

Edexcel A-Level Economics (A)

THEME 3

**Business Behaviour and the
Labour Market**

STUDENT COMPANION

Author: Geoff Riley

Series Editor: Ruth Tarrant

EDITION DATE: SEPTEMBER 2019

WWW.TUTOR2U.NET/ECONOMICS

tutor2u 

COMPANION CONTENTS

3.1.1 Sizes and Types of Firms.....	3
3.1.2 Business Growth.....	10
3.1.3 De-Mergers.....	17
3.2.1 Business Objectives	18
3.3.1 Revenue.....	25
3.3.2 Costs	29
3.3.3 Economies and diseconomies of scale	36
3.3.4 Normal profits, supernormal profits and losses	43
3.4.1 Economic efficiency.....	46
3.4.2 Perfect Competition	50
3.4.3 Monopolistic Competition.....	55
3.4.4 Oligopoly	59
3.4.5 Monopoly	70
3.4.6 Monopsony	79
3.4.7 Contestability	81
3.5 Labour Market Economics.....	86
3.5.1 Demand for Labour	87
3.5.2 Supply of Labour.....	90
3.5.3 Wage determination in competitive and non-competitive markets.....	96
3.6.1 Government intervention in product markets	109
3.6.2 The impact of government intervention	120

3.1.1 Sizes and Types of Firms

Key specification content:

- Reasons why some firms tend to remain small and why others grow
- Significance of the divorce of ownership from control: the principal-agent problem
- Distinction between public and private sector organisations
- Distinction between profit and not-for-profit organisations



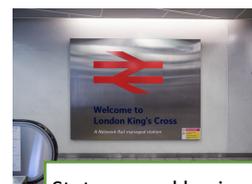
Public limited companies



Privately-owned firms



Start-Ups



State-owned businesses



Social enterprises



Co-operatives and Partnerships

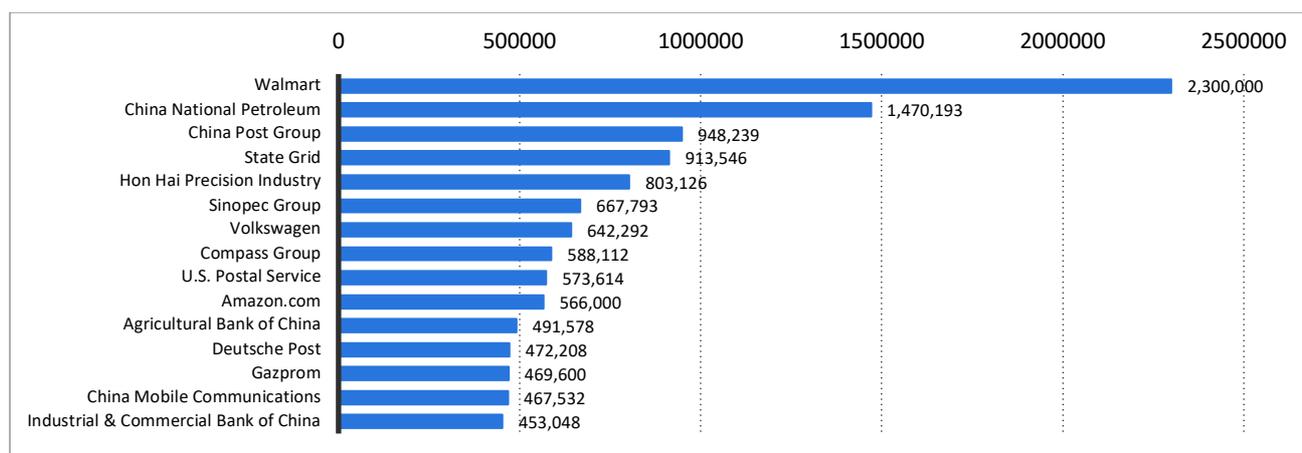
Different types of firm – key terms and examples

- **Firm:** A business organisation such as a corporation that produces and sells goods and services in markets.
- **Not for profit organisation:** Businesses that are operated commercially but with social welfare and environmental aims in mind. Typically, profits are reinvested for social purpose and social aims.
- **Public sector organisation:** Organisations that are owned and controlled by the state e.g. the NHS, social care, state schools, the Police, HM armed forces. The NHS employs 30% of all UK public sector staff, with education employing 28% of public sector staff.
- **Private sector organisation:** Private sector organisations are owned by private investors rather than the state. 84% of jobs in the UK are in the private sector.
- **Private limited companies:** Corporations whose shares are not listed on a public exchange. Examples include McLaren Technology Group, JCB, Specsavers, Matalan.
- **Co-operative producers:** Owned and run by their members. Examples include Arla Foods, Co-Op Group, Richer Sounds, John Lewis / Waitrose.
- **Social enterprise:** With a social enterprise, profit is reinvested for social purposes rather than for the gain of private investors. Examples include: Housing Associations, the National Trust and university Student Unions.

