CHAPTER 1

THE NATURE AND STRUCTURE OF BUSINESS ENVIRONMENT

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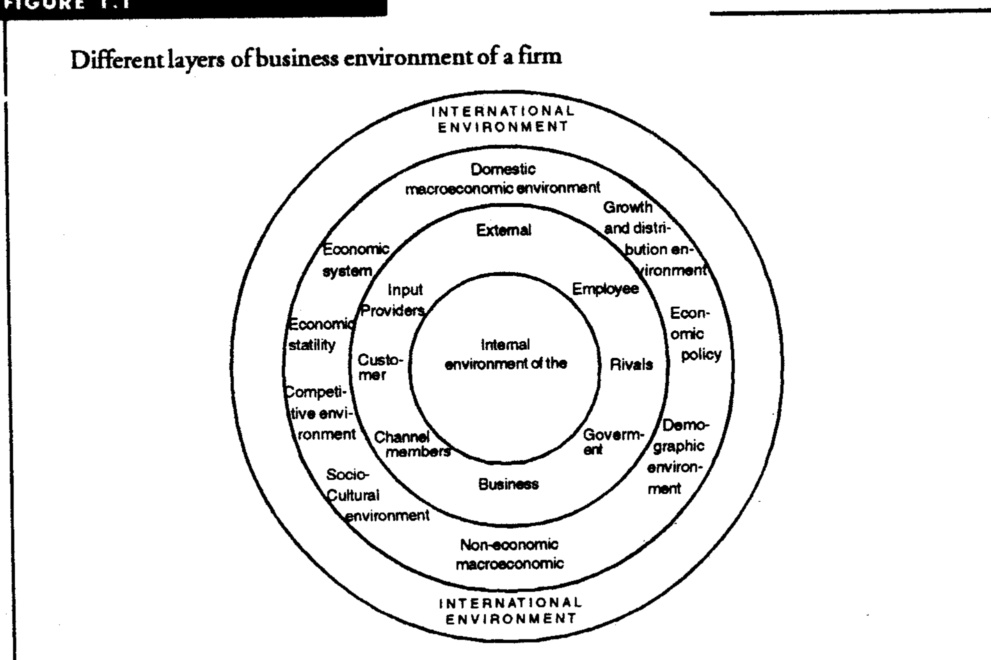
INTRODUCTION

Business environment in the present era of economic **liberalization, privatization** and **globalization** is becoming increasingly complex, unstable and unpredictable. The environment is the resultant of a number of interacting and constantly changing social and economic forces and thus remains in a state of flux. Variations in the overall and sectoral rates of growth and frequent shifts in **macroeconomic policies**, necessitated and triggered by social, economic or even political issues and problems demanding urgent attention keep business environment in a state of continuous change. The changing environment creates challenges, opens up new opportunities and affects the strengths and weaknesses of various business segments. ***An agile organisation not only comprehends and makes strategic adjustments in business planning and operation but is also able to project the forthcoming changes from the current scenario and take appropriate defensive or innoculative measures. An organisation insensitive to change in business organisation is more likely to confront the vagaries of business and may be compelled to make more expensive and painful adjustments at a belated stage or simply be driven out of business in a competitive environment.***

It is necessary for a business firm to comprehend the nature and structure of business environment and the factors causing change in it. At this stage, it must be understood that a particular state of external business environment can be favourable in varying degrees to certain segments of the business sector while it can be adverse to others depending upon the nature of competitive situation, product mix of firms, managerial capabilities and the ability of the firms to make strategic adjustment to environment changes. ***Firms with good adaptability or flexibility are in a better position to capitalize on a given change in business environment and enhance their competitive position in the market.***

FIGURE 1.1

Different layers of business environment of a firm



Business environment for a firm is a multi-layered structure. It is possible that some layers are favourable and others adverse for it. These layers exhibit different characteristics. A layer produces effect, though in a limited manner, over the adjoining layers over a period of time. The closeness of interaction and relationship between the layers is different at different levels. For example, changes in global business environment may affect the domestic growth environment significantly but the effect of the latter on policy environment may be slow and lagged. Some components like non-economic environment are rigid and amenable to slow change due to the nature of their determinants. Different layers of business environment surrounding a firm are shown in **Figure 1.1**.

THE INTERNATIONAL ENVIRONMENT

This is among the most dynamic and volatile components of business environment. At the outset, it must be appreciated that this layer concerns all business firms whether they have international transactions or not. A firm without foreign trade and foreign investment can experience a change in market share while competing with a firm having both domestic and international business. A variation in exchange rate affects the prices of imported goods, which, in turn, can bring about a change in the prices of competing domestic goods. This can affect the production cost of a purely domestic firm necessitating a change in the market price of its products.

