MY REVISION NOTES

HODDER EDUCATION

Pearson Edexcel

A-level

BUSINESS

SECOND EDITION

- Plan and organise your revision
- Reinforce skills and understanding
- Practise exam-style questions

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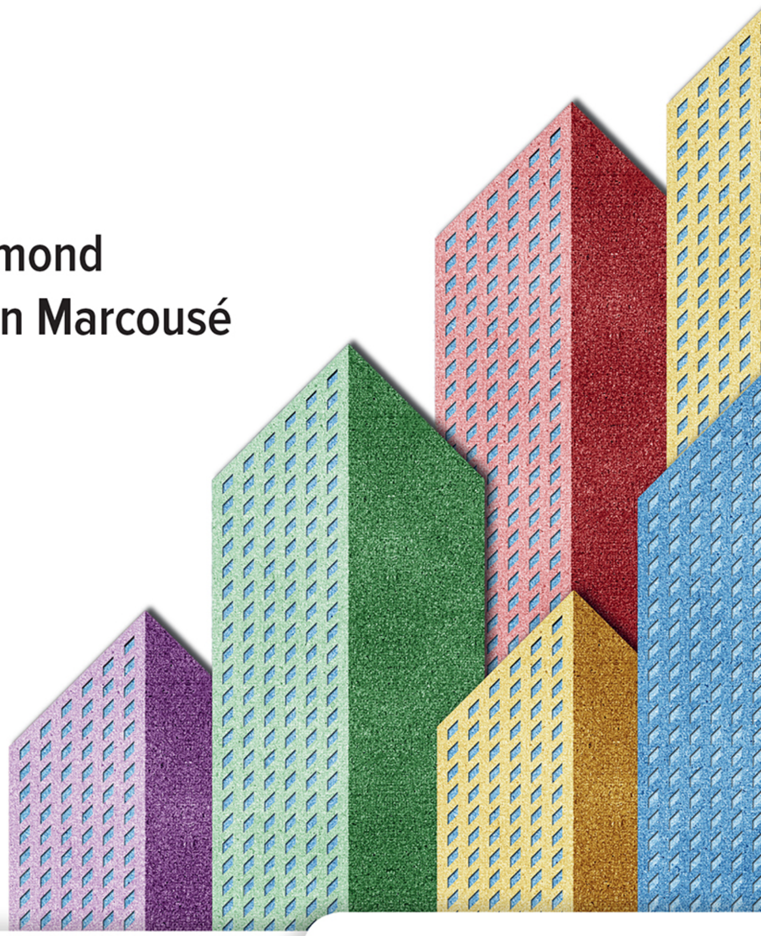

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My Revision Planner

REVISED | TESTED | EXAM READY

	REVISED	TESTED	EXAM READY

1 Meeting customer needs

The market

Markets are where buyers and sellers meet in order to exchange goods or services

A market exists where buyers and sellers meet in order to exchange goods or services. Though some markets can be identified as having a physical location, markets are best thought of as any occasion where a buyer and seller can interact and can therefore be online, by post or in a shopping centre or trade fair.

Mass markets and niche markets

REVISED

Some businesses will produce products and services aimed at satisfying the needs of a whole market, rather than any specific section of the market. Attempting to sell to the whole market is called mass marketing.

Other businesses select a **segment** of the market and sell products specifically to suit the needs of consumers in that segment. This process is called **niche** marketing.

A **market segment** is a subsection of a larger market in which consumers share similar needs and wants.

A **niche market** is a small segment of a larger market.

Table 1.1 Benefits of different marketing strategies

Benefits of mass marketing	Benefits of niche marketing
Huge potential number of customers	Meeting consumer needs more precisely allows higher prices to be charged
Higher production levels allow economies of scale – lower production costs	Higher profit margins
Can use mass media advertising	Easier to enter for firms with limited financial resources

There are notable differences between mass and niche markets as shown in Table 1.2:

Table 1.2 Differences between mass and niche markets

	Mass market	Niche market
Characteristics	Generic products which are broadly similar in form and function	Specialist products and services are required. Changes in consumer preferences can be rapid and devastating to the market
Market size and share	Huge markets in which large firms can operate successfully even though their market share may be low, e.g. Ferrero's 5% share of the UK chocolate market	Smaller markets mean successful firms may achieve far higher shares of their niche than mass market firms
Brands	Huge brands can develop with their name/logo representing a key point of differentiation	Differentiation is more likely to be achieved through product features and functions

Exam tip

Choosing a mass or niche market approach is a strategic choice. In other words, this choice will affect the whole business, from the approach to marketing through to decisions on scale of production and production methods and locations. Try to ensure that when writing about a firm using mass or niche marketing you acknowledge the impact of the choice of marketing strategy on other business decisions.

Now test yourself TESTED

1 State two benefits of mass marketing.
2 State two benefits of niche marketing.

Answers available online

Dynamic markets

REVISED

No business can afford to stand still because markets are dynamic; they tend to change over time. There are four major issues to consider:

Online retailing

Continued growth in online retailing has varied between different markets:

- Clothing has grown tremendously but growth in online sales of books has slowed to a virtual halt.
- This unpredictability of growth adds to the unpredictability of dynamism in online retailing.
- History has shown us that retailers who fail to switch to online retailing can fail completely as online rivals steal sales.

Above all, it is vital to ensure that your product or service is available to buy wherever consumers want to buy it. In some cases it is vital to have an online presence, or if consumers want to buy online and collect from their local store, a click-and-collect service is needed.

Making links

This topic links to small business survival in competitive markets (page 162). One of the strategies a small business can use is e-commerce – which allows it to keep overheads low and therefore prices competitive.

How markets change

Markets change as a result of major external influences, as summarised by the **PESTLE** acronym.

PESTLE highlights the major sources of external changes faced by businesses: Political, Economic, Social, Technological, Legal and Environmental.

Now test yourself TESTED

3 Explain how small e-commerce retailers can charge a similar price to large high street retail chains who receive bulk-buying discounts.
4 Why might niche market businesses be especially vulnerable in dynamic markets?

