PEARSON EDEXCEL INTERNATIONAL A LEVEL

ECONOMICS

Student Book 2

Karen Borrington
Tracey Joad

Published by Pearson Education Limited, 80 Strand, London, WC2R 0RL.

www.pearsonglobalschools.com

Copies of official specifications for all Pearson Edexcel qualifications may be found on the website: https://qualifications.pearson.com

Text © Pearson Education Limited 2019
Designed by Pearson Education Limited 2019
Typeset by Evolution Design & Digital Ltd (Kent)
Original illustrations © Pearson Education Limited 2019
Edited by Andrea Davison, Judith Shaw and Steph White
Cover design by Pearson Education Limited 2019
Picture research by Integra
Cover photo © Thomas Winz/Lonely Planet Images/Getty Images.
Inside front cover photo: **Shutterstock**, Dmitry Lobanov

The rights of Karen Borrington and Tracey Joad to be identified as authors of this work have been asserted by them in accordance with the Copyright, Designs and Patents Act 1988.

First published 2019

22 21 20 19
10 9 8 7 6 5 4 3 2 1

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN 978 1 29223 918 7

Printed by Neografia in Slovakia

Acknowledgements
We'd like to thank our teacher reviewers for their contribution to this book: Clive Agent, Alain Anderton, Sonali Dassanayake, Tony Gray, Colin Leith, Harrison Mwangi and YK Yam.

The publisher would like to thank the following individuals and organisations for permission to reproduce photographs:

(Key: b-bottom; c-centre; l-left; r-right; t-top)

2 Getty Images: Studio 642/Getty Images; **4** (tr) **Shutterstock:** IJeab/Shutterstock; **4** (br) **123RF:** Belchonock/123RF; **10 123RF:** Kzenon/123RF; **13** (ml) **Shutterstock:** JMiks/Shutterstock; **13** (br) **Shutterstock:** ANURAK PONGPATIMET/Shutterstock; **19 Alamy Stock Photo:** Greg Balfour Evans/Alamy Stock Photo; **22 Getty Images:** Dana Lazarus-Casd/EyeEm/Getty Images; **26 Shutterstock:** Alex Babashov/Shutterstock; **27 Shutterstock:** Jean Schweitzer/Shutterstock; **35 123RF:** Petro Perutskyi/123RF; **37 Pearson Education Ltd:** Mark Bassett/Pearson Education Ltd; **43 Shutterstock:** Iam_Anupong/Shutterstock; **45 123RF:** Sean Pavone/123RF; **52 Shutterstock:** Perfect Lazybones/Shutterstock; **53 Shutterstock:** SimonHS/Shutterstock; **54 Getty Images:** FotoVoyager/iStock/Getty Images; **56 Shutterstock:** Jayakumar/Shutterstock; **59 Shutterstock:** Gustavo Frazao/Shutterstock; **60 Shutterstock:** Chuyuss/Shutterstock; **61 Shutterstock:** Valeriy Velikov/ Shutterstock; **64** (tl) **123RF:** George Tsartsianidis/12RF; **64** (ml) **Shutterstock:** Tobkatrina/Shutterstock; **64** (tr) **Shutterstock:** Alex Hubenov/Shutterstock; **64** (mr) **Shutterstock:** Lunamarina/Shutterstock; **68 Shutterstock:** Darren Baker/Shutterstock; **70 Shutterstock:** Bo1982/Shutterstock; **71 Shutterstock:** Fotokostic/Shutterstock; **76 Shutterstock:** John Carnemolla/Shutterstock; **78 Shutterstock:** Tati Nova photo Mexico/Shutterstock; **83 Shutterstock:** Zhu difeng/Shutterstock; **84 Shutterstock:** Kzenon/Shutterstock; **85 Shutterstock:** Labrador Photo Video/Shutterstock; **89** (mr) **123RF:** Bjoern Wylezich/123RF; **89** (br) **Shutterstock:** Masekesam/Shutterstock; **94 Shutterstock:** Pius Lee/Shutterstock; **96 Shutterstock:** Jirapol Konroo/Shutterstock; **107 123RF:** Michael Simons/123RF; **108** (ml) **Shutterstock:** Pressmaster/Shutterstock; **108** (bl) **Shutterstock:** Rainer Plendl/Shutterstock; **110 123RF:** HONGQI ZHANG/123RF; **111 Shutterstock:** Michaeljung/Shutterstock; **113 Getty Images:** Hero Images/Getty Images; **114 Shutterstock:** Jacob Lund/Shutterstock; **119 Shutterstock:** Langstrup/Shutterstock; **121** (ml) **Pearson Education Ltd:** Jules Selmes/Pearson Education Ltd; **121** (bl) **Shutterstock:** DW labs Incorporated/Shutterstock; **125 123RF:** Rainer Plendl/123RF; **130** (tl) **Shutterstock:** Andrey Arkusha/Shutterstock; **130 123RF:** 123RF; **130** (tr) **Shutterstock:** Vankad/Shutterstock; **130** (mr) **Shutterstock:** Rob Byron/Shutterstock; **134 123RF:** Derege/123RF; **136** (ml) **Shutterstock:** Heiko Kueverling/Shutterstock; **136** (bl) **Shutterstock:** Eyeidea/Shutterstock; **138 123RF:** Kzenon/123RF; **139 123RF:** Mark Bowden/123RF; **140 Getty Images:** RoBeDeRo/E+/Getty Images; **149 123RF:** Somsak Sudthangtum/123RF; **157 Getty Images:** Nisa and Ulli Maier Photography/Moment/Getty Images; **164** (tl) **Shutterstock:** Dmitry Kalinovsky/Shutterstock;**164** (br) **Shutterstock:** Rzoze19/Shutterstock; **165 123RF:** Natalia Bratslavsky/123RF; **175 Shutterstock:** Vacclav/Shutterstock; **176 Getty Images:** Anucha sirivisansuwan/Moment/Getty Images; **181 Shutterstock:** Senk/Shutterstock; **184 Pearson Education Ltd:** Studio 8/Pearson Education Ltd; **187 Shutterstock:** Dmitry Kalinovsky/Shutterstock; **193 Shutterstock:** Samot/Shutterstock; **199 Shutterstock:** Siriwat sriphojaroen/Shutterstock; **200 Shutterstock:** 54115341/Shutterstock; **209 Shutterstock:** Delpixel/Shutterstock; **211 Shutterstock:** Donvictorio/Shutterstock; **222 Getty Images:** Thitivong/iStock/Getty Images Plus/Getty Images; **227 Shutterstock:** Paul Cowan/Shutterstock; **230 Shutterstock:** Patrick Foto/Shutterstock; **231 Shutterstock:** Orhan Cam/Shutterstock; **232 Shutterstock:** Mark Van Overmeire/Shutterstock; **237 Shutterstock:** Pavel Shlykov/Shutterstock; **240 Shutterstock:** Pavel Ilyukhin/Shutterstock; **242 Shutterstock:** Javarman/Shutterstock; **243 Shutterstock:** Mentatdgt/Shutterstock; **246 Shutterstock:** Photoinnovation/Shutterstock; **248 Shutterstock:** Vladimir Korostyshevskiy/Shutterstock; **251 Shutterstock:** Graja/Shutterstock; **261 Getty Images:** Puneet Vikram Singh, Nature and Concept photographer/Moment/Getty Images; **266 Shutterstock:** Lazyllama/Shutterstock; **269 Shutterstock:** TheFinalMiracle/Shutterstock; **272 Shutterstock:** Jose Miguel Hernandez Leon/Shutterstock; **280 Shutterstock:** Wong yu liang/Shutterstock; **281 Shutterstock:** Luciano Mortula - LGM/Shutterstock; **282 Getty Images:** Anucha sirivisansuwan/Moment/Getty Images; **289 Shutterstock:** Andrey_Popov/Shutterstock; **309 Shutterstock:** Bolarzeal/Shutterstock; **313 Shutterstock:** Sunsinger/Shutterstock; **314 Shutterstock:** VictoryX21/Shutterstock; **317 Pearson Education Ltd:** Sophie Bluy/Pearson Education Ltd; **322 Shutterstock:** Orhan Cam/Shutterstock; **323 123RF:** Rawpixel/123RF; **326 Shutterstock:** Rafal Cichawa/Shutterstock; **328 Shutterstock:** Norman Chan/Shutterstock; **329 Getty Images:** Miguel Navarro/DigitalVision/Getty Images; **334 Shutterstock:** Cbpix/Shutterstock; **337 Shutterstock:** Fiona Ayerst/Shutterstock; **346 Shutterstock:** Zhu difeng/Shutterstock; **348 Shutterstock:** Szefei/Shutterstock; **357 Shutterstock:** Toonman/Shutterstock; **362 123RF:** Valery Shanin/123RF.
All other images © Pearson Education

