and reputation. Therefore, some owners might not have business growth as an important objective.

Regulation (red tape)

Excessive regulation is also called 'red tape'. It can limit the quantity of output that a firm produces. For example, environmental laws and taxes might result in firms only being able to produce a certain quantity before exceeding a pollution permit. Excessive taxes, such as a high rate of corporation tax, might discourage firms earning above a certain level of profit, since they do not keep as much of it. This might limit the size that a firm chooses, or is able to, grow to.

The UK government has established the 'Red Tape Challenge', which aims to simplify regulation for businesses. This aims to make it cheaper and easier to meet environmental targets and create new jobs.

More information on this can be found here:
http://www.redtapechallenge.cabinetoffice.gov.uk/home/index

Synoptic points:

- Macroeconomic factors can influence a firm's growth. A recession will negatively affect a firm's growth due to there being low levels of demand in the economy. A recession may also reduce the willingness of banks to lend to firms.
- Globalisation has made foreign markets more accessible to domestic firms. It has become easier for firms to export their goods and services. Globalisation has therefore given firms a larger market in which they can sell their products.
- The buying of UK firms by foreign buyers is a form of foreign direct investment. Therefore, takeovers have an effect on a country's financial account on the balance of payments.

3.1.3 Demergers

Reasons for demergers

A demerger is when a large firm is separated into multiple smaller firms. For example, if Boots sold Halfords since it did not match their main activities.

- **Lack of synergies:** A synergy is when creating a whole company is worth more than each company on its own. Without this, firms are likely to demerge because they will be worth more.
- **Growth:** Each part of the firm could grow at different rates. The faster growing part might be separated.
- **Diseconomies of scale:** If the firm is so large that average costs rise with more output, the firm might choose to split.
- **Focussed companies:** The firm might be able to grow faster if it focuses on a few markets, rather than several.
- **Resources:** If a firm can no longer afford to invest the business, due to a lack of resources, they might sell off a part.
- **Finance:** Selling off part of the firm can raise valuable finance, which could be better invested in a more profitable part of the firm.

Impact of demergers

Businesses

Firms can dispose of underperforming or loss-making parts of the firm. It allows the larger firm and the new, demerged firm to focus on their core activities. This allows them to adapt to their unique markets, whereas in a large firm, managers could find it hard to focus on each market.

Firms might be able to eliminate diseconomies of scale, since they are better able to control and coordinate their business.

The firm could make a profit by selling off a part of the firm. This can also be used as a source of finance, which will allow them to invest in other parts of the firm.

Workers

Workers might become confused, and their roles might be shifted between the demerged firm and the parent firm. There could also be job cuts.

- **Consumers**

The removal of diseconomies of scale could lead to lower prices for consumers. There could be a net welfare gain if the demerger results in a higher level of efficiency. If two firms in the same industry and the same stage of production demerge, such as two airlines, this would increase choice for consumers.