Answers available online

Examples of market changes include the following:

- Political: Britain's departure from the European Union (Brexit) has led to significant change in the process of importing and exporting.
- Economic: The economic recession of 2008–09 led to major changes in UK grocery retailing, as price-conscious shoppers opted for Aldi and Lidl.
- Social: An increased desire for convenience has driven the rise in online retailing.
- Technological: 'Apps' did not exist 15 years ago, prior to the advent of the smartphone; by 2020 they were capable of turning century-old markets on their head, such as the effects of Uber on taxi services or of AirBnB on travel.
- Legal: Growth in the market for vapes and e-cigarettes is being affected by the introduction of new laws relating to who can buy these items, how they can be advertised and where they can be consumed.
- Environmental: The car industry is facing major changes in order to try to minimise the damaging impact of exhaust fumes on the environment.

Making links

Many of these PESTLE factors are considered in Chapter 11 under the heading 'Impact of external influences' (page 147). It is there that you will cover why changes take place in more detail – and, even more importantly, go on to consider how external changes require strategic changes from businesses.

Innovation and market growth

- A major cause of change within markets is innovation.
- With competing firms continually trying to develop new products and services that offer features that no rivals offer, consumer loyalties can change dramatically.
- Once one innovation has been successful, other companies may be forced to try to adapt their offerings in order to keep pace with rivals.
- Furthermore, many companies will try to come up with their own innovations in order to try to benefit by leading change in the market.

Now test yourself TESTED

5 How has technological change affected take-away food outlets?
6 Another example of social change is an increase in the amount of 'retired' people still working. What benefits might B&Q experience from their policy of ensuring that an appropriate number of their staff are 'older'?

Answers available online

Typical mistakes

Too often exam answers imply that adapting to change is a simple process for a business. These responses fail to show an appreciation of the impact on all four business functions: marketing, people, finance and operations. Required changes may include production methods, finding new suppliers, redeploying workers and adopting new advertising and distribution methods.

Adapting to change

Market research and an understanding of general trends in the market are vital to successfully adapting to change:

- Identifying subtle changes in what consumers are looking for in their products allows businesses to adapt their products to better suit these needs.
- Changing earlier than rivals offers a major source of competitive advantage, whether it be removing sugar from food products or adding features to mobile phone handsets.

How competition affects the market

REVISED

Competition is the feature of business that most stimulates change and development. This is especially clear in the battle between Apple and Samsung in the smartphone market. Neither can sit back for a moment. That was clear when the market loved Apple's new iPhone 11, knocking Samsung off its top spot. Then, once again, Samsung needed to develop upgrades to its S20 model to try to claw back its market leadership position from Apple.

Increased levels of competition create various pressures for businesses:

- The need to drive down costs.
- The need to maintain competitive prices.
- The need to develop innovative products and services.
- The need to maintain high-quality products and services.

Now test yourself TESTED

7 What are the six major external forces that lead to change in markets?
8 State three benefits experienced by consumers as a result of increased competition in a market.

Answers available online

The difference between risk and uncertainty

REVISED

Operating a business in any market involves facing up to risk and coping with uncertainties:

- The key difference lies in the predictability of events occurring.
- A risk is quantifiable, so if statistics show that only 1 in 20 new consumer goods succeed, the risk involved in launching a new product can be identified and quantified.
- The factors causing the risk are the uncertainties – those factors that cause a lack of certainty in future events – such as reactions of rivals, reactions of consumers, reactions of retailers and such unexpected events as currency movements and economic downturns.

Typical mistakes

Too many exam answers use the terms 'risk' and 'uncertainty' interchangeably – they are not the same thing.

Making links

Market research can help to reduce risk by eliminating some uncertainties (see below). Recognising this can help to assess the usefulness of market research when tackling exam questions. An answer explaining that research has reduced the uncertainty over which product to launch leading to a reduction in risk will show good justification.

Now test yourself

TESTED

9 What marketing activity tends to be the key to successfully adapting to change in markets?

Answers available online

Market research

Discovering information that helps a business understand its market

Product and market orientation

REVISED

Product orientation is an approach to making decisions that considers internal factors before worrying about changes in the market:

- This means that product-orientated businesses can focus on their own key strengths, which can lead to revolutionary new ideas that consumers would never have dreamed of.
- However, the danger is that the business fails to adapt its products in line with what consumers are looking for, which could lead to huge problems.

The opposite approach – market orientation – is more likely to lead to marketing success since it places consumers' views and behaviours at the heart of decision-making within the business.

Now test yourself

TESTED

10 Which type of business is likely to allocate a larger budget to market research – a product-orientated or a market-orientated business?

Answers available online

Primary research is new research conducted for a particular purpose.

Secondary research uses pre-existing data that has been gathered for another purpose.

Primary and secondary research

REVISED

Market research can use either secondary data or primary data, with **primary research** being new research carried out for the first time, and **secondary research** being research that uses data that has already been gathered for some other purpose.

Primary versus secondary research

Table 1.3 Advantages and disadvantages of primary and secondary research

	Primary research	Secondary research
Advantages	+ Addresses the specific issues the business interested in + Data is up to date + Can help to understand customer psychology	+ Often free + Provides a good market overview + Usually based on large-scale, reliably produced research
Disadvantages	+ Expensive, costing thousands of pounds to do properly + Risk of bias from questionnaire and interviewer + May need to compare with other information to understand the meaning of findings	+ Information may be out of date + Not tailored to suit your particular needs + Can be expensive to buy published research reports on markets

Typical mistakes

Primary research does not have to be carried out by individual businesses. They can hire a market research company to do the research for them. If it is new research it is still primary. Primary means newly gathered, whereas secondary uses data that has already been gathered for another purpose.

Now test yourself

TESTED

11 Is a product-orientated or market-orientated business more likely to come up with brand new, revolutionary product ideas?

12 What type of research uses data that has already been gathered for another purpose?

13 What type of research gathers brand new data?

Answers available online

Exam tip

Generally most firms will use a combination of secondary and primary research, with secondary often conducted first to help design the primary research needed without incurring the high cost of primary research first.

