10

Firms, Industries and Markets

This is a chapter about economic organisation. If economies are about the production and allocation of goods and services then there will be organisations that are responsible for those tasks. In the previous chapter we saw how people can meet their needs directly from the natural world and that livelihoods understood in this way have dominated human history and are widespread across the world today. However in a capitalist economy goods and services are bought and sold in the market and it is this form of organisation that is the focus of this chapter. So we will be exploring what is meant by a market system and will examine the claim that this is an efficient way of organising economic life. We will also be examining the firm, the most common type of productive unit within a capitalist economy, and considering different ways that firms can be governed internally, and what implications this has for effectiveness and equity. We will be exploring the connection between economic efficiency and innovation.

1. Markets and Competition

Economists frequently claim that the market system is an ideal, a superior system for allocating goods and resources, or sometimes that it is the worst system apart from all the others. How are we to evaluate this claim? The claim to superiority is based on the theory of perfect competition, the idea that a large number of producers and a large number of consumers will all act in their own self-interest but that the very competition between them will spur efficiencies and innovations that mean that the outcome will be optimal. Adam Smith famously referred to this as the 'invisible hand of the market' and others have called it the 'miracle of the market'. So how miraculous is the market system: in this section we will explore its claim to superiority.

At the heart of the justification of the supremacy of the market system within academic economics lies the theory of perfect competition, a theory which is based on a series of assumptions. This first assumption is that *economic actors are divided between producers and consumers: producers seek to maximise profits while consumers seek to maximise utility*. In reality, our purchasing involves significant psychological and cultural content, and our production and exchange of goods plays a far deeper and more significant part in our human lives that this assumption suggests. Our decisions about purchasing may be based on strong moral or religious commitments, as the growth in the fair trade movement has made clear. Some economists would argue that their theory can absorb these concerns by extending their concept of 'utility', but they are unlikely to succeed in summing up such complex social processes within this rather vague concept. We might also argue that the division of people into producers and consumer is problematic: after all most of us have jobs as well as going shopping, so we are mostly both producers and consumers. The theoretical division can become a real and damaging division if our pressure to reduce costs and seek the lowest price puts pressure on our own employment conditions and threatens our own likelihoods. For example, we might appreciated having low-priced electronic goods imported from Asia but the imports may lead to the closure of factories in our own communities which were paying ourselves or our neighbours higher wages and now can no longer compete.

The second assumption is that *there are a large number of producers and that new producers can easily enter the market.* This intended to guarantee that neither individual buyers nor individual sellers can have undue power within any market. This is because, with so many sellers, it would be impossible to operate an effective cartel (an agreement between producers to fix prices), since the cost of finding information from so many sources would preclude such an arrangement. Again, because there are so many sellers, none can individually influence the price of the good s/he is selling. Large buyers might also come to have too much power in a market, so the assumption

applies also to the demand side of the market. This assumption relies on a separate sub-theory focused around the concept of 'barriers to entry'. In order to ensure that there are plenty of buyers and sellers in the market, there must be nothing to stop the potential market players from entering the market, no 'barriers'. Competition only works when there are large numbers of suppliers who cannot unduly influence our purchasing decisions or preventing other producers from entering the market and improving on their offer to us as consumers. We will explore this assumption more fully in the following section, but for now we should recognise that it is a view of the world that has not survived successfully the move from the early days of capitalism to the later form of globalised capitalism dominated by a small number of powerful corporations.

One possible barrier that producers just setting up a business might face is that they are only producing on a small scale and that their costs are therefore higher than those of larger producers. So to have an effective market we have to assume that *there are constant returns to scale*, meaning that it costs you exactly the same to make the first car or pair of shoes as the millionth car or pair of shoes, so that it is no cheaper to be a large manufacturer than it is to be a small manufacturer. This assumption is needed to allow for the potential entrants to a market to enter that market without facing the obstacle of higher costs in the initial period because they are producing fewer units of the product. This is a strange assumption since it has little if any evidence to support it, it runs counter to common sense and it is also in direct opposition to another favourite economic principle: the importance of economies of scale. It is because through growing larger and producing more companies can reduce costs that what we really see in capitalist economies is high rates of consolidation, as we will discuss in the following section.

