Edexcel

AS Level

BS

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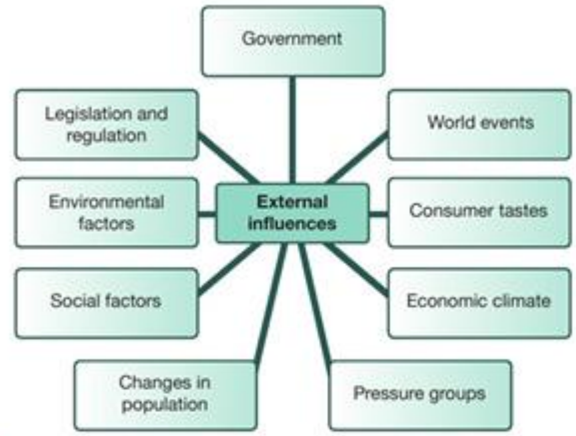
Unit 02

External influences

Chapter 41 – Economic influences

EXTERNAL INFLUENCES

Business activity is influenced by a number of external influences. These are factors beyond the control of businesses. In some cases they restrict a business's decisions and may prevent its growth and development. Examples of these external influences are summarised in Figure 1.



▲ Figure 1 External influences on businesses

INFLATION

A government will want to keep prices stable in the country's economy. This means that inflation must be kept under control. Inflation is when the general price level is rising.

HOW IS INFLATION MEASURED?

A common approach to measuring inflation is to calculate changes in the consumer price index (CPI). This involves gathering information about the prices of goods and services in the economy. Each month the government records price changes of about 600 goods and services. From these records an average price change is calculated and converted into an index number.

HOW DOES INFLATION AFFECT BUSINESSES?

Inflation rates between 0 and 4 per cent, like those in the EU between 2008 and 2017, are not likely to have a big impact on businesses. However, once the CPI gets into double figures and beyond, inflation can have some damaging effects on businesses.

High and particularly fluctuating inflation is likely to be damaging to businesses for a number of reasons.

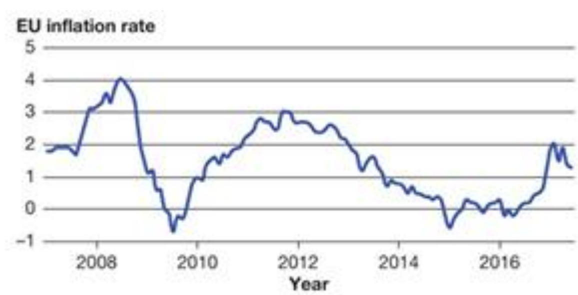
Increased costs: High or fluctuating inflation imposes a variety of costs on businesses.

• With suppliers' prices rising all the time, but at different rates, time must be spent researching the market for the best deals. Equally, more time has to be spent monitoring the prices of competitors to decide when and by how much to increase your own prices. These costs are called shoe leather costs, because before the age of the telephone and the Internet, businesses would have to send their employees round on foot to gather this information.

• Raising prices costs money. Customers have to be informed of the new prices. Brochures might have to be reprinted and sent out. Websites might have to be updated. The sales force must be made familiar with new prices. These costs are called menu costs because, for a restaurant, increasing prices means that it must reprint its menus.

• Management is likely to have to spend more time dealing with workers' pay claims. Instead of being able to sign a 2- or 3-year deal, annual pay negotiations are likely to be the norm. If there is hyperinflation, where inflation is running into 100 per cent per annum or over, pay negotiations may have to take place each month.

Uncertainty: With high and fluctuating inflation, businesses do not know what prices will be in 3- or 6-months' time, let alone in 1 or 5 years. But decisions have to be made now



▲ Figure 2 EU inflation rates, 2008–17
Source: Tradingeconomics.com I Eurostat

which will affect the business in the long term. For example, businesses need to invest to survive. But how much should they invest? The price of a new machine, a shop or a new computer system will probably be higher in 6 months than today.

Borrowing and lending: Borrowing and lending becomes an opportunity and a problem for businesses. On the one hand, the real value of debts incurred in the past can become quickly reduced by inflation. If inflation is 100 per cent per annum, the real value of money borrowed a year ago falls by 50 per cent in 1 year. Inflation initially benefits borrowers and harms lenders.

But in an inflationary environment, interest rates rise to match inflation. If there is prolonged inflation, interest rates are likely to become index linked - linked to the index of prices. So interest might be charged at the rate of inflation plus 5 per cent or plus 10 per cent.

Consumer reactions: Consumers react to inflation as well as businesses.

International competitiveness: High inflation can have an impact on businesses that import or export goods and services. For example, if a country has higher inflation rates than its trading partners, businesses in that country will become uncompetitive. As a result, they are likely to lose sales and shares in overseas markets. Also, businesses facing competition from overseas will lose out because imports become relatively cheaper. For example, consumers in a particular country may buy foreign goods instead of domestic goods because their prices are rising less quickly than those at home. The impact of changes in the price of imports and exports are discussed in more detail later in this chapter.

HOW MIGHT BUSINESSES RESPOND TO INFLATION?

Although inflation rates around the world were fairly low between 2008 and 2017, there is always a chance that inflation will start to rise again. Some businesses would probably respond to an increase in inflation in an effort to protect their profits.

EXCHANGE RATES

Different countries in the world have their own currencies. For example, the USA uses the dollar, Japan uses the yen, many EU countries use the euro and the UK has the pound. When countries use different currencies transactions between people and businesses are affected.

THE IMPACT OF AN APPRECIATION IN THE EXCHANGE RATE ON IMPORTS AND EXPORTS

build up inventories ahead of further inflation so that the exchange rate is the price of one currency in terms products are sold at future higher prices of another. Like all prices the exchange rate can change.

For example, if the demand for UK exports rises, there will be an increase in the demand for pounds. This is because foreigners need pounds to pay for exports. The increase in demand for pounds will raise the exchange rate (i.e. raise the value of the currency, the pound, against that of another currency). When it rises, the exchange rate has **appreciated**.

