



Introduction: 'business' and its 'environment'

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Learning objectives

When you have completed this chapter you will be able to:

- Recognize different uses of the term **business**, and understand the different forms of business in terms of, for example, private, public and not-for-profit organizations
- Describe the complexity of the **external environment** in which business operates and explain the idea of **environmental uniqueness**
- Understand the nature of the 'internal' environment of business
- Understand how businesses must respond to changing environmental factors in order to operate successfully, but also how they seek to influence the environment
- Use analysis tools such as PEST or SWOT to examine the business environment
- Understand the approach to the business environment of this book and how to use it in your studies

The approach of this book— themes and issues

Eight key themes that will help you to understand and analyse the business environment run through this book. You will encounter these themes in this introduction and in each of the subsequent chapters as you examine a range of issues in the business environment. The themes will be signposted by the use of markers in the margin:

Diversity of business: business is a diverse category

Internal/external: the environment is both inside and outside organizations

Complexity of the environment: the external environment is multi-dimensional or complex

Variety of spatial levels: from the local to the global

Dynamic environment: the environment of business does not stand still

Interaction between business and the environment: there is interaction between business organizations and their environments

Stakeholders: individuals and groups that are affected by business decisions

Values: business decisions involve ethical questions

The themes are ways of conceptualizing business and the environment in which it operates. You will master these themes increasingly as you work through the book, but it is useful to begin with a brief introduction to each one.

Diversity

- Business is a diverse category. It does not refer only to **private sector**, profit-making companies. Public and voluntary sector organizations may also be regarded as businesses. The boundaries between these sectors are contested and shift over time, for example as a result of the policy of **privatization** initiated by Conservative governments in the UK in the 1980s. Within the dominant private sector, businesses vary in a number of ways, such as legal structure, industry, size and **market** power, and geographical reach. This diversity also means that, although there are common elements in the business environment, each business operates in an environment that is, to some extent, unique.

- This book mainly deals with the external environment, the surrounding conditions and processes in the world outside the organization. However it is useful to think of the environment as also having an internal dimension. This is because a business organization is not really a single, unified entity but is internally differentiated. In other words, it is a complex system. Managers within business, to be effective, have to deal with this **internal environment** as well as the external one. In addition, the ability of an organization to operate successfully within its external environment depends, in large part, on the effectiveness of internal systems and procedures. The internal environment has to be managed and adapted to the demands and opportunities of the external environment.
- We might think of the external environment primarily in terms of economic conditions and trends, to do with the behaviour of competitors and customers. The economy is, of course, of major importance. However, a moment's thought makes it clear that the external environment in which business operates is more complex and needs to be analysed also in terms of its political-legal, social-cultural, and technological aspects. These aspects are interrelated, as we can see if we think of the role that political decisions made in government have in shaping the economic environment. We will also see that many issues facing business have economic, social, political and technological aspects.
- **Spatial level** refers to the geographical or territorial unit of analysis that we use to conceptualize the business environment. As citizens we live within the territory of a nation-state, such as the UK, and we tend to think of our identities at least partly in terms of nationality. Similarly the business environment tends to be discussed primarily at national level. For example, in the media we come across references to British business, the British economy, British society and the British government. However sometimes it is more appropriate to think of business and its environment at a more local level, perhaps in terms of an urban area or region. On the other hand it has become increasingly important to think of business and the environment on a much larger spatial level, such as European or global. There is much debate about the nature, extent and implications of globalization. Globalization refers, roughly, to the tendency of business and other economic, social and political processes and relationships to move across or beyond the borders of nation-states. One of the most important manifestations of this is the growth of multinational businesses.
- We live in a fast-changing world, especially in the advanced or rich societies such as in western Europe. We have come to expect that the society in which we live and the way we live our lives will change over time, even within fairly short periods. This can be seen most clearly in relation to technological innovation and its impact in all areas of our lives. Equally, the environment of business is dynamic. Because of this businesses have to respond and adapt to changes in their environment, and deal with uncertainty about the future. But, at the same time, business organizations are powerful agents of change. This can be seen very clearly from the example of technological innovation which is driven largely by business. Indeed the dynamism of western societies is deeply rooted in basic features of their market economies—competition and the **profit** motive. This is often discussed in terms of entrepreneurial behaviour, which involves risk-taking and innovation, rather than relying on tried and tested approaches. Competitive markets place emphasis on innovation as the means of keeping up or getting ahead.
- There is two-way interaction between business organizations and their environment. Businesses influence and are influenced by their environments. Business organizations are not passive but seek to shape environmental factors to their own advantage. For example, business is an important actor in the political arena.
- Business decisions have to be made in a context of multiple stakeholder interests and demands. A stakeholder is any individual or group that is affected by, and thus has a stake in, business decisions. More than before business has to work to retain public trust.
- There are competing perspectives and values concerning the nature and purpose of business in society—relating to its power, responsibilities, performance and ethics. These are not just

*Internal/
external**Complexity**Spatial levels**Dynamic**Interaction**Stakeholders**Values*

debates that take place in universities on degree courses, but are part of everyday political discussion and dialogue in which business must engage.

What is business?

This is a book about the ‘business environment’. The purpose of this introduction is to help you to get to grips with what the business environment is, why it is important to study and understand it, and the particular approach taken in this book. In simple terms, the importance of studying the business environment is that all businesses operate in a changing and, in some ways, unique environment that is the source of both threats and opportunities. Business decisions are concerned with operating successfully in this environment by countering threats and exploiting opportunities. For example, businesses may have to respond to changing market conditions affecting the demand for their products, the behaviour of competitors, or changes in government policy. We begin by looking more closely at the meaning of the two words in the title: ‘business’ and ‘environment’. What do we mean by business, and how might we think about the environment in which it operates?

Business and the problem of scarcity

One way to think about the meaning of business is in terms of what economists call the **basic economic problem** that, it can be argued, confronts all societies, rich and poor. This is a problem of scarcity, which means that there is ‘not enough to go round’. (This problem will be discussed in more detail in Chapter 2.) We are all used to the problem of scarcity in our daily lives as individuals or households, in not having enough money to do (or buy) all that we would like to and therefore having to make choices between alternative activities or forms of spending. The same problem faces society as a whole. In each case the problem is one of limited resources against the large, and even open-ended, set of wants, needs and goals that make demands on those resources. Scarcity creates the problem of how to allocate available resources of all kinds between competing wants which can’t all be satisfied at once. Business is a way of dealing with this problem.

Business can be defined in terms of the activity of production—the transformation of various inputs (or ‘factors of production’) into diverse outputs in the form of goods and services to meet particular wants or needs of people in society. This involves a series of activities and chain of relationships between a number of organizations, from the initial procurement or acquisition of the factors of production (raw materials, labour, machinery) to the supply of the finished good or service to a consumer, buyer or user.

Business is a mechanism for deciding the allocation of the resources available to society between various possible uses (or competing wants), the methods of production and the distribution of the output, in a situation of scarcity where not all wants can be satisfied.

We can add to this that businesses produce outputs for consumers (customers, users or clients) and in response to their requirements, wants or needs. For example a professional football club playing for an audience is a business whereas an amateur club, involved in the same activity, is not. Thus the relationship with consumers is an intrinsic aspect of business. This does not mean that the consumers have to be paying customers like those who go to watch Liverpool FC at Anfield, for they could be users of a public service for which there is no charge. The important point is that

businesses always produce goods and services for consumers of one kind or another, and that the success of the business is always bound up to some degree with consumers' requirements and expectations.

We commonly think of businesses in terms of companies, firms or enterprises in the private sector of the economy. This is a good place to start since the private sector dominates the economic and business life of societies like the UK. However, as we will see, business also takes place outside of the private sector.

Diversity

The private sector of business

The private sector is made up of business organizations that are owned and controlled as forms of private property. The largest businesses take the form of public limited companies (PLCs) which are owned by their shareholders. These shareholders can be private individuals, although a majority of shares is owned by financial institutions such as pension funds and insurance companies. Private sector businesses can take other legal forms, such as sole traders, partnerships and private limited companies (see Chapter 13). Private ownership is the thread connecting all these types. However, the private sector is characterized by further specific features:

- production of goods and services for sale
- the profit motive
- competition.

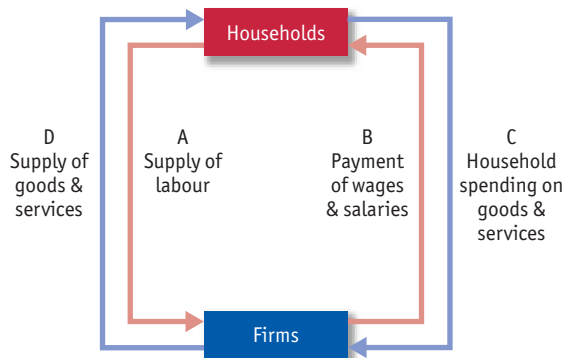
Private sector businesses produce goods and services for sale to customers in a context of competition with other firms in the market and with the prime purpose of making a profit. We will examine in more detail how markets operate in Chapter 2, but here we can see in a fairly simple way how private business in a market system is a specific way of 'solving' the basic economic problem.