In order for an economy to operate in a competitive way it has to be possible for producers to move into markets where there are profits to be made, and for consumers to be able to always be sure of paying the lowest prices. So for markets to work efficiently *both producers and consumers needs to have perfect information.* The sellers in any market must have a knowledge of market opportunities to ensure entry of new producers which is the way that prices are kept low and racketeering is prevented, the basis of why the market system is a good system for distributing goods. Potential entrepreneurs are expected to scan the economy for market opportunities for them to exploit, which are those opportunities where existing suppliers are making the largest profits, 'abnormal profits', as economic theory calls them. But how are we to know the size of these profits, normal or abnormal, when such knowledge is constrained by commercial confidentiality? And how are those seeking to enter market to know what the opportunities are when the market they are dealing with is now global?

Of all the assumptions of perfect competition the assumption about knowledge of opportunities to buy and sell has failed the test of time perhaps worst of all and this is even more obvious when it comes to consumers. In Adam Smith's 18th-century market it was a reasonable suggestion that you might be able to have 'perfect information' about all the goods between which you were making your choice. There were, let's say, three shoemakers and you could stroll from one stall to the next, and on to the third. In markets and fairs of this time, producers of similar goods helpfully located themselves alongside one another, which is why we are left with street names such as Butcher's Row or Shoe Lane. Pretty nearly perfect information was possible then, because there was such a limited range of goods. Proponents of market capitalism frequently list the expanded range of goods as one of the achievements of their favoured economic system, yet they have failed to consider how this impacts on the assumption about perfect knowledge. With millions of goods currently available how could we possibly know about all of them? Internet shopping has certainly improved the level of information of consumers but only for goods which can be sold electronically and for those who are able to shop in this way.

We saw in Chapter 3 how some economists think of resources as 'factors of production': market theory makes some strange assumptions about these factors: *factors of production are perfectly mobile*. Clearly land cannot be mobile, but does it make more sense to think of labor and capital as being mobile? Policy controlling markets at the global level has been focused on enabling the mobility of capital, that is to say making it as easy as possible for investors in one country to invest in any other, but there are still countries that exercise control over the flow of wealth into and out of their countries. This is important, because if competition is to work then producers who see the opportunity of manufacturing in another country at lower cost need to be able to move to exploit that opportunity rapidly (see the What's Going on box for some detail about the problems investors have faced capitalizing on foreign investments). If labour were perfectly mobile then this would mean that there were no barriers to immigration and workers who saw opportunities to earn higher wages elsewhere would move to those jobs. The US border with Mexico shows the limitations of this assumption: Mexican workers who could earn higher wages across the border are strenuously prevented from gaining access to the US. Aside from legal restrictions there are personal and social limits on the mobility of capital. People are reluctant to move far from their families and find it hard to succeed in countries where a different language is spoken.

In order for markets to work perfectly we have to make some rather strange assumptions about products: on the production side *all firms produce an identical product* and on the consumer side *consumers are indifferent between the products of different manufacturers*. This assumption is necessary to achieve the required situation where we make our purchases solely on the basis of price; it is often referred to as the homogeneity of the product, while consumers are defined as being indifferent between the different products on offer. We are indifferent between the products of different suppliers, since we regard all units of the industry's product as identical. The fact that this assumption is unlikely to be met in practice is clear from the amount of time an energy firms spend building up the brands which guarantee their sales. For it to be true we would, as consumers, have to show no preference between different brands of cola or make of car.

So we see that the theory of perfect competition describes a market ideal that does not exist in reality. This is a serious issue, since the theory carries considerable weight in discussions around what is the ideal form of economic system (discussions that are taken further in Chapter 12). In the following section we will explore some of the reasons why the globalised capitalist economy falls short of the ideal sketched in many economics textbooks. We will conclude this section by raising some questions about its limitations even in its unrealistic, ideal form.