For acknowledgements of text materials in this textbook, please see the inside back cover of the book.

Endorsement statement
In order to ensure that this resource offers high-quality support for the associated Pearson qualification, it has been through a review process by the awarding body. This process confirms that this resource fully covers the teaching and learning content of the specification at which it is aimed. It also confirms that it demonstrates an appropriate balance between the development of subject skills, knowledge and understanding, in addition to preparation for assessment.

Endorsement does not cover any guidance on assessment activities or processes (e.g. practice questions or advice on how to answer assessment questions) included in the resource, nor does it prescribe any particular approach to the teaching or delivery of a related course.

While the publishers have made every attempt to ensure that advice on the qualification and its assessment is accurate, the official specification and associated assessment guidance materials are the only authoritative source of information and should always be referred to for definitive guidance.

Pearson examiners have not contributed to any sections in this resource relevant to examination papers for which they have responsibility.

Examiners will not use endorsed resources as a source of material for any assessment set by Pearson. Endorsement of a resource does not mean that the resource is required to achieve this Pearson qualification, nor does it mean that it is the only suitable material available to support the qualification, and any resource lists produced by the awarding body shall include this and other appropriate resources.

UNIT 3: BUSINESS BEHAVIOUR

UNIT 4: DEVELOPMENTS IN THE GLOBAL ECONOMY

ABOUT THIS BOOK

This book is written for students following the Pearson Edexcel International Advanced Level (IAL) Economics specification. It covers the second year of the International A Level qualification.

The book has been carefully structured to match the order of the topics in the specification, although teaching and learning can take place in any order, both in the classroom and in any independent learning. This book is organised into two units (Unit 3 Business behaviour and Unit 4 Developments in the global economy), each with several topic areas.