THE IMPACT OF A DEPRECIATION IN THE EXCHANGE RATE ON IMPORTS AND EXPORTS

When the exchange rate falls it has depreciated. The impact on the demand for imports and exports is the opposite.

The effects of changes in the exchange rate on the demand for exports and imports are summarised in Table 1.

Exchange rate	Price of exports	Demand for exports	Price of imports	Demand for imports
Falls	Falls	Rises	Rises	Falls
Rises	Rises	Falls	Falls	Rises

▲ Table 1 Summary of the effects of changing exchange rates

HOW ARE BUSINESSES AFFECTED BY EXCHANGE RATES?

The preceding examples show what happens to the prices of imports and exports when exchange rates appreciate and depreciate. Sometimes these changes will benefit a business, other times they will not. For example, if the value of the rupee falls, Indian exporters will benefit because the price of exports falls and demand should increase. However, Indian importers will lose out because their purchases will be more expensive.

HOW MIGHT BUSINESSES RESPOND TO A CHANGE IN EXCHANGE RATES?

The response by businesses to a change in exchange rates will depend on whether they are exporters or importers and whether the exchange rate appreciates or depreciates.

Appreciation: An export business will find that the prices of its products will be higher for overseas customers when the exchange rate appreciates. Therefore, trading conditions have worsened. They might respond by lowering their prices to compensate for the increase in the exchange rate. They may also consider improving the quality of products and customer service. They may offer more favourable payment terms - extending the credit period perhaps.

Depreciation: An export business will find that the prices of its products will be lower for overseas customers when the exchange rate depreciates. Therefore trading conditions have improved. They might respond by raising prices to increase their profit margins since overseas customers would not feel the impact.

INTEREST RATES

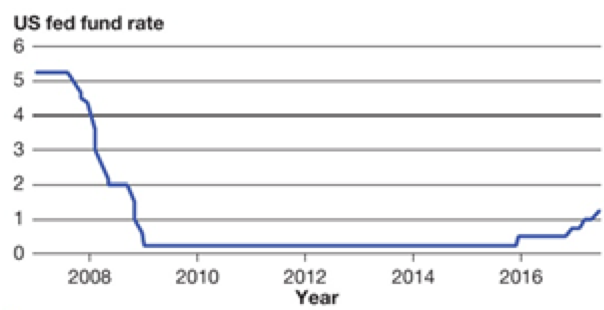
If a business or an individual borrows money, they usually have to pay interest on the loan. Equally, if they put their savings into a bank or building society, they expect to receive interest.

The interest rate is the price of borrowing or saving money.

EFFECT OF INTEREST RATES ON COSTS

Changes in interest rates are likely to affect the overheads of a business. Interest charges are part of overhead costs. If interest rates rise, businesses are likely to have to pay higher interest payments on their borrowing. For example, a business might borrow US$10,000. The annual payments on this would rise from US$600 to US$700 if the rate of interest rose from 6 to 7 per cent per year.

Not all borrowing is at variable rates of interest. Variable rates mean that banks or other lenders are free to change the rate of interest on any money borrowed. Many loans to businesses are at fixed rates of interest. This is where the bank cannot change the rate of interest over the agreed term (the time over which the loan will be paid off) of the loan. A rise in interest rates in the economy will not affect the overheads of a business with only fixed-term loans. But, if a business wanted to take out new loans, it would have to pay the higher rates of interest the bank or other lender was now charging. So overhead costs would rise.



▲ Figure 3 US interest rates, 2008–17
Source: Tradingeconomics.com I Federal Reserve

EFFECT OF INTEREST RATES ON INVESTMENT

Changes in the rate of interest affect the amount that businesses invest, for example in new buildings, plant and machinery. There are four main reasons for this.

The cost of loans: Investment projects are often financed through loans. A rise in interest rates increases the cost of borrowing money. So projects financed this way will find that the total costs have risen, reducing profitability.

This might be enough to persuade some businesses to cancel their investment plans. Total investment in the economy will then fall.

Attractiveness of saving: Businesses have the alternative of putting their funds into savings schemes rather than investing in machinery or buildings, for example. A rise in interest rates makes putting money into financial assets relatively more attractive. For example, if interest rates rise from 5 to 8 per cent, a business might decide to cancel an investment project and save the funds instead.

Paying off existing loans: A rise in interest rates will increase the cost of existing variable rate borrowing. A business could choose to pay off existing loans rather than increase its investment. This will reduce its costs. It also reduces the risk associated with borrowing.

A fall in demand: A rise in interest rates is likely to reduce total spending in the economy, as explained below. This might affect the profitability of many investment projects. For example, a business might forecast that an investment project would be profitable with 20,000 sales per year. But if sales were forecast to be only 15,000 per year because of a downturn in demand, then the investment project could be unprofitable and might not go ahead.

EFFECT OF INTEREST RATES ON DEMAND

The level of interest rates affects aggregate demand (i.e. total demand) for goods and services in the economy. A rise in interest rates will tend to push down aggregate demand. A fall in interest rates will tend to increase demand.

Businesses are directly affected by changes in demand. When demand falls, their sales go down because less is being bought. If demand rises, businesses receive more orders and more sales.

There are many different ways in which changes in interest rates lead to changes in the sales of businesses.

Domestic consumption: Consumers will be hit by a rise in interest rates. The cost of loans will rise. This will discourage consumers from buying goods bought on credit, such as cars, furniture and electrical equipment. These goods are known as consumer durables because they are 'used up' over a long period.

Some potential new home buyers will be put off because they cannot afford the repayments, directly hitting the new housing market. If unemployment begins to rise because of less spending, consumer confidence will fall. This will make consumers even less willing to take out loans and spend.

Domestic investment: As explained above, businesses are likely to cut back plans for new investment if interest rates rise. Investment goods, like new buildings or machines, are made by businesses. So, these businesses will see a fall in their demand.

Stock: Businesses keep stocks of raw materials and finished goods. Stock costs money to keep, because a fall in stock levels could be used to finance a fall in borrowing and interest payments. So a rise in interest rates will increase the cost of keeping stock.