We would be foolish to deny that the system based on markets and competition has brought about rapid technological innovation and greatly improved standards of living and the efficiency of productive systems. However, it is based on certain social and ecological traits that are less attractive, and have become actually threatening to the human species. A competitive system relies on citizens being competitive and this can have damaging social consequences, as countries compete with each other to reduce wages and employment standards and consumers engage in consumption-based competition that threatens their psychological well-being. The market system also brings inequality, since where there is competition there are losers as well as winners (you can find more about this in Chapter 3). Perhaps most importantly of all, the very benefits claimed for market systems--their dynamism and compulsion to create innovation and economic growth--has led us into a situation where progress is often interpreted in human terms but ignores the limits of the natural system that we must learn to live within.

Theory: Schumpeter on Innovation

Joseph Schumpeter (1883-1950) was a highly creative economic thinker who contributed to a wide range of aspects of economic theory. Here we are going to focus on his ideas about how innovation

happens within capitalist economies. Economists at the time were interested in ‘business cycles’ (see more in Chapter 17), an explanation for the way that capitalist economies go through periods of ‘boom’ (rapid expansion) and ‘bust’ (when the expansion comes to a sudden end). Schumpeter followed Marx in portraying capitalism as a highly dynamic system and one which evolved through series of crises. He used the Marxist term ‘creative destruction’ to describe this process, and has become identified with that phrase. This challenged existing thinking that economies would eventually find their way to an ‘equilibrium’ or stationary point where resources were used in the most efficient way to achieve maximum well-being. In contrast, Schumpeter thought that economies passed through periods of radical and rapid change brought about by challenges to the existing technological or social systems.

In his most famous book *Capitalism, Socialism and Democracy*, Schumpeter writes that ‘The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.’ The process of innovation is his explanation for this process of creative destruction ‘that incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in’.

We can think of the changes brought to the global economy through the development of the internet as an example of the process of creative destruction through innovation. The ability of large corporations to maintain production units in low-wage economies, while undertaking research and development in other countries on the other side of the globe has greatly increased their profitability and reduced the prices of goods for consumers. However, this process has also had negative impacts, such as the destruction of small retailers who cannot compete with online retailers and the difficulties faced by smaller producers who do not have access to the same global production systems.

The individual entrepreneur plays an important, almost heroic, role in Schumpeter’s theory. It is his desire to advancement and ability to identify the important technological innovations that spurs the disruptive process of transformation within capitalism that leads to continued economic growth. This aspect of his theory has proved popular with contemporary commentators who use it as justification for the major social dislocations that often accompany economic transformation, such as the movement from the land and into factories of many people who live in today’s ‘developing economies’.

2. Markets and Consolidation

It is interesting being an educator in a business school: in the introductory economics course you can find yourself teaching about perfect competition and the superiority of the market, and then in the strategy course you can find yourself teaching the same students how in reality firms manoeuvre to achieve dominate market power. This tendency of firms to become larger, or to join up, in order to have more power in the market is known as ‘consolidation’ and it is a significant aspect of how the global economy works in practice. Consolidation on is a word used to describe the concentration of a market between a smaller number of players, and has been a pattern that we have seen in an increasing number of markets in the era of globalisation. Consolidation in the global music industry has been intense in recent years, with the industry now dominated by the ‘big four’, Universal Music Group, Sony, EMI and Warner Music Group, who together account for 75% of the global music market (see more detail in Table 9.2). It is clear that this is not the sort of competitive environment that was described in the previous section and is used to justify the superiority of the

market system as a form of economic organisation. At the harder end of the global economy, the mining industry is also becoming highly consolidated, with a small number of multinational corporations—primarily BHP Billiton, Vale and Rio Tinto—coming to own most of the world's scarce mineral resources.

