Edexcel

A Level

Economics

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Unit 03-Section 1

Types and sizes of businesses

1.Types of business

PRIVATE SECTOR ORGANISATIONS

Private sector organisations are organisations that are owned by individuals or companies and not the state. Almost all private sector organisations aim to make a profit. Exactly how much profit depends on the objectives of the organisations themselves.

In the case of large companies, the owners of the company are the **shareholders** and they will want the company to make the maximum profit possible.

A **sole trader or sole proprietor** is a business where only one person owns and controls the business. Most businesses in the majority of countries are sole traders. They are easy to set up, often require little capital, and have few, if any, legal requirements. The owner has full control of the business and keeps all the profit themselves.

However, they will have **unlimited liability** due to the fact that, as a sole trader, the owner and the business are one and the same.

A **partnership** is similar in many ways to a sole trader except that there are two or more people in the partnership and so capital, risks and responsibility are shared between the partners. The partners have full control of the business and keep all the profit themselves. Unlimited liability also applies to the partners in the partnership. Partners are liable for the actions of the other partners.

Limited companies are businesses that have gone through legal formalities to be registered, usually with the government. With this registration comes limited liability, which separates in law the company and the owners (the shareholders). This means the shareholders can only lose the amount of capital they have invested as share capital and their personal possessions are protected if the company has debts it cannot pay. The shareholders are paid a share of the profits, assuming profits are made, and this is called **dividends**.

Co-operatives are businesses that are owned by members and each member has one vote on major business decisions and issues. Any profits that are made are shared out equally among the members. The members have limited liability. The main objective of the co-operative form of business organisation is to provide service rather than to earn a profit.

There are three main types of co-operative:

Consumer co-operative: owned by consumers who buy goods or services from their co-operative Producer

co-operative: owned by producers of commodities or crafts who work together to process and market their products

Worker co-operative: owned and democratically governed by employees who become co-op members.

STATE-OWNED ENTERPRISES (PUBLIC SECTOR)

State-owned enterprises (SOEs) are large government-owned organizations with significant control over commercial activities. They operate as separate legal entities, with profits paid to the government. SOEs are crucial in countries like UAE, China, India, and South Africa, often in key sectors like energy, water, transport, banking, and telecommunications.

FOR-PROFIT AND NOT-FOR-PROFIT ORGANISATIONS

Private sector businesses often aim for profit, but some **non-profit organizations**, such as charities, use any surplus generated to support their aims. The UAE's Federal Ministry of Social Affairs regulates charitable activities and fund raising, while similar regulations exist in other countries to ensure proper operation of these organizations.

JOINT VENTURES

A joint venture is a separate business entity created by two or more parties, sharing ownership, returns, and risks of a new project or business activity. It can be for a specific project or to advance understanding between parties. Joint ventures are often set up between global businesses expanding into new markets and local businesses with knowledge of that market. Examples include Chery Jaguar Land Rover Automotive Company in China, and Chery Automobile Co. and Jaguar Land Rover in India. Some governments allow foreign companies to set up in their country through joint ventures to prevent exploitation, ensure knowledge transfer, and improve income distribution.

SUBJECT VOCABULARY

co-operative a firm owned, controlled and operated by a group of users, such as the workers, for their own benefit. They each contribute by buying shares in the co-operative but have control of the firm on the basis of a one-member, one-vote principle rather than having votes in proportion to the number of shares owned, i.e. one-share, one-vote

dividends a share of the profit of a company that is distributed to its shareholders according to the number of shares held by them

exploitation the act of using resources or a person's labour without offering adequate compensation

for-profit organisations organisations that have making a profit as a goal

joint venture where a separate business entity is created by two or more parties. It involves sharing ownership, returns and risks of the new project or other business activity for which the joint venture was set up

limited company a type of business organisation where the owners are its shareholders, i.e. those who have bought a part of the business by buying shares in the company; it offers limited liability or legal protection to the shareholders as the company and its owners are legally separate

not-for-profit organisations organisations that do not have making a profit as a goal but may use any profit or surplus they generate to support their aims

partnership a type of business organisation where two or more people own the business

private sector organisations organisations that are owned by individuals or companies and not the state

shareholder any person or company that owns one or more shares in a limited company

sole trader or sole proprietor a business owned and controlled by one person

state-owned enterprises (SOEs) large organisations that are created by a country's government to carry out commercial activities

unlimited liability the owners of the business are personally liable for its debts and may have to sell personal assets to pay for them