Examiner tip:

A great way to pick up strong evaluation marks is to consider your points from different perspectives. Remember that different types of firms will have different objectives as well as facing different cost structures and different challenges.

World's 50 largest companies based on number of employees in 2017



Largest companies in the world by market value in 2018 (in billion U.S. dollars)

<i>Ranking of the companies rank 1 to 18</i>	<i>Market value in billion U.S. dollars</i>
Apple	926.9
Amazon.com	777.8
Alphabet	766.4
Microsoft	750.6
Facebook	541.5
Alibaba	499.4
Berkshire Hathaway	491.9
Tencent Holdings	491.3
JPMorgan Chase	387.7
ExxonMobil	344.1
Johnson & Johnson	341.3
Samsung Electronics	325.9
Bank of America	313.5
ICBC	311
Royal Dutch Shell	306.5
Visa	295.1
Wells Fargo	265.3
China Construction Bank	261.2

Small firms in the economy

The majority of businesses registered in the UK are **small or medium-sized enterprises** (known as SMEs)

Why do many small firms survive?

1. Many smaller businesses act as a **supplier / sub-contractor** to larger enterprises especially in the construction industry and in sectors such as software coding / web design
2. They might take advantage of a **low-price elasticity of demand** and **high income-elasticity for specialist** 'niche' or 'bespoke' products that can be sold at a higher price with a large profit margin
3. Smaller businesses can avoid **internal diseconomies of scale** (rising long run average cost)
4. Many smaller businesses run as **lifestyle enterprises** where owners are looking to satisfy not maximise profits
5. Small businesses are often **innovative, flexible and nimble** in responding to changes in market demand
6. Small businesses have benefitted from consumers willing to buy online – the barriers to entry into the market have come down because of digital technology
7. Small businesses **keep their over-head costs** low e.g. a smaller full-time staff or relying on leasing equipment
8. All firms – regardless of size – can benefit from **external economies of scale** especially if located in cities

Smaller Firms & Business Objectives

Many smaller firms have different business objectives contrasted with bigger-scale corporations:

Typical Objective	Relevance to Smaller Firms
Business Survival	A key objective for start-up firms and many smaller firms. Whilst small firms have lower costs, over-reliance on one or a few products can threaten their survival.
Revenue Maximisation	Rarely a key objective for smaller firms, although they are often keen to grow sales albeit from a low base level.
Profit Maximisation	Smaller firms will normally earn lower absolute levels of profit (because their revenues are lower). However, they can still achieve high profit margins if operating in a suitable niche market.
Cost Efficiency & Scale	Smaller firms are unlikely to benefit from significant economies of scale although they may be good at keeping their cost base low.
Customer Service	Smaller firms are often associated with higher levels of customer service and satisfaction, perhaps because the business owner is closely involved with the provision of customer service.

Key Reasons to Stay Small

- Product differentiation & having a USP (unique selling point)
 - Positioning a business as small can help differentiate against larger competitors
 - Customer perception - may be an expectation of a better product from a business that "cares"
 - More scope for adding value and charging a higher price through selling specialist expertise
- Flexibility in meeting customer needs
 - Many small businesses talk to their customers regularly; sometime every day

- Small firms often communicate in the customers' language which give the impression to the customer that they are more in tune with their changing needs
- Makes it easier to get customer feedback (larger firms can struggle with this – a diseconomy of scale)
- Deliver a high standard of customer service
 - Most small businesses operate in the service sector, so this is a key source of competitive advantage
 - Employees in smaller firms are likely to treat customer service as a priority (compared with larger firms) though there is no guarantee!
- Exploit opportunities from e-commerce
 - E-commerce is a common way for small firms to reach a broader customer base
 - It is now relatively easy for a small firm to target niche segments using e-commerce
 - Smaller firms can gain significant traction with customers using social media
- Avoid risks of higher unit costs from internal diseconomies of scale (rising long run average cost)
- Smaller firms can be more innovative / creative and respond more quickly to changing market trends

Divorce of ownership from control: the principal-agent problem

Examiner tip:

This is a small topic and therefore unlikely to be explicitly tested regularly – but you can demonstrate top knowledge by making references to the issue in other questions, perhaps **relating to business objectives** or the risk of an expanding business experiencing diseconomies of scale. It is also advisable that you use the correct spelling of **principal**!