Table 9.1. Proportions of Global Sales by Leading Corporation and Independent Labels, 2011

UMG	27.9
Sony	21.9
EMI	9.9
Warner	15.1
Indie	25.2

Source: Music & Copyright annual survey:
http://musicandcopyright.wordpress.com/2012/05/02/the-adele-effect-hits-major-record-company-market-shares-in-2011/
Xi3, B. (2012), 'Mining Overview', Columbia University Consulting Club, 5 March 2012:
http://www.columbia.edu/cu/consultingclub/Resources/Mining_Boyi_Xie.pdf

In reality, the business of a corporation in the global economy focuses on holding and expanding its market share. This is achieved through a number of strategies including horizontal and vertical diversification, control of intellectual property, and the exercise of dominant market position. Vertical diversification refers to the process by which companies extend their reach to more stages in the production cycle where they are located. For example, a dairy farmer might decide to begin manufacturing cheese, or even move into the production of milking equipment. A company can thus use its established position, technical knowledge and market connections to broaden its production range and hence its size and profitability. Horizontal diversification refers to a firm's decision to expand the range of products it sells, using its existing customer base but making more products available to them. For example, a company that presents offers an internet service might begin to also offer a mobile phone service or a cable TV service.

History: The Co-operative Movement

The impulse for the the growth of the co-operative movement arose from a critique of capitalist production called 'the labour theory of value'. This suggested that from any manager- or shareholder-owned firm, a large amount of the value created by the labour of working people was taken out of the firm by owners who did not themselves contribute to the product. The idea of the co-operative is to remove such external owners so that the employees themselves own the firm, control their own work and that the surplus they generate will either be reinvested in the firm or paid to them as bonuses.

In Britain, the co-operative movement began on the consumer rather than producer side. After the Industrial Revolution people were drawn away from the land and into the industrial towns. For the first time they had to buy most of their food from shops and the shops had a monopoly and often sold low-quality food at high prices. In 1844 in the Lancashire town of Rochdale a group of local people came together to establish a buying co-operative to prevent the shop-owners exploiting them. They became known as the 'Rochdale Pioneers' and started the cooperative retail shop that is still a major player in the UK today. In continental Europe co-operatives focused more on the production side of the economy and grew into a movement known as 'syndicalism', which sought worker control of firms. In some areas of Europe co-operatives now control large sectors of production and distribution.

Co-operatives are a significant part of many modern economies. For example, in the USA 30,000 co-operatives provide more than 2 million jobs and over 900, mainly rural, energy co-operatives own 40% of national power lines and provide light and power to 42 million people in 47 states. In France 21,000 co-operatives provide over 1 million jobs representing 3.5% of the active working population. Co-operatives are particularly strong in some national economies and in particular sectors. For example in Denmark in 2007 consumer co-operatives provided for 36.4% of consumer retail market; in Japan agricultural co-operatives produce $90 billion worth of food with 91% of all Japanese farmers being members of co-operatives; in New Zealand 3% of the gross domestic product (GDP) is generated by co-operative enterprise. Co- operatives are responsible for 95% of the dairy market and 95% of the export dairy market.

Data source: International Co-operative Alliance: http://2012.coop/en/ica/co-operative-facts-figures

We have seen above that the reason market economies are superior relates to the fierce competition between firms, meaning that consumers receive better service and lower prices. For this to be enabled, information about products must be freely available. However, in the global economic system of the 21st century firms working very hard to control their knowledge which is defined as 'intellectual property' and its ownership limited by international law known as TRIPs (trade-related intellectual property). The pharmaceutical industry offers a clear example of how companies control intellectual property to maximize profits, even when it means the loss of life in some of the world's poorest communities. Patents have long been used in the pharmaceutical industry to protect the fruits of research. With 25 per cent of its people of working age being HIV-positive, in the late 1990s the South African government decided to ignore international law and import generic AIDS drugs from India. The price difference is staggering—$350 for a year's supply compared with $10,000 for the branded medicines—so a poor country like South Africa had little choice. Under the TRIPs agreement South Africa was clearly able to justify its actions under clauses exempting countries facing public-health disasters, but its actions were legally challenged by the US trade representative and action was taken against the government of South Africa by the Pharmaceutical Manufacturers' Association. The courage of the government was rewarded and the PMA eventually withdrew its case in 2001, coming to a deal with the government over reasonable pricing and availability of AIDS drugs.