Firms interact with households in a way that is depicted in Figure 1.1. Households act both as consumers and as suppliers of labour or employees. Firms purchase the inputs needed for production from households (here we assume for simplicity that labour is the only 'factor of production') and supply goods and services to them. The profit motive means that private businesses produce only those goods and services that households are willing and able to buy at prices that generate a profit for the business. Profit is the difference between the total costs incurred by the business in the production process and the total revenue generated by sales of the products.

The profit motive makes businesses highly responsive to consumer demand or customer-focused. They want to be customer-focused, since this is the best way to make a profit. But they also have to be, for if they produce goods or services that people do not want or at unattractive prices they will not stay in business very long. Competition means that businesses cannot easily get away with products that consumers are not satisfied with, since they can 'shop around'. Thus both profit and competition keep businesses customer-focused.

The level of consumption that households enjoy depends on their ability to pay, and this is determined by their income in the form of earnings from employment. This, in turn, depends on the prices that the skills and knowledge that household members possess command in the labour market (wages and salaries). A higher standard of living can be obtained through the possession of skills that are in short supply and hence command a premium in the labour market (see Chapter 5). Thus the composition of output and its distribution are 'solved' by the interaction of firms and households through the distribution of earnings from employment and the preferences of consumers in households with different income levels. Looked at in another way, businesses act as mediators between households who supply labour for production and share out the resulting goods and services.

Figure 1.1 The interaction between firms and households—the **circular flow of income**.



Notes: Households supply labour to firms (A) in return for payments of wages and salaries (B) (In this simple model labour is assumed to be the only input or 'factor of production'). Household income, derived from wages and salaries, finances spending on goods and services (C). Firms produce and supply goods and services to meet demand from households (D).

There is another dimension to add—deciding the methods of production. Profit provides a motive, and competition a pressure, for continual improvements in **efficiency**. This is because greater efficiency means lower costs of production and cheaper products. It is rational for profit-seeking firms to strive to improve efficiency to keep up with or get ahead of their rivals. Firms that fall behind in the efficiency race end up pricing themselves out of the market. It is this continual pressure to increase efficiency that is built in to the market through profit and competition that drives the process of **economic growth** and rising living standards.

➡ Stop and Think

Can you explain how profit and competition in the private sector of business 'solve' the components of the basic economic problem?

Can you identify any shortcomings in this solution?

This is a very simple model of how private business operates in the market to 'solve' the economic problem. However, we will see in Chapter 2 and in subsequent chapters that things are more complicated

and more controversial than is suggested here. There are strong disagreements about the advantages and disadvantages of the private sector model of business. These disagreements are an important element of the business environment. Let's try a taste of controversy.

The logic of the profit motive suggests that it doesn't really matter to business who the consumers are or what their wants are so long as a profit can be made. The customer is always right! This seems to be a good thing since businesses ought to treat everyone in the same way, and the market provides for a vast array of tastes. Yet, in practice, not everyone is treated in the same way and there are continuing problems of discrimination on grounds of race or sex in business (see Chapter 5). Of course this is not a problem that is specific to business, and it could be argued that business tends to reflect the values of the wider society of which it is part. Are there relatively few women in management positions because of discriminatory attitudes within business, or because of sexism within the wider society?

The idea that markets produce whatever customers want looks rather different when we consider the effort that goes into persuasive advertising. Businesses may be able to get away with producing goods and services that are of poor quality or even harmful. For example, food manufacturers and supermarkets have come in for criticism for producing and marketing unhealthy products, high in salt, fat and sugar, contributing to the obesity 'epidemic' (see Chapter 4). Gerald Ratner was forced to step down as chief executive of Ratners jewellery business in 1992 having described one of its products as 'total crap'. Although it is possible that this remark was meant as a joke, it seems to illustrate the point that private sector companies are not averse to selling products of dubious quality as long as they are profitable. Is it fair to criticize businesses for selling unhealthy foods or jewellery that isn't very good, or is it a reasonable defence to say that it is up to consumers what they buy? Are consumers really able to make these decisions for themselves, or are they manipulated by sophisticated marketing techniques?

➡ Stop and Think

Do you agree that the logic of the profit motive goes against discrimination?
Is the customer always right?

The private sector—on closer inspection

On closer inspection, common characteristics of the private sector of business—private ownership, competition and profit—are not as straightforward as they first appear.

Diversity

Free market vs. regulation?

Firms exist as legal entities, which means that they are defined by law, but the private ownership label covers businesses with different types of legal status. These include sole traders, partnerships, limited companies and cooperatives. The basic idea of private business is that firms are free to manage their own affairs and use their own resources as they choose. In this way private ownership of business may be likened to other forms of private property where the whole point of owning our own property is to use it as we please and for our own benefit or self-interest. In business terms this means that businesses should be managed in the interests of their owners, and this means making a profit. It might be added to this that businesses are best able to judge for themselves how to manage their affairs efficiently, and that by being left to do this there is benefit for the wider public through the resulting innovation and economic growth. However, in reality there is no such thing as a **free market** in the sense of businesses being left entirely free to make decisions for themselves. In all market systems the law is used extensively to regulate various aspects of business decisions and behaviour. As we will see in Chapter 4 the law is made and enforced by government and so constitutes a key element of the political environment of business.

One of the prime reasons for using the law to regulate business is recognition that a free market would have undesirable consequences for certain groups in society. Consumers and employees would be at a disadvantage in their dealings with business without various protections afforded by law. In other words, although business pursuing its self-interest produces substantial public benefit such as greater prosperity, there are many ways in which business self-interest and the public interest clash. For example, the Minimum Wage Act, requiring all businesses in the UK to pay a **minimum wage**, ensures that profit-seeking businesses facing competitive pressures do not harm vulnerable groups of employees by forcing wages down below a decent level. This means that although we refer to private ownership of business, decisions about managing those businesses are never purely private ones since they involve certain restrictions and obligations defined by law.

Of course, there are different views about how far the law should be used to regulate business, and the role of law varies both between different societies and between different governments within each market system. Chapter 13 will examine the difficulty of balancing the authority of the law with the freedom of business.

Values



Mini-Case 1.1 Guiding the 'hidden hand'—the minimum wage

The idea of the 'hidden hand' is a metaphor for the way the market system, though based on millions of independent decisions and not subject to overall plan or control by any actual hand, does not degenerate into chaos but operates in a highly coordinated way. It is as if a hidden hand is guiding it.

Adam Smith pointed out in the 18th century that even though businesses may be concerned only with their self-interest (profit) they would be guided, by and large, to serve the public good. This

seems like a paradox—promoting the common good by acting selfishly. Smith's insight was that it would only be by serving the needs of others (customers) that businesses would be able to make a profit. When businesses throughout the economy act in this way the result is that the supply of goods and services matches consumer demand.

The hidden hand of the market operates through the price mechanism. The price adjusts until balance is achieved between

supply and demand. For example if supply exceeds demand the price will tend to fall, and vice versa.

However, the hidden hand can produce outcomes that are not socially desirable. In a market system profit-seeking businesses respond to ability to pay—it is not their purpose to act like charities. The problem is that the price determined by the hidden hand might be one that not everyone can afford to pay because of differences in levels of household income. Perhaps it doesn't matter that not everyone can afford a BMW, but it is more serious if some people cannot afford healthcare when they need it.

In labour markets price is the wage or salary that people receive for the jobs they perform. In this case the problem is that for some low paid occupations this price might not be sufficient to enable people to have a decent standard of life.

One solution to this problem is to use the law to guide the hidden hand through price controls. The Labour government introduced a National Minimum Wage (NMW) in 1999. The Department for Trade and Industry explains the rationale of the NMW as follows:

The national minimum wage is an important cornerstone of government strategy aimed at providing employees with decent minimum standards and fairness in the workplace.

It applies to nearly all workers and sets hourly rates below which pay must not be allowed to fall. It helps business by ensuring companies will be able to compete on the basis of quality of the goods and services they provide and not on low prices based predominantly on low rates of pay.

www.dti.gov.uk/employment/pay/national-minimum-wage/index.html/

Since 1999 the NMW has been increased at a faster rate than average earnings, thus improving the position of low paid workers. As the NMW has increased it has embraced a larger share of the workforce, rising from 1 million in 1999 to 2 million in 2006. In October 2006 the NMW for adult workers was increased to £5.35 per hour.

The point of the NMW is that low paid workers are better off as a result of the visible hand of government than they would have been if wages were left entirely to be determined by the hidden hand of the market.

❓ **How does the NMW affect the private ownership of business?**

❓ **If you were an employer, would you support the NMW?**

Since 1999 the National Minimum Wage has been increased at a faster rate than average earnings thus improving the position of low paid workers.

© istockphoto.com/Silvia Jansen



Competition vs. market power?

So private ownership turns out not to be a straightforward idea. The same can be said of competition and profit. Competition is a key aspect of the environment in which businesses in a market system operate, and we will look at it more closely in Chapters 2 and 14. It is competition that keeps businesses responsive to consumers since they have the option of going elsewhere if they are not satisfied. However it seems clear that firms do not all face the same amount of competitive pressure and that some firms exercise more market power than others. If consumers really are ‘sovereign’ this suggests that firms have to respond to their preferences and have little or no power in the market themselves.