2. Sizes of business

THE SIZE OF BUSINESSES

Small and medium-sized enterprises (SMEs) play a crucial role in many industries, employing fewer than 250 employees and having an annual turnover of €50 million or less. The European Union defines a large corporation as one with more than 250 employees, an annual turnover of €50 million, and a Statement of Financial Position of €43 million or higher.

Large firms exist for two main reasons:

• Economies of scale (explained in Chapter 6) in the industry may be significant. Only a small number of firms producing at the minimum efficient scale of production (explained in Chapter 6) may be needed to satisfy total demand.

• Barriers to entry (explained in Chapter 9) may exist which protect large firms from potential competitors. Small firms survive for the opposite reasons:

• Economies of scale may be very small relative to the market size. A large number of firms may be able to operate at the minimum efficient scale of production. Small firms may also be able to take advantage of the higher costs of larger firms in the industry caused by diseconomies of scale (explained in Chapter 6).

• The costs of production for a large-scale producer may be higher than for a small firm. Large firms may operate within their average cost curve boundary due to productive inefficiency, poor organization in market niches, or X-inefficiency. The average cost curve may be higher in certain markets, forcing large firms to pay high wages in formal labor markets, while small firms can pay relatively low wages in informal markets. Owners of small companies may work long hours at unacceptable pay rates.

• Barriers to entry may be low. The cost of setting up in an industry, such as the food retail industry, may be small. Products may be simple to produce or sell. Finance to set up in the industry may be readily available. The product sold may be relatively homogeneous. It may be easy for a small firm to produce a new product and establish itself in the market.

• Small firms can be monopolists. A monopolist (explained in Chapter 13) offers a product for sale which is available from no other company. Many small firms survive because they offer a local, flexible and personal service.

HOW BUSINESSES GROW

Firms may grow in size in two ways:

- By organic growth
- By external growth through merger or takeover.

Organic growth refers to firms increasing output through increased investment or labor force. A merger involves joining two or more firms under common ownership, with shareholders' agreement. A takeover involves one company buying another, which can be amicable or contested. In a hostile takeover, the board of directors may recommend rejecting the bid's terms.

Company X needs to get the shareholders to agree to sell just over 50 per cent of the shares to take control Economists distinguish between three types of merger:

• Horizontal integration is a merger between two firms in the same industry at the same stage of production, for instance, the merger of two car manufacturers or two bakeries.

• Vertical integration is a merger between two firms at different production stages in the same industry. Forward vertical integration involves a supplier merging with one of its buyers, such as a car manufacturer buying a car dealership, or a confectionary manufacturer buying candy/sweet shops.

• Conglomerate integration is the merging of two firms with no common interest. A tea company buying an insurance company, or a food company buying a clothing chain would be conglomerate mergers.

ADVANTAGES AND DISADVANTAGES OF EACH TYPE OF MERGER/TAKEOVER

Firm growth is primarily organic, as most start small. Vertical, horizontal, and conglomerate integration through mergers and takeovers is common for medium-sized and large firms. These are expensive, time-consuming, and high-risk. To succeed, firms should have a growth strategy. Organic growth is the norm for medium-sized and large firms, but some firms may have markets or assets that organic growth cannot. For example, a European company may prefer to buy a company selling into the Asian market. Organic growth may also be slow for directors and managers.

VERTICAL INTEGRATION

There are several possible advantages of vertical integration:

• There may be cost savings. Integrating a supplier or a buyer into the firm may make the firm more efficient.

• Vertical integration may reduce risk.

• Forward vertical integration could give a firm more control over its market.