The international environment is basically determined by the growth of the world economy, distribution of world GDP, economic relations and interdependence between nations and international economic policies of major industrial market economies, ***multinational corporations*** (MNCs), banks and multilateral institutions like ***International Monetary Find*** (IMF), ***World Trade Organisation*** (WTO), ***World Bank and International Labour Organisation*** (ILO) –(**Box 1.1**). These variables are given permanent effect by international economic laws, treaties, agreements and conventions. These factors affect the costs and flows of international trade, international investment, international finance and international technology affecting the growth and competence of the firms the world over. In recent years, some of the major events affecting international business environment have been:

BOX 1.1

Leading determinants of the international environment for business

- The state of the world economy and distribution of world output
- International economic cooperation
- Role of multilateral economic institutions
- International economic laws, treaties, agreements, norms, practices and codes
- Political system and conditions in different countries
- Cultural factors across countries
- Growth and spread of multinational corporations
- Technology growth and transfer
- *Corporate governance* standards and ethical practices across countries
- International market structure and competition
- Barriers to international trade and investment
- National economic policies of different countries

- Formation of the WTO in 1995 and ratification of the earlier agreements on trade and related issues;
- Collapse of the Eastern Europe in 1989 and USSR in 1991 and emergence of the transitory economies;
- Emergence of the **European Union** (EU) and introduction of **Euro** as common currency;
- Increasing economic strength and presence of MNCs the world over;
- Increase in the number of **free trade areas** and **custom union** arrangements between countries notably **North American Free Trade Area** (NAFTA);
- Economic crises in East and South-east Asian countries;
- Economic slowdown in a number of industrial market economies including Japan;
- Economic reforms and opening up of a large number of less developed countries (LDCs) including India; and
- Protectionist trends in the industrial market countries notably in USA.

In addition to the economic factors, international social, cultural and demographic factors play an important role in setting the environment. These factors determine consumer attitudes, tastes and preference and are subject to slow changes over time. The consumption patterns are greatly affected by demographic profiles and physical or geographical conditions and characteristics of overseas markets. These factors have to be closely researched by firms engaged in international marketing.

The risk and uncertainty content of the international environment is generally higher as compared to the domestic environment. Not only that, the international environment is more volatile and the domestic firm generally does not have full information about the environment and the factors causing change in it. For such reasons, the perceived risk of operating in this environment is much higher. This risk is basically three-fold:

- **Political risk**, emanating from political instability, changes in government, internal strife and law and order problems, open war, cold war, possibility of **confiscation, appropriation, nationalization** or **domestication**;
- **Country risk**, emanating from erratic economic and social performance, vagaries of national economic policies, economic nationalism and discrimination in foreign countries; and
- **Cultural risk**, affecting marketing communication, consumer attitudes towards foreign goods and changes in fashions, tastes and preferences.

As the level of such risks increases, firms have to either restructure or restrategise their operations or gradually withdraw from foreign markets.

DOMESTIC MACROECONOMIC ENVIRONMENT

Macroeconomic environment envelopes all business firms and provides them a framework within which they have to operate and adapt themselves. The environment provides national level economic conditions and circumstances affecting the level of aggregate economic activity in which individual

firms derive or seek their own business opportunities. It is circumscribed by the **economic system** under which an economy functions. It describes the level of prosperity indicated by the level and growth of income and wealth of the society and these variables are important for determining market potential for specific product groups. Like the international environment, domestic macroeconomic environment too shows variability, sometimes by wide margins, posing adjustment challenges for individual firms. It will be useful to analyze the environment in terms of its main dimensions as below.

ECONOMIC SYSTEM

An economic system is a way in which a society is organized to decide the following three basic questions of any economic organisation:

- What products should be produced and in what quantities?
- How should the products be produced?; and
- For whom should the products be produced?

There exist alternative economic systems which provide various mechanisms for allocation of scarce resources among various uses and in the best interest of the country. ***An economic system provides the framework within which an economy operates and the various economic units and agents mould themselves to fit into the system.*** In most countries, the system is enshrined in their constitutions; in others, the system is a legacy of history or a product of economic conventions and institutions. Major economic systems the world over can be broadly classified as follows:

Market Economy

It is an economic system in which the basic economic questions are left to the market mechanisms for solutions. From the standpoint of ownership, it is founded on the principles of capitalism under which productive assets are privately owned and individuals and private firms have the freedom to make major decisions about production and consumption under competitive conditions. Firms decide the product mix technology and target customers on the basis of an interrelated system of prices, markets and profits. An extreme form of market economy is the laissez-faire economy in which the government plays little role in economic decision making. Most of the developed countries like USA, Canada, Australia, Japan and countries in Western Europe have market economies. In these countries, role of the government is mostly regulatory.