Yet firms are often felt to be powerful entities, particularly in the case of ‘big business’. In recent years there has been much public debate about the power and impact of vast global businesses in the form of **multinational corporations** (MNCs) that operate in several different countries (Chapter 12).

It seems clear that firms have more power when they face no or few competitors and less power when they face a large number of rivals. When there are many firms in a market competitive pressure is increased and consumers can more easily shop around. In economic analysis these issues are examined in terms of distinctive **market structures**—principally monopoly, oligopoly and perfect competition. The prediction of economic theory is that market structure influences a firm’s conduct or behaviour and performance so it is an important element of the business environment.

Values

Spatial levels

Profit vs. social responsibility?

The performance of business is conventionally measured in terms of profitability, because profit is seen as the prime motive of business in the private sector. However the notion of business ‘success’ is not quite so straightforward. This is because businesses may themselves have other non-profit objectives and because, in any case, other groups in society increasingly demand or expect business performance and success to be measured by criteria other than just profit. In the modern world businesses have come increasingly under pressure to legitimize their activities and role in society with reference to a wider range of social benefits. This is sometimes referred to as maintaining the ‘licence to operate’. As we will see in Chapter 7, business has to engage in public dialogue in matters of business ethics and respond to the concerns and demands of a range of stakeholder groups.

This area of debate is often expressed in terms of ‘corporate social responsibility’. A crucial question, discussed in Chapter 15, concerns the threat of climate change and the responsibility of business to demonstrate an ethic of care towards the natural environment.

The private sector of business has certain common characteristics—private ownership, competition and profit—that are important for an understanding of its decisions and behaviour and how it ‘solves’ the basic economic problem. However we have seen that the private sector is highly diverse, and the principal aspects of this diversity are summarized below:

- type of good or service produced (the industry in which the firm is located)
- legal status of the firm (e.g. sole trader, partnership, limited company)
- legal regulation of business (the variable use of law to place restrictions and obligations on private business)
- size (e.g. measured in terms of number of employees or sales revenue)
- geographical reach (i.e. the geographical spread of the firm’s activities within and between countries)
- degree of competitive pressure (market structure)
- objectives (profit and corporate social responsibility)

Values

Stakeholders

Diversity

🔄 Stop and Think

Do you think that the sole purpose of business is or should be to make as much profit as possible?

If your answer is 'no', would you think differently if you were a shareholder?

If your answer is 'yes', do you think that the pursuit of profit leads business to serve the public interest or common good?

Other sectors of business—the public sector and the third sector

There is a good reason why people tend to think first of private sector firms when asked to think of an example of business, and this is that the private sector is the dominant element within the UK and other capitalist or market economies. In other words, most of the goods and services that we consume on a daily basis are purchased from private sector businesses, and most employees work in the private sector.

Diversity

Another reason is that the term 'business' is often associated specifically with the profit motive. Yet this is a narrow conception of business. If we think in terms of our broad definition—transforming inputs into outputs of goods and services to meet the needs and wants of consumers—it is clear that other types of organization are also involved in business. These are not-for-profit organizations operating in both:

- the **public sector**, and
- the 'third' sector of voluntary organizations.

Dynamic

Although these organizations make up a relatively small part of the business or economic life of the country, they are involved in the production of some key services, such as healthcare and education services. It is also important to note that the boundaries between these sectors are not fixed but can, and do, shift, largely as a result of political decisions. For example, in the recent past in the UK, mainly under Conservative governments in the 1980s and '90s, a programme of privatization transferred businesses that had operated for many years as parts of the public sector—such as British Telecommunications, British Gas and British Rail—into the private sector.

The point is that the public and third sectors also provide mechanisms for 'solving' the basic economic problem, and societies have to choose how to balance these different sectors of business. Therefore, in addition to the private sector, we should also think of business in terms of not-for-profit organizations operating in the public sector and the voluntary (or 'third') sector. Within these sectors business organizations are also diverse when considered, for example, in terms of the type of output they produce, their legal status and size.

Differences between the private and public sectors

Public and private sector organizations differ in important respects.

- **Revenue.** Public sector organizations like schools and NHS hospitals are largely financed through taxation rather than sales revenue generated by customers paying a price in a market.



Supermarkets are an example of an oligopoly.

© Brigitte Bott/Robert Harding World Imagery/Corbis

- *Accountability.* Private sector organizations are accountable to customers and shareholders. If they are not responsive to their customers they risk losing business to their more customer-focused competitors, and public limited companies (PLCs) are legally required to safeguard the interests of their shareholders. Public sector organizations do not have shareholders. Some of them do have users who may be thought of (and think of themselves as) customers (such as students), and they are expected to be more responsive to them than perhaps they were in the past. But some parts of the public sector deal with people who do not choose to be users of the service and are therefore not customers in this sense, for example the prison service. In general, political rather than market-based forms of accountability are more important in the public sector, meaning accountability to politicians or public officials (civil servants or local government officers).
- *Competition.* Finally, a characteristic of the private sector is that consumers can 'shop around' because firms operate in competitive markets. It is this that keeps businesses customer-focused and is the basis of **consumer sovereignty**. Of course, the amount of competition and consumer choice varies between markets and an important question concerns the operation of markets dominated by a small number of large businesses,

known as oligopolies (e.g. supermarkets). Some public sector organizations also face competition in ‘internal markets’ where ‘customers’ have some ability to exercise choice (i.e. to ‘shop around’) between alternative service providers such as schools, universities or hospitals. However in general such choices are constrained and these organizations operate in less volatile, if not captive, markets.



Mini-Case 1.2 Is a school a business?

Values

Some people might describe a school as a business on the basis that it provides a service—it is ‘in the business’ of providing education for children. A school might well have a business plan, and we might expect the headteacher and governors to run the school in a ‘business-like’ way. The children, or their parents, might be

referred to (and might think of themselves) as customers, just as they might be customers of McDonalds. In Britain, under the Labour government’s policy of establishing ‘City Academies’, it became possible for individuals from the world of business to invest their own money in a school and play a leading role in its management and in determining its ethos.

These all look like good reasons for thinking of schools as businesses. Yet other people would reject the idea that a school can be thought of as a business, and prefer instead a term like public service. They might think that a business is primarily concerned with making money, whereas a school has other values and objectives such as ensuring that all children have the same opportunities regardless of their parents’ income, and the chance to realize their potential.

This example illustrates the dispute over where the boundaries of business lie, but also shows that important issues can be at stake in what seems like a quibble over mere words. For the debate about whether a school should be thought of as a business is really a dispute about the purpose of schools and the ways they are managed. Those who reject the term business believe that making a school more ‘business-like’ threatens its public service mission or ethos, whereas those who think of schools as businesses will see this in positive terms of improving the efficiency of management and the performance of the school as measured by academic performance.

The dispute also illustrates, in a more general way, the debate about the role and purpose of business in society and whether, as in this case, there are certain areas of life that should be kept separate from business or business should be allowed to extend its role without limit. It shows, in other words, that the role of business in modern society remains controversial. What do you think?

- ❓ **Do you think of yourself as a customer of your university? How does this differ, if at all, from the ‘traditional’ idea of a student?**
- ❓ **Do you have the same expectations and the same idea of your rights in relation to the university as you do in relation to a high-street business?**
- ❓ **Do you think it would be a good thing for universities to be run more on business lines? Would there be any disadvantages?**



Is a school a business?

© Photo by Christopher Furlong/Getty Images

A simple model of business in its environment—transforming inputs into outputs

Business organizations are systems that interact with the external environment in which they operate. Business, in its broad sense, is the activity of transforming inputs into outputs or, in other words, the activity of producing goods and services to meet the wants and needs of consumers. The inputs come from, and the outputs are sent into, the environment. To be successful, businesses have to produce outputs that meet the expectations of consumers, and to do this they have to be able to acquire the necessary inputs at the right time, price, quantity and quality. Thus businesses have to understand the 'surrounding conditions and circumstances' at both the input and output ends of their operations. And in between they have to manage the process of transformation of inputs into outputs (production) within the organization (the internal environment). This understanding of business interacting with its environment through three stages of activity is shown in Figure 1.2.

Interaction

There are two other ways of picturing this transformation process:

- as part of a longer chain
- as a cycle.

The longer chain is the **supply chain** of which the individual business is normally only one link. The supply chain is the whole series of organizations, relationships and processes that link the consumer or end-user of the final or finished product back to the original raw materials which have been converted or transformed into that product. Thus in Figure 1.2 the inputs might not be raw materials but semi-manufactured products or components, and the outputs might not be final products for end-users but parts that enter into the next stage of the production process carried out by another firm.

The transformation process may be thought of as a cycle because for each organization the supply of outputs to consumers is not really the end of the process but leads back to the procurement of inputs to start the cycle again, as illustrated in Figure 1.3. Thus revenue earned from the supply of outputs is 'ploughed back' into the business to procure further inputs in order to carry on production of further outputs, and so on. In the private sector the profit motive means that firms aim to earn more from total sales revenue than was laid out as costs of production. Earning profit allows firms to

- expand the scale of production and grow the business

and/or

- pay out part of the profits to the owners of the business (e.g. payment of dividends to shareholders).