There are a number of disadvantages to vertical integration:

• A firm making a vertical merger may have little expertise in that particular industry.

• Firms often pay too much for the firm they take over and the share price of the firm falls rather than rises.

• There can be difficulties in merging two firms together into one firm. Either the costs of creating a single firm from two separate firms are too great, or the two firms fail to integrate but costs rise because extra layers of management are needed to control the new, larger firm.

• Many of the key workers in the firm that has been taken over may leave, taking with them much of the expertise that made it successful.

HORIZONTAL INTEGRATION

Most mergers and takeovers are examples of horizontal integration. At the small firm level, an

example would be a hairdresser buying a second hairdressing business. At an international level, it might be one pharmaceuticals company buying another pharmaceuticals company.

Horizontal integration has a number of advantages for the firm:

• It may allow reductions in average costs due to economies of scale.

• It can reduce competition in the market by removing a competitor.

• The firm has an increased ability to control prices in the market.

• It can allow one firm to buy unique assets owned by another company, such as a new drug or operations in another part of the world.

• It allows a business to grow in a market where it already has knowledge and expertise. This is likely to make the merger more successful.

CONGLOMERATE INTEGRATION

There are several advantages of conglomerate integration:

• One advantage is to reduce risk. Buying another firm operating in a completely different market means that a firm is not so dependent on the ups and downs of one market.

• A conglomerate may find it easier to expand compared to a situation where the companies or operations are independent. Size gives a conglomerate more options to obtain finance to expand the business. Successful senior managers can be transferred from company to company depending on their need.

• It could be an opportunity for **asset stripping**. Some companies specialise in buying other companies which they see as having more valuable individual assets than the purchase price of the company.

Conglomerate integration can have disadvantages such as lack of market expertise, asset stripping, high costs, poor management, and potential job loss. Key workers may leave after the takeover, and resources may be spread thinly across various activities. This can lead to reduced performance, job losses, and disused industrial sites. It's crucial for firms to understand and manage their operations effectively.

CONSTRAINTS ON BUSINESS GROWTH

There are a number of different constraints on business growth, including the following.

SIZE OF THE MARKET

Markets vary in size. Some local markets are very small. Take the example of a flower shop in a large village in rural Spain. The local market may be able to support the business adequately with customers coming from surrounding villages.

ACCESS TO FINANCE

Firms expand by using past profits, loans, and overdrafts from banks, depending on bank willingness. Medium-sized and large firms may obtain equity funding through new shares sold to investors or second-hand shares bought on stock exchanges. However, finance only comes from share issues, allowing shares to change ownership. Selling shares makes it easier to raise initial finance from investors.

OWNER OBJECTIVES

Not every owner wants to grow a firm. Owners can have many objectives. They may be happy with the profit they are currently making and not wish to have the extra work or the extra risk that comes from growing the business.

REGULATION

Most firms can expand without government interference, but EU Merger Regulation prohibits mergers and takeovers that reduce competition in the EU Single Market. The EU authorities only examine larger mergers with EU dimension, and competition law restricts takeovers and mergers for large companies with combined turnover over €5000 million.

REASONS SOME FIRMS TEND TO REMAIN SMALL AND OTHERS GROW

It is suggested that profit maximising companies are motivated to grow in size for a number of reasons.

- A larger company may be able to exploit economies of scale more fully. The merger of two medium- sized car manufacturers, for instance, is likely to result in potential economies of scale in all fields, from production to marketing to finance.
- A larger company may be more able to control its markets. It may therefore reduce competition in the market place in order to be better able to exploit the market as its price-setting power is increased.
- A larger company may be able to reduce risk. Many conglomerate companies have grown for this reason. Some markets are unreliable. They are subject to large changes in demand when economies go into boom or recession.
- Where there is a divorce of ownership from control, a larger company may justify higher salaries and bonuses to directors and managers. Since it is directors and managers who run the firm, they can take decisions about the size that will benefit them, but not necessarily bring any benefit to shareholders.

