Satisfying wants and needs

Businesses are usually set up to satisfy the wants and needs of customers. Everybody has wants and needs. We *need* food, drink, clothing, shelter and other essentials to stay alive. Other things are not quite so essential, but we still *want* them so our life can be enjoyable.

Business activity is concerned with satisfying these wants and needs. The act of preparing a good or service for sale is called production.

Businesses are set up to satisfy our needs by providing physical goods (manufacturing) and services. When you visit a restaurant not only are you provided with a physical product, the food, but you also receive a service in the form of a member of the restaurant staff bringing the food to the table and making sure that you have everything that you want to enjoy the meal.

Adding value

Businesses aim to provide products and services to customers that are more attractive than those of their competitors. Everything that a business does to make a good more desirable is *adding value*.

For example, cold fresh orange juice is enjoyed across the globe. Oranges are grown in temperate climates such as California (United States), Libya (North Africa) and Italy (Southern Europe). The oranges are transported in lorries, freight trains and ships across the globe. Hotels and restaurants buy and squeeze the oranges to make a fresh drink for the end customer. Ice may be added to cool the juice.

A restaurant selling fresh squeezed orange juice might buy three oranges at 10 cents each (totalling 30 cents) to make a glass of fresh orange juice which it sells to a customer for $1. The value added by the restaurant is therefore 70 cents. $1 – 30 cents = 70 cents.

Scarcity

We cannot have everything we want: we have to make *choices*. This is because resources are scarce: there are not enough for all the things that we would like to do. If we turn a field or park into a car park, then we lose the green space. Choices have to be made all the time.

In the same way, a business makes choices. Farmers make choices about when and how to improve their land. Farmers in Jamaica can decide to grow sugar cane or coffee. They sometimes make choices about who to sell their produce to (e.g. at a local market or to an agent of a food company).
STUDY TIP

One way of making a product more desirable, and so adding value, is by branding. A brand is any distinguishing mark that is associated with a product. Consumers are often attracted by brand names and many people will pay more for branded products.

Figure 1.1.1.2

Adding value to a product: the customer benefits from value being added at each stage of production

Stage of production: How value is added

1 Growing the oranges

Farmers look after the orange trees for several years before they give fruit. Each year they must be treated against pests.

2 Transporting the oranges

Fresh ripe oranges are transported closer to market.

3 Preparing the oranges

The juice is squeezed from the oranges and ice added.

4 Serving the customer

The juice is presented to the end consumer in a polite and friendly way.

DID YOU KNOW?

Opportunity cost is the term used to describe the cost of a choice made in terms of the next best alternative. For instance, the opportunity cost of the choice made by a business to buy a new computer may be the building repairs that can no longer be afforded.

KEY POINTS

1 Everyone has basic needs for food, shelter and clothing in order to survive. On top of these we have additional wants.

2 Businesses are set up to meet the needs of consumers.

3 Businesses produce goods to help consumers satisfy their wants and needs.

4 Businesses add value, to make products more desirable and suitable for customers.

SUMMARY QUESTIONS

1 In your own words, write definitions for: needs, wants, scarcity, choice, opportunity cost, adding value.

2 How might packaging of a product add value to it? Explain your answers.

3 How would you explain the difference between wants and needs? Give further examples to show the difference.
To specialise is to concentrate on a particular task. Specialisation in business takes a number of forms:

- Firms specialise in particular activities and products.
- Factors of production specialise in particular areas of production.
- Countries specialise on certain lines of economic activity.

**Specialisation by businesses**

Firms concentrate on particular areas of activity in which they have built up a competitive advantage over rivals. Competitive advantage involves superiority in terms of having a better product, better marketing of a product, cheaper prices or some other advantage. For example, Shell the oil company concentrates on the oil and gas sector, Singapore Airlines focuses on luxury long-distance air travel, and Intel concentrates on producing computer chips. There are two important aspects of specialisation by firms:

- Firms concentrate on doing things that they do better than rivals.
- Firms concentrate on doing those things that involve the best use of resources by that company. For example, Shell could potentially focus on another industry, e.g. retailing. However, over time Shell has built up a skilled workforce, strong products, and research and development into new products – so that today it is a really efficient operator in the oil and gas industry. Shell’s most efficient use of its existing resources is therefore in oil and gas extraction, refining and distribution to the end consumer. Shell therefore specialises in what it does best. Shell can be said to have a comparative advantage in using its resources in oil and gas production. Compared with all the other ways that the company can use its resources the greatest advantages can be gained through specialising in oil and gas.

**Specialisation by factors of production**

Factors of production are the resources that go into making products. There are four categories of factors of production – land, labour, capital and enterprise. Land not only includes physical land but also other natural resources, e.g. rivers and seas providing fish stocks. Labour consists of the physical and mental effort of workers. Capital includes all those items that go into producing other things, e.g. machines and tools. Enterprise is the factor that brings other factors together to produce goods. Entrepreneurs are people who take risks by running businesses. Each of these factors will specialise on particular activities and lines of production depending on the areas in which they have greatest comparative advantage.

The division of labour is one example of specialisation. Division of labour involves breaking down a production process into a number of clearly defined specialist tasks. The reason for doing this is that the total output of a group can be increased if, instead of each person trying to do everything, each one specialises in a particular skill or activity (i.e. the activity in which they have the greatest comparative advantage).
advantage). Similarly, a piece of land will normally be used for the purpose that yields the highest return, e.g. a site for an office block, or for growing potatoes, or a swimming pool. Machinery can be used for producing particular components or products. Entrepreneurs will concentrate on enterprises in which they have the greatest ability.

