Preface

Once upon a time if you wanted to learn about business you would have been advised to study economics. It used to be pretty much your only option. Nowadays you will probably choose instead to study business administration or business studies and your only exposure to economics is likely to be a compulsory unit called 'Business Economics'. It is compulsory because it is seen as an essential foundation stone for the rest of your business education, so the content of this unit had better give you the opportunity to learn some useful stuff! That's exactly what this book aims to do.

Business economics in relation to other business disciplines

If you were free to choose, would business economics really be the sort of subject you would choose as part of your training in business? We think the answer is a definite 'Yes', because we also have experience of working in other business disciplines. This experience has led us to believe that if you can develop an 'economic way of thinking', you will be far better able to appreciate the issues that are dealt with in business disciplines such as accounting, marketing and strategic management.

In fact, these other business disciplines actually owe a great deal to economics. For example:

- Cost concepts in accountancy grew out of work by economists at the University of Chicago and the London School of Economics in the 1920s and 1930s (the current state of economists' thinking in this area of costs is explored in Chapters 5 and 6).
- Marketing as a field of academic research grew out of economics in the early twentieth century and the '4Ps of marketing management' (price, product, place and promotion) come straight from economics, namely from the theory of monopolistic competition (which is considered in Chapter 7).
- Modern work in strategic management theory draws heavily on economists' writings on industrial organization, which are considered in Chapters 8, 9, 10 and 11.

Why use this book rather than another business economics text?

From the outset, this book was designed to offer a very different approach to business economics from that presented in existing texts. This is because the authors, the publisher and many lecturers believe that you will be better served by a complete rethink of what a business economics text covers and how the ideas in it are presented. As a result this book offers a pluralistic approach to economics. What does this mean?

A typical textbook looks at business economics in terms of just *one* brand of economic theory and presents it as a definitive, finished product. This theory is typically called mainstream (or neoclassical) economics and it is what virtually all Western economists learn in their first few years of study (hence its 'mainstream' tag). The mainstream approach dates from the 1870s but the version employed today is largely due to the independent reworking of it in the 1930s and 1940s by Nobel Laureates Sir John Hicks in the UK and Paul Samuelson in the USA. It lends itself readily to translation into mathematical form, and thereby into numerical exercises that have definite answers. By contrast:

> *A scientist who practises pluralism considers which problems are worth investigating and how to make sense of them in terms of more than one theoretical perspective and does not claim that any one perspective is definitive.*

As pluralists, then, we will be offering you not just a taste of mainstream economics but also of non-mainstream approaches. We have grouped the non-mainstream approaches under the title 'heterodox economics' (contributions to heterodox economics come from the related approaches of behavioural economics, institutional economics, evolutionary economics and post-Keynesian economics).

Adopting a pluralistic approach is more intellectually honest than adopting a mainstream-only approach because it does not conceal the existence of alternative points of view. Nor does it fail to confront difficulties in one point of view that have led some economists to construct different ways of making sense of the world of business. With a variety of perspectives at your disposal, you should have a better chance of offering good advice when you get involved with real business decisions. You should at least be able to avoid coming to simplistic conclusions and be well equipped to challenge colleagues who offer them. But, as with everything in economics, this advantage comes at a cost. In this case, the cost is that it initially requires a bit more effort and can seem rather daunting.

Pluralistic thinking tends to be unsettling partly because we live in a world where engineers seem to create definite outcomes in the form of machines and appliances that work with a particular degree of reliability, and where managers are expected to be able to quantify everything. Most buildings don't fall down, and most large companies don't go broke. This probably gives the impression that a science such as economics, which has been around for a couple of centuries or more, should likewise be able to come up with black-and-white answers to economic problems. Here, by contrast, we are promising shades of grey: in other words, a world in which the best way to solve the problems of businesses will often appear to be debatable. It may take you a while to get used to this but the effort will be well worthwhile, because the real world of business – including the quality of engineers' designs and the numbers that managers work with – is *not* normally a world of black and white.

A good way to start coming to terms with this is to recognize that in other parts of everyday life things are, on a closer examination, not so black and white either. Despite this, and despite often having no formal education in the area in question, we do manage to develop an ability to argue about things, such as the quality of a politician's or sporting referee's decision, whether or not a film review was unfair or whether a friend has made a wise career move.

If you see the process of studying business economics as entailing gathering tools for arguing about practical problems, and honing up your skills in using them, and if you recognize that you are already quite relaxed about arguing about other debatable areas, then you should find you can proceed with confidence into this book. You should not feel worried that sometimes you may want to use ideas from one variety of economics to look at a problem, whilst at other times you would prefer to use other perspectives: it is a matter of 'horses for courses', of developing an eye for a suitable tool for the job at hand. Just be sure to reflect on whether your alternative tools give you grounds for being careful not to claim too much for the results you get with the tool you favour in the context in question.