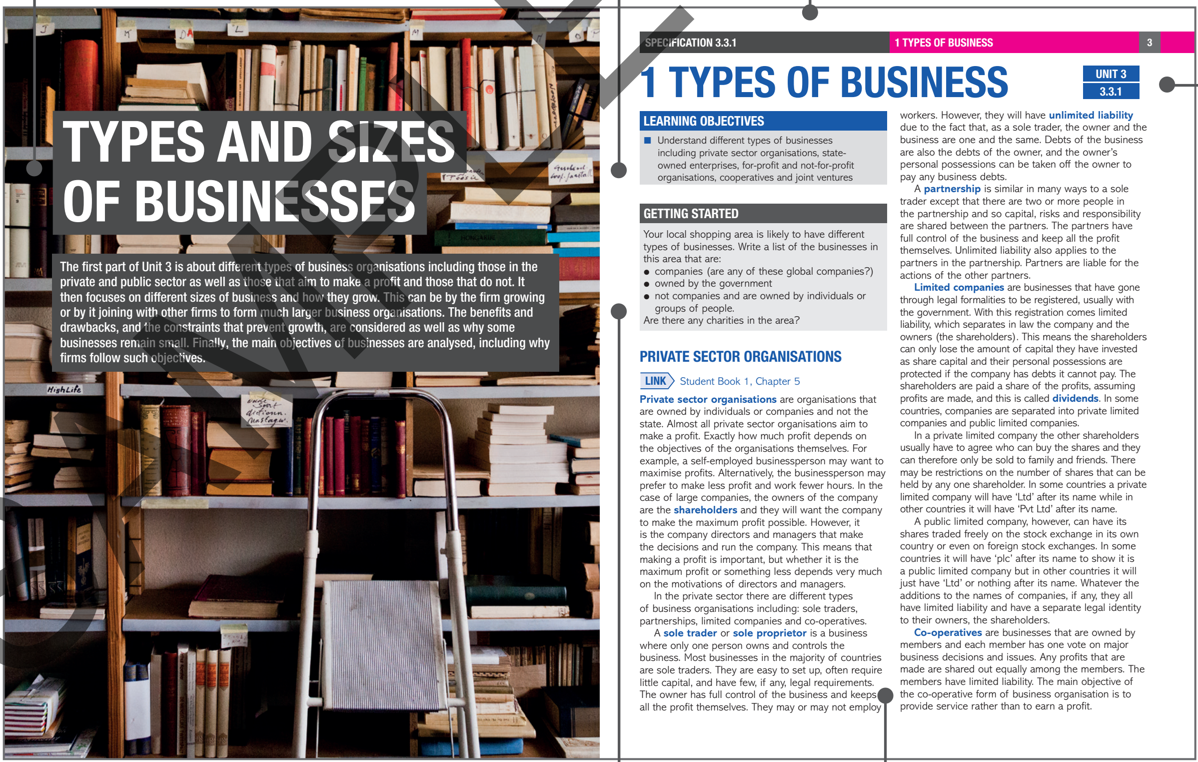
Each topic area is divided into chapters to break the content down into manageable chunks. Each chapter begins by listing the key learning objectives and includes a getting started activity to introduce the concepts. There is a mix of learning points and activities throughout, including global case studies that show a range of examples within real-life contexts. Checkpoint questions at the end of each chapter help assess understanding of the key learning objectives.

The content for Unit 3 is applicable to Paper 3 (Business behaviour) and the content for Unit 4 is applicable to Paper 4 (Developments in the global economy). Knowing how to apply learning to both of these papers will be critical for exam success. There are exam questions at the end of each chapter to provide opportunity for exam practice. Answers are provided online in the teaching resource pack.

Topic openers
Introduce each of the key topics in the specification.

Learning objectives
Each chapter starts with a list of key assessment objectives.

Specification reference
The specification reference is given at the start of each chapter and in the running header.

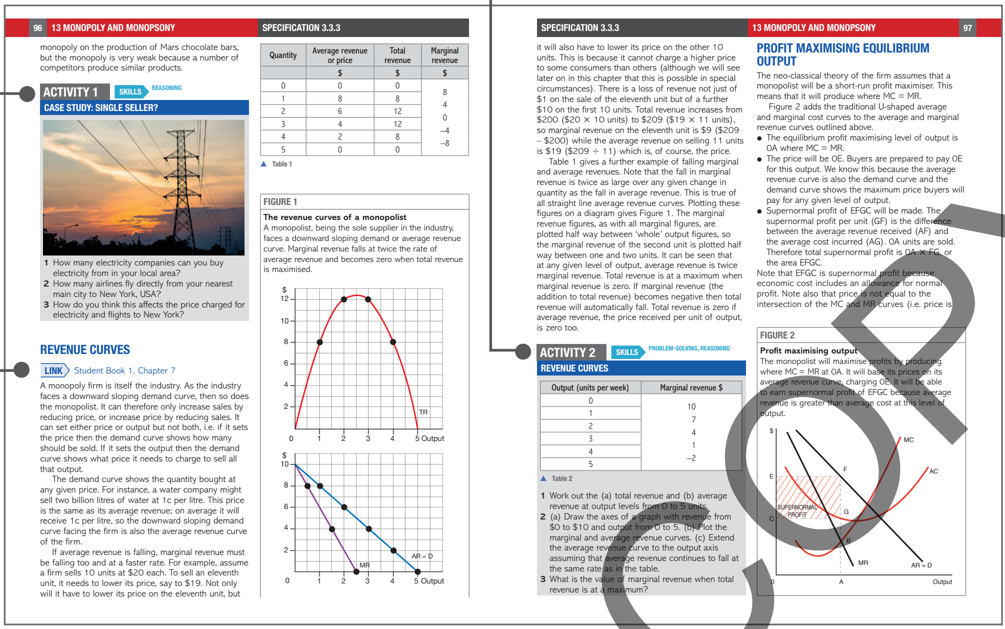


Getting started
An activity to introduce the key concepts in each chapter. Questions are designed to stimulate discussion and use prior knowledge. They can be tackled by individuals, pairs, groups or the whole class.

Key subject terms are colour coded within the main text.

Activity
Each chapter includes activities to embed understanding through case studies and questions.

Skills
Relevant exam questions are labelled with key skills, allowing for a strong focus on particular academic qualities. These transferable skills are highly valued in further study and the workplace.



Links
Suggest ways that topics link to others to build on knowledge and develop synoptic skills.

Checkpoint
These questions check understanding of the key learning points in each chapter. These are NOT exam-style questions.

Exam practice
These questions are found at the end of each chapter. They are tailored to the Pearson Edexcel specification to allow for practice and development of exam writing technique. They also allow for practice responding to the command words used in the exams.