Table 1.4 Different primary and secondary research methods

Secondary research methods	Primary research methods
The internet	Surveys
Trade press	Retailer research
Government statistics	Observation
Past internal sales figures	Group or individual discussions

Quantitative versus qualitative data

The data gathered by market research may be quantitative or qualitative:

+ Quantitative data is factual, often numerate data that aims to be statistically representative of the whole market.
+ Qualitative data contains opinion and is unlikely to have been gathered on a large enough scale to give statistically reliable data. It is designed to give insight into why customers behave the way they do.

Quantitative research is research conducted on a large-enough scale to provide statistically reliable data, usually aimed at discovering factual information about how customers behave.

Qualitative research is unlikely to be carried out on a large-enough scale to give statistically valid data, but is instead aimed at providing insights as to why customers behave the way they do.

Now test yourself

TESTED

14 What type of research is aimed at delivering statistically reliable information?

15 What type of research is aimed at finding out about customer attitudes in the hope of gaining insights into consumer behaviour?

Answers available online

Limitations to market research

REVISED

If all market research provided accurate and reliable data, then all businesses would succeed. There are two major reasons why market research data may be unreliable:

+ Sample size too small: This means that there is more chance that respondents who do not reflect the overall views of the market are over-represented in the sample.

- Sample bias: The way that respondents are selected may cause certain types of people to be over-represented in the sample. Their views may skew the overall findings away from the views of the total population being researched.

Exam tip

The research method may not be the major mistake made by a business whose research seems to let them down. Analysing and then interpreting market research data is the most common problem within the marketing process. The best marketing decision-makers use surveys to provide insights – but they still take the key decisions based as much on experience and intuition as on research.

Use of ICT to support market research

REVISED

There are three main ways in which ICT can support market research:

- Company websites can gather data on visitors to the website, which can provide some information about online shoppers' or browsers' interests.
- Social media can also offer information on consumer attitudes to a product or service, and even allow for an element of relationship-building between the business and consumers.
- Database technology, which has advanced so far in recent years, allows vast quantities of data relating to consumers to be trawled in order to identify patterns that can help to explain how consumers actually behave, with much of this data being generated by loyalty cards.

Typical mistakes

Despite their name, a major purpose of loyalty schemes is to gather information on customers' buying habits. Therefore expect to use the concept of loyalty in answers about market research as well as in answers about building customer loyalty.

Market segmentation

REVISED

One main function of market research is to help to decide on useful ways to **segment markets**. Splitting markets up helps to target specific groups of consumers who share similar needs and wants, enabling a firm to meet these more closely. Market research can unearth insights that allow firms to identify segments that they can fulfil profitably.

Benefits of segmenting a market include:

- Products and services can be designed to suit specific customers.
- Meeting customers' needs precisely allows a higher price to be charged.
- Promotional activity is easier to target.

Market segmentation means discovering useful ways to split up a market into different groups of consumers who share similar characteristics, wants and needs.

Now test yourself

TESTED

16 State two reasons why the results of market research may give misleading results.
17 List three ways that ICT can help with market research.
18 State three benefits of segmenting a market.
19 State three criteria by which a market may be segmented.

Answers available online

Market positioning

Deciding how you want consumers to perceive your product

Decisions over fine tuning the product being sold must follow earlier, strategic decisions about what products to sell to which markets. This fine tuning is the process of **market positioning**.

Making links

The marketing mix (see Chapter 3) represents the toolkit a business can use to precisely position its product. Therefore you should be able to link the concept of market positioning to any answer where you are explaining a decision on the marketing mix.

Market positioning means deciding exactly what image you are trying to create for your product, relative to its rivals.

Market mapping

REVISED

The two key judgements required in successful market mapping are:
- choosing the right variables to place on each axis
- placing rival brands in the correct places on the map, truly reflecting consumer perceptions of those brands.

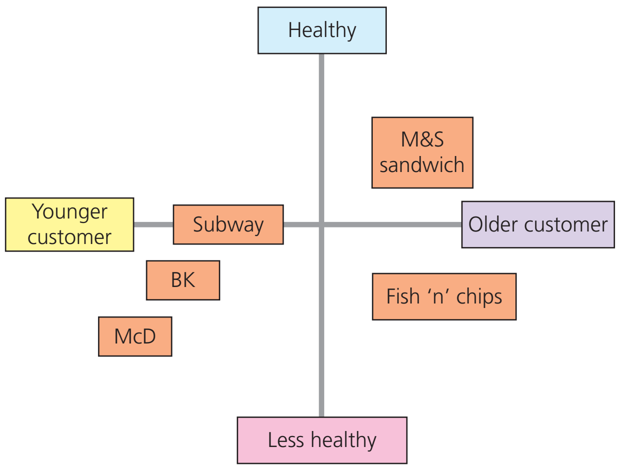

Figure 1.1 Market map of the UK fast food industry

With a market map produced, a business can identify the gaps in the market more easily. So Figure 1.1 suggests that a gap selling healthy fast food to younger customers may be a business opportunity.

Following this is a check to ensure that any gaps can be filled profitably. For example: drawing a map of the UK car market can identify a gap for a truly luxurious sports car selling for £10,000. Of course, the reason why this gap exists is that no firm is capable of making the product at a cost that will give them a profit at a price of £10,000.

With a gap identified, the firm must then decide how to use the marketing tools at its disposal. Managers will want to create an image that matches the product to the gap that has been identified.

Competitive advantage

REVISED

Products without any competitive advantage over their rivals have been proven time and again to have no long-term future. The two major generic routes to finding a competitive advantage are to:
- be the lowest cost producer, e.g. Ryanair in the European airline market
- find a sustainable point of differentiation, e.g. KFC in the market for fast food.

Producing your product more efficiently and thus more cheaply than any rivals will ultimately allow a business to sell at a lower price than any other firm, yet still make a profit. Generally, in any given market there is space for one firm to fulfil this role of lowest cost producer.

The key to competitive advantage is that it should be sustainable in the long term. A really strong brand name and image can achieve this, but only if the whole business focuses on providing the products and service that match or even enhance the brand.