Exports and imports: A rise in interest rates tends to lead to a rise in the value of one currency against others. A rise in the rupee, for example, will make it harder for Indian businesses to export profitably. At the same time, foreign firms will find it easier to gain sales in the domestic market because they will be able to reduce their prices. The result is likely to be a fall in exports and a loss of sales to importers in the domestic market. Both will reduce demand and hit Indian businesses.

HOW MIGHT BUSINESSES RESPOND TO CHANGES IN THE INTEREST RATE?

The response by businesses to a change in interest rates will depend on whether they rise or fall.

Higher interest rates: Higher interest rates are generally bad for businesses. The cost of borrowing rises and demand for goods bought with borrowed money is likely to fall. Businesses may respond in the following ways:

- reduce the amount they borrow by cutting back on loans and overdrafts - this will help to compensate for the higher cost of borrowing
- postpone or cancel marginal investment projects. Higher interest rates mean that marginal projects become unprofitable
- if higher interest rates are sustained, and the economic situation starts to weaken, some businesses might react by modifying growth targets or even scaling down operations by releasing resources. They may lay off staff for example
- businesses with a wide range of financial assets might begin to put more money into deposit accounts since returns will be greater.

Lower interest rates: Business will generally prefer lower interest rates since the cost of borrowing will be lower and demand for goods bought with borrowed money, such as cars, will rise. Businesses may respond by:

- increasing investment since the returns will be higher if the cost of borrowing is lower.
- since demand for some goods will rise, firms affected by this increase will have to prepare to increase production. They may need to recruit more staff and increase their productive capacity. This may mean they need to expand the scale of their operations - moving to larger premises for example
- some businesses may decide that they can increase their prices if demand is growing fast. This will help to boost revenue and profits - particularly if demand is inelastic.

TAXATION

Governments can affect business decision making using **fiscal policy**. This involves changing **taxation** and **government expenditure** to influence the economy. Taxes vary from country to country but are paid by both businesses and individuals. The main taxes in the UK are shown in Table 2. Most countries have a range of taxes which are either the same, or very similar, to those in Table 2.

Direct taxes (taxes on income)	
Income tax	Paid on personal income and that from paid and self-employment
National Insurance contributions	Paid by businesses and individuals on employee's earnings
Corporation tax	Paid by companies based on how much profit they make
Capital gains tax	Paid on the capital gain (profit) made when selling an asset
Inheritance tax	Paid on money transferred to another individual, usually after death
Indirect taxes (taxes on spending)	
Value added tax (VAT)	Paid mainly when buying goods and services (except food)
Excise duties	Paid when buying certain goods such as petrol
Customs duties	Paid when buying certain goods from abroad
Council tax	Paid by residents to the council to help fund local services
Business rates	Paid by businesses to the council to help fund local services

▲ Table 2 The main taxes in the UK

THE EFFECT ON BUSINESSES OF CHANGES IN TAXATION

How might changes in taxation affect businesses?

Consumer spending: Changes in certain types of taxation are likely to increase the income consumers have left after tax. These include reductions in income tax rates, increases in personal allowances and an increase in the limits on which inheritance tax is paid or a reduction in the rate of inheritance tax. If consumers have more income left they might increase spending on the products of businesses.

Prices: An increase in VAT or excise duty will raise the costs of a business. Businesses often pass this on to customers by raising the price of goods. An increase in customs duty will increase the price of goods being imported into a country.

Business costs, revenue and profits: Increases in some taxes might raise the costs of business. For example, VAT will raise costs. A business might try to raise prices to cover this and maintain profit. However, higher prices can reduce sales and so profit could still be affected if revenue falls.

Business spending and investment: Increases in costs and reduced profits mean that businesses have less retained profit. This can affect the ability of the business to pay its debts, buy stocks and meet other expenses. It can also affect whether it invests in new factories or machinery.

Shares: Changes in capital gains tax and stamp duty might affect shareholding. For example, an increase in capital gains tax might discourage people from becoming shareholders or delay sales of shares.

Importing and exporting: Increases in customs duties can affect businesses. However, domestic businesses buying imported supplies would have to pay higher prices.

Business operations and employees: Increases in National Insurance contributions of employers might discourage employers from recruiting extra workers. Changes in taxation on company cars or allowances for staff using their own vehicles for work purposes might also change how a business offers these benefits to employees.

Other effects: Certain types of business might be affected by changes in tax. For example, an increase in landfill tax might encourage businesses to recycle. A rise in passenger duty could discourage holidaymakers and reduce the demand for holidays.

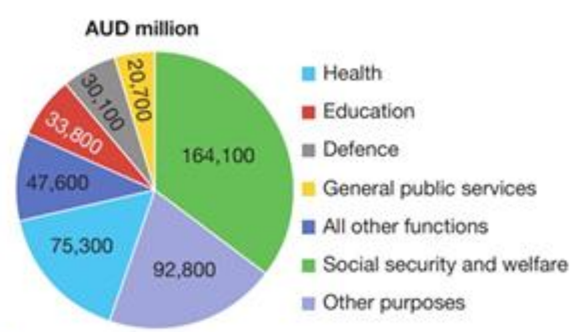
Tax avoidance and evasion: Increases in taxation often lead businesses to try to avoid paying the tax. For example, they might not hire workers to avoid higher National Insurance contributions or switch from buying imports to avoid customs duties.

HOW MIGHT BUSINESSES RESPOND TO CHANGES IN TAXATION?

Businesses will prefer lower taxes to higher taxes. If taxation in general is increased there is likely to be a fall in demand and businesses might respond defensively. If business taxes are increased businesses might take action to avoid taxes. For example, if there is an increase in the rate of corporation tax businesses might decide to relocate their operations in a country where corporation taxes are lower. The difference in corporation tax rates around the world is significant.

GOVERNMENT EXPENDITURE

The government is responsible for spending in the public sector. It provides a range of services, such as education, defence, welfare benefits, transport and healthcare. In Australia, the government planned to spend AUD 464.4 billion in 2017/18. Figure 4 shows the categories of planned expenditure.