Thinking like an economist
Provide opportunities to explore an aspect of economics in more detail to deepen understanding.

Subject vocabulary
An alphabetical list of all the subject terms in each chapter with clear definitions for EAL learners. A collated glossary is provided in the eBook.

Exam hint
Give tips on how to answer the exam questions and guidance for exam preparation.

ASSESSMENT OVERVIEW

The following tables give an overview of the assessment for this course. You should study this information closely to help ensure that you are fully prepared for this course and know exactly what to expect in each part of the assessment.

PAPER 3	PERCENTAGE OF IA2	PERCENTAGE OF IAL	MARK	TIME	AVAILABILITY	STRUCTURE
BUSINESS BEHAVIOUR Written exam paper Paper code WEC13/01 Externally set and marked by Pearson Edexcel Single tier of entry Calculators can be used	50%	25%	80	2 hours	January, June and October First assessment: January 2020	**Section A:** six multiple-choice questions (6 marks), **Section B:** a five-part question, based on data provided in a source booklet (34 marks), and **Section C:** two 20-mark essay questions from a choice of three (40 marks)
PAPER 4	**PERCENTAGE OF IA2**	**PERCENTAGE OF IAL**	**MARK**	**TIME**	**AVAILABILITY**	**STRUCTURE**
DEVELOPMENTS IN THE GLOBAL ECONOMY Written exam paper Paper code WEC14/01 Externally set and marked by Pearson Edexcel Single tier of entry Calculators can be used	50%	25%	80	2 hours	January, June and October First assessment: June 2020	**Section A:** six multiple-choice questions (6 marks), **Section B:** a five-part question, based on data provided in a source booklet (34 marks) and **Section C:** two 20-mark essay questions from a choice of three (40 marks)

ASSESSMENT OBJECTIVES AND WEIGHTINGS

ASSESSMENT OBJECTIVE	DESCRIPTION	% IN IAS	% IN IA2	% IN IAL
A01	Demonstrate knowledge of terms, concepts, theories and models to show an understanding of the behaviour of economic agents	27.5	18.8	23.1
A02	Apply knowledge and understanding to various economic contexts	30	22.5	26.3
A03	Analyse issues and evidence, showing an understanding of their impact on economic agents	22.5	28.8	25.6
A04	Evaluate economic arguments and use appropriate evidence to support informed judgements	20	30	25

Note: Percentages may not add up to 100 due to rounding.

RELATIONSHIP OF ASSESSMENT OBJECTIVES TO UNITS FOR THE INTERNATIONAL ADVANCED SUBSIDIARY QUALIFICATION

UNIT NUMBER	ASSESSMENT OBJECTIVE			
	A01	A02	A03	A04
Unit 1	6.9%	7.5%	5.6%	5%
Unit 2	6.9%	7.5%	5.6%	5%
Unit 3	4.7%	5.6%	7.2%	7.5%
Unit 4	4.7%	5.6%	7.2%	7.5%
Total for International Advanced Level	**23.1%**	**26.3%**	**25.6%**	**25%**

Note: Percentages may not add up to 100 due to rounding.

RELATIONSHIP OF ASSESSMENT OBJECTIVES TO COMMAND WORDS

COMMAND	NUMBER OF MARKS	MARK SCHEME	AOS
Calculate	2	Points Based	AO2
Draw	4	Points Based	AO1, AO2
Explain what is meant by Explain the term Explain two characteristics	4	Points Based	AO1, AO2
Explain why Explain how Explain the likely impact Explain and illustrate	4	Points Based	AO1, AO2, AO3
Analyse	6	Points Based	AO1, AO2, AO3
Examine	8	Points Based	AO1, AO2, AO3, AO4
Discuss	14	Levels Based	AO1, AO2, AO3, AO4
Evaluate/To what extent	20	Levels Based	AO1, AO2, AO3, AO4

2 SIZES OF BUSINESSES

UNIT 3
3.3.1

LEARNING OBJECTIVES

- Understand there are different sizes of businesses and the ways businesses grow
- Understand the advantages and disadvantages of each type of merger/takeover
- Understand the constraints on business growth, including the size of market, access to finance, owner objectives and government regulation and bureaucracy
- Understand the reasons for some firms remaining small and others growing
- Understand the impact of growth of firms on businesses, workers and consumers
- Understand the reasons for demergers and the impact of demergers on businesses, workers and consumers

GETTING STARTED

Use the internet to find out about a recent merger or takeover. What did the two (or more) firms produce? What were the reasons given for the merger? Is it likely to create a business with a higher value measured by its share price?

THE SIZE OF BUSINESSES

Although production in many economies is dominated by large firms, there are many industries where small and medium-sized enterprises (SMEs) are important.

SMEs are independent firms, not owned by another firm, which employ fewer than a given number of employees. This number varies between countries. The most frequently used classification for an SME is one that employs fewer than 250 employees – this is the measure used by the European Union. However, financial assets are also used as part of the definition and an SME should have an annual turnover of not more than €50 million, and/or an annual Statement of Financial Position not higher than €43 million.

A large corporation, by EU definition, is one that has more than 250 employees, an annual turnover of more than €50 million and/or a Statement of Financial Position of €43 million or higher.

Large firms exist for two main reasons:

- Economies of scale (explained in Chapter 6) in the industry may be significant. Only a small number of firms producing at the minimum efficient scale of production (explained in Chapter 6) may be needed to satisfy total demand.
- Barriers to entry (explained in Chapter 9) may exist which protect large firms from potential competitors.