Now test yourself

TESTED

20 What is market mapping designed to reveal?

21 What are the two main routes to competitive advantage?

22 Explain the effects that the arrival of Aldi and Lidl have had on Tesco in the UK grocery market.

23 Explain the main sources of competitive advantage for each of the following:

a) iPhone

b) Nestlé's KitKat

c) Nando's.

24 How can being the most efficient producer of a product create long-term success?

Answers available online

Making links

Sustainable competitive advantage is the principle is at the heart of Porter's strategic matrix, which you will look at closely in Theme 3 (see page 130). According to Porter, no business can experience long-term success without sustaining a competitive advantage.

Product differentiation

REVISED

Standing out from rivals can be achieved through actual, tangible differences between products or through manipulating consumer perceptions of your product – a kind of psychological differentiation. Possibilities are shown in Table 1.5.

Typical mistake

Be careful not to over-use the term 'unique selling point'. Many product features can differentiate a product without actually being unique.

Table 1.5 Tangible and psychological differences between products

Actual product differentiation	Perceived product differentiation
Design	Branding
Different functions	Advertising
Taste	Sponsorship
Performance	Celebrity endorsement

The purposes of **product differentiation** are:

- insulating the product from the actions of competitors
- allowing prices to be increased without a major fall in demand or sales.

Product differentiation means attempting to make a product seem different, in the minds of consumers, to any other rival in the market.

Making links

As we will see later, in Chapter 2, differentiation is the key to reducing a product's price elasticity. A product that stands out from its rivals will be perceived to have fewer close substitutes, so customers will keep buying even when price is increased as they do not believe there are any alternatives.

Adding value

REVISED

Product differentiation generally helps to add value to products and services:

- The ability to push prices higher without increasing the costs of producing a product will naturally add value.
- **Added value** may come about through tangible, engineering methods, such as creating a great design or finding a way to produce in a far cheaper manner, or it may be added through perception, generally through promotional methods used by the business, such as advertising and branding.
- L'Oréal's long-standing slogan 'Because I'm worth it' is the company's clever way of persuading customers that paying a higher price for L'Oréal products is 'worth it', i.e. it adds value.

Added value is the difference between the cost of bought-in goods and services and the selling price of a product.

Making links

Effectively adding value boosts profit margins – most notably gross profit margins – as the gap between the selling price and variable costs widens (see Chapter 8).

Now test yourself

TESTED

25 What are the two main benefits of successful product differentiation?

26 How can advertising add value to a product?

Answers available online

Exam practice

The market for toys in the UK is highly seasonal. It is a market that has a strong record for innovation, especially in the development of electronic toys that use the latest audio-visual technology, and can often throw up surprise success stories. Over the past three years, the market has grown. As well as new toy products, some old products are also making a return. In the niche market of sports games, a global giant Hasbro has relaunched Subbuteo table football in the UK. It decided to go ahead after studying the results of some quantitative research among boys. The game, which was first launched in the 1950s, had been withdrawn from the market in 2007. With the game beginning to appear in major toy retailers such as Argos and John Lewis, the relaunch seems to be proving a modest success. Nevertheless, many commentators have suggested that the company's failure to launch an e-commerce site through which Subbuteo products can be bought directly may be harming sales growth.

Questions

1. Explain how the use of a familiar brand name can help Hasbro relaunch Subbuteo products. [4]
2. Assess the decision to relaunch Subbuteo without an e-commerce site. [10]
3. Assess the major influences on the market size of the toy market examined in the item. [12]

Answers and quick quiz 1 online at www.hoddereducation.co.uk/myrevisionnotesdownloads

Summary

- Mass marketing and niche marketing are alternative approaches to marketing that both offer benefits and drawbacks.
- Markets are dynamic. They change, raising the following issues for businesses: how markets change, the rise of online markets, innovation in markets and adapting to change in markets.
- Competition is a key driving force behind features within markets such as prices, quality and innovation.
- Risk is quantifiable; uncertainty is unquantifiable and unpredictable.
- Market research can allow businesses to understand the customers to whom they plan to sell, enabling better business decisions to be made.
- Market research can gather fresh information (primary) or be based on information already gathered (secondary).
- Market research can be carried out on a large enough scale to give statistically reliable results (quantitative) or can be small scale, in-depth and designed to give insights (qualitative).
- Market research methods can undermine the reliability of research results if sample sizes are small or samples are poorly selected.
- ICT can help gather and analyse market research data.
- Market research can help to segment markets.
- Market mapping helps to make decisions over where to try to position a product in the market.
- Successful market mapping requires good decisions on what to plot on the map's axes and where to place existing products.
- Having some kind of competitive advantage is crucial for the success of any product.
- Competitive advantage can come from lowest costs or product differentiation.
- Differentiation may be tangible or perceived.
- Differentiation helps to lessen the effects of competitors' actions, allows firms greater price flexibility and helps to add value to products and services.

Exam skills

- With so many exam questions ultimately asking about business success or even more often business problems, the concept covered within this section – of the need to meet customer needs – is a pretty simple underlying factor determining success.
- Given that any business must sell customers something they are willing to buy, the process of identifying, understanding and then designing a product or service to meet these needs is fundamental to success.
- When looking to offer evaluation in longer written answers, being able to see underlying causes of business success or failure shows the ability to sift through less important issues to get to the very heart of a business scenario.
- Often, attributing a business's performance to the extent to which it has successfully met its customers' needs will show a level of depth of insight that will effectively draw together the threads of your argument to pick out what really matters.

2 The market

Demand

How much of a product consumers buy

Demand is such a fundamental concept in business that understanding the factors that affect demand is critical to running a successful business. The main factors affecting demand are listed below.

Demand is the term used to describe the level of interest customers have in a product.

Price

REVISED

Higher prices lead to lower effective demand, since fewer customers can afford to pay. Price also affects consumers' decisions on relative value of the product compared to alternatives – higher prices make alternatives seem better value. On the other hand, prices give off a signal about the product being sold – so lower prices may damage consumer perceptions of quality.

Effective demand is interest backed by the ability to pay.