Even when they have innovative products to offer, new manufactures can find it hard to move into established markets where there are well-established and powerful players. Creating such a product already represents a significant investment in terms of research and development, which can operate as a 'barrier to entry' for those cannot access capital. James Dyson has described the sort of problems that can be created for innovative products such as his Dual Cyclone vacuum cleaner, which was rigorously opposed by the existing manufacturers:

The Dual Cyclone™ was nearly never made due to patent and legal costs. Unlike a songwriter who owns the song he writes, an inventor has to pay substantial fees to renew his patents each year. During the development years when James Dyson had no income, this nearly bankrupted him. He risked everything, and fortunately the risk paid off. Then in 1999, Hoover tried to imitate a Dyson and James Dyson was forced back to court to protect his invention. After 18 months Dyson finally won a victory against Hoover for patent infringement.

It is important to understand that there is a complex relationship between scale and market power. In the case of most manufacturing activities producers have to pay fixed costs and variable costs. Fixed costs include things like renting office space or taking on staff and will have to be paid for no matter how many products are made and sold; variable costs include things like the raw materials used to produce goods and the quantity of them used, and therefore the cost, is directly proportional to the quantity of output. For a larger output the fixed costs make up a smaller proportion of the cost

if the production of each item, and hence the average costs of production: this ability to achieve lower costs at a higher scale of production is referred to as 'economies of scale' and is the key motivation for firms and companies to expand. However, as we have already seen, the market is more efficient only if new small-scale producers can come into the market to offer their more innovative products or goods at lower prices and hence provide the sort of competition that makes capitalism a superior economic system. If economies of scale mean built in advantages for established producers it is hard to argue that new, smaller producers face the same market conditions as the dominant players. (See the History box in Chapter 20 for details about how US regulators used to ensure fair competition.)

What's Going On? The Risks of Foreign Investment

As we have seen, one of the justifications for the superiority of a globalised economy based on open markets is that capital can flow freely from country to country, bringing together the optimal combination of human and material resources to achieve efficient production. What is the empirical basis for this argument? How secure is foreign capital when it is invested in countries with different economic cultures and histories?

Since the end of the communist system (see Chapter 12) in 1990 Russia has become a highly attractive destination for foreign investment, especially because of its significant oil reserves. However, information from the US State Department suggests that the conditions under which money invested in Russia are not the same as those facing an investor in the US itself. On the positive side, rapid growth in the market economy and a highly educated population are listed as advantages, but political conditions are not so favourable. Russian politicians are much more willing to investigate the activities of businesses that they believe are accumulating unjustifiable levels of profit or not operating in the national interest. This has alarmed US investors, although foreign investments into Russian in 2011 increased 11.8% on the previous year.

Companies may also lose their investments if governments take a nationalist approach to the ownership and control of national resources. This is a strategy being followed increasingly by Latin American leaders. Following his re-election in 2006, Venezuelan President Hugo Chavez nationalized the country's remaining private oil companies. In 2012 Argentina's President Cristina Fernandez de Kirchner followed a similar policy, nationalizing the oil assets of the Spanish company Repsol. In both cases compensation was paid but the companies involved disputed the value of their assets and legal action followed.