There is clearly a potential tension or trade-off between these two purposes or functions of profit, and between short-term and long-term objectives. Shareholders may expect short-term profits, but managers may wish to invest profits back into the business to secure long-term competitiveness and growth.

In the private sector inputs and outputs generally involve market relationships of exchange—buying

Figure 1.2 Business interaction with the environment—the transformation of inputs into outputs

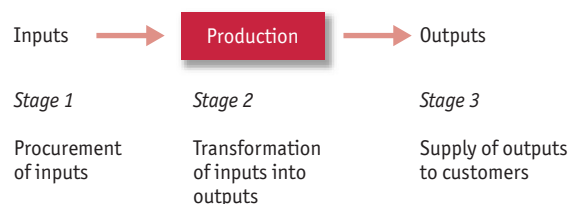
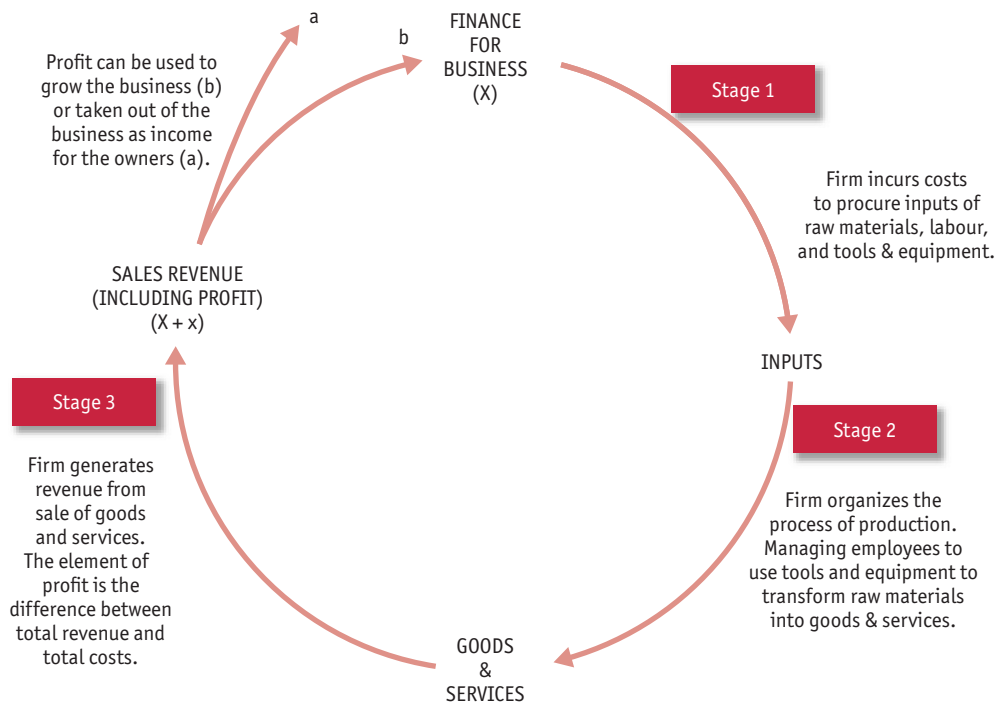


Figure 1.3 The transformation process as a cycle

Notes: Profit (x) is what is left from total sales revenue after the total costs incurred by the business have been replaced (X). There is a tension or trade-off between two functions or purposes of profit: it may be taken out of the business as income for the owners (a) or used as retained earnings to grow the business (b).

and selling—but public sector organizations produce services, such as health and education, which are supplied to end-users free of charge (or mainly so). However, the inputs used by public sector organizations, such as drugs and medical equipment in the health service, generally have to be purchased in a market. The private sector does not operate entirely as depicted by the simple model, for businesses rely on some crucial inputs provided by government. For example the skills and knowledge of employees are developed largely through the state education system.

Understanding the environment of business in this way mainly involves understanding the market conditions that the firm faces in relation to procurement of inputs and sale of outputs, particularly how competitive these markets are. We can say that as buyers of inputs firms benefit (as do buyers generally) from competitive market conditions (though there can be a downside if, for example, your current supplier goes out of business), while as sellers of outputs competitive markets are sources of threat (though a competitive or contestable market may be an opportunity if, for example, the firm is a new entrant). Porter's well-known **five forces** model identifies five sources of competitive pressures (Porter, 1980).

Porter's 'five forces' model

- *Current competitors*

The most immediate and obvious threat comes from rivals in the market producing or selling the same product and trying to attract the same customers. In general markets are considered to be

more competitive the greater the number of firms operating in them because it is easier for consumers to 'shop around'. However even when a small number of firms dominate a market, as with the major supermarkets, competition between them may be intense. As well as current competitors firms have to be aware of:

- *the possibility of new entrants into the market*

Entry may come from new start-ups or from existing businesses pursuing diversification strategies. Through diversification supermarkets have entered other markets such as for books and CDs, making it harder for existing businesses to survive. Entry may be deterred by barriers such as the ability of established firms to use advertising and branding to build up customer loyalty. Competition exists in a less direct form through.

- *the availability of substitute products*

A substitute is a different product which provides the same service or function, such as different modes of transport. Finally, firms have to deal with suppliers and customers at each end of the transformation process, in procuring inputs for the production process and selling their products. But these relationships of exchange also involve a dimension of power. Thus firms have to deal with

- *the power of buyers, and*
- *the power of sellers*

It is clear that a business will benefit if market conditions are reversed in relation to inputs and outputs so that there is buyer power in the former and seller power in the latter. For example, supermarkets are often accused of 'squeezing' their suppliers by demanding price reductions and more stringent quality criteria. In this case farmers, as sellers, have little power and supermarkets, as buyers, have much power. In effect, it can be argued, supermarkets are able to compete by offering low prices to their customers at the expense of farmers' livelihoods.

Conceptualizing the environment of business

Just as the term 'business' in reality refers not to a single type of organization but to a diverse range, so the environment of business is similarly diverse. Different types of business organization operate in different environmental settings or contexts.

Spatial level—local to global

The environment is usually thought of as the world 'out there', the external context, comprised of the wider social, cultural, economic, political, legal, technological and other systems in which businesses operate. In the context of debates about 'globalization' we may think of this external environment in terms of 'the world' in the sense that businesses may be affected by, and in turn influence, events on a global scale. This is particularly true in the case of companies that have a global reach or span of operations, especially multinational corporations (MNCs) that undertake production in more than one country.

However, we can think of the environment in terms of different levels of analysis ranging from the small scale and local environment at one end of a spectrum through to global systems and events at the other. We might think of small and medium-sized enterprises (SMEs) as operating

in a more localized environment, such as within the local economy of a town or city, and giant corporations operating in a more national or global environment. However, even small businesses may be affected by events at a national or global level because of the way they are often linked in with supply chains spanning several countries. For example, they may depend on imported raw materials or components. At the other end of the spectrum even the largest companies also have to deal with local issues and concerns. Indeed the term ‘glocalization’ has been coined to draw attention to the need for global businesses to remain sensitive to the peculiarities of the local contexts in which they operate.

External and internal environments

Internal/ external

Although the environment of business mainly suggests the external world ‘out there’, it also has a critical internal dimension concerned with relations and processes within the organization. We have already seen that the transformation of inputs into outputs involves the stage of production within the organization. But we can get further with the idea of an internal environment if we think of the organization not as a single unified entity but more as an internally differentiated system made up of different parts or ‘sub-systems’.

For example, firms typically are made up of specialized sub-systems or departments dealing with particular aspects or functions of the business—such as production, marketing, finance, human resources (HR) and research. This may be seen as a division of labour within the organization which allows it to draw on the highly specialized knowledge of employees in these distinct functional areas. The other side of this differentiation is, of course, the need to ensure coordination so that individuals and departments are working together effectively to achieve the organization’s goals. That is a key task of managers at the senior level of the organization.

Now we can see that a director of human resources, for example, has to operate within an internal environment, dealing with issues such as training and development of the existing workforce and, in the process, having to manage relationships with other departments. These are the ‘surrounding conditions’ in which the director of human resources has to operate. For example, faced with scarcity the organization has to deploy its available resources carefully to achieve its objectives. It has to make decisions about the allocation of these resources between different possible uses, weighing up how each might contribute to its success. In this situation the director of human resources might have to win the case for more investment in the ‘human capital’ of the organization in the form of staff development against competing claims on those resources from other departments.

Consideration of the internal environment raises the issue of the internal ‘politics’ of organizations (or ‘office politics’). This is because we can see that businesses are arenas in which different views are put forward about the allocation of resources and questions of business strategy more generally. In other words there is scope for disagreement about the best way forward for the organization and this means that it has to be able to manage and resolve these disagreements in a positive way that contributes to the success of the business. This process of resolving disagreements is at the heart of what politics is about, and we will return to this question in Chapter 4.