Small firms survive for the opposite reasons:

- Economies of scale may be very small relative to the market size. A large number of firms may be able to operate at the minimum efficient scale of production. Small firms may also be able to take advantage of the higher costs of larger firms in the industry caused by diseconomies of scale (explained in Chapter 6). Changing technology, such as the internet, can allow small firms the same cost advantage as large firms in reaching out to customers, especially in small **niche markets**.
- The costs of production for a large-scale producer may be higher than for a small firm. In part, this may be due to productive inefficiency – a large firm operating within its average cost curve boundary (explained in Chapter 8). For instance, larger firms may be poorly organised in what they see as small insignificant segments of the market (called market niches) or X-inefficiency (explained in Chapter 8) may be present. Equally, the average cost curve of a large producer may be higher in certain markets than for a small producer. For instance, a large firm may be forced to pay its workers high wages because it operates in formal labour markets, i.e. it is organised and registered to pay tax. A small firm may be able to pay relatively low wages in informal labour markets, i.e. those that are not recognised by the government and do not pay tax. Indeed, owners of small companies can work very long hours at a rate of pay per hour which they would find totally unacceptable if in a normal job.
- Barriers to entry may be low. The cost of setting up in an industry, such as the food retail industry, may be small. Products may be simple to produce or sell. Finance to set up in the industry may be readily available. The product sold may be relatively homogeneous. It may be easy for a small firm to produce a new product and establish itself in the market.
- Small firms can be monopolists. A monopolist (explained in Chapter 13) offers a product for sale which is available from no other company. Many small firms survive because they offer a local, flexible and personal service. For instance, a

small local shop may have a monopoly on the sale of newspapers, magazines, greetings cards, toys and stationery in a local area. Consumers may be unwilling to walk half a mile extra to buy greetings cards at a 10 per cent discount or travel 10 miles by car to a local superstore to buy a $2 toy at a 25 per cent reduction. Or the small local shop may also be a food store, open until 10 o'clock at night seven days a week, again offering a service which is not offered anywhere else in the area. A small shop could be the only place locally where credit is offered, or where it is possible to buy a single item instead of a pack of six. Equally in the case of some products, such as cricket balls, the size of the market is so small that one or two very small firms can satisfy total demand.

ACTIVITY 1 SKILLS REASONING, ANALYSIS

CASE STUDY: SIZE OF BUSINESS

1 Why can small firms survive successfully in the hotel industry?
2 What advantages do large hotel chains enjoy over small independent hotels?

HOW BUSINESSES GROW

Firms may grow in size in two ways:

- by **organic growth**
- by external growth through **merger** or **takeover**.

Organic growth simply refers to firms increasing their output, for instance through increased investment or an increased labour force. A merger is the joining together of two or more firms under common ownership. The boards of directors of the two companies, with the agreement of shareholders, agree to merge their two companies together. A takeover implies that one company wishes to buy another company. The takeover may be amicable. Company X makes a bid for company Y. The board of directors considers the bid and finds that the price offered is a good price for the shareholders of the company. It then recommends the shareholders to accept the offer terms. However, the takeover may be contested. In a hostile takeover, the board of directors of company Y recommends its shareholders to reject the terms of the bid. A takeover battle is then likely to happen. Company X needs to get the shareholders to agree to sell just over 50 per cent of the shares to take control.

Economists distinguish between three types of merger:

- **Horizontal integration** is a merger between two firms in the same industry at the same stage of production, for instance, the merger of two car manufacturers or two bakeries.
- **Vertical integration** is a merger between two firms at different production stages in the same industry. **Forward vertical integration** involves a supplier merging with one of its buyers, such as a car manufacturer buying a car dealership, or a confectionary manufacturer buying candy/sweet shops. **Backward vertical integration** involves a purchaser buying one of its suppliers, such as a drinks manufacturer buying a bottling manufacturer, or a car manufacturer buying a tyre company.
- **Conglomerate integration** is the merging of two firms with no common interest. A tea company buying an insurance company, or a food company buying a clothing chain would be conglomerate mergers.

ADVANTAGES AND DISADVANTAGES OF EACH TYPE OF MERGER/TAKEOVER

There are advantages and disadvantages to firms growing organically or through different types of integration.

Initially, almost all growth of firms is organic. This is because almost all firms start small. Vertical, horizontal and conglomerate integration through mergers and takeovers is associated with medium-sized and large firms. Merging with or taking over another firm is expensive and time-consuming. Mergers and takeovers are high risk and evidence suggests that most fail in the sense that they reduce the long-term share price of the company. For mergers and takeovers to succeed there should be some sort of strategy for the growth of the firm. Taking on an extra worker, renting the shop next door to expand premises or buying an extra machine are much easier than targeting another firm for expansion. Even with medium-sized and large firms, organic growth is the norm and integration through mergers and takeovers is the exception.

However, sometimes another firm has a market or an asset that it would be difficult or impossible to gain through organic growth. For example, a European company may wish to expand into the Asian market but has no expertise in this market. It might be cheaper and far less risky to buy a company selling into the Asian market rather than try to achieve this through organic growth. Organic growth may also be too slow for directors and managers who wish to maximise their salaries and bonuses from the business.

The easiest way to expand rapidly and justify higher pay is through mergers and takeovers.

VERTICAL INTEGRATION

There are several possible advantages of vertical integration:

- There may be cost savings. Integrating a supplier or a buyer into the firm may make the firm more efficient.
- Vertical integration may reduce risk. For example, a supplier might have a technology that it could offer to rival firms, giving them a competitive advantage. A supplier might unexpectedly refuse to sell its product to the firm. Alternatively, a buyer could decide to buy from another firm.
- Forward vertical integration could give a firm more control over its market. For example, if a firm owned another firm that bought its products, it could decide at what price to sell the product and in what markets. It could better control branding of the product.