Command Economy

In this system, most of the productive assets are owned and operated by the government. Government makes all important decisions about production and distribution and owns and directs the operations of enterprises in most industries. The government thus decides the basic questions of the economy. It is based on the tenets of socialism in which equity and welfare are utmost considerations. The system operated in the former Soviet Union and a number of East European countries.

Mixed Economy

In fact no economy is a purely market economy or command economy. All countries of the world have economic systems which combine the elements of 'market' and 'command' though in different proportions. In a mixed economy, none of the two elements has dominating presence. Most of the developing economies like India are mixed economies with public sector and private sector playing important roles together. In such economies, the role of the government is both developmental and regulatory.

Socialist Market Economy

In this system, productive resources are owned by the state but the resource allocation, production and distribution decisions are based on the principle of the market. The first socialist market economy appeared in Yugoslavia in early 1950s which was characterized by a high degree of decentralisation, producers' participation in decision making, workers' participation in management and market-based adjustment in supply and demand. Under this economic system, Yugoslavia experienced a high rate of growth and the system was exposed in sixties by other East European countries including Czechoslovakia and Hungry. The system is now breaking up under strains of marketisation, privatization and globalisation and most of the erstwhile socialist economies are making transition to open market economies. In this phase, such economies are termed as 'transition economies'.

Over the last two decades, there has been a remarkable shift from socialism to market socialism and further to capitalism and the role of private ownership and enterprise has been gradually increasing almost all over the world. As already pointed out, all economies of the world are mixed but they differ markedly with respect to the relative position and role of the public and private sectors. Even in capitalist countries, the extent of government regulation is wide and encompasses almost every sphere of economic activity. Economies under different economic systems have historically exhibited different rates of growth and it is difficult to ascribe growth of an economy to its economic system. Different models exist on the allocative efficiency of the alternative economic systems but the key factor is the efficiency of the macroeconomic management system and the productivity of the factor inputs.

GROWTH AND DISTRIBUTION ENVIRONMENT

Economic growth refers to the process of increase in real output over a period of time (usually a year).

There are three basic measures of a country's real output. The most widely used measure is **Gross Domestic Product** (GDP) which is the sum of four major components:

i) Personal consumption expenditure;

ii) Gross private domestic investment;

iii) Government expenditure on consumption and investment; and

iv) Net exports (exports minus imports).

GDP gets allocated in an economy by way of wages and salaries (to labour), interest (to capital owners), rent (to land owners), profit (to entrepreneurs), indirect business taxes (to government) and depreciation (to capital consumption). The second measure is **net domestic product** (NDP)

which is obtained by deducting depreciation from GDP. GDP is more popular than NDP in computing aggregate output as depreciation is difficult to estimate or is estimated using some arbitrary basis. The third measure is **Gross National Product** (GNP) which is the total final output produced by resources owned by the residents of the country. Thus, the output produced by foreign companies and nationals would be included in the GDP data but excluded from the GNP data. These interrelationships are provided in detail in **Chapter 7.**

BOX 1.2

Alternative measures of aggregate output and income

Gross domestic product, GDP	=	C + I + X - M
Net domestic product, NDP	=	GDP - D
National income, NI	=	GDP - D - T_i
Disposable Income, DI	=	NI - T_d

Where,

C = private consumption expenditure
I = private investment expenditure
G = total government expenditure on consumption and investment
X = exports
M = import
D = depreciation
T_i = indirect taxes
T_d = direct taxes

Aggregate output measures help us to derive data on **national income.** ***National income is obtained by deducting depreciation and indirect business taxes from GDP. This is the income received by the owners and suppliers of land, labour and capital in the form of rent, wages, interest and profit.*** If we further deduct **direct taxes** from national income, we obtain **disposable income,** which people divide between consumption and saving. Value of aggregate **real output** is obtained by **deflating** its value at current market prices by an appropriately selected inflation rate (called **GDP deflator**). A country with a high level of national income signifies good market potential in aggregate terms. International trade and investment have a greater tendency to move towards high-income economies, which are synonymous with large market size. Savings, credit availability and rate of interest also significantly affect consumer expenditure. A good growth environment is the one in which **national income** growth rate is significant (usually more than 5 per cent), saving rate and rate of interest are low and adequate consumer credit is available from banks and other financial institutions. ***Major factors affecting growth are availability and quality of raw materials, quantum and quality of capital stock, entrepreneurship, innovation and human skills, availability of quality infrastructure, social development and standards of governance and administration.***