**Specialisation by region or country**

Regions and countries focus on those products where they have the greatest comparative advantage – for example, today Scotland concentrates on alternative energy (e.g. wave and wind power), whisky and water, whereas China concentrates on textiles and a range of manufactured goods.

<table>
<thead>
<tr>
<th>Advantages of specialisation</th>
<th>Disadvantages of specialisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resources can be focused on their most productive lines.</td>
<td>Specialisation can lead to over-reliance on a set task or product. When the product or task is no longer required the specialist becomes redundant.</td>
</tr>
<tr>
<td>Focusing on a set task enables an individual, company, region or country to become more productive in that task.</td>
<td>Focusing on set tasks means that specialists spend all their time doing the same or similar things with little opportunity for variety.</td>
</tr>
<tr>
<td>Larger outputs can be produced at lower unit costs.</td>
<td>Narrow specialism might make it difficult for businesses, individuals, regions and countries to respond to change because they lack flexibility.</td>
</tr>
<tr>
<td>Concentration of specialists enables the sharing of knowledge and skills between specialists.</td>
<td>Where tasks are closely linked, delays or hold-ups in one area can slow down the whole process.</td>
</tr>
</tbody>
</table>

**CASE STUDY** Prawn hatcheries in Bangladesh

The development of freshwater prawn hatcheries in Bangladesh illustrates the benefits and drawbacks of specialisation. In recent years the number of freshwater prawn hatcheries has increased substantially as these hatcheries supply the large global export trade. Today there are estimated to be 120,000 farmers operating in this field in Bangladesh. Hatcheries have replaced traditional agriculture in which farmers produced many different crops for their own consumption and for sale to others. Prawn farming is labour-intensive work. Prawns command good prices on international markets, but the product is notoriously susceptible to health issues which can lead to import bans in some countries when health standards fall below expected requirements.

**Questions**

1. How can Bangladeshi farmers and Bangladesh as a country benefit from the freshwater prawn industry?
2. How can Bangladeshi farmers and Bangladesh as a country lose out from specialisation in the prawn industry?
1.2 Classification of businesses

1.2.1 Types of business activity

Business activity is often broken down into three types:

- **extractive (primary industry)**
- **manufacturing and construction (secondary industry)**
- **services (tertiary sector).**

Brazil is the world's second-largest ethanol supplier after the United States. The following table shows the three stages involved in providing ethanol fuel for cars in Brazil.

### Extractive industries

<table>
<thead>
<tr>
<th>Stage 1: Primary production</th>
<th>Stage 2: Secondary production</th>
<th>Stage 3: Tertiary production</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farmers grow sugar cane in Brazil</td>
<td>The sugar cane is refined to make ethanol</td>
<td>The ethanol is sold on service station forecourts to car owners and truck drivers in Brazil</td>
</tr>
</tbody>
</table>

**Figure 1.2.1.1** The three stages involved in providing ethanol fuel for cars in Brazil

Extractive, or primary, industries are concerned with using natural resources. They include farming, mining and oil drilling. Farmers grow and harvest crops and farm livestock, while miners take out fuel and minerals from the ground. Primary industries sometimes produce raw materials like iron ore (for making steel) and oil (for making petrol, plastics, fibres, etc.). They also produce finished products like fish and oranges.

### Manufacturing and construction industries

Manufacturing and construction industries are concerned with making and assembling products. Manufacturers use raw materials and parts from other industries. Most products go through several stages of production: when the good is only partly made, it is a semi-manufactured good. Examples of manufactured products are furniture, cars, chocolate and oil rigs. An example of a semi-manufactured good would be the shell of an aeroplane that has not yet had the engine and inside furnishings (seats, etc.) added.

### Service industries

Service, or tertiary, industries give something of value to people, but are not physical goods. You can physically touch or see a packet of biscuits, a bicycle or a computer. You cannot touch or hold a visit to the cinema or a lesson given to you in school: these are both services.

Other services include banks keeping your money safe, public transport carrying people around or hairdressers cutting your hair.
Group the following activities under the headings of Primary, Secondary and Tertiary Industry.

<table>
<thead>
<tr>
<th>ACTIVITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
</tr>
<tr>
<td>Cloth Making</td>
</tr>
<tr>
<td>Fire Fighting</td>
</tr>
<tr>
<td>Selling Lottery Tickets</td>
</tr>
<tr>
<td>Food Manufacture</td>
</tr>
<tr>
<td>Retailing</td>
</tr>
</tbody>
</table>

CASE STUDY

Employment is classified into different industries by a national classification system such as the Standard Industrial Classification (SIC) in the UK or the North American Industrial Classification System (NAICS) in North America. This identifies and classifies specific sectors, e.g. 11 Agriculture, Forestry, Fishing and Hunting, which is then broken down into further sectors, e.g. 111 Crop production, and then into types of crop production, e.g. 1111 Oilseed and grain farming. The latest forecast figures for the US for 2016 are that 1.6 per cent of the population will be employed in primary industry, 12.7 per cent in secondary industry, and the vast majority (85.7 per cent) in the tertiary sector. This data for the US contrasts with that of newly industrialised countries (NICs) such as Brazil. In Brazil, roughly 20 per cent of the population is still engaged in agriculture and other primary industries, and a further 14 per cent in manufacturing, with the remainder working in services.