Making links

Changing price affects demand – the concept of price elasticity (see page 24) measures the extent to which demand is affected by changes in price.

Changes in prices of substitutes and complements

REVISED

A clear relationship exists between demand for a product and the price of its substitutes. If the price of a tin of *Roses* falls, demand for *Quality Street* will fall as consumers switch to buying the cheaper substitute. The same relationship holds if the price of the substitute rises; demand for *Quality Street* will increase as consumers switch away from *Roses*, the more expensive substitute.

The relationship between demand for a product and the price of its complements works in the other direction:

- Should the price of a complementary product rise, demand for the original product is likely to fall.
- Often, complementary products can represent the 'running costs' of another product, such as petrol for cars or coffee capsules for coffee machines.
- If the price of the complementary product rises, demand for the original will fall, and vice versa.

A **substitute** is a similar, rival product that consumers may choose instead.

A **complement** is a product whose use accompanies another, so petrol is a complementary product to cars.

Now test yourself

TESTED

1 If the price of petrol falls, what is likely to happen to demand for cars?
2 If the price of Adidas trainers increases, what is likely to happen to demand for Nike trainers?

Answers available online

Typical mistake

Too many candidates under pressure confuse the terms complement and substitute – pause before choosing the appropriate term.

Changes in consumer incomes

REVISED

- As income levels rise, demand for most products (normal goods) rises in line, as consumers have more income to spend. For luxury goods such as Porsche cars, demand will rise even faster than incomes.
- Of course, incomes do not always rise. As economies go through recession, incomes will fall, and for normal and luxury goods demand falls as consumers try to save money.
- However, some products, known as inferior goods, see demand rise when incomes fall, as happened to Poundland in the recession-affected years 2008–13.
- Inferior goods, as their name suggests, tend to be cheaper alternatives to normal goods, which consumers can switch to in order to save money when their incomes are falling.
- As incomes rise again consumers will switch back to normal and luxury goods, leading to a fall in demand for inferior goods.

Making links

The concept of income elasticity (see page 26) allows the measurement and prediction of the impact of changing incomes on demand for products.

Fashions, tastes and preferences

REVISED

Subject to change over time, factors such as attitudes to diet (for example, no sugar or low fat) change unpredictably but can have a major impact upon demand for products, either positive or negative.

Advertising and branding

REVISED

Successful advertising can lead to major short-term increases in demand. Consistent advertising linked to other marketing activity may help to build a brand, protecting it from direct competition and making sales volumes relatively stable.

Demographics

REVISED

Changes in the make-up of populations, which form the basis of any market's demand, can affect demand for individual products. Major demographic trends in the UK in recent years have seen a growing population of over-60s, a rising birth rate and increased numbers of non-EU migrants. All these groups provide opportunities for increased demand for carefully targeted products.

External shocks

REVISED

Natural disasters, global issues like the coronavirus pandemic, changes in the law, unexpected traffic problems or a major customer not renewing a contract are all examples of events that can have a hugely damaging impact on demand for small or large businesses. The major problem with many external shocks is their unpredictability. They are outside the business's control.

Seasonality

REVISED

Seasonal factors affect demand for many products, whether they are related to the weather and nature's seasons or due to special events during the course of a year, such as Christmas.

Now test yourself TESTED

3 List seven factors that could affect demand for a product.
4 Give two examples of external shocks that could damage demand for a local independent coffee shop.

Answers available online

Supply

How much of a product firms are willing to produce

Along with demand, the amount that businesses are willing and able to supply will have a major impact on the price of all products:

- The general rule governing the amount firms are willing to supply is that the more profit they can make by supplying a product, the more they are willing to supply.
- This is because firms making choices over how to use the resources they have available are assumed to put those resources to whatever use will maximise profit for them.

Changes in costs of production

REVISED

If the cost of making a product changes, the amount that a business is willing to supply will adjust accordingly:

- If production costs rise, the amount supplied will fall.
- If production costs fall, the amount supplied will rise.

This is because as costs rise and fall, the amount of profit the firm can make changes. Firms will always supply more if they can make more profit and less if profits are lower.

The most common cause of changed production costs is changes in the costs of the resources used to make a product, including materials and labour.

Making links

Economic influences, particularly exchange rates (see page 119), but also weather conditions affecting food harvests, are likely to lead to changes in the costs of resources.

Introduction of new technology

REVISED

New technology used in production, such as industrial robots, tends to reduce the costs of production:

- The introduction of new technology should lead to an increase in supply.

Not only are firms willing to supply more with lower production costs offering higher profits, but also new production technology may increase capacity, meaning that there is more output available.

Now test yourself TESTED

5 Explain the relationship between costs of production and supply.
6 How might the invention of a new, more efficient production robot affect the supply of cars?

Answers available online

Indirect taxes

REVISED

Indirect taxes act just like another component of the cost of producing a product or service. Therefore:

- An increase in indirect tax rates will increase costs and therefore reduce supply.
- A decrease in indirect tax rates will cut total costs and therefore increase supply.

Indirect taxes are taxes that the government imposes on goods and services, for example VAT.

Government subsidies

REVISED

These are the opposite of taxes. When the government wants to encourage the supply of a product, such as wind-powered energy, it may offer subsidies to businesses producing this product. This cuts the cost of production faced by the business, meaning that subsidies will increase supply.

External shocks

REVISED

Unexpected events, such as economic crises, poor harvests of agricultural commodities or natural disasters, can have the impact of reducing the total quantity of an item that is available. This would lead to an increase in the price of the item, meaning that production costs rise for firms, thus reducing the amount they are willing to supply.

Revision activity

Produce a mind map, with 'Supply' in the centre, which summarises the major factors affecting supply and then *how* that factor affects supply. So, you will have one branch for each factor and each branch will break off to explain how changes in that factor might increase or decrease supply.

Now test yourself

TESTED

7 Give an example of an external shock that may reduce the supply of wheat.
8 Explain two reasons why governments might offer subsidies to firms supplying wind turbines.
9 What would be the effect of a reduction in the rate of VAT on supply?