Aggregate **market potential** is also determined by the distribution of national income among the various sections of society. ***Income distribution data is organized by ranking the population on the basis of their monthly or yearly income and then dividing the ranking into equal size groups such as top 10 per cent, next 10 per cent and so on up to bottom 10 per cent, or into quartiles (representing 25 per cent population) or percentiles (representing one per cent population).*** The

degree of inequality is shown by **Lorenz Curve**, which is widely used for analysing income and wealth inequalities. Income distribution affects both the market size and consumption pattern. Sharp inequalities lead to clear identification of different market segments allowing the firms to produce different classes of products for premium, upper-end and lower-income segments. The range of product mix tends to narrow down as income inequality decreases. Income inequalities are generally sharp in capitalist and open economies and where redistributive role of the government is not much.

An effective business manager keeps a watch over the extent of income inequality and the factors affecting the equality. Inequalities in wages and salaries are largely due to differences in abilities and skills, number of work hours, type of occupation, wage discrimination and state of competition in the job market. Inequalities in wealth are accounted for by differences in the saving rates, entrepreneurship and inheritance by individuals. Significant changes over time in consumption patterns trigger reorientation in marketing strategy of firms.

MACROECONOMIC STABILITY

Macroeconomic stability is one of the important conditions for the growth of business. It is achieved when most of the variables affecting growth environment are stable. ***It is manifested in the stability of the price level, exchange rate, interest rate, money supply, aggregate demand, balance of payments, employment rate, budgetary balance and eventually national income and output. In a macroeconomic framework, all of these variables are interactive and interdependent so that instability of one or few variables has the potential to upset other variables.*** In an open economy, such changes can be triggered by external or international factors. Alternatively, the changes could be brought about by changes in internal economic conditions or macroeconomic policy, which is mismatched to economic conditions. The instability enhances the level of ***country risk*** and discourages both domestic and foreign investments. Firms often find themselves vulnerable to cope with frequent recurrence of **booms** and **recessions** under unstable conditions. As speculation intensifies, hedging business hots up and capital tends to shift from economically productive to unproductive areas. Most countries adopt macroeconomic planning and policy to achieve economic stability.

ECONOMIC POLICY

Macroeconomic policy, as determined and changed from time to time, impacts business conditions more directly. The policy design can be a response to actual economic conditions or problems or is developed to create favourable conditions in the near future. The basic objectives of macroeconomic policy is to stimulate or maintain growth, achieve economic stability, increase employment, stabilize **balance of payments**, correct regional imbalances and make the economy more competitive. ***Much depends on the wisdom and philosophy of the ruling government and the quality of policy implementation and economic administration.*** In open or globalising economies, the policy is significantly affected by world economic conditions. The countries which borrow heavily from multilateral institutions like IMF and World Bank often have to adjust their macroeconomic policy structure to the lending criteria and conditionalties imposed by these institutions. Changes in the policy are also warranted by international treaties, laws, conventions and agreements. Quite often, political considerations have an overriding influence on the policy design and implementation. All these developments pose formidable challenges to the business manager. The main components of the policy are the following:

Monetary Policy

It refers to all the actions of the government or the central bank of a country which affect, directly or indirectly, supply of money, credit, rate of interest and the banking system. Basically, it affects the cost and availability of credit in the economy. For individual firms, the policy changes affect their **liquidity**, **cost of capital** and tend to induce them to adjust their **debt-equity ratios**. A restrictive monetary policy seeks to raise the rate of interest, reduce money supply growth rate and restrict the flow of credit and is generally aimed to fight **inflation.** A liberal or **accommodating monetary policy** is generally meant to fight **recession** and stimulate demand through credit liberalization, monetary expansion and fall in the rate of interest. In an open economy, monetary policy also seeks to regulate the foreign exchange market and exchange rates. The instruments of monetary policy are discussed in **Chapter 11.**

Fiscal Policy

Fiscal policy is basically concerned with the use of taxes and government expenditure, though the issues relating to non-tax revenue, government borrowings and fiscal federalism are closely associated with these factors for achieving pre-determined objectives. Government expenditure is basically composed of consumption expenditure, investment expenditure and **transfer payments** like subsidies, grants and unemployment allowances. The expenditure increases incomes of targeted groups and causes an overall increase in demand for consumption and capital goods. A rising government expenditure creates demand for the products of the private industry but increasing public investment also tends to crowd out private investment. In economies that follow private investment as a part of the economic reform process, there is sustained public sector **disinvestment** by the government leaving a wide field for private investment to fructify.