Questions

1. In your country which is the largest sector of the economy: primary, secondary or tertiary?
2. What are the main types of industries involved in your largest sector?
3. What industrial classification system is used in your country? What industries are recognised in this classification?

DID YOU KNOW?

The process of development has involved the transformation of society over time. In the first wave of development the focus was on primary activity – particularly agriculture and fishing. In the second wave societies experienced an industrial revolution with the growth of manufacturing industry to become the main form of economic activity. In the (most recent) third wave, developed societies principally focus on tertiary (service sector) activity.

SUMMARY QUESTIONS

1. The following statistics relate to employment by the industrial sector in China. (Source: China Statistical Yearbook, 2012)

<table>
<thead>
<tr>
<th>Year</th>
<th>Primary (%)</th>
<th>Secondary (%)</th>
<th>Tertiary (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>70</td>
<td>18</td>
<td>12</td>
</tr>
<tr>
<td>1988</td>
<td>58</td>
<td>22</td>
<td>20</td>
</tr>
<tr>
<td>1998</td>
<td>50</td>
<td>23</td>
<td>27</td>
</tr>
<tr>
<td>2009</td>
<td>40</td>
<td>27</td>
<td>33</td>
</tr>
</tbody>
</table>

Describe the key trends that you see in the data. Explain why these changes might have occurred. Do you expect these trends to continue?

2. What are service industries? Give five examples of jobs in service industries.

3. State whether you would classify the following industries as primary, secondary or tertiary. Give reasons for your choices.

Construction / transportation and warehousing / retail trade / financial activities / manufacturing / mining / farming / educational services / leisure and hospitality / fishing.

KEY POINTS

1. It is helpful to classify business activity into primary, secondary and tertiary sectors.
2. There has been a global increase in the tertiary sector.
The private and public sector

Another major classification is into the public and private sectors. The private sector consists of businesses that are owned by private individuals, e.g., people that own and run businesses directly themselves, and businesses that are owned by shareholders, i.e., people who have bought a share in a company (they have the right to share in the profits of the company and to appoint directors to run the business on their behalf).

Most economies in the world today consist of a mix of private sector and public sector enterprises and are hence called ‘mixed economies’. In some economies the majority of production is carried out by state-owned (i.e., government-owned) enterprises. For example, in China and Cuba government-owned enterprises (the public sector) are responsible for the majority of production. In contrast, in the US, Canada, Mexico, Japan and the EU countries the majority of production is carried out by private businesses in the private sector.

Over the last 20 years the size of the private sector has increased. For example, in countries such as China and Cuba, where in the past business activity was almost exclusively in government hands, the government has allowed an increasing number of private sector businesses to set up particularly in the small business sector, e.g., hairdressers, taxi firms, photocopying companies, etc. Increasingly the government in the People’s Republic of China has encouraged the set up of large private sector businesses that can be competitive on the world stage, such as the computer company Lenovo.

You will see in Unit 2, however, that private enterprises may have additional, or secondary objectives. India’s Tata Group of companies created India’s first steel plant, hydroelectric plant and inorganic chemistry plant. Today the group has operations in six continents and produces many different goods. The group is not concerned solely with profits; however, in 1941 it created the Tata Memorial Hospital, India’s first hospital for the treatment of cancer.

Setting up and running a private enterprise involves risk. The person who takes this risk is an entrepreneur. If the business succeeds, the entrepreneur makes a profit. Should it fail, he or she will be
responsible for the losses. The loss could involve having to sell personal possessions, in order to meet the business debts.

**Public enterprise**

In many countries, the government is a major employer. Governments employ public sector workers to carry out work on their behalf, such as providing a police force, education and a health service. The size of the public sector varies from country to country. Figure 1.2.2.2 shows some of these differences.

The goal of a public sector enterprise such as Indian Railways is to provide an essential economic service for the nation. Hundreds of millions of people in India rely on the railway service to get around the country and to transport goods.

Public sector enterprises need to be carefully run. They are often funded by taxpayers’ money, so they need to look after the taxpayers’ interests by providing the best possible value for money.

**DID YOU KNOW?**

In India, large numbers of people work for government-owned businesses, including India’s largest employer, Indian Railways. The energy companies are also state-owned, as is Indian Airlines. Indian Airlines is currently facing major competition from the new privately owned low-cost airlines, especially Indigo Airlines, India’s fastest-growing business.

**SUMMARY QUESTIONS**

1. Explain how goals of public sector organisations may differ from those in the private sector.

2. Read the following statements and then suggest whether the organisation is more likely to be in the private or public sector.

   - Our goal is to make a profit for our owners. We will achieve this by providing excellent customer service.
   - Our goal is to provide an efficient postal service to every single household in the country. This includes providing deliveries every day to out-of-the-way locations.
   - Our goal has always been to make a profit. If we provide additional benefits to the wider community, this is a bonus.

3. Classify the following according to whether they are primary, secondary or tertiary and private or public sector.

   a. A state-run mining company
   b. A telecoms company owned by shareholders
   c. A small family-run hotel company
   d. A government-owned steel manufacturer
   e. A joint venture between a family business in China operating in insurance and a foreign company.