Shareholders and Stakeholders in a Business

- **Stakeholders:**
 - A stakeholder is any individual or organisation who has a **vested interest** in the activities and decision making of a business
 - Note that you are unlikely to see the word 'stakeholder' appear on an EdExcel exam paper itself, but is a great way to introduce a range of different perspectives!
- **Shareholders:**
 - Own the business – they have an equity stake in the business - perhaps a founder
 - May also work day-to-day in the business
 - Mainly interested in growing the value of their shareholding
 - **Capital gain** – an increase in the market value of a share
 - **Dividends** – a share of the profits made by a business

Examiner tip:

A good way to pick up evaluation marks is to consider issues from a **range of stakeholder perspectives** i.e. consider the impact of a policy intervention / event on employees, small business owners, large business boards, suppliers, exporters & importers

Stakeholder	Mainly interested in:
<i>Shareholders / Owners</i>	Return on investment + profits and dividends as a source of income Success and growth of the business Proper running of the business including meeting standards of corporate governance
<i>Managers & Employees</i>	Rewards, including basic pay and other financial incentives Job security & improved working conditions

	Promotion opportunities + job satisfaction & status – motivation, roles and responsibilities
<i>Customers</i>	Value for money, consumer surplus / real purchasing power Product quality, performance & reliability of customer service including after-sales service
<i>Suppliers in the market</i>	Continued, profitable trade with the business Financial stability – can the business pay its bills? Minimizing the problem of late payment to suppliers
<i>Banks & other finance providers</i>	Can the business repay amounts loaned or invested? Profitability and cash flows of the business Growth in profits and value of the business
<i>Government</i>	The correct collection and payment of taxes (e.g. VAT and national insurance) Helping the business to grow – creating jobs e.g. in areas of above-average unemployment Compliance with business legislation including environmental laws & health and safety
<i>Local community</i>	Success of the business – particularly creating and retaining jobs Compliance with local laws and regulations (e.g. noise, pollution)

Potential Conflicts between Stakeholders

Business Decision	Likely to be Supported By	Possibly Opposed By
<i>Cut jobs to reduce costs</i>	Shareholders Banks (lenders)	Employees Local community
<i>Add extra shifts to increase factory capacity</i>	Management Customers & suppliers	Local community
<i>Introduce new machinery to replace manual work</i>	Customers Shareholders	Employees
<i>Increase selling prices significantly to improve profit margins</i>	Shareholders Management	Customers

Divorce between Ownership and Control

In most businesses, there is a **divorce between ownership and control**. In other words, the owners of a business may not be the same as those people who are **taking key day-to-day decisions** such as pricing, investment and marketing.

Agency problem	Possible conflicts of interest that may result between shareholders (principal) and the management (agent) of a firm
Stakeholders	In most businesses, there are many different stakeholders. These include customers, managers, employees, shareholders, debt holders and the government
Stakeholder conflict	Stakeholder conflict occurs when different stakeholders have different objectives. Firms have to choose between maximizing one objective and satisfactorily meeting several stakeholder objectives, so called satisfying

The Principal Agent Problem

The principal agent problem is **an asymmetric information problem**. Owners of a firm often cannot observe directly the day-to-day decisions of management. The decisions and performance of agent are costly and difficult to monitor.

- Principal
 - Owner of the business i.e. has a significant equity stake
- Hires an agent
 - e.g. sales or finance manager
- Managers
 - May have different business objectives to the principal, such as revenue maximisation

Overcoming the Principal Agent Problem

What is in the best interest of the management is not necessarily the same as the optimum interests of the shareholders. Strategies involve trying to **align the aims** of these two different stakeholders.

- Employee share ownership schemes
 - John Lewis and Waitrose have a well-regarded partnership model
 - Stock options might lead to perverse behaviour – e.g. deliberate attempts to hike up share prices through illegal action (think back to the notorious case of Enron)
- Long term employment contracts for senior management
 - Security of tenure might encourage managers to take pricing and investment decisions in the long-term best interests of the business
- Long term stock commitment
 - Apple requires senior executives at Apple to hold three times their annual base salary in stock, and executives have to keep this salary in stock for a minimum of five years to satisfy the requirement

Public and private organisations

Public sector organisations are wholly or partly owned and run by the state / government.