Perhaps the most well recorded story of the failure of the global investment is that of the Cochabamba Water Revolt. Cochabamba is the third largest city in Bolivia and by 2001 its rapidly growing population had exceeded half a million people. Bolivia is a poor country where the minimum wage at this time was around US$70 per month. Due to its poverty it had also become indebted to the World Bank and was urgently in need of further loans. In February 1996 the World Bank made the privatisation of Cochabamba's water supply company a condition of the new $14 million loan the country urgently needed. National law 2029 privatised all the country's water, including water that fell as rain. A 40-year contract was signed with a consortium of US corporations led by engineering giant Bechtel: it was worth $2.5billion and meant that citizens now had to pay monthly water bills of around $20. Since they could literally no longer afford to pay for water this led to huge street protests throughout 1999 and 2000. Eventually the Bechtel executives left the country and the government cancelled the contract.

Data sources: US State Department, Investment Climate Statement: Russia: http://www.state.gov/e/eb/rls/othr/ics/2012/191223.htm

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3. What is a firm?

In a market economy producers have to organise their resources and the people they are going to employ to turn those resources into products. In economic theory the organisation of people in this way is defined as a 'firm'. It is important to realise that, as we will see later, a firm could be organised and managed in many different ways, although most firms in capitalist economies such as those of the UK and USA are either owned by shareholders, as partnerships, or by families (we will discuss the possibilities for workers to exercise power within companies in Chapter 19). Other firms have a single proprietor and, as we have seen in the previous section, many aspects of the global economy are dominated by large-scale multinational corporations.

Economists are keen to discover which firms are more efficient, that is to say which firms use the inputs to the production process, and the labour employed, most effectively to make high-quality products for the lowest prices. The size of the firm has an important impact on efficiency since larger companies can exploit economies of scale to achieve lower prices. Whether such scale economies are available depends on the kind of product or services that the firm trades in. For example it is clear that making a larger number of shoes in a single factory would be more efficient, but this cannot be argued in the same way for personal services, such as health-care. If firms become too large it is possible for them to encounter 'diseconomies of scale', when the size of their operations leads to problems of co-ordination, perhaps between different sites of production or between different types of employee or elements of the production process.

In many firms there is a separation between the people who manage the firm and the people who own the firm, who may be shareholders or partners who are not directly involved in managing the business. Both are rewarded if the firm is successful--the shareholders will receive dividends and the managers will receive higher pay--but they may be in conflict over the proportion of the surplus that should be paid to them, and also about how the firm should be run. This is sometimes called the 'principal-agent problem' where the owner is the principle who employs the manager to run the firm on her behalf. Clearly the managers have much more detailed information about what is happening within the firm, and this can give them considerable power, especially if they choose not to share this information with shareholders.

Table 9.1. Forbes's Corporate Scandal Sheet

Company, date scandal broke	Nature of offence	Outcome
AOL Time Warner, July 2002	AOL inflated the value of its sales by counting deals sold on behalf of others on its own balance-sheet	No prosecution; the company has voluntarily 'written down' the value of its stock
Arthur Andersen, November 2001	This international accountancy firm shredded documents relating to its client Enron to obstruct the investigation into that company	Andersen was convicted of obstructing justice. It has changed its name to Accenture and continues to be one of the world's largest accountancy firms

Enron, October 2001	Artificially boosted profits and hid debts worth more than $1bn. by trading 'off the books'; manipulated the Texas and California energy markets to increase profits; bribed foreign governments	Former chairman and CEO Kenneth Lay and former CEO Jeffrey Skilling were prosecuted and found guilty of fraud in 2006. Lay died during the trail but Skilling was sentenced to 24 years in prison
Halliburton, May 2002	Included in accounts $100m. of construction costs before customers had agreed to pay for them	Individuals and mutual funds who lost as a result of the manipulation of the stock price are battling to bring a class action suit
Worldcom, March 2002	Total assets inflated by $11bn; overstated cashflow by accounting for $3.8bn. of operating expenses as capital expenses; gave founder Bernard Ebbers $400m. in loans that were not included in the accounts	Filed for bankruptcy in July 2002. In 2005 Ebbers as convicted of fraud and false accounting and sentenced to 25 years in prison. Several other former executives were also convicted.
Xerox, June 2000	Falsifying financial results to boost income by $1.5bn.	Came to arrangement with the Securities and Exchange Commission to pay a $10m. fine