The fact that your instructors have chosen to recommend this text should also inspire confidence that you will be able to handle the challenge of pluralism. Their recommendation is a sign of how seriously they take the pursuit of knowledge about business economics. Instead of resting easily with sets of notes used many times before and problems that have definite answers, they too are working that bit harder on your behalf. They are happy to do so in many cases because they know that the mainstream approach to economics is of limited use when it comes to dealing with many business problems.

Despite its limited use we do cover the essence of mainstream economics. We cover mainstream economics for three reasons:

- because at times it provides a useful starting point, so long as we keep an eye out for its limitations;

- so that you will know what others are studying;
- so that you will be able to cope with elective courses in other areas of economics where the traditional view dominates.

The organization of the book

The way we have organized the material in this book was inspired by the work of three great scholars who focused on the process of doing business:

(i) Alfred Marshall, who taught economics at Cambridge University at the end of the nineteenth century.

(ii) Joseph Schumpeter, originally from Austria, who taught at Harvard University in the middle of the twentieth century.

(iii) Harvard University's Alfred Chandler, the most influential business historian of the past four decades.

Marshall was fascinated by the problems that new firms had in securing footholds in their markets, and by the problems that established firms had in remaining innovative and adaptable. Writing shortly after Charles Darwin's *The Origin of Species*, Marshall likened the competitive struggle of firms in an industry to plants competing in a forest ecosystem.

Schumpeter saw little hope for managers ever to be able to get a peaceful life. This was because he thought the essence of competition between firms was innovation, which meant that an innovation introduced by one rival would require the others to try and hit back with something even better. He called this the process of 'creative destruction' and also noted that entire industries could sometimes be thrown into turmoil by one innovation leading to many others related to it.

Whilst Marshall's vision seems to have been inspired by the rise and fall of family businesses of a relatively small scale, Chandler sought to document and make sense of the development of giant corporations from around 1870 onwards. These organizations, run by salaried managers rather than their shareholders, pioneered strategic decision making and worked out solutions to new kinds of problems, such as those of internal organizational design, long before academic theorists had much to say about them. Along the way, these firms developed new capabilities, both managerial and operational, that helped them expand both their scale and diversity of operations, and helped them to keep lobbing new competitive bombshells at their opponents.

As a result of the influence of these three great scholars this book has an unfolding plot. It is structured around the changing sets of problems that decision makers need to be able to solve at different points in time in order to:

(i) get a firm started;

(ii) keep the firm in business in the face of growing competitive rivalry;

(iii) if they so desire, grow the firm into a much larger operation;

(iv) rejuvenate the firm in the face of declining demand.

In terms of specific content, Chapters 1 and 2 are essential grounding. In Chapter 1 we take you through some preliminary ideas that are essential for you to begin to see the world through the eyes of a pluralist business economist. In Chapter 2 we discuss markets and their limits and along the way introduce you to the idea of economic model building. Once again this is fundamental material.

Firms are created by entrepreneurs, so in Chapter 3 we take a good look at what entrepreneurs do and provide you with insights into what it really means to be an entrepreneur. We begin here with a detailed story of the early days of one of the world's most famous entrepreneurs – Sir Richard Branson. Despite the rather obvious importance of entrepreneurs in the economy you might be surprised to learn that it is unusual for an economics textbook to dedicate an entire chapter to them.

In Chapter 4 we examine how potential customers make their purchasing decisions. If an entrepreneur has had a business idea he or she will have to gain an insight into what makes customers 'tick'. It is usual in mainstream economics to paint a rather one-dimensional picture of customers, but here we explore their motivations and their decision-making processes in greater detail than a standard business economics text would bother to do. Like Chapter 3, this is an atypical chapter, but the material we cover here should be of more practical use to you than the typical mainstream economic analysis of the consumer.

Chapters 5 and 6 are complements in which we examine the kinds of knowledge and resources an entrepreneur needs to have access to in order to set up a business enterprise and the implications his or her choices have for the costs the firm will incur. We begin Chapter 5 with a detailed look at the story of the British entrepreneur James Dyson as a way of grounding the discussion that follows in a real world scenario. We hope that this will help you to see the kinds of problems real world entrepreneurs face in regard to their production decisions and their associated costs and also help you to see the limitations of a purely mainstream approach.