▲ Figure 4 Planned government spending in Australia, 2017/18

THE EFFECT OF CHANGES IN GOVERNMENT EXPENDITURE ON BUSINESSES

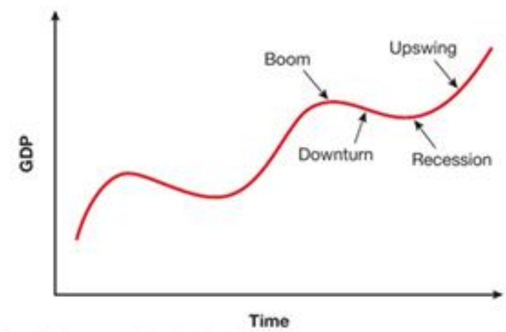
Levels of government expenditure can influence business activity. If the government increases spending to more than it raises in taxes, total spending in the economy will rise. The exact impact of such a measure is complex. Although many businesses may benefit from higher spending levels in the economy, too much spending can lead to other problems, such as inflation and higher interest rates. spending is discussed below.

HOW MIGHT BUSINESSES RESPOND TO CHANGES IN GOVERNMENT EXPENDITURE?

Higher government expenditure generally benefits businesses by increasing demand in the economy, leading to increased production and expansion. Conversely, lower government expenditure can have the opposite effect. Some businesses, such as renewable energy and construction companies, may benefit more from changes in government spending patterns. However, excessive public sector spending may reduce private sector development, as it attracts more resources, making it harder for businesses to invest and expand.

THE BUSINESS CYCLE

Over a period of time **gross domestic product (GDP**) (output in the economy) is expected to grow. However, the rate of growth is rarely smooth; there are likely to be some fluctuations. It is also possible for GDP to fall. These fluctuations are often referred to as the **economic, trade or business cycle**. Figure 5 shows these fluctuations and identifies four different phases in the cycle.



▲ Figure 5 The economic, trade or business cycle

Boom: The peak of the cycle is called a boom. During a boom GDP is growing fast because the economy is performing well. Existing firms will be expanding and new firms will be entering the market.

Downturn: A boom will be followed by a **downturn**. The economy is still growing, but at a slower rate. Demand for goods and services will flatten out or begin to fall, unemployment will start to rise and wage increases will slow down. Many firms will stop expanding, profits may fall and some firms will leave the market. Prices will rise more slowly.

Recession or depression: At the bottom of the business cycle GDP may be flat. If GDP starts to fall, the bottom of the cycle may be referred to as a **slump or depression**. Such a period is often associated with hardship. Demand will start to fall for many goods and services - particularly non-essentials. Unemployment rises sharply, business confidence is very low, bankruptcies rise and prices become flat. The prices of some things may even fall. A less severe version of a depression is a **recession**.

Recovery or upswing: When GDP starts to rise again there is a **recovery or upswing** in the economy. Businesses and consumers regain their confidence and economic activity is on the increase. Demand starts to rise, unemployment begins to fall and prices start to rise again.

HOW MIGHT BUSINESSES RESPOND TO THE DIFFERENT PHASES IN THE BUSINESS CYCLE?

During a boom, business owners are confident and seek opportunities to expand and increase profitability. They invest in product development, diversify, and hire more staff. After a boom, businesses become more cautious, seeking ways to cut costs and tighten operations. In a recession or depression, businesses may lack confidence and scale back operations, often laying off staff or downsizing resources. During recovery, businesses and consumers feel more confident, with unemployment falling and demand rising, stimulating business activity and encouraging owners to take a "longer view" and invest more.

SUBJECT VOCABULARY

appreciated (of a currency) a rise in the value of a currency.
boom the peak of the economic cycle where GDP is growing at its fastest.
consumer price index (CPI) a common measure of price changes used in many countries.
depreciated (of a currency) a fall in the value of a currency.
downturn a period in the economic cycle where GDP grows, but more slowly.
economic, trade or business cycle regular fluctuations in the level of output in the economy.
exchange rate the price of one currency in terms of another.
fiscal policy using changes in taxation and government expenditure to manage the economy.
government expenditure the amount spent by the government in its provision of public services.
gross domestic product (GDP) a common measure of national income, output or employment.
index linked the linking of certain payments, such as benefits, to the rate of inflation.
inflation a general rise in prices.
monetary policy using changes in the interest rate and money supply to manage the economy.
recession a less severe form of depression.
recovery or upswing a period where economic growth begins to increase again after a recession.
slump or depression the bottom of the economic cycle where GDP starts to fall with significant increases in unemployment.
taxation the charges made by government on the activities, earnings and income of businesses and individuals.

Chapter 42 – Legislation

THE NEED FOR LEGISLATION IN BUSINESS

Without legislation it is possible that some businesses could neglect the needs of certain stakeholders.

It is important for the government to find the 'right balance'. Too much legislation will discourage enterprise and foreign investment. This might reduce growth in national income, reduce job creation, decrease tax revenues and reduce consumer choice. Too little, and some stakeholders' best interests might be neglected.

▲ Figure 1 Consumer issues affected by legislation

CONSUMER PROTECTION

Consumers want to buy good-quality products at fair prices and receive good customer service. They also want clear and accurate information about products. They do not want to buy goods that may be dangerous, overpriced or sold to them on false grounds. Without government legislation some firms would exploit consumers. Some of the consumer issues affected by government legislation are summarised in Figure 1.

HOW DOES CONSUMER LEGISLATION AFFECT BUSINESSES?

The increase in the number of consumer laws and the concern about protecting consumers has a number of possible implications for firms.

Increases in costs: Improving the safety of a product or ensuring that measuring equipment is more accurate can increase the costs of a firm. For example, an electrical firm producing table lamps may find that its product failed to comply with legislation. The firm would have to change or improve the components used to make the lamps or redesign the lamp itself. Such changes would be likely to raise the firm's costs.

Quality control: Many firms have needed to improve their quality control procedures as a result of legislation. For example, firms involved in bagging or packaging goods must ensure that the correct quantities are weighed out. Failure to do so could result in legal action against the business. In addition, businesses must be careful not to sell substandard or damaged products.