Note: Many of these scandals concern the use of 'creative accounting' to make the company look more successful than it is and thus raise stock values artificially.
Source: http://www.forbes.com/2002/07/25/accountingtracker.html

In such a situation the 'principals', i.e. the shareholders will seek to improve systems of reporting what happens in the firm and enhance the audit process. They may also seek to find ways of making sure that their objectives and those of the managers who run the company match up better. An example would be to create a system whereby employees of the company own some of the stock. If managers know that they receive a dividend in return for a good performance by the firm rather than just their salary this will give them an incentive to ensure that the value of the company is maximised. The most powerful body within a company is the board and so shareholders might also insist that the board includes directors who are not employed by the firm, perhaps especially for tasks such as auditing and setting salary rates.

In recent years there have been a number of high-profile scandals where those running firms have deceived the company's owners and defrauded them of large amounts of money (see Table 9.1). This has led to questions being raised about the nature of the firm and whether it is any longer and ideal form of organization of productive activity. The problem of the conflict between owners and employees can be solved by the co-operative form of enterprise, where the employees actually own the firm (see the History box and the further detail in Chapter 19).

As well as the relationships and power dynamics within the firm and the relationship between managers and shareholders we should also be aware of the relationship between the employees of the firm and all the other citizens they come into contact with, a group of people who are sometimes referred to as 'stakeholders'. In recent years corporations have focused on generating the maximum amount of value for shareholders but this has sometimes meant that the firm has had a highly

negative impact on those outside the ownership and governance structure of the firm. As Figure 9.1 illustrates, there are a vast range of people who are impacted on by a firm's activities and to whom the firm has a responsibility and to whom it should, to some extent, be accountable for its activities. The process of identifying stakeholders is described in the Technique box.

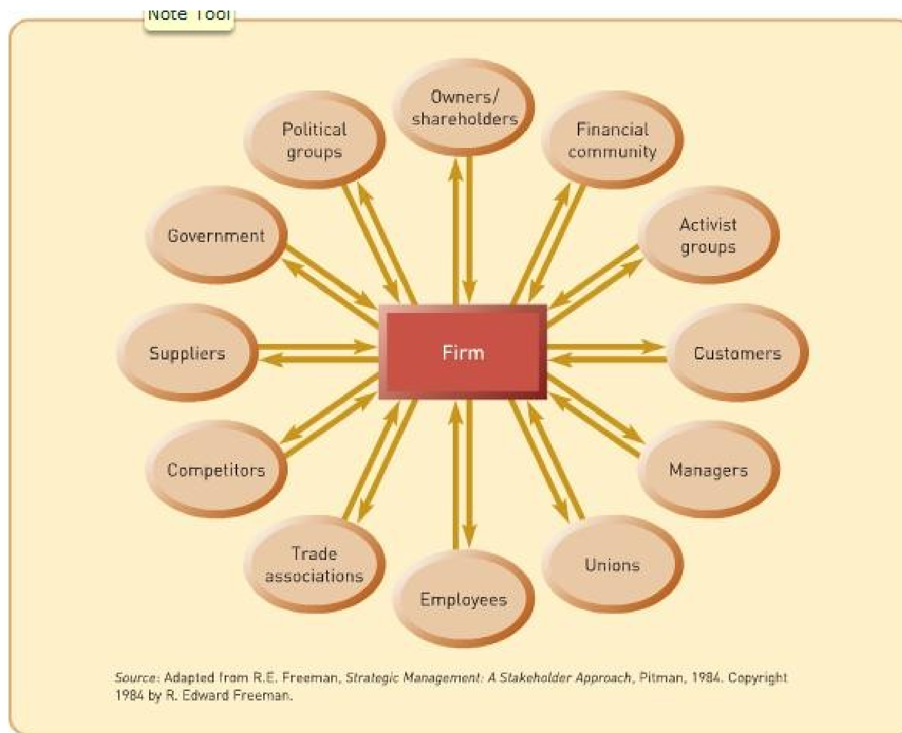

Figure 9.1. Identifying a firm's stakeholders

Technique: Stakeholder Analysis

Conducting a stakeholder analysis successfully depends on being committed to genuinely seeking to work with all your actual or potential partners as a business. For some companies the idea is more to manage expectations and deflect potential damaging criticism. However, responsible companies recognise their social responsibility that goes beyond the confines of the firm itself.