The internal and external dimensions of the business environment are closely related since many business decisions cross over this boundary—they have internal and external aspects. For example, **product innovation** may involve not only internally managed research and development activity but also collaboration with external partners. Businesses have to ensure recruitment of the right people from the external labour market, but they also have to manage the internal labour market within the organization to deploy human resources effectively.

Interaction

It is also important to note that the character of internal processes may influence the speed and effectiveness with which organizations respond to external opportunities or threats. Indeed the internal environment may be shaped by the way the organization responds to its external environment.

Immediate and general environments

The 'immediate' environment involves those aspects which may require day-to-day or regular decisions and actions (e.g. relations with suppliers), while the 'general' environment is concerned with more distant or remote, but nevertheless consequential, issues (e.g. macroeconomic trends). On the whole, the general environment concerns events and systems that operate on a large scale and form a backdrop to day-to-day business decisions. The general environment also contains issues and events which are more beyond the capacity of individual organizations to influence or control. For example, the rate of growth of the economy, the level of unemployment and rate of inflation, and central bank (Bank of England) decisions on interest rates all form important elements of the general environment or backdrop of business decisions in the UK. These are macro-economic phenomena and decisions (operating at the level of the economy as a whole), affecting all businesses in the economy, and over which no individual business has much (if any) influence or control. On the other hand the decision by a particular components manufacturer to raise its prices is part of the **immediate environment** only directly affecting other businesses which it supplies. This will affect day-to-day decisions by those businesses (e.g. to switch suppliers) and they may have some ability to influence the price change through negotiation.

Environmental uniqueness

The idea of 'environmental uniqueness' tells us that each business organization operates within an environment that is, to some extent, unique to it, and no two organizations operate in exactly the same environment. This idea warns against over-generalization in analysing the business environment. It reminds us that for **environmental analysis** to be useful to an organization it must be sensitive to the particular aspects of the environment that affect it and to which it must respond.

But we shouldn't take this idea too far—at its extreme it would suggest that a business environment textbook is required for every business organization in the economy! The absurdity of that idea shows us that **generalization**—meaning to make a statement with general application, about how things are in general terms, or that is intended to be true in most cases—is a necessary and useful approach in business and management. There are, in other words, general aspects of the environment that affect most businesses, so a firm should find environmental analysis useful that deals both with the general and the particular.

Interaction between business and the environment—responding, influencing and choosing

Responsiveness

In order to operate successfully businesses must be able to respond effectively to factors in their environment that affect them. The environment may be seen as presenting a range of threats and opportunities. A successful business will be one that is able to deal effectively with threats and take advantage of opportunities or, at least, is able to do so as well as or better than its competitors.

Interaction

Influence

However, success may also depend on the ability of business to influence the environment in which it operates to its own advantage. Advertising is a clear example of business activity that is intended to influence the environment. Shifts in consumer preferences and spending patterns may pose threats or opportunities to which businesses must respond. Such shifts may occur for a variety of reasons, such as

- changes in values and lifestyles in society
- greater affluence resulting from economic growth, and
- changes in the age structure of the population.

Some of these shifts result from large-scale social changes over which business has little or no influence, and which constitute aspects of the general environment. For example, the ageing of the population has implications for the pattern of consumer spending as older people have wants and needs that differ from those of younger people.

However, businesses do not simply respond to shifts in preferences and spending patterns among consumers but are active in seeking to influence these shifts to their own advantage. Through advertising and branding strategies businesses may be able to create new tastes and fashions in society to which they then apparently respond. Ageing is a good example of this. As people get older their wants and needs change, but the lifestyles of older people today have also changed compared to previous generations. Older people now want to have a more active lifestyle than in the past. This is in part due to higher incomes and improved health, but we can also see how business may play a powerful role in influencing these changing lifestyles as they develop and promote new types of goods and services, such as in the field of leisure and tourism.

This example of interaction between business and the environment—responding to and seeking to influence consumer preferences—has implications for how we understand the working of a market system. The idea of ‘consumer sovereignty’ expresses the idea that consumers are ultimately in charge of the economic system because it is their preferences which drive business decisions about what to produce.

Values

On the other hand the power of advertising leads us to question how far consumers really are in charge. The purpose of advertising is, after all, not merely to inform but to persuade. How far do we as consumers make decisions for ourselves, and how far are our decisions influenced by sophisticated advertising methods?

🔄 Stop and Think

You make choices about the music you listen to and the clothes you wear. We all like to think of ourselves as making our own decisions. But what factors in your environment have influenced your choices? How far has business shaped your lifestyle choices?

Choice of environment

Beyond responding to or influencing the environment, businesses may be able to choose a favourable environment in which to operate. For example, businesses may be able to shift the geographical basis of their operations—moving into more favourable environments and away from unfavourable ones. When businesses expand into new markets, for example exporting to new countries, they are searching for favourable geographical areas in which to sell their products. The phenomenon of international trade is driven by the geographical expansion of business searching for opportunities for sales in new markets overseas. Whether these new markets will provide favourable trading environments will depend on factors such as culture, consumer tastes and income levels within the society. Thus as countries develop they may offer favourable environ-

ments for companies from Europe to increase their sales as consumers' incomes increase and, crucially, as 'western' lifestyles spread. An example of this is the way western tobacco companies have been seeking to increase sales of cigarettes in developing countries. These countries offer favourable environments as more people can afford to smoke and, to some extent, desire to emulate affluent western lifestyles. (Again, these lifestyle associations of cigarettes are promoted by the companies in their advertising.) At the same time the trading environment in western societies has become less favourable due to increased awareness of the health hazards of smoking among consumers and moves to limit smoking by governments, as in the UK.

Businesses can also choose the environment in which they operate by deciding the location of their production activities. In searching for favourable environments in which to carry on production firms are said to seek locational advantage. This applies to the establishment of new businesses or new offices or factories on the part of existing firms, but it can also involve transferring operations from one location to another. Locational advantage may derive from factors such as:

- the availability of skilled labour
- the cost of labour
- a favourable tax or regulatory environment
- the proximity of suppliers or consumers
- the quality of infrastructure such as transport.

The type of business that we most associate with this capacity to seek locational advantage, and particularly to transfer production between locations, is the multinational corporation (MNC). These are companies that control production facilities in more than one country. Although not all MNCs are large, MNCs include the largest businesses in the world, and the largest of them are bigger (measured by sales revenue) than all except the biggest countries (measured by GDP). These companies are often truly global in the sense that the production facilities they control are spread throughout the world, and they are the originators of readily identifiable 'global brands'. It



Mini-Case 1.3 Dyson: champion of British manufacturing?

James Dyson has been regarded as a champion of British manufacturing because of the success of his company manufacturing vacuum cleaners in Malmesbury, Wiltshire and because of his public statements supporting the need to retain manufacturing in the UK.

However in 2002 Dyson announced his decision to shift production to Malaysia with the loss of 800 jobs at the company's Wiltshire plant. The company had opened its first plant in Malaysia in 2000. The reason for the shift of production out of the UK were indicated by Dyson as follows:

By moving to the Far East where many suppliers are based and where production is more cost effective, we would be able to continue to grow, invest heavily in new technologies and launch more products faster. ('Dyson to shift manufacturing operations to Asia', *Guardian*, 5 February 2002)

Labour costs in Malaysia were reported to be around one-third of those in the UK. Other factors influencing the decision were planning restrictions at the UK plant and the high value of the pound.

In 2003 Dyson announced plans to shift production of washing machines to Malaysia. The Malmesbury site would cease to function as a manufacturing facility.

However the company retained research and development activity at Malmesbury and announced that it was recruiting more employees at the site in high value-added and high-paid positions.

The decision to shift manufacturing to Malaysia and retain R&D in the UK shows the ability of Dyson to choose favourable environments for these activities. Malaysia offers advantages for low skill manufacturing operations particularly due to much lower labour costs than the UK. The UK offers advantages for R&D and design operations because of the availability of highly skilled workers with relevant scientific qualifications.

These decisions were taken by Dyson on commercial grounds. This case shows the vulnerability of UK manufacturing jobs in the face of low wage competition overseas. For critics it also shows the lack of commitment of a successful British company to its country of origin. Thus Dyson was accused by some of betraying British manufacturing.

❓ **In moving production to Asia do you think that Dyson did the 'right thing'?**

is sometimes argued that these companies are increasingly ‘footloose’ in the pursuit of their global business strategies. This means that they have no particular attachment to any country in which they operate but will shift production in search of favourable environments for their business.

🔄 Stop and Think

Can you think of other examples of how business is able to respond to, influence or choose its external environment?

The nature of the internal environment

The internal environment concerns all those activities and relationships within the organization that are involved in the transformation of inputs into outputs. The internal activities and relationships add value to the inputs. A successful business has to manage the internal environment effectively as well as interact with the external environment. Of course, the internal environment is not sealed off from the external one, rather there is an interface or relationship between the two.