Examples of public sector organisations in the UK (fully or partially)

- British Nuclear Fuels plc.
- Network Rail
- Bradford and Bingley
- Royal Bank of Scotland
- Urenco – the UK government has a 33% stake in this uranium enrichment company
- Met Office, Ordnance Survey
- Nuclear Decommissioning Authority
- UK government has a stake in Channel 4 Television, Eurostar and the Green Investment Bank

Privatisation

- Privatisation means the **transfer of assets** from the public (state or government) sector to the private sector of an economy – privatisation causes a change of ownership
- In the UK, the process has led to a reduction in the size of the public sector.
- State-owned enterprises in Britain now contribute less than 2% of GDP and 1.5% of employment.
- Privatisation has become a common feature of micro-economic reforms throughout the world not least in many transition economies including a large number in eastern Europe
- But over recent years privatisation in the UK has given way to a new wave of nationalisation including some high-profile banks, building societies and transport services.

Key examples of privatisations in the UK over the years

- British Aerospace (1980)
- British Airports Authority (1986) – bought by Ferrovial in 2006
- British Airways (1987)
- British Coal (1994)
- British Gas (1986)
- British Petroleum – Gradually privatized between 1979 and 1987
- British Steel (1988)
- British Telecom (1984)
- National Power and PowerGen (1990)
- Regional water companies
- Plasma Resources UK – a blood plasma business sold to Bain Capital in 2013
- The Tote – sold to Betfred in 2011
- The Royal Mail (part privatized in 2013) – it was fully privatized in 2016

Not-for-Profit Organisations

Producer Co-operatives

- Co-ops are owned and also run by their members, who can be customers, employees or groups of businesses.
- The supermarkets-to-funerals Co-op Group is the biggest, followed by John Lewis Partnership, the retailer.
- Farmers' co-ops are also popular in the UK. Other co-ops include community pubs, supporter-run football clubs and foster care and local childcare providers.
- These businesses are run on principles of shared ownership, shared voice & shared profits.

Social Enterprises

- A social enterprise is a not-just-for-profit business created to address a social problem.
- Profits are reinvested for social purposes in the community, rather than the need to satisfy investors.
- Good examples of social enterprises include the Big Issue magazine and the Eden Project in Cornwall.

Not for Profit & Not for Dividend Firms

- Not for profit businesses are charities, community organisations that are run on commercial lines.
- Network Rail is a good example to use:
 - Network Rail's purpose is to deliver a safe, reliable and efficient railway for Britain
 - It is a company limited by guarantee – whose debts are secured by the government
 - Network Rail is a "not-for-dividend" company - profits are invested in the network.
 - Train operating companies such as First Great Western and Virgin Trains pay Network Rail for use of the rail infrastructure when running services
 - Network Rail is given targets for punctuality and safety by the Rail Regulator

BBC

The BBC runs as a public-sector enterprise, in comparison to private sector rivals like Sky and ITV. A sizable proportion of the BBC's income is derived from commercial activities.

Quick question

Can you think of pros and cons of a business choosing to operate as a not-for-profit business?

Common error alert!

Students sometimes believe that not-for-profit businesses do not earn any profit...this is not always the case! All businesses need to at least cover their production costs. Profits may be used to reinvest or support other community enterprises, etc.

3.1.2 Business Growth

Key specification content:

- How businesses grow:
 - Organic growth
 - Forward and backward vertical integration
 - Horizontal integration
 - Conglomerate integration
- Advantages and disadvantages of:
 - Organic growth
 - Vertical integration
 - Horizontal integration
 - Conglomerate integration
- Constraints on business growth

How businesses grow



Organic Growth

Organic growth is known as **internal growth** and it happens when a business expands its own operations rather than relying on **external takeovers and mergers**. Organic growth can come about from:

1. Increasing existing production capacity through investment in capital & technology
2. Development & launch of new products (e.g. to achieve economies of scope)
3. Finding new markets by exporting into emerging countries such as India and South Africa
4. Establish new distribution channels such as online sales platforms
5. Growing a customer base through marketing and adding new users of a product

Organic growth builds on the business' own capabilities and resources. **For most businesses, this is the only expansion method used.**