In Chapter 7 the mainstream approach is used to good effect to tell some simple stories about the kinds of things that need to be taken into account when the entrepreneur is trying to decide on a price for the firm's product. We also look at the heterodox approach which outlines the practicalities of the pricing problem that are glossed over in the mainstream approach. This chapter marks something of a turning point in the book because subsequent chapters feature much less mainstream economics.

Chapter 8 deals with the problem of competitive rivalry: before committing resources and taking the plunge into the market an entrepreneur will need to think seriously about how long the window of opportunity for making healthy profits will be open. Here we introduce the evolutionary theory of the firm and industry to gain deeper insights into how firms can earn persistent profits in a dynamic setting.

Having thought about the things covered in Chapters 4 through to 8 the entrepreneur will be in a good position to put together a business plan in order to seek funding for the new enterprise. This is the subject of Chapter 9. In Chapter 10 we examine how an established firm can grow (if the entrepreneur wishes it to) and in Chapter 11 we consider what an entrepreneur or management team can do in order to stave off decline in one or more of its lines of business, or alternatively how it can exit from a declining market.

In Chapter 12 we change emphasis from the more microeconomic focus of previous chapters by turning your attention to macroeconomics. Here we introduce you to a baseline macroeconomic model that you can use to understand big issues such as unemployment and inflation and to derive the likely implications for the firm. In Chapter 13 we explore some of the controversies that have cropped up in macroeconomics and, finally, in Chapter 14 we consider international trade, exchange rates and globalization and once again look at implications for the firm.'

How to use this book

As befits an introductory text, we have tried to break up the economic ideas covered in this book into bite-sized chunks with simple chains of links in explanations of how they work. However, it is in the nature of economics, as a subtle subject that deals with complex systems of interrelationships, that sometimes a point-by-point explanation is not possible and, instead, it is necessary to grasp a set of connected points as a whole all at once. Because of this, you should not presume that you will be able to 'get' everything first time around. Some portions, be they sentences, paragraphs or entire sections, may require several attempts before they become clear.

The pluralistic approach is another complicating factor that will sometimes necessitate dwelling on a particular piece of the text, for sometimes you may find it possible to see one perspective on an issue but be totally unable to 'get' another one that is being presented. (The point here is the same as that illustrated by some famous ambiguous diagrams developed in cognitive psychology, such as a rabbit that can also be seen as a duck, or a picture of a wrinkled elderly woman that can also be seen as a beautiful young woman: many people can see one immediately but can only see the other interpretation if it is carefully explained to them, and it is hard to keep both in mind at the same time.)

An inability to 'get it' is not something that only afflicts students: many debates in economics persist because established ways of looking at the world get in the way of seeing another theorist's point of view. Often it is useful to get another person's point of view in such a situation, so don't be afraid to discuss with your lecturers or tutors any hurdles that you can't jump yourself.

Don't feel that asking for help is a sign of failure if you have had a serious go at cracking the problem yourself. After all, if teaching materials could be guaranteed to be completely transparent to students, there would be little need for the alternative perspective offered by the lecturer who has chosen to adopt a particular text. Teaching staff would far rather deal with important puzzles at an early stage, rather than try to pick up the pieces close to exam time after you have gone for weeks without having grasped basic points. We also strongly recommend that you form a study group with two or three others to help share ideas about possible interpretations of theory materials and coursework questions.

At the end of each chapter we provide 'recommended additional reading sources', normally including some brief notes on what particular readings have to offer. We do not expect that you will have the time to follow up most of these but we expect that from time to time you will be intrigued by particular ideas or will have an assignment that requires deeper knowledge of particular ideas. If so, these listings should make it easy to find out more. Like a conventional text in this Internet age, this book has its own website of materials to help you grasp the ideas it covers and get proficient in applying them. We hope you will enjoy using the materials there and find them useful.

Finally, we offer what may seem an unlikely piece of advice yet one that we think is very valuable: if you are trying to tackle questions about particular business problems or industries using theory from this book, don't initially try to gather a lot of information about the particular business or industry. Many students tackle case study problems by 'researching' them to find 'the' answer, only to end up scoring quite mediocre grades. The problem here lies in the difference between information and knowledge (which we discuss in Chapter 1). If you have a lot of information about what is actually going on, it is likely to get in the way of you using your knowledge of economic theory to predict what is likely to be going on. If you have a lot of information you are likely to write answers that involve using commonsense to organize this information without analysing it using economic theory. By contrast, if you have no information from research, all you can do is to try to use your knowledge of economic theory to tell a story about how things are likely to be under various assumptions. If you do this, you are doing economic analysis.

Peter Earl and Tim Wakeley