There are a number of disadvantages to vertical integration:

- A firm making a vertical merger may have little expertise in that particular industry. For example, a motor manufacturing company might, over many years, have developed a deep knowledge of motor manufacturing. However, it is unlikely to have that same level of knowledge in selling cars. If the motor manufacturing company buys a chain of car dealerships, to sell its cars to the public, it is likely that the car dealership part of the business will perform much worse than the core motor manufacturing business. The more distinct parts there are to a business, the less likely it is that senior management will be able to get the best out of every part of the business.
- Firms often pay too much for the firm they take over and the share price of the firm falls rather than rises.
- There can be difficulties in merging two firms together into one firm. Either the costs of creating a single firm from two separate firms are too great, or the two firms fail to integrate but costs rise because extra layers of management are needed to control the new, larger firm.
- Many of the key workers in the firm that has been taken over may leave, taking with them much of the expertise that made it successful.

HORIZONTAL INTEGRATION

Most mergers and takeovers are examples of horizontal integration. At the small firm level, an example would be a hairdresser buying a second hairdressing business. At an international level, it might be one pharmaceuticals company buying another pharmaceuticals company.

Horizontal integration has a number of advantages for the firm:

- It may allow reductions in average costs due to economies of scale.
- It can reduce competition in the market by removing a competitor.
- The firm has an increased ability to control prices in the market.
- It can allow one firm to buy unique assets owned by another company, such as a new drug or operations in another part of the world.
- It allows a business to grow in a market where it already has knowledge and expertise. This is likely to make the merger more successful.

Despite the many advantages of horizontal integration, evidence suggests that most horizontal mergers are not successful. As with vertical integration, firms often pay too much for the firm they are buying. Integration of the two firms is too often badly managed and many of the key workers may leave following the takeover.

CONGLOMERATE INTEGRATION

There are several advantages of conglomerate integration:

- One advantage is to reduce risk. Buying another firm operating in a completely different market means that a firm is not so dependent on the ups and downs of one market.
- A conglomerate may find it easier to expand compared to a situation where the companies or operations are independent. Size gives a conglomerate more options to obtain finance to expand the business. Successful senior managers can be transferred from company to company depending on their need.
- It could be an opportunity for **asset stripping**. Some companies specialise in buying other companies which they see as having more valuable individual assets than the purchase price of the company. For example, a company might be bought for $100 million. It is then broken up. Most of its land holding might be sold for $60 million, a part of the company is sold for $30 million and some patents are sold for $20 million. What is then left of the company might be kept, sold on or simply closed down.

One disadvantage of conglomerate integration is that firms do not have expertise in the market into

ACTIVITY 2

SKILLS REASONING

CASE STUDY: GROWTH BY TAKEOVERS

Robert Forrester is chief executive of the fast-growing UK motor dealer, Vertu. He learned about the business of selling cars by being a group finance director for Reg Vardy, the Sunderland based motor dealer. In 2006, Reg Vardy was taken over by Pendragon and Mr Forrester lost his job.

He decided to set up his own car dealer company. He realised that he could not challenge the big, long-established companies in the sector by setting up just another small, privately owned dealership. Instead, his strategy was to grow through buying up existing businesses. He assembled a team of former Reg Vardy executives and persuaded City of London investors to invest £25 million in a new, publicly quoted company. Mr Forrester himself invested £400,000. Vertu Motors floated on AIM (the Alternative Investment Market based in London) in December 2006.

Its first deal was the £40 million takeover of Bristol Street Motors Group, which had sales of £576 million. The purchase was funded through the initial £25 million raised a year earlier and a further £26 million sale of shares.

When the recession struck in early 2008, car values dropped 5 per cent in a month. With £20 million worth of stock, the company suffered an overnight loss of £1 million on the value of the cars it held. However, the company survived. The recession also provided a good buying opportunity for Vertu.

Car dealerships fell in price and Vertu accelerated its acquisition-buying programme. In 2009, it raised a further £300 million by selling new shares to fund more purchases.

Today, Vertu has over 5000 employees and 128 car dealerships across England and Scotland. Sales were £2.8 billion in 2018 with pre-tax profit approaching £25 million.

1 What is meant by horizontal integration? Use Vertu as an example.
2 Give two constraints on business growth that Vertu might have experienced.
3 Would Vertu have been more successful if it had grown organically rather than through takeovers? Give reasons for your answer.

which they buy. As with vertical integration, a lack of specialist understanding of the market can reduce performance. As for asset stripping, it provides a quick profit for the asset stripper. It doesn't benefit workers, customers or local economies. Workers lose their jobs. Customers might find they are no longer able to buy products which they value. Local economies can end up with fewer jobs and disused industrial sites. As with vertical integration, firms engaging in conglomerate integration often pay too much for the firm they are buying. Integration of the two firms is too often poorly managed and many of the key workers may leave following the takeover. Moreover, resources of the business and the time and effort of senior managers may be spread too thinly over the range of activities the business is involved in.

CONSTRAINTS ON BUSINESS GROWTH

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

SIZE OF THE MARKET

Markets vary in size. Some local markets are very small. Take the example of a flower shop in a large village in rural Spain. The local market may be able to support the business adequately with customers coming from surrounding villages. However, expanding the business, for example by opening a new shop in the next village, may fail because there are not enough customers in the market in the two villages. Equally, national and international markets can be relatively small. The market for cricket balls, for example, is much smaller than the market for coffee. The opportunities for expansion in the cricket ball market are very limited in comparison to the coffee market.

ACCESS TO FINANCE

To expand, firms need access to finance. Most firms expand by using the profit they have made in previous years and putting this back into the business. However, firms also commonly use loans and overdrafts from banks to finance their expansion. This depends on banks being willing to give them a loan. For medium-sized and large firms, they may be able to obtain equity funding. In a limited company, new shares are sold to investors. If the company is a public limited company, second-hand shares will be bought on a stock exchange, like Abu Dhabi Securities Exchange (ADX) that lists mostly UAE companies and NASDAQ Dubai that lists international companies. However, companies only gain the finance from a share issue when it is the new issue of these shares; the rest of the time shares are traded the finance does not go to the company, it simply allows shares to change ownership. However, being able to sell shares does make it easier to raise the initial finance from investors.