Dealing with customer complaints: Many businesses now have a customer service or customer complaints department to deal with customers. These allow firms to deal with problems quickly and efficiently, and to deal with any problems before the customer turns to the legal system.

Changes in business practice: Attempts to ensure that customers are treated fairly by a business may place pressure on it to become more market orientated. The firm would attempt to ensure that it is actually meeting the needs of those people it is attempting to serve. Such a change, for example, may lead to greater use of market research.

EMPLOYEE PROTECTION

In many countries, employers have a responsibility towards their employees, but legislation is necessary to ensure that minimum standards are applied. Without legislative protection some businesses could exploit their workers.

Employment contract: Workers are entitled to a contract of employment. This is a legal agreement between the employer and the employee. It is likely to contain details including the start date, term of employment, job title and duties, place and hours of work, pay and holiday entitlement, pension and sickness absence, termination conditions (saying how the contract can be ended) and details relating to disciplinary, dismissal and grievance procedures.

Discrimination: Businesses have to make a choice when recruiting staff or selecting employees for promotion or training. Businesses will evaluate candidates in order to choose which one to employ or promote. It is usual to choose the person that is most experienced or better qualified; this is legal discrimination. However, it is illegal in most countries to discriminate on grounds of gender, race, disability, sexual orientation or age. This is unfair discrimination.

Unfair dismissal: The UK Employment Relations Act 1999 states that employees who have worked for an employer for a year have the right not to be unfairly dismissed. Employees may have grounds to claim unfair dismissal if they were dismissed because they:

- were trying to join a trade union
- became pregnant
- refused to work on a Sunday
- were made redundant without a proper procedure.

Employees can be dismissed fairly if they are incapable of doing their job, found guilty of misconduct (wrongful or illegal actions), become ineligible to work (drivers losing their driving licence, for example), are made redundant or for any other substantial reason, such as giving false details on an application form. However, if employees feel that they have been unfairly dismissed in some countries they can take their case to an **employment tribunal**.

Equal pay: Historically, in many countries women have not received the same pay as men in lots of professions and occupations. To address this issue in the UK the government introduced the Equal Pay Act 1970. This stated that an employee (whatever their gender) doing the same or 'broadly similar' work as a member of staff of the opposite sex is entitled to equal rates of pay and conditions.

HOW DOES EMPLOYMENT LEGISLATION AFFECT BUSINESSES?

Businesses often complain about the burden of employment legislation. Many say that the legislation discourages them from taking on staff. Some of the negative effects of employment legislation are outlined below.

Compliance costs: The expenses incurred by a business in meeting the requirements of employment and related legislation can be significant.

• When taking on a new employee a business must check that the person is entitled to work in that particular country.

• Employers are responsible for the well-being of employees at work. They must take out the necessary insurance policies and guard against discrimination or harassment. They may also have to deal with matters such as health and safety, discipline and grievances, discrimination in the workplace, bullying, annual leave and redundancy.

• Businesses must also deal with the tax authorities.

Higher labour costs: Some employment legislation has resulted in certain businesses having to meet higher labour costs. For example, in many countries there is a national minimum wage. This is designed to boost the earnings of very low-paid workers taking some people out of poverty.

Changing working practices: In many countries, as a business employs more people it will have to introduce systems to deal with compliance and human resource management. It will also have to ensure that job advertisements do not discriminate on the basis of gender or whether or not candidates are married. For example, job titles should be gender neutral, as in 'fire fighter' or 'salesperson'. There will be a greater need for job descriptions and person specifications.

Loss of flexibility: Some businesses argue that sections of the legislation make it more difficult to run a business because the laws are too inflexible. For example, in the EU employees can ask for flexible working arrangements that suit them if they have worked continuously for 26 weeks or if they have a child under the age of 6 (or a disabled child under the age of 18). Reasons for refusing an employee flexible working must be set out in writing and be legally justified.

Penalties: If businesses fail to comply with the laws outlined above there may be penalties. For example, fines can be imposed, and the image or reputation of a business might be damaged. Businesses might also be forced to backdate claims from employees where 'wrongdoing' is proven. This can be very expensive. For example, an employee may receive all the lost pay resulting from unfair dismissal.

Positive effects: Employment legislation can also have a positive effect on businesses. Complying with employment legislation is also likely to improve worker motivation and employee welfare, which will help raise productivity, reduce levels of staff absence and cut staff turnover. It might also help to create a more positive and friendly culture within organisations. This can improve the image of businesses and make it easier to recruit and retain high-quality staff.

ENVIRONMENTAL PROTECTION

Without regulation, business activity can have a negative effect on the environment. For example, governments are becoming concerned about global warming and resulting changes in weather patterns and climates. The emissions from cars and aircraft also add to global warming. Some specific problems include the following.

- Pollution. There are different types of pollution. Water pollution may be caused by businesses dumping waste into rivers, streams, canals, lakes and the sea. An example would be warm water or chemicals being leaked into rivers.

- Destruction of wildlife habitats. Some business development destroys wildlife habitats and spoils the natural environment.

- Traffic congestion. Extra traffic caused by commercial vehicles or workers travelling to and from work can cause congestion resulting in delays and accidents. For example, in one Indian city, Bangalore, traffic congestion costs about 5 per cent of its economic output.

- Resource depletion. Non-renewable resources, such as oil, coal, gas and minerals, cannot be replaced. Therefore, as business development accelerates these resources are depleted. Once they have run out, future generations will have to do without. High-quality soil, which is needed to grow food, is also being lost. The condition of around 40 per cent of the world's agricultural land has significantly declined.

One approach used by many governments to minimise the damage done by businesses to the environment is to pass new laws. Much of the pressure for environmental legislation has emerged due to the growing concerns about global warming. If businesses fail to comply with environmental laws they may be fined or forced to close until the problem is resolved. Examples of environmental legislation are shown in Table 2 at the end of the chapter.

HOW DOES ENVIRONMENTAL LEGISLATION AFFECT BUSINESSES?