**KEY POINTS**

1. The private sector of the economy consists of firms that are owned by private individuals including shareholders.

2. The public sector of the economy is the state-run sector.

3. In recent years there has been a tendency in many economies for a reduction in the number of state-run enterprises.
1.3 Enterprise, business growth and size

1.3.1 Characteristics of successful entrepreneurs

Being enterprising
An entrepreneur is someone who not only comes up with a great new idea but is also able to put this idea into practice.

TOPIC AIMS
Students should be able to:
• identify the characteristics of successful entrepreneurs.

CASE STUDY James Dyson and the Dyson Dual Cyclone

James Dyson was doing some housework in 1979. His first job was to vacuum the living room using a Hoover Junior machine. The vacuum cleaner that he was using employed the standard technology of the time – the air being sucked through the nozzle and the dirt and dust trapped in a cloth bag between the intake and the exhaust.

James felt that the system was very inefficient because there was so much dirt and dust that was not being sucked up. As a consumer he felt that the existing method did not fully meet his needs. He felt that given time he could add value to the machine to make it better.

James was already a well-known designer, having invented (among other things) the ‘ballbarrow’ (a wheelbarrow with a ball rather than a wheel). As chance would have it, his business was installing a powder coating plant for the ballbarrows. To capture dust that was not being sprayed into the barrows, they were using an industrial cyclone made of steel and about 6 m tall. Cyclone towers are a well-known industrial filtering system, with air being dragged into a tower and whirled around, at very fast speeds, forcing the dust against the outer wall of the cyclone. James realised that the cyclone system could be applied to vacuum cleaners to enable them to work more efficiently. He started to work on the task, which took him four years and 5,127 prototypes (i.e. trial models). He realised that for household vacuuming you need a dual cyclone – one to separate out larger items like cigarette ends and dog hairs and the second to catch the smaller particles. Unlike traditional vacuum cleaners, the Dyson Dual Cyclone does not use bags. The product has proved to be a great success story, revolutionising the industry and turning the Dyson company into a large and successful international business manufacturing and exporting the product across the globe.

Questions
1. How did James Dyson turn an idea into an effective product?
2. What does this case study tell you about the qualities of an effective entrepreneur?
Starting an enterprise

People like James Dyson start their own enterprise for a variety of reasons. Some have a bright idea that they think will make them rich (e.g. a ballbarrow or dual cyclone). Others find themselves unemployed and start their own business to survive. Some can only be themselves when they are their own boss. Others want to give something to the community and can see no other way of doing it except by setting up on their own. However, setting up an enterprise is not for everyone. It requires a lot of hard work and long hours to make an enterprise a success. It also requires a lot of attention to detail, not just the creation of exciting ideas. Often someone who is creative and imaginative (important qualities for an entrepreneur) will need a business partner with greater attention to detail and who can set firm commercial foundations in place (other qualities of an entrepreneur).

Characteristics of entrepreneurs

Generally speaking it is possible to identify a number of characteristics of entrepreneurs. As you work through the list consider whether the points apply to you.

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Do you have these characteristics?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Logical, perceptive, organised, realistic, responsible – good at getting things done.</td>
<td></td>
</tr>
<tr>
<td>Outgoing, confident</td>
<td></td>
</tr>
<tr>
<td>Good communicator – able to get a point across.</td>
<td></td>
</tr>
<tr>
<td>Sociable, good leader – can win people over instead of irritating them.</td>
<td></td>
</tr>
<tr>
<td>Single-minded, decisive, independent.</td>
<td></td>
</tr>
<tr>
<td>Open-minded, able to take advice.</td>
<td></td>
</tr>
<tr>
<td>Flexible, adaptable</td>
<td></td>
</tr>
<tr>
<td>Opportunistic, risk taker, ambitious.</td>
<td></td>
</tr>
<tr>
<td>Hard-working, committed, determined, ‘get up and go’ type.</td>
<td></td>
</tr>
<tr>
<td>Tough – often the best test of a successful entrepreneur is their ability to deal with failure.</td>
<td></td>
</tr>
<tr>
<td>Individual – not afraid to stand out from a crowd, or of what others think.</td>
<td></td>
</tr>
</tbody>
</table>

STUDY TIP

Being enterprising does not always involve inventing a totally new product. An entrepreneur may find a new variation or style on an existing product, or a new process of production or selling.

SUMMARY QUESTIONS

1. Identify a celebrated local entrepreneur in your country. To what extent does he or she have the characteristics that have been outlined in this unit?
2. How could you go about developing the characteristics required to be a successful entrepreneur?
3. What enterprising ideas do you have? What would you need to turn these ideas into a successful enterprise?
How a business plan assists entrepreneurs

A good business idea on its own does not create a good business. What is required in addition is the ability to organise and plan. A business plan is one of the key ingredients of any successful business, no matter how big or well established. If you want to start a business, it is vital. It helps you to anticipate problems and work out how to deal with them. It also gives essential information to the people whose support you need – particularly anyone lending you money.

A business plan is a complete description of a business and its plans for the next one to three years. It explains what the business does (or will do if it is a new business). It suggests who will buy the product or service and why. It provides financial forecasts demonstrating overall viability, and it indicates the finance available and explains the financial requirements.

The business plan should be presented in a form that can be quickly and easily understood. The main part of a business plan normally needs no more than 8–10 pages supported, if necessary, with more detailed appendices.