OWNER OBJECTIVES

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

REGULATION

Most firms are able to expand their businesses without any interference from government. However, government regulation can be an important factor in a few cases. For example, EU Merger Regulation prohibits mergers and takeovers which would significantly reduce competition in the EU Single Market, for example if they would create dominant companies that are likely to raise prices for consumers. The EU authorities only examine larger mergers with an EU dimension, meaning that the merging firms reach certain turnover levels. For large companies, competition law can restrict the scope for takeovers and mergers. Any merger which creates a company with a combined worldwide turnover of all the merging firms over €5000 million and an EU-wide turnover for each of at least two of the firms over €250 million would be reported to the Commission. It can investigate the merger and has the power to forbid it. About 300 mergers are typically notified to the Commission each year in the EU.

REASONS SOME FIRMS TEND TO REMAIN SMALL AND OTHERS GROW

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

- A larger company may be able to exploit economies of scale more fully. The merger of two medium-sized car manufacturers, for instance, is likely to result in potential economies of scale in all fields, from production to marketing to finance. Vertical and conglomerate mergers are less likely to yield economies of scale because there are unlikely to be any technical economies. There may be some marketing economies and more likely there may be some financial economies.
- A larger company may be more able to control its markets. It may therefore reduce competition in the market place in order to be better able to exploit the market as its price-setting power is increased.
- A larger company may be able to reduce risk. Many conglomerate companies have grown for this reason. Some markets are unreliable. They are subject to large changes in demand when economies go into boom or recession. A steel manufacturer, for instance, will do exceptionally well in a boom, but will be hard hit in a recession, so it might decide to diversify by buying a company with a product which does not have a demand pattern that changes in different parts of the economic cycle, such as a supermarket chain. Other industries face a very uncertain future, such as the newspaper industry (which faces falling revenues due to the rise of digital media) so newspaper companies may merge or be taken over by other companies to reduce the risk of failure.
- Where there is a divorce of ownership from control, a larger company may justify higher salaries and bonuses to directors and managers. Since it is directors and managers who run the firm, they can take decisions about the size that will benefit them, but not necessarily bring any benefit to shareholders.

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

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

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

IMPACT OF GROWTH OF FIRMS ON BUSINESSES, WORKERS AND CONSUMERS

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

Workers may benefit or lose out following a merger. Some workers may gain promotion in the new, larger firm while others might lose their jobs. For example, if only one senior financial director is required in the new firm, the financial director from the first firm may be promoted while the financial director from the firm that has been taken over is made redundant or moved to another job. If the new, larger business is more successful then higher wages may be paid.

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

REASONS FOR DEMERGERS

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

LACK OF SYNERGIES

Management may feel that there are no **synergies** between the parts of the firm. This means that one part of the firm is having no impact on the more efficient and profitable running of the other part of the firm. Where there are no synergies, there could even be diseconomies of scale because senior management are having to divide their time between two or more businesses which have little to do with each other.

VALUE

The price of the demerged firms might be higher than the price of the single larger firm. For example, a firm may be valued at $300 million on a stock exchange. But if it split into two, the new firms might be valued at $150 million and $250 million. Investors in companies base valuations on a variety of different factors but one of them is the growth prospects of a firm. If a firm has a part which is growing fast, that part will be worth more than another part of equal size which is growing more slowly. The relatively poor performance of one part of a company can drag down the share price of the whole company despite the fact that other parts are performing well. Financial markets talk about 'creating value' by splitting up companies in this way.

FOCUSED COMPANIES

In the 1970s, it was fashionable to create conglomerates to diversify risk. In recent years, it has become popular to create firms which are highly focused on one or just a few key markets. The argument is that management can deliver higher profits and growth by concentrating their energies on getting to know and exploiting a limited range of markets. Evidence also suggests that being the market leader in terms of sales tends to be relatively more profitable than being, say, number three or four in the market. Companies therefore divest themselves of (i.e. sell off) parts which do not fit in with their core activities. Sometimes, a firm will sell off a part cheaply which goes on to be very successful. It could be argued that the firm's management sold the part too cheaply. Equally, this can be seen as evidence that a company has only limited management resources. The part sold off would never have been successful within that particular firm because management did not have the time or expertise to make it succeed.

IMPACT OF DEMERGERS

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

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

Workers may benefit or lose out following a demerger. Senior managers may gain promotion. For example, one firm only needs one senior financial director. If it splits into two, each firm will need its own senior financial director. On the other hand, some workers may lose their jobs following a demerger. If each firm becomes more efficiently run as a result of the demerger, then some job losses are likely.

Consumers may benefit or lose out following a demerger. They will gain if the demerged firms become more efficient, cut costs and offer lower prices. They could also gain if the demerged firms invest more and develop new and innovative products. Consumers will lose out if the demerged firms become more focused on increasing profit in their businesses through raising prices or reducing their product ranges.

ACTIVITY 3

SKILLS REASONING

CASE STUDY: DEMERGER

eBay Inc is to be split into two companies. It owns eBay, the online auction site and PayPal, a payments business.

For some time, the company has come under pressure from some shareholders to sell PayPal. They argue that eBay and PayPal would be worth more as two separate companies. This is because the two businesses have different growth rates and profit rates. PayPal is the star performer, with revenues up 20 per cent. eBay is highly profitable but it is forecast to grow only between zero and 5 per cent in the next few years.