Interaction

Businesses are, in other words, open systems that interact with their environments, not closed systems. Some ‘internal’ activities involve relationships with external people and organizations, most obviously suppliers and customers. For example, in a retail business and other services the interface with the external environment in the guise of customers is the core activity of the business. Therefore, managing the internal environment is, in part, concerned with managing this relationship or interface. Further, the internal environment may need to be adapted to suit the particular characteristics of the external environment if the business is to be successful. This means that there might not be just one way of organizing and managing the internal environment, but a variety of possible ways, depending on what works best in the particular situation of the firm. For example, if the external environment is characterized by rapid change or volatility it may be important to ensure flexibility of staffing or tasks within the business. On the other hand in a stable and predictable environment a more rigid, bureaucratic and rule-based approach might work well. Just as the external environment of each business is, in some degree, unique, the same can be said of the internal environment.

Analysing the internal environment involves looking at businesses as particular types of organizations. An organization can be defined as a group of people that comes together for the purpose of achieving a specific goal or objective, and which involves a series of activities and relationships undertaken within a framework of some kind of rules or procedures. The essential purpose of management, as an indispensable function of the organization, is to facilitate and ensure that clear organizational objectives are formulated and achieved.

What is an organization?

- objectives
- people/relationships
- tasks/functions
- technologies
- rules

We have already seen that the objectives of business may not be straightforward, but for our purpose here they can be stated quite simply, as follows:

- to produce certain types of output of goods and/or services
- to meet the wants and needs of customers
- to realize a profit (in the private sector).

Profit is the ultimate objective—the decision about the product mix and the aim to satisfy consumers are really means to this end.

The internal environment, in contrast to the external one, is much more within the control of the organization—so much so that we can think of the internal environment in terms of **organizational design**. Design involves the deliberate shaping of the **organization structure** and culture so that it supports effectively the achievement of organizational goals, rather than getting in the way of these goals. It involves the idea of managerial choice. Designing and implementing organization structure can take up a great deal of management time and energy, and there are always transitional costs in implementing change in the organization. For example, change can be experienced as demotivating when it involves changes to people's responsibilities. Existing working patterns and relationships may be discontinued and new ones need time to 'bed down'. It is probably true that there is no such thing as the perfect organization structure—every structure has its problems as well as its advantages. However, there is no doubt that organization structure can be an important factor in the success of a business.

Types of organization structure

There is a large literature on organization structure. Here we will only indicate some of the principal types. We can think of organization structure in terms of two key issues or problems that all organizations have to solve:

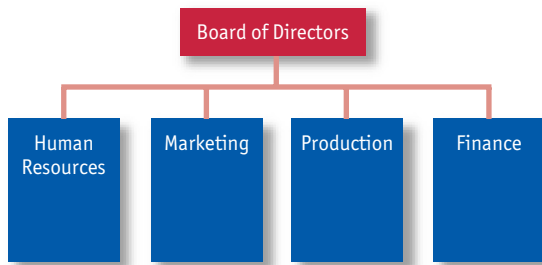
- the problem of division of labour—all organizations have to decide how to divide up the various tasks or functions that must be undertaken in transforming inputs into outputs
- the problem of management—all organizations have to decide how to arrange lines of authority and accountability.

Each of these problems involves an intrinsic tension or dilemma:

- the dilemma of the division of labour is between the fragmentation of tasks/functions and their effective coordination
- the dilemma of management is between the centralization and decentralization of authority and decision-making.

Functional structure

We referred earlier to the idea of an organization as a system interacting with its environment. This leads on to looking at the internal environment in terms of sub-systems or parts that make up the whole. In other words, organizations are internally differentiated. Typically, the design of business organizations involves a **functional structure** in which the sub-systems are specialized departments or units dealing with specialist tasks or functions that contribute to the transformation process. Classically these functions include production, finance, personnel (or human resources), marketing, sales, and research and development. The chief advantage of this structure is efficiency, and this derives from the fact that staff in each department or section specialize in specific tasks in which they may have expert knowledge, often based on academic and/or professional qualifications. It also means that there is a clear career path for staff within each department.

Figure 1.4 Functional structure

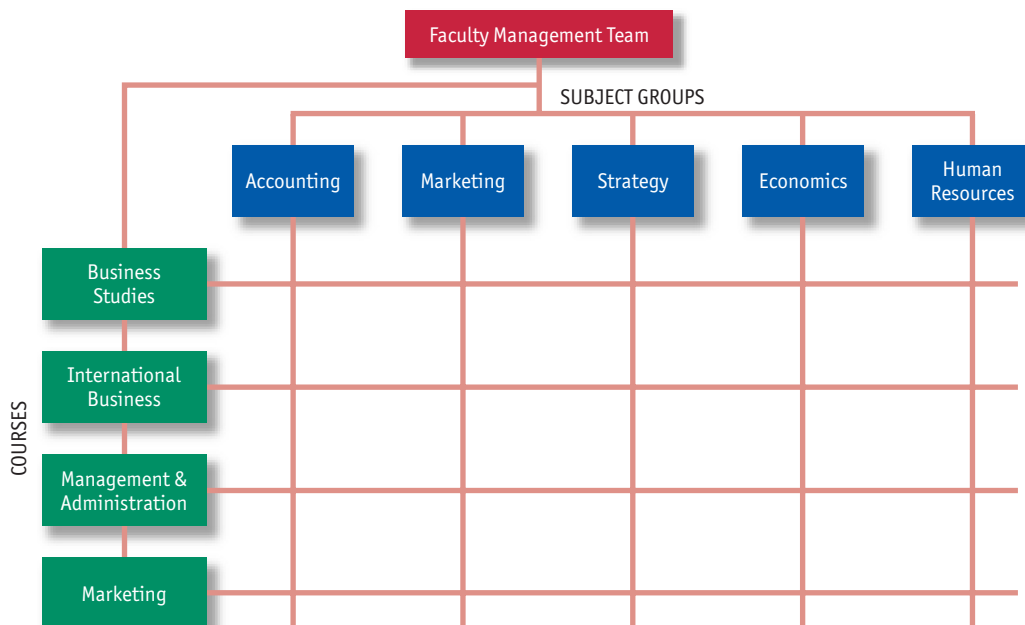
The chief disadvantage is the problem of coordinating the work of these various departments and making sure that they are all contributing effectively to organization goals. There is a risk that departments become parochial or inward-looking, or that rivalries between departments can hinder organizational effectiveness.

Matrix structure

A functional structure involves a vertical principle of organization design, with each department seen as a column usually with its own internal hierarchical levels of management and decision-making, as shown

in Figure 1.4. A **matrix structure** introduces a horizontal principle cutting across the vertical departmental columns, often on the basis of project teams involving staff from many or all departments, as shown in Figure 1.5. This means that individuals operate within a two-way flow of authority and responsibility—vertically within their department and, at the same time, horizontally within the project team.

The chief advantage of a matrix structure is the focus it provides on projects or programmes and the ability to bring together relevant functional expertise. This ensures more of an external focus and can combat the parochialism of departments. The chief disadvantage is the confusion that can be created over ‘who’s in charge?’ Individuals can feel pulled in two directions and unsure of who they are accountable to. Departmental managers and team leaders can feel unsure about the scope of their authority.

Figure 1.5 Matrix structure—University Faculty of Business

Academic staff are members of subject groups and course teams.

Divisions and operational units

The functional and matrix structures may operate across the whole organization. This may be best suited to single-product firms. On the other hand, there may be benefit in dividing up the organization into operational units on the basis of distinct products or services. **Divisional structures** are best suited to large companies with diverse product portfolios. In a divisional structure each division operates as a semi-independent business run as a separate profit centre, but within the parameters of the overall corporate strategy determined by the company's headquarters, as depicted in Figure 1.6. Within each division there may be a functional or matrix structure, although some functions, such as research and development, may be undertaken centrally. The chief advantage of a divisional structure is that it overcomes the limitations of centralized coordination and control of a large and diverse business. It allows each division to respond to its own market conditions. However there can be tensions between the semi-independence of divisions and the formulation and implementation of a corporate strategy for the company as a whole. The allocation of the central overhead costs to each division can be a source of conflict.

Figure 1.6 Divisional structure

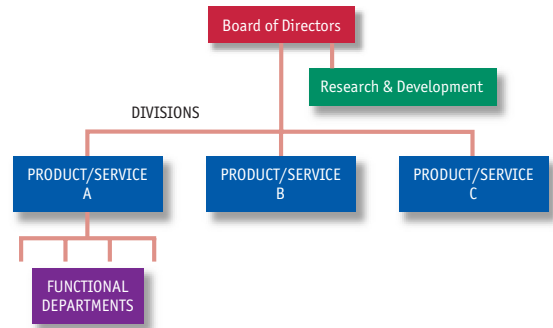
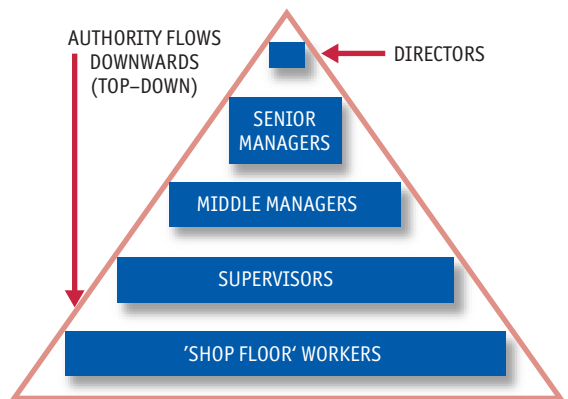


Figure 1.7 Hierarchical structure (tall pyramid)



Hierarchical structure

Business organizations are typically hierarchical, which means that authority is concentrated at the top of the organization and flows downwards. This usually involves a number of layers of authority. Those at the bottom of the hierarchy may have little or no authority and control—their role is to carry out instructions from above. This type of structure can be represented as a pyramid, as shown in Figure 1.7, with authority concentrated at the pinnacle. In a bureaucratic structure positions of authority are allocated on the basis of expertise. The chief benefit of the **hierarchical structure** is that the few at the top of the company are experts and best able to make decisions about corporate policies and strategy. It can also be argued that decision-making is more streamlined and decisions are authoritative. A major disadvantage is that hierarchies are not very good at drawing on the knowledge that exists in the lower layers of the organization, and that those at the bottom may not feel a strong sense of commitment to the organization. Having many layers of management within the hierarchy is also very costly for the business. These problems may be alleviated by moving to a flatter structure.