Contents of a business plan

A simple business plan should be clearly set out under the following headings:

1. Executive summary. A very brief summary of the key features of the business and the business plan.
2. The owner. This section should give some information about the owner (or owners) including their educational background and what they have done (previous work experience). It should contain the names and addresses of two referees.
3. The business. This should first contain the name and address of the business and then go on to give a detailed description of the product or service being offered, how and where it will be produced, who is likely to buy it, and in what quantities.
4. The market. This section will describe the market research that has been carried out, what it has revealed, and it should give details of prospective customers – how many there are, and how much they would be prepared to pay. It should also give details of the competition.
5. Advertising and promotion. This should give information about how the business will be publicised to potential customers. It should give details of likely costs.
6. Premises and equipment. This section should show that the business has considered a range of locations and then chosen the best site. It should also give details of planning regulations (if appropriate). Costs of premises and the need for equipment should be included.
7. Business organisation. State whether the enterprise will take the form of sole trader, partnership, company or cooperative.
8 Costings. The business should give some indication of the cost of producing the product or service, and the prices it proposes to charge. It is then possible to make profit calculations.

9 The finance. This should give details of how the finance for the business is going to be raised. How much will come from savings? How much will need to be borrowed?

10 Cash flow. This should list all expected income and outgoings over the first year. Cash-flow calculations are important, but at this stage they can only be approximate.

11 Expansion. Finally, the business should give an indication of future plans. Does it want to keep on producing a steady output or is a dramatic expansion possible? Does it intend to add to its product range? What kind of new competition is likely to emerge, and how will the business deal with it?

CASE STUDY An effective business plan

In 1.3.1 we saw how James Dyson was able to convert a great idea into a successful business. In order to secure finance for his ideas he would need to show his plans to outside investors and to lenders such as banks. The following things would help to convince them to finance the business:

1. The detailed research that had gone into perfecting the product (e.g. over 5,000 prototypes) to come up with a working model.
2. They would have also wanted to see a demonstration of the final model of the product.
3. They would have wanted to check on the manufacturing costs to see how these compared with the price of the product.
4. They would want to know about the advertising and promotion of the model.
5. In particular they would want to know that there was a sufficiently large market for the product to make it worthwhile.
6. They would want to know about Dyson’s track record as an entrepreneur and running a successful business.
7. They would want to know about the timing of inflows and outflows of cash to and from Dyson’s business to make sure that he always had enough cash to pay his bills.
8. They would also want to know about ideas for future expansion of the business and what the financial implications of this would be.

Questions

1. Identify a business idea of your own. What does it entail? How would you be able to persuade potential investors that your idea is a good one?
2. What details would you need to include in a business plan if you were going to be able to convince investors to invest in you and your idea?

SUMMARY QUESTIONS

1. What are the most important details that should go into a business plan in relation to the following?
   - a who the owner is
   - b who makes up the market and market characteristics
   - c finance of the business
   - d potential profitability of the business.
2. When should you make out a business plan and how long should it be?

KEY POINTS

1. A business plan helps the entrepreneur to decide whether to proceed.
2. The plan can be presented to providers of finance.
3. The plan should give details of the owner, the idea, the market, the advertising and promotion, costs, cash flow and likely profits.
Why government supports business start-ups

Small and medium-sized businesses (see 1.3.4) provide the engine of growth of economies across the globe. These relatively small companies provide about 90 per cent of all employment opportunities in many newly industrialising economies such as India. Business start-ups provide real opportunities for employment, not just among the people that set up these enterprises but among those that work for the enterprises. The Ministry of Micro, Small & Medium Enterprises in India has estimated that about 45 per cent of all manufacturing jobs are in this sector, as well as accounting for 40 per cent of all exports. There are about 30 million small enterprises in India.

Therefore, it is not surprising that governments across the globe support the set-up of new businesses as they:

• employ large numbers of people
• account for a large component of employment growth in countries
• account for a substantial component of the production of goods and services in economies
• enable equitable growth – in other words they provide good opportunities often for the poorer members of society
• account for a substantial proportion of the exports of a country
• encourage new ideas and new technologies that help a country to develop new opportunities.

Small enterprises also tend to be much more labour intensive than larger enterprises because they use less capital (e.g. machinery) and more physical labour (thus acting as major employers).

Government also recognises that the small firms of today will become the large firms of tomorrow.

How government supports start-up enterprises

The three main ways in which government supports start-up enterprises are:

• by providing support with the start-up process. This includes providing help with advisers (e.g. showing how a business owner can create a business plan or acquire finance)
• by providing direct financial and other forms of help. Specific government grants and loans (e.g. related to the acquisition of capital/machinery/premises etc.; technical help through research and product development centres)
• by removing obstacles to the setting up of businesses (e.g. simplifying paperwork to set up a company, low business taxes, simplification of laws to increase the ease of doing business).

Grants and loans

Two of the main ways that a government supports start-ups is through grants and loans. Typically a grant does not need to be paid back, whereas a loan would need to be paid back with interest (although this may be relatively low for a start-up).
Grants are normally given where the start-up helps the government achieve objectives, e.g. to reduce unemployment, or to focus on high-growth sectors of the economy.