Some analysts have questioned whether eBay, the auction site, will be as profitable without PayPal. Currently, eBay uses information about customer purchases made from other internet sites when these purchases are made using PayPal. Without PayPal, it will have less information about the buying behaviour of its customers. This will make it more difficult to target eBay users with information about what they could buy on the site.

1 Why might eBay demerge with PayPal?
2 To what extent is the demerger likely to lead to higher growth for each of the businesses?

THINKING LIKE AN ECONOMIST

MCDONALD'S STEPS UP EXPANSION IN ASIA AND RUSSIA

McDonald's has mainly expanded by organic growth. It was originally founded in America by the McDonald brothers in 1940. It grew by using a franchise model to expand organically across America. In the first few decades it established itself across America but from the 1970s onwards it began to open restaurants in several other countries. The American market had become saturated (where so much of a product is offered for sale that there is more than people want to buy) and if McDonald's wanted to continue to expand it needed to move into other markets. It now has restaurants across most countries in the world and has kept its own brand identity, not growing by taking over other companies.

An example of its growth is its plans to open more than 1500 restaurants in China and South Korea with local partners between 2017 and 2022, as it focuses on expansion in the world's second-biggest economy. There are many difficulties in expanding into a market such as China. However, local partners will help make business decisions that are suitable for Chinese customer tastes while increasing funds available for investment needed. Once the outlets are opened, McDonald's, the world's largest fast-food chain by sales, will have more than 4300 restaurants across the two countries, 54 per cent more than the 2800 it had in 2017.

McDonald's is also opening 20 new restaurants in Russia, as it aims to expand its business in this market as well. It has signed an agreement with local company GiD, which will extend McDonald's restaurants into western Siberia. It is hoped that the agreement with GiD will help enhance the McDonald's brand in Russia, build a successful business over the long term and further strengthen the relationship with its customers.

CHECKPOINT

1 What is the difference between SMEs and large corporations?
2 What is the difference between organic growth and growth by merger or takeover?
3 What is the difference between forward vertical integration and backward vertical integration?
4 What is meant by horizontal integration?
5 What is meant by conglomerate integration?
6 Give the advantages and disadvantages of vertical integration.
7 Give the advantages and disadvantages of horizontal integration.
8 Give the advantages and disadvantages of conglomerate integration.
9 Why do some firms remain small while others grow?
10 How does the growth of firms affect businesses, workers and consumers?
11 What are the reasons for demergers?
12 What is the impact of demergers on businesses, workers and consumers?

SUBJECT VOCABULARY

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

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

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

demerger when a firm splits into two or more independent businesses

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

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

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

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

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

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

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

EXAM PRACTICE

CELGENE

SKILLS REASONING, ANALYSIS, CRITICAL THINKING

Pharmaceutical companies spend billions of pounds researching and developing new drugs. The problem is that very few of those drugs ever make it to market. Either they do not work well enough or they have significant side effects.

Large pharmaceutical companies may then be forced over the 'patent cliff' (when there is a huge fall in its revenue after the patent runs out). Many pharmaceutical companies rely on just one or a few 'blockbuster' drugs for most of their sales. Celgene, for example, a biotech company with a market value of almost $100 billion, is heavily reliant on sales of one drug, Revlimid. The drug accounts for 65 per cent of annual sales of the company. In 2019, it faces its own patent cliff when patents on Revlimid begin to expire. This means that any pharmaceutical company will be able to produce its own 'generic' copy of Revlimid and sell it to customers, usually for a fraction of the price of the original drug. Celgene could then see its sales fall dramatically in value and billions could be knocked off its share value.

Celgene has responded to this threat by buying up companies completely or in part, or entering into agreements with companies to share the costs and revenues of promising new drugs. For example, Celgene has spent $7.2 billion buying Receptos, a biotech company specialising in treatments for multiple sclerosis and inflammatory bowel conditions. In April, it paid $710 million to Nogra Pharma, a privately held Irish biotech company, to access its drug for Crohn's disease, a bowel disorder. The drug is still at the clinical trial stage and Celgene is hoping that it will make it to market. In 2018, Celgene bid to take over Juno and enter the new field of chimeric antigen receptor therapy (Car-T), which involves re-engineering a patient's white blood cells so they can identify and attack cancer. Celgene also announced it would pay $1.1 billion for Impact Biomedicines, another cancer company, in a transaction that could be worth up to $7 billion if the group's medicine is successful.

In all, over the past six and a half years, Celgene has taken minority stakes or struck agreements with more than 30 companies, as well as taking over two companies completely: Receptos for $7.2 billion and Abraxis for $2.9 billion.

George Golumbeski, senior vice-president of business development at Celgene, says the company has been pursuing what it calls a 'distributive model of research and development'. 'We consciously decided not to always grow our own R&D and that we would work as closely and actively as we could with smaller companies, who have an exquisite focus, a leanness and a superior, efficient output.'

It is unlikely that all of Celgene's takeovers will be successful, given that so many of the companies are focused on drugs that are still at an early stage of development. However, it only needs one or two to deliver a 'blockbuster' drug to prevent its sales from falling once Revlimid begins to go out of patent after 2019.

Q

1 Using pharmaceutical companies as an example, explain what it means for a firm to grow internally. **(4 marks)**

2 Analyse one advantage and one disadvantage to consumers of horizontal integration. **(6 marks)**

3 Analyse two possible reasons why Celgene has chosen to grow through a process of horizontal integration rather than to grow organically. **(6 marks)**

4 Evaluate whether it would be better for pharmaceutical companies, such as Celgene, to become conglomerates rather than remaining narrowly focused on selling pharmaceutical products. **(20 marks)**

EXAM HINT

Evaluation for Question 4 will come from comparing the advantages and disadvantages of conglomerates using pharmaceutical companies as an example. Evaluation could also come from a discussion of the meaning of 'better'. What are the possible objectives of pharmaceutical companies and how might this affect their decisions?