Answers available online

Markets and equilibrium

What happens when demand (customers) and supply (producers) meet

The interaction of supply and demand

REVISED

In **commodity markets**, price is determined simply by the interaction of supply and demand. Simply stated:

- If demand is higher than supply, the price of the product will rise, until demand falls back to the level of supply.
- If supply is higher than demand, price will fall, stimulating more demand to ensure that all that is supplied is sold.

What is happening is that price adjusts until demand and supply are in **equilibrium**. This is the natural state for all markets in which price is determined simply by demand and supply.

Commodity markets are markets for undifferentiated products, generally raw materials such as gold, crude oil or rice.

Equilibrium describes a situation in a market where supply and demand are balanced, making the price stable.

Making links

The section on pricing strategies on pages 34 and 35 of Chapter 3 explores how producers decide what price to charge when selling non-commodity products.

Now test yourself

TESTED

10 What name is given to products that cannot be differentiated?

Answers available online

Supply and demand diagrams

REVISED

Drawing a demand curve simply involves plotting a series of points showing how much of a product would be demanded at a range of different price levels. In a similar way, a supply curve can be plotted, showing how much of a product businesses are willing to supply at a range of price levels.

Table 2.1 shows the demand and supply of sacks of coffee beans at a range of prices.

Table 2.1 Demand and supply of sacks of coffee beans

Price ($ per sack)	Demand (million sacks)	Supply (million sacks)
210	175	125
230	165	140
250	155	155
270	145	170
290	135	185

This information can be used to plot both a demand curve and a supply curve on a diagram that will show the market for coffee beans (Figure 2.1).

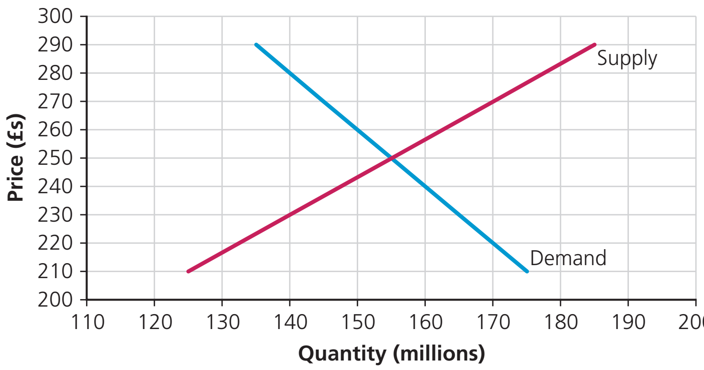

Figure 2.1 Equilibrium in the market for coffee beans

Now test yourself

TESTED

11 Why does a demand curve slope downwards from left to right?

12 Why does a supply curve slope upwards from left to right?

Answers available online

As Figure 2.1 clearly shows, the current equilibrium price is at $250 per sack, i.e. the place at which the level of demand and supply are the same.

If there is a significant change in the factors that determine the demand or supply of coffee, the lines will change. Possible reasons for these changes are examined through pages 19 to 22. These will cause leftward or rightward shifts in the demand and supply curves. They will need to be redrawn and are likely to generate a new equilibrium price. Table 2.2 summarises the effect on price of shifts in the curves.

Table 2.2 Effect on price of shifts in the demand/supply curves

If this changes	Price will move
Demand curve moves to the right (rises)	up
Demand curve moves to the left (falls)	down
Supply curve moves to the left (falls)	up
Supply curve moves to the right (rises)	down

Now test yourself TESTED

13 What name is given to the point at which demand and supply curves cross?

14 State two factors that may cause a demand curve to shift.

15 State two factors that may cause a supply curve to shift.

Answers available online

Price elasticity of demand

What happens if a business changes its selling price

Price elasticity of demand measures the responsiveness of demand for a product to a change in its price.

Calculation

REVISED

Price elasticity of demand can be calculated by measuring the percentage change in demand that follows a change in price:

$$\text{Price elasticity of demand} = \frac{\%\text{ change in demand}}{\%\text{ change in price}}$$

Exam tip

The two percentage changes should always be in opposite directions. The price elasticity will therefore always be a negative figure. To calculate a percentage change, take the change between the two figures for, say, price, divide by the original price and multiply by 100. For example, a change in price from £80 to £100 is a 25 per cent change ((£20/£80) × 100 = 25%).

Typical mistake

Always use percentage change figures. Do not simply use the absolute changes in price (£s) or demand (units sold).

Interpreting price elasticity

REVISED

Table 2.3 Differences between price elasticity and inelasticity

If price elasticity is between 0 and –1	If price elasticity is a negative number greater than 1
Product is price inelastic	Product is price elastic
Changes in price have a proportionately smaller effect on demand/sales	Changes in price have a proportionately larger effect on demand/sales

Exam tip

Check to see if the examiner's text tells you the price elasticity of the product/business. Use it if it does. However, you can also infer price elasticity by assessing the extent to which the product is differentiated; see the section on page 25 on factors affecting price elasticity.

Now test yourself TESTED

16 If a business increased its price from £2.50 to £2.75, what is the percentage change in price?

17 If that change in price led to a fall in sales from 1,500,000 units to 1,200,000, what is the percentage change in demand?

18 Using your answers to questions 16 and 17, calculate the price elasticity of the product.

Answers available online

Price elasticity and revenue

REVISED

Depending on a product's price elasticity it is possible to make definitive statements about the effect of price changes on its revenue (Table 2.4).

Table 2.4 Effects of price change on revenue

If the product is:	Change in price:	Effect on revenue:	Explanation:
Price elastic	Increasing price	Fall in revenue	Because a small increase in price leads to a large fall in demand
Price elastic	Decreasing price	Increases revenue	Because a small cut in price leads to a large increase in demand
Price inelastic	Increasing price	Increases revenue	Because an increase in price leads to only a small fall in demand
Price inelastic	Decreasing price	Fall in revenue	Because a price cut will only cause a small increase in demand

This predictability gives the opportunity to generate clear advice to offer in answer to questions asking for recommendations about a product's selling price.