**Government institutions to support start-ups**

Many governments provide a range of support mechanisms for new businesses. For example, in India the Ministry of Micro, Small & Medium Enterprises (Suksma Laghu Aur Madhyam Udyam Mantralaya) provides grants (funds) to support small businesses to meet capital costs, as well as funds for working capital. The government provides low-cost loans to encourage the development of modern companies. There are specific government institutions that help directly, such as the Small Industries Development Bank of India (SIDBI) providing loans and grants to start-ups in important industries. The National Bank for Agricultural and Rural Development (NABARD) supports farmers and others in rural areas. The Ministry has also set up cluster centres across India. These consist of a cluster of useful services such as design centres, testing laboratories and skill development centres. They support small businesses to engage in research and development, technology upgrades, the standardisation of products, quality testing, marketing and branding activities.

In 2010 the UK government produced a report (‘Backing Small Business’) setting out its support for small businesses. The report showed that 60 per cent of jobs are in this sector and 50 per cent of the value of all goods produced is in the small-business sector. The report showed how the government would make more funding available for this sector, and that the government is investing in Technology and Investment Centres to support small businesses. Regulations and laws were also being changed to support this sector. Key aspects included:

- reducing taxes on small profits (to 20 per cent)
- simplifying taxes for small businesses
- promising to introduce the One-in, One-out rule so that new regulations on small business would only be introduced if existing rules were removed, benefiting small businesses
- making it easier for small firms to acquire finance (setting up a fund to be available to small businesses) particularly for firms with high growth potential and those focusing on exporting
- making it easier for small firms to win government contracts and arranging rapid payment for providing supplies to government
- reducing the paperwork to set up a business
- providing access to mentors (advisers) and small loans to help the unemployed to set up their own enterprise.

**Questions**

1. What similarities can you see between the ways in which the Indian and UK governments are supporting small enterprises?
2. What other approaches can you think of that might support the development of new enterprises?

**SUMMARY QUESTIONS**

1. A country is seeking to develop alternative energy sources, e.g. solar power. What would be the relative merits of offering start-up companies in this sector (a) government grants and (b) government loans?
2. In which sectors of your economy do you mainly find start-up enterprises?
You will often come across the terms small, medium and large businesses. However, it is not always clear what the difference is. In different industries, size is measured in different ways. Also, the definitions used will vary from country to country. The following table shows how the size of a business is measured.

<table>
<thead>
<tr>
<th>Method</th>
<th>How is it done?</th>
</tr>
</thead>
<tbody>
<tr>
<td>The number of employees</td>
<td>A small business might be one employing fewer than 50 employees.</td>
</tr>
<tr>
<td>The value of output</td>
<td>Determined by the value of sales in a year: a small business might be one selling up to $6.5m worth of goods.</td>
</tr>
<tr>
<td>The market share of the business</td>
<td>Determined by the share of the market that the business is responsible for: a small firm might supply less than 5% of the market.</td>
</tr>
<tr>
<td>The value of the capital employed by the business</td>
<td>Determined by the value of what the business owns.</td>
</tr>
</tbody>
</table>

The number of employees is a straightforward method. However, it is difficult to compare businesses in different industries. For example, a huge modern farm, working with the latest machinery, may employ just a few people. In contrast, a local supermarket may employ a hundred or more people.

The following table shows how the definition of small business in South Africa varies from industry to industry.
### Business growth

Businesses may be able to gain advantages over competitors by growing: they may be able to cut costs and win a greater share of the market. By growing they may also be able to develop new products or sell to new markets. Growth may be internal (inside the business) or external (joining together with existing businesses).

#### Internal growth

‘Organic’ growth takes place within a business. Money to finance the expansion can come from ploughing back profits or asking the owners to put in more ‘capital’. Many small businesses grow organically in their early years. This is because the owners will not want to risk borrowing money from outside the business. However, it is quite a slow way of growing a business. Internal growth can then take place by investing in new products or selling more of existing products.

#### External growth

External growth involves the takeover of another business, or merger with another business.

An important way of raising finance in a large company is to sell shares. One **share** represents one unit of ownership in the business. (A **shareholder** is someone who is a part-owner of the business; they will typically have many shares.)

A merger occurs when two businesses combine to form a single company. The existing shareholders of both businesses retain a shared interest in the new business.

An acquisition occurs when one business gains control of part of another business. A business may be prepared to sell off one of its divisions that it no longer wishes to keep.

Businesses carry out external growth in order to:
- buy new and exciting brands where sales are likely to be high
- acquire new inventions and new technologies
- break into new markets, perhaps in other countries.

### Summary questions

1. Compare the merits of the following methods for classifying the size of retail units.
   - Capital employed in the business
   - Size of sales revenues
   - Number of employees
   - % market share

2. The following are methods for defining a business: the number of employees / sales turnover / market share / capital employed.

   Which method/s do you think would be the most useful for classifying whether a business is small, medium or large? Explain your answer.

3. What methods of growth would you suggest to the owner of a small successful family hotel that has accumulated profits for several years?
The causes of business failure

You will often see statistics which show that a large number of businesses close down within 12 months or two years of start-up. However, it is important to differentiate between business failure and business closure. A study carried out in the US by Brian Headd showed that in fact one-third of businesses that close down are actually successful in terms of trading profitably, but the owner has decided to close them down for one reason or another, e.g. moving on to something else. The study (Redefining Business Success) showed that in the US about two-thirds of businesses survive two years or more and a half survive four years or more. However, many do fail and it is important to know why.

Common causes of business failure are as follows:

- Not having enough cash to pay outstanding bills. The business may be profitable, but it has managed badly the timing of receipts from people that owe the company money (trade receivables) and payments to those that the company owes money to (trade payables). Running out of cash (and not being able to borrow more) is a common cause of business failure.