Delaying—flat structure

Businesses are never **flat structures**, but they may become flatter by reducing the number of layers or levels of management. In this way they become less-steep pyramids. The motivation for delaying may be to strip out managerial costs from the business to enhance competitiveness.

There may also be a desire to streamline decision-making further and bring senior management closer to those at the bottom of the hierarchy. This may improve employee motivation and commitment. An obvious drawback of a flatter structure can be an excessive workload on managers—there is a danger that the organization really needs those layers of management that are being removed.

🔄 *Stop and Think*

It is sometimes said that there is no perfect organization structure. Do you agree?

Environmental analysis

Dynamic

As we have seen, businesses have to understand the ‘surrounding conditions and circumstances’ in which they operate in order to be successful. Environmental analysis is needed because the environment does not stay the same—it is dynamic. If the environment were static it would be possible to plan for the future on the basis of what was done in the past—to carry on in the same way. But because the environment is dynamic, businesses must operate under a general assumption that the future will be different from the past. Therefore it is necessary to know how it will change in order to respond to or influence this change in a way that will allow the organization to achieve its goals. Of course, remembering the point about environmental uniqueness, some firms operate in a more volatile environment than others, and there are some periods of relative environmental stability and others of greater dynamism. However the general point about change still stands, and business success depends on dealing with change effectively.

Uncertainty and ‘bounded rationality’

Businesses can never have complete knowledge of how the environment will change. There are always limitations on knowledge, and therefore businesses must operate in a somewhat uncertain environment. Although businesses may strive to act rationally in monitoring the environment and responding to change in the most effective way, their rationality is always ‘bounded’ by limited knowledge. It is sometimes said that by the time firms have monitored environmental change, analysed their findings and formulated a response it is too late to do anything. If this were true then environmental analysis would be a waste of time. Certainly businesses have to make judgments about the resources and energy they invest in environmental analysis in terms of likely benefits of the exercise. However, we return to the point that some level of understanding of the environment is essential to business. The question then is not so much whether but how. In this section we will outline briefly some of the more familiar methods.

PEST (and its variants)

Complexity

Thinking about the external environment in terms of inputs and outputs is useful but not sufficient. It focuses attention on relationships with sellers or suppliers, competitors, and buyers or consumers. But there are other important types of organizations, processes and relationships in the external environment. The external environment is not just made up of markets but also includes political, legal, social, cultural, technological and other factors and influences. It is, in other words, multi-faceted and complex.

PEST is a simple framework for environmental analysis that distinguishes four categories or areas:

- political
- economic

- social
- technological.

Variations on this basic type are set out below. In each case the order of the factors is not intended to indicate their relative importance but rather to produce a memorable acronym.

- PEST (Political, Economic, Social, Technological)
- SLEPT (Social, Legal, Economic, Political, Technological)
- PESTLE (Political, Economic, Social, Technological, Legal, Ethical)
- STEEPLE (Social, Technological, Economic, Educational, Political, Legal, Environmental)
- SPECTACLES (Social, Political, Economic, Cultural, Technological, Aesthetic, Customers, Legal, Environmental, Sectoral)

(Sutherland and Canwell, 2004: 113–14; Cartwright, 2001)

The purpose of the more elaborate frameworks is to allow a more comprehensive coverage of environmental factors, but this may be at the expense of becoming rather unwieldy.

SWOT (strengths, weaknesses, opportunities, threats)

SWOT analysis combines internal and external analyses—the strengths and weaknesses of the organization coupled with the opportunities and threats in the external environment. The capacity of a business to take advantage of opportunities and resist threats will depend on its internal strengths and weaknesses. An opportunity only really exists if an organization has the necessary skills or resources. Thus an opportunity is not simply a feature of the external environment. Like PEST, SWOT is a simple framework, but its sophistication depends on the quality of the analysis under each heading.

Strengths	Weaknesses
Opportunities	Threats

Alternative scenarios

A scenario is an imagined sequence of future events. It might be highly speculative or based on forms of expert knowledge or data. The idea of **alternative scenarios** is that there are different possible futures to imagine and be prepared for. These alternatives might be assessed in terms of whether they are more or less likely, but the point is that being aware of less likely outcomes allows for the preparation of contingency plans—just in case. It is also common to think in terms of ‘best case’ and ‘worst case’ scenarios.

Trend extrapolation

Extrapolation involves using known variables and data as a guide to unknown ones, or to estimate data beyond the existing range. **Trend extrapolation** involves using the past as a guide to the future by projecting established trends. For example, if sales of a product have been growing at a steady annual rate and over a reasonably long period we might feel confident in projecting that

sales growth in years to come. The basic problem is that we cannot assume that ‘everything else stays the same’. There might be wider factors that explain the growth of sales in the past and these factors might alter.

Expert opinion

Expert opinion involves just what it says: relying on expert sources of opinion to provide understanding of the environment and guide the company’s thinking. Often these will be experts outside the company, such as consultancy firms. These firms, or other experts, may have knowledge that it is difficult to sustain within the company. The Delphi method draws on the opinions of a range of experts with each one offering advice independently. There will be a round of consultations with questions being refined at each stage with the aim of arriving at a measure of convergence or consensus among the expert opinions.

Stakeholder analysis

Stakeholders

A stakeholder is any individual, group or organization that is affected by and therefore has an interest in the decisions and behaviour of the business. This might not be a direct effect as some stakeholders have public interest motivations. For example, an environmental pressure group has an interest in a business on account of the perceived harm its actions cause to the environment rather than the direct effect on the group’s members. Other stakeholders have a direct interest because of the benefits or harm of the firm’s actions to them. All the internal members of a business are stakeholders, including employees, directors and shareholders. External stakeholders include customers, suppliers, competitors, politicians and policy-makers, and the community or general public.

Values

As well as being affected by a business stakeholders may seek to influence business decisions in their own interests. There is a debate about how far businesses ought to be accountable to a wide range of stakeholders, and a stakeholder model of business may be contrasted with the traditional view of the firm as primarily or solely concerned with profit. Firms may themselves have different views about the desirability of stakeholder engagement. In terms of environmental analysis, businesses need to have an understanding of:

- who their stakeholders are
- the nature and level of their interest in the business
- their power to exert influence.

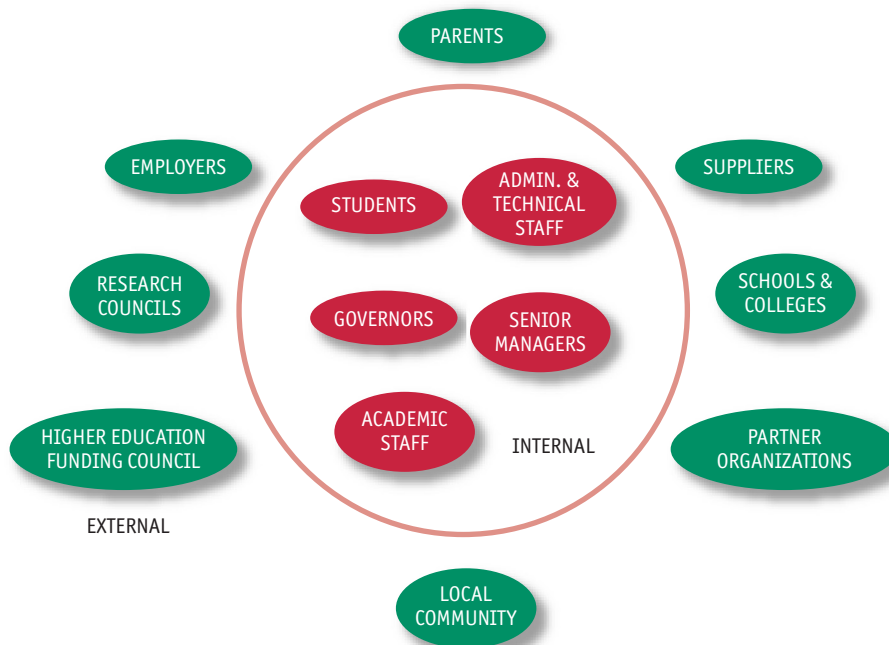
A stakeholder map is shown in Figure 1.8.