Making links

This stresses why the concept of price elasticity links clearly with decisions on pricing strategies (see page 34) – the predictability of the relationship between price and sales helps businesses to make more informed decisions.

Exam tip

Using price elasticity as a way of justifying a recommendation on whether a business should increase or decrease price allows you to develop a sophisticated argument that uses theory well.

Now test yourself

TESTED

19 Would a well-known popular branded product be likely to be price elastic or inelastic?

20 To increase revenue on a price elastic product, should price be increased or decreased?

Answers available online

Factors influencing price elasticity

REVISED

The major factors affecting price elasticity all boil down to whether the product seems different from its rivals. They are:

- degree of product differentiation
- availability of direct substitutes
- branding and brand loyalty.

Ultimately, the issue is whether customers go into a shop seeking out *Marmite* or *Heinz Tomato Ketchup*, or whether they'll scan the shelves making price comparisons to decide which condiment to buy. If price is a central factor in the decision, price elasticity will be high ('elastic'). If it's got to be *Nike*, price elasticity will be low ('inelastic').

Significance of price elasticity

REVISED

Price elasticity is a useful concept for managers for two major reasons:

- Price elasticity can help in forecasting sales, by considering the likely impact of planned future price changes.
- Knowledge of price elasticity can help to decide on the best pricing strategy for increasing revenue, as shown in Table 2.4 above.

However, it is important to consider that price elasticity values tend to change over time:

- In a competitive market many firms' actions will affect the extent to which one product stands out from its rivals (just think how many chocolate bars there are).
- This unpredictability can undermine the usefulness of price elasticity by making it hard to really know the current price elasticity until after the price has been changed and the effect on demand measured.

Now test yourself TESTED

21 What three factors determine price elasticity?
22 What are the two major uses of price elasticity for marketing managers?
23 What is the major limitation to the use of price elasticity?

Answers available online

Exam tip

Most businesses prefer to have price inelastic products because they are able to increase their price if necessary as a result of perhaps in an increase in costs. This helps to explain why so much marketing activity can be traced back to attempts to make the product stand out from its rivals, reducing price elasticity.

Income elasticity of demand

How do changes in average incomes affect a business's sales?

Income elasticity of demand measures the responsiveness of demand for a product to a change in **real incomes**.

Real income is the amount by which average incomes have adjusted for inflation – the amount by which prices have risen. For example: average household incomes up 3% in the past year; inflation at 1.2% – so real incomes are up by 3% – 1.2% = 1.8%.

Making links

Changes in the state of an economy, as explored in Chapter 10, would prompt decision-makers to use knowledge of their products' income elasticities to help with sales forecasting.

Calculating income elasticity

REVISED

Income elasticity of demand can be calculated by measuring the percentage change in demand that follows a change in real incomes:

$$\text{Income elasticity of demand} = \frac{\%\text{ change in demand}}{\%\text{ change in real incomes}}$$

Typical mistake

Unlike calculations of price elasticity, the result of an income elasticity calculation can either be positive or negative. It is important to make sure you pay attention to whether the changes in demand and income are positive or negative and carefully note the sign of your answer. This will determine how the product is categorised.

Now test yourself TESTED

24 If average earnings rise by 4 per cent and prices rise by 2.5 per cent, what is the change in real income?
25 If a 3 per cent fall in real income leads to a 6 per cent rise in demand for potatoes, what is their income elasticity?
26 What are the two main factors affecting the income elasticity of a product?

Answers available online

Typical mistake

Always use percentage change figures. Do not simply use the absolute changes in income (£s) or demand (units sold).

Interpreting income elasticity

REVISED

When categorising products and services according to their income elasticity there are three possible types:

- Inferior goods: These will have a negative income elasticity.
- Normal goods: These are products with a positive income elasticity between 0 and 1.
- Luxury goods: These goods and services have a positive income elasticity that is greater than 1.

Table 2.5 Effect of changes in income on different types of product

Type of product	Change in real incomes	Change in demand	Explanation
Inferior good	Increase	Decrease	Consumers stop buying cheaper substitutes and trade up now they have more money
	Decrease	Increase	Consumers switch to these products to save money as their incomes fall
Normal good	Increase	Increase at the same rate as real income or a little slower	Increasingly affluent consumers are now able to buy a little more of this type of product
	Decrease	Decrease at the same rate as real income or a little slower	As consumers tighten their belts they will cut back a little on these products
Luxury good	Increase	Increase at a faster rate than real incomes	As consumers' incomes rise these luxuries are the ones that most of their extra income will be spent on
	Decrease	Decrease at a faster rate than real incomes	These will be the first products to disappear from consumers' shopping baskets when they feel the need to tighten their belts

Now test yourself TESTED

27 What name is given to a product with a negative income elasticity?

Answers available online

Factors affecting income elasticity

REVISED

Necessity or indulgence?

- The indulgences – those things we can easily live without, but love to treat ourselves to when we can afford to – will be those that are most sensitive to changes in income.
- Necessities are those more basic items that we would always expect to buy, even when times are tight, therefore they are not as sensitive to changes in real incomes; although we may try to cut back on the amount of pasta we buy when times are tight, we will continue to buy it.

Who buys the product?

The super-rich will still be able to afford to buy luxuries even during a recession, so demand for Bugatti cars may well be unaffected, whereas demand for Porsche sports cars may fall, as those who are 'merely rich' need to cut back on some of their luxuries.

Significance of income elasticity

REVISED

Sales forecasting

Knowledge of the likely reaction of a product to a change in real incomes allows a business to forecast sales *if* they have reliable economic forecasts available. Of course, the reliability of economic forecasts is not always strong.

Typical mistake

Income elasticities change over time. As a result, a company can never be 100 per cent confident that what happened to sales last time real incomes changed will be repeated. Add to this the fact that most economic forecasts tend to be a little inaccurate (at best) and writing about using elasticity to forecast sales should be accompanied by words such as 'may' or 'could' instead of 'will'.

Financial planning

If income elasticity gives sales forecasts, then this information can be factored into budgets and financial plans. If a recession is forecast, a firm producing luxuries can plan ways to reduce costs in advance of a probable sharp fall in sales.