- Operating in a line of business where profit margins are low. In some industries (often because of competition) profit margins are low. A poorly run business in such an industry has a much higher chance of failing.

- Failure to meet the requirements of customers. A successful company understands its customers and their requirements. Lack of such understanding can lead to failure.

- Changes in the external environment. The external environment consists of all of those factors outside the business over which the business has little control. These factors include:
  - the level of competition – increased competition can slash profit margins
  - changes in laws and regulations – rules governing business activity can substantially increase the cost of doing business, e.g. a law governing how a business disposes of its waste
  - changes in consumer preferences and tastes. Businesses that continue to produce products that become outdated fall behind the times and their sales will reduce.

- Poor selling of products. It is not enough to have the right products. A business also needs to make sure that customers know about these products and understand what they are offering.

- Relying too much on a single customer. Relying on a single customer is like putting all of your eggs in the same basket. If the customer gets into financial difficulties and has to close down then the market will disappear overnight. The customer may fail to pay what they owe to the business and it will be unable to retrieve this.
• Poor management is another cause of business failure.
• Lack of planning. Lack of a plan for the future means that a business has poor direction.
• Trying to grow too quickly. Successful early start-ups can often result in the owners overstretching themselves in order to secure even more profit. A business will often borrow in order to grow. Where sales prove to be lower than anticipated, the business will be faced with a lack of finances, while interest payments on borrowed money still have to be made.

Why small businesses are at greater risk
The reasons why new businesses are at greater risk of failing are very similar to the reasons listed above:
• A larger proportion of start-ups than existing businesses are set up by younger people who have less business and management experience.
• Start-ups typically need to borrow funds in order to get the business off the ground. Right from the start repayments on these loans have to be made, yet it may take the business a while to generate cash.
• Start-ups have less experience of the market than existing businesses, which have already learned important information about the market.
• Start-ups may not fully anticipate the strength of existing competition, the cost of setting up, the importance of careful planning and other important factors associated with setting up.
• New entrepreneurs are typically more optimistic about sales and market trends than existing entrepreneurs who may have a more realistic picture of the market.
• Start-up entrepreneurs may focus on a small snapshot of their success as an entrepreneur. Business tends to go through a cycle of growth and slow down in business activity. A new start-up may just focus their planning on the growth part of the cycle and underestimate the way in which the market for their product (and the whole economy) may contract in future periods.

Why some businesses remain small
While many businesses benefit from growth (e.g. being able to draw on larger profits and to raise capital from lenders more easily) others prefer to remain small. Reasons for remaining small include:
• the flexibility of the business, including the ease with which owners can make quick decisions
• the benefits of not having to raise large sums of capital that increase the debt of a business
• the greater control that the owners retain over their business
• the direct interface that owners and managers can have with customers
• the benefits of understanding your market more fully because its scale is limited
• the reduced level of complexity of decision-making resulting in a less-stressful life for the owners.

SUMMARY QUESTIONS
1 A number of businesses in your neighbourhood will have closed down in recent times. Which of the factors listed in this unit appear to have resulted in them closing down?
2 If you were the owner of a small local business why might you want to continue to operate on a small scale rather than to expand?

KEY POINTS
1 There are a number of reasons why businesses fail. Factors in the external environment include increasing competition and changing consumer buying patterns.
2 Causes of failure from within the business include lack of management experience and lack of cash to finance business activity.
3 Some businesses remain small because the owners prefer to operate at this scale as they have more interaction with customers, as well as greater personal control and flexibility over how they run the business.
Types of business organisation

1.4.1 Sole traders and partnerships

When setting up a business, one of the first decisions is ‘what type of business to form’. The type of business chosen determines the legal status of the business and how easy it is to raise capital.

The sole trader

This section looks at privately owned businesses – that is, ones that are owned by individuals or groups of owners rather than by the government.

Private businesses (private sector)       Public businesses (public sector)
Sole traders                             Government-owned businesses
Partnership                              Companies (including multinationals)

A sole trader is the most common form of business ownership and the easiest to set up. Examples include street-corner flowers or drinks sellers in cities, tailors and operators of shoeshine services. A sole trader is a business owned by one person – though it may still employ a large number of people.

The table below shows some of the advantages and disadvantages of setting up as a sole trader rather than as a larger business.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easy to set up; no special paperwork is required</td>
<td>Having unlimited liability endangers personal possessions</td>
</tr>
<tr>
<td>Usually a small business; less capital is required</td>
<td>Finance can be difficult to raise</td>
</tr>
<tr>
<td>Speedy decisions can be made by the owner – few people involved</td>
<td>Small scale limits discounts and other benefits of large-scale production</td>
</tr>
<tr>
<td>Personal attention given to business affairs</td>
<td>Prices often higher than those of larger organisations</td>
</tr>
<tr>
<td>Special services can be offered to customers</td>
<td>Ill health, holidays, etc. may affect the running of the business</td>
</tr>
<tr>
<td>Can cater for the needs of local people; because the business is small, the owner comes into contact with the customers</td>
<td>Only one owner may mean narrow range of skills</td>
</tr>
<tr>
<td>Profits do not have to be shared</td>
<td>Mistakes possible, because no colleagues to consult for advice</td>
</tr>
<tr>
<td>Business affairs can be kept private</td>
<td></td>
</tr>
</tbody>
</table>

Unlimited liability

When you set up a business you will need capital to run it. Sole traders have only their own resources to draw on. They will finance their business through savings, and borrowing from banks and on their credit card.
Any debt that a sole trader builds up has to be paid by the owner. They are personally responsible for all the debts of the business. This situation can be contrasted with larger companies. Owners of a company have legal protection known as limited liability: this limits the debts owed by an individual owner of a company to the sum of money they have put into their business. In contrast, sole traders’ debts are unlimited. If sole traders find themselves in debt, they may have to sell off their house, car and other possessions in order to pay what they owe.