Environmental issues offer both threats and opportunities to businesses. Businesses which may benefit the most from growing environmental regulation are those selling pro-environmental and anti-pollution products. These businesses range from engineering companies selling equipment designed to reduce emissions, to service companies which advise other businesses on how they can comply with regulations, to businesses selling environmentally friendly products, such as managed wood.

Marketing: Environmental issues can be a highly effective marketing tool for some businesses. Many businesses claim on their packaging to be environmentally friendly in some way. However, some businesses have found that environmental issues pose a marketing threat.

Finance: In some cases, responding to environmental concerns or new laws and regulations can have a positive financial impact on a business. Energy-saving measures, for example, can lead to a business having lower costs than before because of previous inefficiencies. In most cases, though, taking environmental action is likely to lead to higher costs. If all businesses in the industry also face these higher costs, prices are likely to rise to reflect the higher costs.

Operations management: Pollution controls and other environmental measures could have an impact on how a product is made. This could range from changes in the type of materials used, to production methods, to storage and after-sales service.

Human resources: Environmental concerns and policies have human resource implications. Staff will need to be recruited and trained to deal with ever increasing government regulations concerning the environment. Some businesses may choose to outsource the guidance they need. Larger businesses are likely to put environmental policies in place.

COMPETITION POLICY

There is a need to monitor the activities of monopolies and markets that are dominated by a small number of large businesses. Without government regulation some businesses would exploit consumers by using anti-competitive or restrictive practices to reduce competition in the market. Such practices might include the following.

• Increasing prices. Raising prices to levels above what they would be in a competitive market. For example, some manufacturers supply goods to

retailers and insist that they are retailed at a fixed price.

• Restricting consumer choice. A manufacturer of a strong brand might refuse to supply a retailer if that retailer stocks rival products. This will reduce choice for the consumer.

• Raising barriers to entry. By spending huge amounts of money on advertising, for example, a dominant firm can squeeze others out of the market. It might also lower its price for a temporary period. This would make it difficult for a new business to get established in the market.

• Market sharing. This might occur if there is collusion. When a market is shared out between the dominant firms, choice is restricted and prices rise.

In the UK, the Competition and Markets Authority (CMA) is responsible for serving the interests of consumers and protecting them from restrictive practices. This body was formed in 2014 and replaced the Office of Fair Trading (OFT) and the Competition Commission. Its responsibilities are summarised in Table 1.

HOW DOES COMPETITION POLICY AFFECT BUSINESSES?

It might be argued that competition policy will have both a positive and a negative impact on businesses.

Positive: Businesses might get frustrated if their restrictive practices are judged to be illegal and they are forced to comply with the law. This is because such practices are often very highly profitable. However, since competition policy is designed to promote competition, many firms will actually benefit from it. For example, if dominant firms construct barriers to entry, this will make it very difficult for smaller firms to break into the market. Thus, if such barriers are made illegal then it is easier for new firms to break into the market. This will give opportunities to more businesses.

Negative: Some businesses might argue that competition policy restricts their activities. For example, if a proposed merger or takeover is investigated by the CMA, this might slow down the whole process. This could cause delays and cost the businesses involved a lot of money. In 2014, a proposed merger between soft drinks companies Britvic and AG Barr was investigated by the authorities. The decision was delayed for about 4 months.

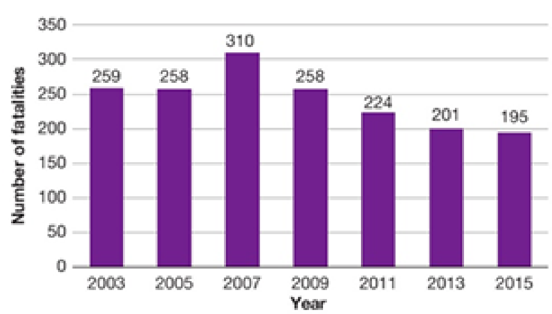
HEALTH AND SAFETY

Figure 2 shows that work can be a dangerous environment. Although the graph shows that fatalities at work in Australia have fallen during the period shown, people are still being killed at work in large numbers.

to protect workers by passing legislation that forces businesses to provide a safe and healthy workplace. This might involve:

- providing and maintaining adequate safety equipment and protective clothing, such as fire extinguishers, aprons, hard hats, ear plugs and safety goggles
- ensuring workers have enough space to do their jobs
- guaranteeing a hygienic environment with adequate toilet and washing facilities
- maintaining workplace temperatures and reasonable noise levels
- providing protection from hazardous substances
- providing protection from violence, bullying, threats and stress in the workplace
- providing adequate breaks for rest.

In most countries around the world, there are numerous laws designed to protect people at work. There are also many regulations concerning health and safety at work that are regularly updated. follow codes of practice designed to protect workers. Some examples of health and safety legislation are given in Table 2.



▲ Figure 2 Fatalities at work in Australia, 2007–15

• Investigating mergers which could restrict competition
• Conducting market studies and investigations in markets where there may be competition and consumer problems
• Investigating where UK or EU laws against anti-competitive agreements and abuses of dominant positions may have been be broken
• Bringing legal action against individuals who commit the cartel offence
• Enforcing consumer protection legislation to tackle practices and market conditions that make it difficult for consumers to exercise choice
• Co-operating with sector regulators and encouraging them to use their competition powers
• Considering regulatory references and appeals

▲ Table 1 Responsibilities of the Competition and Markets Authority for protecting consumers from restrictive practices