While some firms grow large others remain small. This is due to many reasons, such as:

- The owners want the business to remain small and do not want to have the increased risk from operating a larger firm or take unnecessary risks with personal finance.
- The firm may operate in a niche market and so demand may be too low to expand.

- The firm may offer a personal service, where loyal customers know the owners. Such customers may go elsewhere if the business grows.
- The owners may lack the expertise and finance to expand and are happy to remain small.

IMPACT OF GROWTH OF FIRMS ON BUSINESSES, WORKERS AND CONSUMERS

Businesses will benefit from a merger if economies of scale lead to greater efficiency. If firms are able to cut costs or develop new and innovative products, their profits should rise. Greater efficiency will also enable firms to survive greater competition in their markets.

Workers may benefit or lose out following a merger. Some workers may gain promotion in the new, larger firm while others might lose their jobs.

Consumers may benefit or lose out following a merger. They will gain if the merged firms become more efficient, cut costs and offer lower prices. They could also gain if the merged firms invest more and develop new and innovative products. Consumers will lose out if the merger reduces the number of firms in the market and there is less choice.

REASONS FOR DEMERGERS

A demerger occurs when a firm splits itself into two or more separate parts to create two or more firms. The new firms may be of roughly equal size. Sometimes, though, the term is used to describe the sale of a small part of a business to another business. Demergers occur for a variety of reasons:

LACK OF SYNERGIES

Management may feel that there are no synergies between the parts of the firm. This means that one part of the firm is having no impact on the more efficient and profitable running of the other part of the firm.

VALUE

Demerged firms may be valued higher than larger firms, as investors base valuations on growth prospects. Fast-growing parts of a company are worth more than slower-growing ones. Poor performance in one part can lower the whole company's share price, creating value by splitting companies.

FOCUSED COMPANIES

In the 1970s, conglomerates were used to diversify risk, but now firms focus on a few key markets for higher profits and growth. Market leaders tend to be more profitable than third or fourth. Companies often divest from parts that don't fit their core activities, often at a low cost, indicating limited management resources and time or expertise.

IMPACT OF DEMERGERS

Demergers can have an impact on businesses, workers and consumers.

Businesses will benefit from a demerger if the increased specialisation that results leads to greater efficiency. If firms are able to cut costs or develop new and innovative products, their profits should rise. Greater efficiency will also enable firms to survive greater competition in their markets. Firms will lose out if the demerger leads to more inefficiency. If the demerged firms are run less well than when they were one single firm, then profits are likely to fall.

Workers may benefit or lose out following a demerger. Senior managers may gain promotion. For example, one firm only needs one senior financial director. If it splits into two, each firm will need its own senior financial director. On the other hand, some workers may lose their jobs following a demerger.

Consumers may benefit or lose out following a demerger. They will gain if the demerged firms become more efficient, cut costs and offer lower prices. They could also gain if the demerged firms invest more and develop new and innovative products.

SUBJECT VOCABULARY

asset stripping the practice of buying a company cheaply and then selling all the things it owns to make a quick profit

backward vertical integration a joining together of two or more firms into one firm, where the purchaser merges with one or more of its suppliers

conglomerate integration a joining together into one firm of two or more firms producing unrelated products

demerger when a firm splits into two or more independent businesses

forward vertical integration a joining together of two or more firms into one firm, where the supplier merges with one or more of its buyers.

horizontal integration a joining together of two or more firms in the same industry at the same stage of production

merger or takeover the joining together of two or more firms under common ownership

niche market a market for a product or service, perhaps an expensive or unusual one, that does not have many buyers but that may make good profits for companies that sell it

organic growth a firm increasing its size through investment in capital equipment or an increased labour force

synergy/synergies when two or more activities or firms put together can lead to greater outcomes than the sum of the individual parts

vertical integration a joining together into one firm of two or more firms at different production stages in the same industry

3. Business objectives

BUSINESS OBJECTIVES

A business objective is a result that a firm aims to achieve. It forms part of the planning process for firms and will influence the pricing policies and the planned output for the firm. There are four main objectives discussed below:

- profit maximisation
- revenue maximisation
- sales volume maximisation
- profit satisficing: an example of behavioural theories.