Making links

Keep in mind the chance to link the concept of income elasticity to financial planning techniques (Chapter 7) – more effective planning can come from the use of income elasticity.

Product portfolio management

- Having a product portfolio consisting entirely of luxuries or inferior goods increases the danger of changes in real income having a critical impact on sales.
- Firms intending to spread their risk will look to ensure that their product portfolios contain products with a range of income elasticities.
- Though this may sound easy, it can be hard for a business selling a luxury good to prevent damage to their image if they release an inferior version.

Now test yourself TESTED

28 State two reasons why sales forecasts based on income elasticity may prove inaccurate.

Answers available online

Exam practice

The UK market for milk

Demand and supply of milk in the UK at different price levels

Price (pence per litre)	Demand (billion litres)	Supply (billion litres)
42	15	14.0
43	14.8	14.3
44	14.6	14.6
45	14.4	14.9
46	14.2	15.2

The estimated income elasticity of milk in the UK is +0.1.

Questions

1 On one diagram, draw a demand and supply curve for milk in the UK using the data in the table above. [4]

2 Using the data in the table for demand at a price of 44p per litre and 45p per litre, calculate the price elasticity of demand for milk. [4]

3 Calculate the impact on demand for milk in the UK if incomes fell by 5 per cent in a year, if the price was 42p per litre. [4]

4 Explain two possible factors affecting supply of milk in the UK. [8]

Answers and quick quiz 2 online

Summary

- In addition to price there are seven other major factors that could affect demand for a product. They are:
  - changes in the prices of substitutes and complementary goods
  - changes in consumer incomes
  - fashions, tastes and preferences
  - advertising and branding
  - demographics
  - external shocks
  - seasonality.
- Decisions on how much to supply are governed by how much profit a business can make.
- Changes that would increase the amount of profit a firm can make lead to an increased willingness to supply and vice versa.
- The major factors affecting supply in most markets are: changes in the costs of production, introduction of new technology, indirect taxes, government subsidies, external shocks.
- In markets with undifferentiated products, price is determined by the interaction of demand and supply.
- A demand curve shows the amount of the product that would be demanded at a range of price levels.
- A supply curve shows the amount of a product that firms would be willing to supply at different price levels.
- The point where the two curves cross is the equilibrium position, i.e. the point at which the price will be stable in the short term.
- Demand and supply curves shift due to a range of different causes.
- Shifts in demand or supply cause changes in the equilibrium price in a market.
- Price elasticity measures the responsiveness of demand to a change in price.
- All price elasticities are negative values.
- Price inelastic products have an elasticity between 0 and –1.
- Price elastic products are those with a price elasticity greater than –1.
- Price elasticity depends on the extent to which a product stands out from its rivals.
- Increasing the price of a price inelastic product will lead to an increase in revenue.
- Income elasticity of demand = $\frac{\text{\% change in demand}}{\text{\% change in real income}}$
- According to their income elasticity, products are classified as luxury goods, normal goods or inferior goods.
- Income elasticity depends on whether the product is an indulgence or a necessity and on who buys the product.
- Income elasticity information can be used to forecast sales, aid financial planning and design a balanced product portfolio.

Exam skills

- Reflecting on this second chapter, the market, illustrates that one of the real difficulties in running a business, and in being able to craft effective business exam answers, is being able to recognise the way in which more than one factor will impact on a business scenario.
- In very simple terms, we have seen that the interplay between demand and supply in a market are the fundamental drivers of price.
- There will be even greater complexity at play in many scenarios – as shown by the need to consider price and income elasticities of demand when assessing a future strategy for a product.
- The very best exam answers are those that are able to strip out what issues are relevant for a question, but then show the examiner that the student can build a logical argument by drawing these issues together and painting a verbal picture of how they are related, especially demonstrating that they understand cause and effect.

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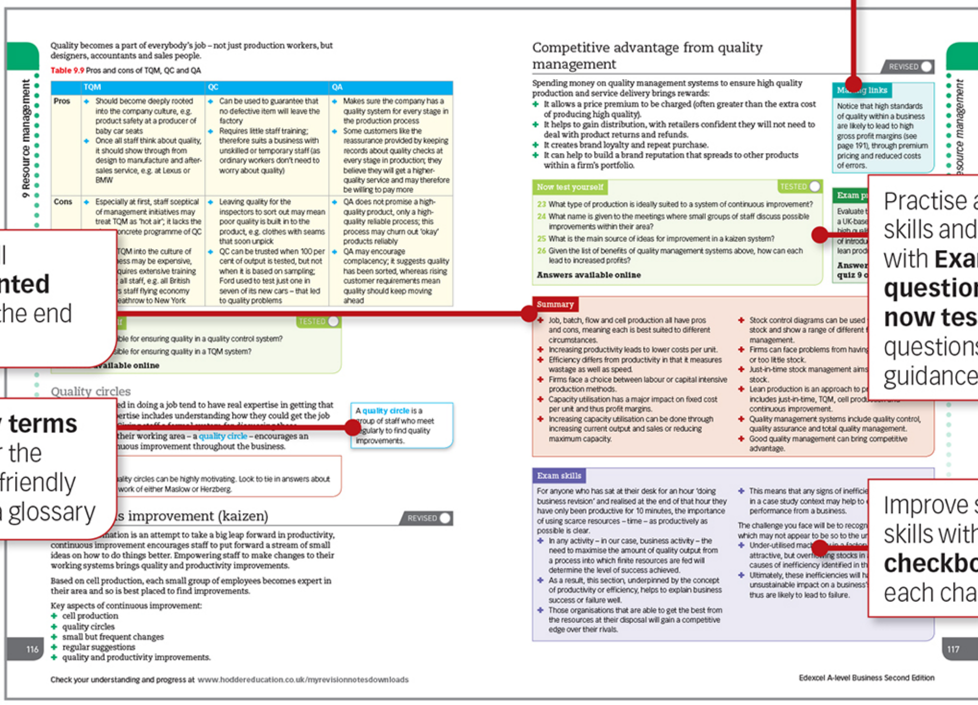

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