Step 1. Identify your stakeholders

Stakeholders have been defined as 'Individuals or groups with an interest, claim or stake in the company, in what it does, and in how well it performs' (Hill & Jones, 2009:367). As is clear from Figure 9.1, this can be a very complex business. It is best undertaken through a brainstorming exercise, following which company executives need to make decisions about who are the most important stakeholders and how they should all be kept informed and allowed to participate in decisions.

Step 2. Prioritise your stakeholders

Power / influence		Little	Some	High
	High	Watch	Keep Satisfied	Actively Manage
	Some	Keep On Side		
	Little	General Communication	Keep Informed	

Interest

Sometimes a 'power grid' is used to assess potential stakeholders according to two variables: how interested they are in the activities of the firm, and the degree of their power in affecting the operation of the firm. From the point of view of the profit-driven firm the most important stakeholders are those with a high degree of power who are also very interested in the firm's business. They need to be kept fully informed and on side with company decision-making. Powerful stakeholders with a low level of interest also need to be given information but not so much that it becomes irritating. The ethical behaviour of a firm can be judged by how it deals with its less powerful stakeholders. Companies whose commitment to corporate responsibility is only superficial or intended for marketing purposes are likely to feed interested but powerless stakeholders heavily slanted information, and to prevent them from discovering potentially damaging information about the firm. More ethical firms may use such individuals or groups as useful sounding-boards for potential controversial new strategies or policies.

There are also interesting questions to be asked about how a company assesses the potential power of stakeholders. For example any large corporation is likely to maintain friendly relations with politicians responsible for regulating their industry, but what about campaigners? Do they also constitute powerful stakeholders? Helen Steel and Dave Morris were two stakeholders who were heavily interested in the activities of the global fast-food giant McDonalds, which judged them to have a low degree of power and so did not engage with them. As members of London Greenpeace they distributed leaflets outside McDonalds premises criticising the companies environmental record and the quality of the food it sold. In 1990 McDonalds sued the pair for libel, beginning the longest legal trial ever to take place in England. The outcome resulted in very negative publicity for McDonalds. The judged ruled that they produce misleading advertising that exploits children, that they pay low wages and are responsible for cruelty to animals. Steel and Morris were found guilty of libel on other aspects of their claims that they could not substantiate and were ordered to pay £60,000 in damages. In a later appeal case the Court of Appeal ruled that 'if one eats enough McDonald's food, one's diet may well become high in fat . . . with the very real risk of heart

disease', a statement that was clearly damaging to McDonalds. Through poor management of stakeholders its global reputation was undermined.

Step 3. Map your stakeholders

Key individuals and groups can be plotted onto the power grid. This will enable the firm to devise appropriate strategies to deal with them in terms of engagement, consultation, information and dealing with conflicts of objectives.

Source: Thanks to Manchester Metropolitan University for its toolkit: http://www.mmu.ac.uk/bit/docs/Stakeholder-analysis-toolkit-v2.pdf

Further Resources

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Questions

What do you understand by the phrase 'economies of scale'? Can you give an example of when it does and when it does not apply to a certain production process?
How would the issue of shares to employees deal with the principal-agent problem of corporate governance?
To what extent has consolidation of the music industry been the result of technological change rather than market power?

Activities for Students

Students can be given summaries of a range of companies—their key markets and strategies—and be asked to conduct a stakeholder analysis.

Students could be asked to undertake research into the consolidation of different industries over the past 30 years. How many companies were powerful players in the market in 1980 and how many today? What impact has this had on competition?