PROFIT MAXIMISATION

Neo-classical economics prioritizes shareholders' interests, aiming to maximize short-term profits. Firms aim to maximize satisfaction and rewards, ensuring marginal cost equals marginal revenue, which determines their production level and ultimately maximizes profits.

Profit maximisation occurs at the output where the difference between total revenue and total cost is the greatest, as explained in Chapter 7. Another way of expressing this is to say that a firm maximises profits when marginal cost equals marginal revenue (MC = MR).

Neo-Keynesian economists believe that firms maximise their long-run profit rather than their short- run profit. This is based upon the belief that firms use **cost-plus pricing techniques**.

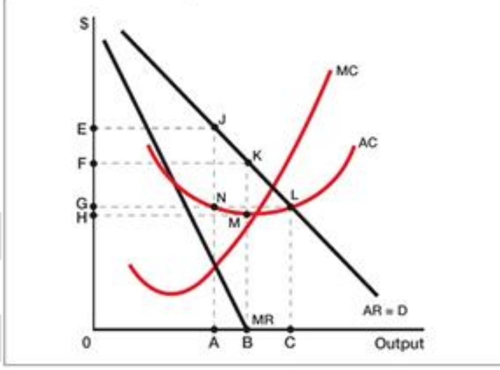
REVENUE MAXIMISATION

One theory that uses the concept of **divorce of ownership from control** is the theory of **revenue maximisation**. In this theory, it is assumed that the objective of managers is to maximise total revenues for the firm, subject to a **profit satisficing** constraint.

FIGURE 1

Maximisation alternatives

The profit maximising firm will produce at OA and price at OE. The revenue maximising firm will produce at OB and price at OF. The sales volume maximising firm will produce at OC and price at OG.



SALES VOLUME MAXIMISATION

Firms aim for sales volume maximisation, maximizing the number of products they sell. This is similar to revenue maximisation, where sales volume is a measure of a firm's size. If a firm is a monopoly or oligopoly, it can make supernormal profits in both short and long run. The level of production where sales volumes are maximized is where average costs = average revenue, where normal profit is part of cost. The firm's output is higher than revenue maximisation output and profit maximising output.

FORMULAE FOR DIFFERENT BUSINESS OBJECTIVES

	Level of output occurs*
Profit maximiser	MC = MR
Revenue maximiser	MR = 0
Sales volume maximiser	AC = AR or TC = TR

*assuming the firm profit satisfices where it just makes normal profit

▲ Table 1

BEHAVIOURAL THEORIES: SATISFICING

Profit satisficing is an objective in business ownership where ownership is separate from control. Owners aim to maximize profits, while managers and workers may not. The firm aims to achieve a minimum or target level of profits, based on goals like production, price, sales, and past experience. Behavioral economics considers various factors motivating people at work, ensuring that maximum profit is not achieved.

DIVORCE OF OWNERSHIP FROM CONTROL

In small and medium-sized businesses, owners work in the firm, while in large businesses, owners appoint directors and managers to run the firm on their behalf. This divorce of ownership from control occurs when large firms are listed and have shares traded on stock exchanges. Owners aim to maximize dividend returns and short-run profit maximization, while directors and managers aim to maximize their own rewards, including pay, bonuses, fringe benefits, and power.

SUBJECT VOCABULARY

business objective a result that a firm aims to achieve

cost-plus pricing the technique adopted by firms of fixing a price for their products by adding a fixed percentage profit margin to the long-run average cost of production

divorce of ownership from control occurs when the managers and directors of a business are a different group of people from the owners of the business

profit maximisation occurs when the difference between total revenue and total cost is greatest

profit satisficing making sufficient profit to satisfy the demands of owners, such as shareholders

revenue maximisation occurs when total revenue is highest and when marginal revenue equals zero

sales volume maximisation occurs when the volume of sales is greatest; when the objective of a firm, this is usually subject to a profit satisficing constraint