Source: www.gov.uk

Legislation	Date	Brief description and example
Sale of Goods Act (Consumer legislation)	1979	Products must be undamaged, usable and fit for purpose Example: a garment sold as 'waterproof' must not let in the rain
Food Safety Act (Consumer legislation)	1990	Food should be fit for human consumption and comply with safety standards Example: food should not be sold if decaying
Equal Pay Act (Employment legislation)	1970	Pay and conditions must be the same for all people doing the same or 'broadly similar' work Example: male and female bus drivers must be paid the same rates
National Minimum Wage Act (Employment legislation)	1998	It is illegal to pay a worker a wage rate below the set minimum wage rate Example: in 2014 a wage of £6.00 per hour would be illegal (£6.50 was the minimum wage)
Environment Act (Environmental legislation)	1995	Set up the Environment Agency to monitor and control pollution Example: it is unlawful to release emissions into the air (above certain levels)
Environmental Protection Act (Environmental legislation)	1990	Controls pollution caused by the disposal of waste into land, water and air Example: an unlicensed carrier of waste can be fined
Competition Act (Competition policy)	1998	Prohibits agreements, cartels or practices that restrict or prevent competition Example: it is illegal for a group of businesses to charge an agreed price
Enterprise Act (Competition policy)	2002	Established the Office of Fair Trading (OFT)* as an independent body Example: the OFT can refer investigations to the Competition Commission**
Health and Safety at Work Act (Health and safety)	1974	Aimed to raise the standard of health and safety at work Example: employers must provide a written statement of policy on health and safety
Working Time Regulations Act (Health and safety)	1998	Clarifies hours of work and break entitlements for workers Example: 48 hours is the maximum working week

▲ Table 2 Examples of UK legislation directed at businesses

* The Office of Fair Trading was replaced by the Competition and Market Authority in 2014
** The Competition Commission was replaced by the Competition and Market Authority in 2014

HOW DOES HEALTH AND SAFETY LEGISLATION AFFECT BUSINESSES?

The Health and Safety at Work Act 1974 requires businesses to prepare a written statement of their general policy on health and safety. Businesses also have to give training, information, instruction and supervision to ensure the health and safety of workers. Finally, health and safety inspectors have the right to enter business premises to ensure that health and safety measures are being carried out by businesses.

Penalties: Failure to comply with the law can be serious. At worst, employees' safety might be compromised, which could lead to accidents - in some cases fatal. Businesses can also be fined if they fail to comply with legislation.

Benefits: Although complying with health and safety legislation imposes costs on businesses, there are some considerable benefits that result from it. For example, a good health and safety record will help to improve the image of a business. This will make it easier to attract and retain high-quality staff - especially in industries with 'hostile' working conditions where health and safety issues are of the utmost importance.

INTELLECTUAL PROPERTY RIGHTS

In many industries protection is required for the creation of new products, technology and other original work such as a piece of music. Therefore, legislation is needed to ensure that inventors, writers, developers and other creators are not exploited. Technically, intellectual property is something unique that is physically created. Intellectual property can be owned if:

- it is created (and it meets the requirements for copyright, a patent or a design)
- the intellectual property rights are purchased from the creator or a previous owner
- you have a brand that could be a trademark, e.g. a well-known product name.

Intellectual property can have more than one owner and belong to a person or a business. It can also be sold or transferred to another owner. If it is protected it will be easier to take legal action in the event of theft. Such protection may take several forms.

SUBJECT VOCABULARY

anti-competitive or restrictive practices attempts by firms to prevent or restrict competition.
collusion two (or more) businesses agreeing to a restrictive practice, such as price fixing.
contract of employment a written agreement between an employer and an employee in which each has certain obligations.
copyright a legal right that grants the creator of an original work exclusive rights for its use and distribution. Usually only for a limited time.
discrimination favouring one person over another. For example, in the EU it is unlawful to discriminate on grounds of race, gender, age and disability.
employment tribunal a court that deals with cases involving disputes between employers and employees.
intellectual property an idea, design, or artistic work which a person or organisation has invented or created and on which they have obtained a copyright, trademark or patent.
national minimum wage a wage rate set by the government below which it is illegal to pay people at work.
unfair dismissal the illegal dismissal of a worker by a business.

Automatic protection: With some types of creations such as writing and literary works, art, photography, films, television, music, web content and sound recordings, protection is automatic. This means that the creator is automatically entitled to copyright protection. Copyright protects the creator's work and stops others from using it without their permission. There is no register of copyright and it is not necessary to make an application or pay a fee. The protection is completely

Applying for protection: For some types of intellectual property, such as patents or trademarks, it is necessary to apply for protection. For trademarks, such as the name of a product or any other words, sounds, logos, music or any combination of these, it is necessary to check first to see whether a trademark already exists. There is likely to be a trademark database that will help in the search process. Provided the trademark is unique owners can then follow the registration process. Once a trademark has been registered owners can take legal action against anyone who uses the trademark without permission.

HOW DO INTELLECTUAL PROPERTY RIGHTS AFFECT BUSINESS?

If businesses and people can protect their original work from theft, creativity is likely to be encouraged. In the wider economy everyone benefits from the work done by businesses to develop new products and new technology because they can enjoy more choice and lower prices. Also, the quality of life is improved if there are more books, films, music and other works of art. Therefore, the protection of intellectual rights has a positive impact.

Chapter 42 – The Competitive environment

THE COMPETITIVE ENVIRONMENT

The competitive environment is a significant external factor for businesses, with markets like the European clothes market being highly competitive. With thousands of businesses competing to sell a wide range of clothes, independent stores cater to specific niches, and supermarkets expanding their clothing offerings. The last 10-20 years have seen increased competition due to online sellers, including Amazon and Alibaba, who sell solely from websites.

	Operator	Turnover (€ million)	Stores	Base
1	H&M	15,900	2876	Sweden
2	Inditex	13,000*	4989	Spain
3	M&S	11,600	1109	UK
4	C&A	7200*	1579	BE/DE
5	Primark	6700	330	UK
6	Next	4900*	649	UK
7	Arcadia	2500*	2700*	UK
8	Debenhams	1900*	204	UK
9	Esprit	1300	290	Germany
10	Benetton	1000*	2600*	Italy

▲ Table 1 Top ten fashion/clothes retailers in Europe, 2016
*Estimated

EFFECTS ON BUSINESSES OF COMPETITION

Operating in a competitive market is likely to have a number of implications for a business. The impact on businesses might be influenced by the numbers of competitors, the size of competitors or their behaviour.