**Partnerships**

A partnership is a business association between two or more owners of an enterprise. Setting up a partnership usually involves creating a legal agreement between the partners. Partnerships usually have between 2 and 20 members, though this varies between countries. In some countries, legal restrictions allow a maximum of 20 partners.

Partnerships are common in many types of business – small shops as well as professional practices like vets, doctors, solicitors and dentists.

The table shows the advantages and disadvantages of setting up a partnership.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital from partners, so more capital available</td>
<td>Unlimited liability (except for ‘sleeping partners’, who put money into the business but do not get involved in its running)</td>
</tr>
<tr>
<td>Larger scale than sole trader</td>
<td>Disagreements between partners</td>
</tr>
<tr>
<td>Members of family can join</td>
<td>Limitation of number of partners (in many countries restricted by law to maximum of 20)</td>
</tr>
<tr>
<td>Affairs can be kept private</td>
<td>If partnership was set up by legal agreement, it will need to be re-formed if one partner dies</td>
</tr>
<tr>
<td>Risks and responsibilities spread among partners</td>
<td></td>
</tr>
</tbody>
</table>

Most partnerships are not protected by limited liability.

**SUMMARY QUESTIONS**

1. Abdul is considering setting up a small business repairing broken windows and is not sure whether to set up as a partnership or a sole trader. What would be the benefits of forming a partnership in terms of the following?
   - Access to capital / liability / ease of setting up the business / access to skills
   - What other advantages might there be to setting up a partnership?

2. What is limited liability? How does not having limited liability disadvantage many sole traders and partnerships?

3. Set out a table showing the main differences between partnerships and sole traders.

**KEY POINTS**

1. A sole trader enterprise is run by one person. A partnership is owned and run by two or more people.

2. Sole traders and partners typically do not have limited liability. Capital raised is restricted to the owner’s own savings, borrowing and any profits made.

3. A sole trader has control over their own business and takes all the profits.

4. Partners can share skills and spread the workload of running the business.

**ACTIVITY**

Choose a business and decide on its purpose. Set out a partnership agreement between yourself and a friend for a small enterprise that you could set up.

The agreement should cover these topics:

- Who will provide the capital, and how much.
- How the profits or losses will be shared.
- The duties of the partners.
- When profits will be taken from the business (e.g. monthly).
- Procedures for bringing in other partners and for settling disputes.

**DID YOU KNOW?**

In limited partnerships, one or more of the partners can have limited liability: if a partnership runs into debt, the maximum amount in law that they are expected to lose is what they put into the business. Limited partners would not have to sell off private possessions to pay off the debts of the partnership.
A company

‘Company’ suggests a group of companions who have come together to set up a business. The business they set up becomes a legal body, separate in law from the owners. To become a company, a business needs to become legally incorporated. This involves registering the company with the Registrar of Companies in the country in which the company has its head office.

The owners of a company are its shareholders. They appoint a board of directors to make the strategic decisions. The decisions they make include how much profit to distribute to shareholders, and what direction the business should take. The managing director is the senior director, with the lead role for managing the business.

The reasons for incorporating a business include:

- If the business gets into financial difficulty, shareholders risk losing only the value of their shareholding in the business. Their private possessions are protected by limited liability and only the assets of the business are at risk.
- An incorporated business is easier to sell than an unincorporated one, because all the complicated arrangements of setting up the business have already been done. Companies are expected to keep detailed accounts so that buyers can immediately see how the company is doing financially when they buy it.

The main disadvantages of a company concern the administration needed to register the company and the requirement to produce annual reports. Detailed accounts have to be kept.

The table shows the two types of limited companies.

<table>
<thead>
<tr>
<th>Private companies (ltd)</th>
<th>Public companies (plc)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Shares can only be bought direct from the company with the permission of the board of directors.</td>
<td>1 Shares can be bought and sold on a stock exchange. Anyone can buy them.</td>
</tr>
<tr>
<td>2 Usually has quite a small number of shareholders. May be a family-run business.</td>
<td>2 Can have a large number of shareholders (may be millions) all over the world.</td>
</tr>
<tr>
<td>3 Has access to less capital than a public company.</td>
<td>3 Has access to more capital.</td>
</tr>
</tbody>
</table>

The main advantage of being a private company is that the original owners can stop outsiders from buying up their company. Having a smaller number of people from whom to draw funds, however, may restrict growth. The main advantage of being a public company is access to large amounts of capital, which enables growth.

Franchises

A franchise business is made up of a franchisor and franchisees. The franchisor is an established enterprise (often a public limited
Joint ventures are often used as a means of avoiding tariff barriers and so gaining access to new markets. They reduce the amount of capital that a company needs, but they can also cause difficulties for that company, such as controlling the quality of the products or services provided.