For each of the internal and external stakeholders shown:

- a) identify the nature of their interests (e.g. the interests of students might include high quality teaching)
- b) consider whether there are any conflicts between the interests of different stakeholders (e.g. do students and academics have the same interests?)
- c) consider in what way and to what extent each stakeholder exercises power or influence (e.g. do you have any influence over university decisions? Should you have?)

➡ Stop and Think

Can you explain what is meant by each of the four terms that constitute the PEST framework: political, economic, social, technological?

Figure 1.8 Stakeholder analysis—key university stakeholders

Summary

- Business can be defined broadly as the transformation of inputs (or factors of production) into diverse outputs (goods and services) to meet the needs and wants of consumers. Business is a mechanism for deciding the allocation of the scarce resources available to society between various possible uses (or competing wants) in a situation of scarcity where not all wants can be satisfied
- In a narrow sense business is often used to refer to the private sector and the key characteristics of private ownership, competition and profit. The broad meaning of business includes organizations in the public and third sectors
- Market or capitalist economic systems, such as the UK, are dominated by the private sector. However, the boundary between the private, public and third sectors is not fixed. The private sector is very diverse
- The environment of business does not consist just of the world 'out there', or the external environment, but also has an internal dimension. The external environment can be thought of in terms of the immediate environment and the general environment
- Businesses can be understood as open systems interacting with their environments. Each business operates within an environment that is, to some extent, unique
- The external environment is complex or multi-faceted, dynamic, and must be analysed in terms of a variety of spatial levels or scales, from the local to the global
- The internal environment of business can be understood in terms of the design of organization structure so that it supports effectively the achievement of organization goals. There is a range of types of organization structure. Each has its advantages and disadvantages—none is perfect
- It is important for business to engage in monitoring and analysis of the environment. A variety of techniques is available. However, business can never have complete knowledge of the environment or how it will change



Case study: 'UK plc'

This case study identifies some key aspects of contemporary Britain using the PEST framework.

Political

- Democratic system of government in which the people as a whole exercise political power through the right to vote for members of parliament (MPs) to represent their interests
- Two-party system in which just two main political parties—Labour and Conservative—have dominated elections and government office for the last hundred years
- Civil Society Organizations (CSOs) or 'pressure groups' represent specific groups or causes within the political process, e.g. Greenpeace. Pressure groups also target businesses directly to try to get them to alter their behaviour, e.g. to reduce carbon emissions
- Business is a key political actor with distinctive interests, exercising a degree of power and influence arguably unrivalled by any other group
- One of the basic issues in political debate concerns the purpose of politics and government, especially in relation to the operation of private sector business and the market system. Left–Right politics can be characterized in terms of a 'state versus the market' debate
- Government plays an important role in economic and social life, for example making and enforcing laws, providing a range of public services and managing the economy. Public spending (spending by government) accounted for 41.1% of GDP (or the value of total economic output) in 2003/4
- The EU has become, in defined areas of competence, the supreme source of law and political authority. The UK also participates in a range of inter-governmental organizations (IGOs) and operates within a framework of international decisions and laws created by treaty, such as the Kyoto protocol on climate change

Economic

- Capitalist economic system in which business activity is organized primarily by private sector profit-seeking businesses producing goods and services for sale in a competitive environment
- Most people earn their living from the wages or salaries they receive as employees, and most employees work in the private sector. In spring 2004 29.7 million people were economically active in the UK, of which 28.3 million were in employment and 1.4 million were unemployed
- The UK is one of the richest developed countries in the world. In 2002 the UK was ranked sixth out of the EU

countries in terms of GDP per head (i.e. income per person). The average annual rate of growth of the UK economy (GDP) was 2.6% between 1950 and 2004

- The UK has undergone a long-term process of 'de-industrialization' involving a decline in the importance of manufacturing within the economy, coupled with expansion of the service sector. In 2003 the service sector accounted for 72.7% of UK output (up from 66.9% in 1993), while manufacturing accounted for 15.7% (down from 21% in 1993) (Office for National Statistics, *UK 2005*, p. 351)
- Large firms (with 250 or more employees) dominate the economy, accounting for 42% of private sector employment in 2003. The largest firms operating in the UK are multinational corporations (MNCs) with production facilities in more than one country, many of which are foreign-owned. However the vast majority of firms are small and medium-sized enterprises (SMEs). In 2003 large firms accounted for less than 0.2% of enterprises in the UK (approximately 6,000 from 4 million)
- The UK is one of the world's leading trading nations. In 2003 exports of goods and services accounted for 25% of GDP. Through trade and other linkages the UK has become increasingly integrated in the EU economy. The UK is also affected by processes of economic globalization, involving the stretching of economic relationships, such as trade and investment, across national borders

Social

- The UK has a growing population. In 2004 the total UK population reached 59.8 million, and is forecast to reach 67 million by 2031
- There has been a long-term upward trend of average life expectancy. Coupled with a declining birth rate, this has resulted in ageing of the population
- In recent years net inward migration has been the main contributor to population growth
- As a result of immigration since the 1950s Britain has become a multi-ethnic and multicultural society. In 2001 people from other than a White British ethnic background made up 11.8% of the population of Great Britain.
- British culture is diverse and fluid, due to immigration and other processes of social and economic change. However Britain can be seen as marked by certain characteristic 'western' values and attitudes such as individualism, consumerism and secularism
- Linked with its economic development, Britain is overwhelmingly an urban society

- The economic participation rate of females has increased and narrowed the gap with men. In spring 2005 70% of working-age women were in employment (compared to 79% for working-age men), up from 56% in 1971. However there remains a marked pattern of occupational segregation between males and females, and women are lower paid and more likely to work part-time than men
- The occupational order constitutes the basis for important class divisions in British society, e.g. between the best- and worst-paid occupations
- There are disparities in income levels and other social and economic measures of well-being between the UK regions, reflecting different rates and levels of economic development or decline. These disparities are sometimes referred to as constituting a North–South divide
- The 20th-century 'Fordist' model of economic development was based on assembly line technology and mass production of standardized commodities, exemplified by the car industry and pioneered by the Ford motor company. This type of technological system has increasingly given way to a 'post-Fordist' model utilizing information and communication technologies (ICT) to enable flexible specialization
- Technological change has ushered in what some have referred to as a 'knowledge economy' in which the skills and knowledge of the workforce are seen as the most important assets of business and the nation. Hence education, life-long learning and upskilling are seen as key to the ability of the UK economy to respond to new global competitive challenges

Technological

- Britain's economic wealth and position as one of the world's richest economies can be attributed in large part to its level of technological advancement. Technological progress drives the process of economic growth through improvements in productivity, or output per worker
 - Technology is a key determinant of competitiveness, at the level of firms, industries and nations. Technology is at the heart of price competitiveness gained through productivity improvement, but also boosts competitiveness through quality enhancement and product innovation
 - Technological change is a disruptive force in business, destroying old skills, occupations and industries and creating new ones. The characteristic experience of modern life as subject to continual and speeded-up change is attributable largely to technological innovation
 - Technological change—especially in the fields of transport and communication—is at the heart of the process of globalization affecting all aspects of modern life. Globalization isn't a phenomenon just affecting economic and business life through trade, production and financial flows but also affects social, cultural and political life
 - Growth of the world economy since the 19th century has been driven by the use of oil and other fossil fuels as energy sources. A switch to alternative sources of energy is now being compelled by the depletion of fossils fuels and concern over energy security, and by the damaging environmental impact of carbon emissions in the form of global warming
- ❓ Can you think of any other aspects of modern Britain under any of the PEST headings that have not been included above?
- ❓ In what ways do the aspects of modern Britain listed above impact upon business decisions and behaviour?



Review and discussion questions

- 1 Explain the nature of the 'basic economic problem' facing society, and show how business activity provides a solution to this problem
- 2 Describe and give examples of the elements that make up the external environment of business, and explain the idea of 'environmental uniqueness'
- 3 Give examples of the ways in which the external environment affects business decisions and behaviour, and the ways in which businesses may influence their environments
- 4 What is meant by the internal environment of business? Assess the advantages and disadvantages of the main types of organization structure



Assignments

- 1 You are asked to give a brief presentation to the director of a small business on whether to undertake some form of environmental analysis. Summarize the main points that you would make in the form of six 'bullet points'
- 2 Use the Internet to identify four recent newspaper reports that relate to factors in the external business environment under the PEST headings. Use a PEST grid to show the sources of the reports and to provide a brief bullet-pointed summary of each.



Further reading

Sutherland and Canwell (2004) provides a very useful source for understanding key concepts in business.



Online resources

Test your understanding of this chapter with online questions and answers, explore the subject further through web exercises, and use the weblinks to provide a quick resource for further research. Go to the Online Resource Centre at

www.oxfordtextbooks.co.uk/orc/wetherly_otter/

www.intute.ac.uk/socialsciences/

Intute: social sciences is a gateway to resources on the web for education and research in the social sciences, including business and management.



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