Numbers: The number of rivals in a market significantly impacts competition. Global markets have more rivals due to globalisation, but even small firms can access global markets. National markets have fewer rivals, regional markets have smaller numbers, and local markets have smaller numbers. Generally, competition intensifies as the number of rivals grows, impacting businesses in various ways. For example, in rural areas, only one shop may serve a market, but this does not mean they lack competition.

• **Price**. In a highly competitive market, where there are large numbers of competitors, businesses have less control over the prices they charge. Prices are likely to be forced down. A business that charges a price that is significantly higher than those of its rivals risks losing sales. This is because consumers can switch easily from one supplier to another.

• **Profit**. The profit available in a highly competitive market has to be shared between a greater number of contestants. Profit margins are likely to be squeezed because prices will be forced down. However, businesses that can operate more efficiently and reduce their costs may be able to enjoy higher profits than rivals that operate with a higher cost base.

• **Communication with customers**. Businesses will be under pressure to meet customer needs. Those businesses that meet customer needs effectively are more likely to survive in the market. This competitive pressure may mean that businesses make more of an effort to communicate with their customers. They may carry out more market research for example. They may also use social media to keep in touch with consumer sentiment.

• **Innovation**. In highly competitive markets innovation will be encouraged. This is because if a business can design new products, they may be of more interest to consumers and allow a business to gain a competitive edge in the market. The development of a USP can go a long way to aid survival in a competitive market. Many people prefer to buy products that are differentiated from those of rivals

Size: The size of rivals can have an important influence on the level of competition in a market. Running business in the shadow of a large multinational is clearly going to be challenging. Large businesses can be very powerful. They can exploit economies of scale and lower their costs. They have the resources to recruit the best staff in the world, take risks, dominate suppliers and other stakeholders, change prices in markets and influence political decision making. They can take on large-scale contracts that smaller rivals could not hope to manage.

Generally, smaller rivals pose less of a threat in business than larger ones. The size of competitors though can have a number of effects on a business.

• **Price**. In markets that are dominated by large rivals, smaller businesses have little control over price. In many markets dominated by large firms, the strongest, or the lowest-cost producers, will tend to set the price. Other firms in the market are often happy to copy these prices. However, if a business is able to differentiate its product, there may be scope for higher prices.

• **Profit**. Larger firms will tend to enjoy both higher levels of profits and higher profit margins. Smaller firms may not be able to exploit economies of scale so their costs will be higher and their margins lower. Also, the level of profits made by smaller firms in the market will be lower. This is because they will have a much smaller share of the market compared to their much larger rivals.

• **Communication with customers**. In some respects smaller firms can communicate more effectively with customers than their larger rivals. This might be because smaller organisations are likely to be more personal and much closer to their customers. In contrast, very large companies often encounter problems communicating with customers.

• **Innovation**. It could be argued that large businesses pose a threat to their smaller rivals in the development of new products and technology. This is because they have more resources.

Behaviour: Businesses are likely to be directly affected by the behaviour of their rivals. In a competitive environment businesses will try to develop strategies to 'outcompete' their rivals. They might use a wide range of tactics to win a larger market share at the expense of their business opponents. Some key examples are outlined below.

• Pricing. One way a business will be affected by the behaviour of a competitor is when they change prices. Most consumers are sensitive to price changes and will buy the cheapest products on the market (assuming that quality is the same).

• Marketing. Businesses usually monitor the marketing activities of rivals such as the methods of promotion and advertising they use. If a rival introduces a new and effective promotional strategy, or places an imaginative advert on television, for example, this might boost their sales and market share. This will affect the sales of others in the market and is likely to illicit a response from them.

• Product differentiation. If possible many businesses will try to differentiate their products from those of rivals. If they can do this effectively they may hold a more prominent position in the market and charge a higher price. Once a business has 'broken away from the pack' this puts pressure on rivals to make their own attempts at product differentiation. If they are not able to do so they are likely to lose market share.

• Product development. If competitors develop improved versions of their products, or launch brand new products, businesses can be negatively affected. New and improved products are often very attractive to consumers and businesses risk losing market share if they fail to innovate.

• Collusion. In a minority of industries a number of firms might work together and behave like a monopoly. They might form a cartel and fix prices or share out the market. This behaviour can have a very damaging effect on the remaining firms in the industry. It is very difficult to compete with a monopolist because of the power they have over the market.

• Barriers to entry. In some markets, it is easy for a new business to set up.

WAYS FOR A SMALL FIRM TO COMPETE IN A COMPETITIVE MARKET

Most firms in many countries are small. The number of small firms, along with self-employment, has also grown in the last 30 years. Also, in some cases it might be argued that small firms can have advantages over their larger rivals. Some of the ways in which small firms can compete in a competitive market are outlined below

Develop a market niche: A niche market is a small market segment - a segment which has sometimes gone 'untouched' by larger businesses. Niche marketing involves selling to a small customer group, sometimes with specific needs. Small firms can often survive in a competitive market by supplying a niche. They may also avoid competition. It is also a lot easier to focus on the needs of the customer in a niche market. Also, if there is no competition it may also be possible to charge premium prices.

Flexibility: Small firms can adapt to change more quickly. This is because the owners, who tend to be the main decision makers, are actively involved in the business and can react to change.

Personal service: As firms get bigger it often becomes difficult to offer customers an individual personal service.

Lower wages: Many workers in small firms do not belong to trade unions. As a result their negotiating power is weaker and the owners are often able to restrict wages to the legal minimum wage. Also, employees in small businesses may have lower expectations for their earnings. This might be because employees appreciate that the owner has limited resources due to the size of the business.

Better communication: Since small firms have fewer employees, communication tends to be informal and more rapid than in larger organisations. The owner will be in close contact with all staff and can exchange information rapidly. As a result decision making will be faster and workers may be better motivated.

Innovation: Although small firms often lack resources for research and development, they may be surprisingly innovative. One reason for this is because small firms face competitive pressure to innovate. For example, if they fail to come up with new ideas for products they will lose their market share. It may also be because small firms are more prepared to take a risk. Perhaps they have less to lose than large firms.

Revision questions