Taxes affect both demand and business investment. **Direct personal taxes** reduce **disposable income** of the people and cause market demand to diminish. Indirect or commodity taxes raise prices, which further reduce demand. To lessen the effect on demand, firms often absorb a part of increased tax burden themselves letting their profits to fall partly. **Indirect taxes** on material inputs raise production costs further squeezing the profits. Product-wise differences in the rates of excise and custom duties and sales tax make certain product categories less profitable to produce as compared to others causing transfer of investment to areas where the tax brunt is less. ***A heavy burden of taxation tends to discourage new investment in general. At the individual level, it affects the incentive to work and hence productivity.*** Taxation provisions are generally based on the considerations of resource mobilization, economic growth and fairness and generally tend to be progressive, or, for the sake of simplicity, proportional.

Fiscal policy is determined by the government and monetary policy by the central bank but these have same or closely related objectives. For that reason, there is generally a good degree of coordination between the two. Like monetary policy, fiscal policy has the potential to fight off **inflation** and **recession** and create conditions of economic stability. Similarly, both the policies can be designed to generate demand and rev up the growth process. The comparative role and effectiveness of the two policies depends upon the type of the economic system, economic philosophy of the ruling government and the structure of the economy. Both policies have their own strengths and limitations and so a suitable monetary-fiscal mix is required in the overall macroeconomic policy. In any case, for **synergy effects**, both the policies have to be oriented towards common objectives, synchronized and time sequenced. The policy is discussed in detail in **Chapter 12.**

Industrial Policy

The environment created by industrial policy closely surrounds business enterprises. ***The central objectives of an industrial policy are to promote industrialization, correcting regional imbalances, enhancing competitiveness of firms, developing inter-sectoral linkages, promoting exports and import substitution.*** Industrial policy specifies the relative roles of domestic and multinational enterprise, large and small industries and public and private sector firms. It specifies licensing and registration procedures, norms of capacity expansion and value addition, regulation of industrial costs, prices, product quality and pollution and in certain cases, prescribes the norms of investment. It contains assistance measures for various categories of industries generally ranked according to their national importance. These measures relate to taxation, subsidies, finance, infrastructure, technology, skill development and allied aspects. In India, from the Industrial Policy Resolution of 1956 to New Industrial Policy of 1991, there have been kaleidoscopic changes in policy reflecting the philosophy of different governments and responses to different economic conditions. (See **Chapter 27**)

Trade Policy

Basic objectives of trade policy are to promote exports, regulate imports, improve terms of trade, enhance export competitiveness and create conditions of export-led growth. Export promotion is generally attempted through international market research support, credit facilities, infrastructure facilities, fiscal concessions and incentives to exporters, information services, international trade fairs and exhibitions, import entitlements, foreign exchange facilities, transportation priorities and procedural simplification. Import regulation is monitored through a structure of tariff rates, quotas, anti-dumping and countervailing duties and product quality and safety norms. The policy is substantially conditioned by WTO agreements and commitments and unilateral and multilateral trade relations. Almost all countries with significant trade volumes provide an extensive institutional support system relating to various aspects of foreign trade operations. ***Trade policy is of utmost importance to exporters and importers as it has a major impact on transactions costs and efficiency of trade transactions.*** In India, a five-year EXIM policy (latest being 2002-07 policy) is in operation with provision for periodic fine-tuning depending upon the exigency of trade conditions. (See **Chapter 34**)

COMPETITIVE ENVIRONMENT

The state of market competition is one of the major factors affecting the rate of growth, income distribution and consumer welfare. For an individual business, the state of competition spells out freedom of entry and exit in the market and affects its price and scale of output under long-run profit-maximising behaviour. An elementary knowledge of managerial economics tells us that in a firm under imperfect conditions, price is higher and the level of output is smaller as compared to competitive conditions. Most governments in capitalist and mixed economies attempt to maintain through suitable economic laws (called competition or anti-trust laws) and regulation, free and fair competition in the various sectors of their economies and check monopolistic or anti-competitive abuse of market power. Major examples of such abuse include **price-fixing**, division and sharing of market territories between large firms, **predatory pricing, price discrimination** and **tie-in arrangements**, particularly through **oligopolistic collusion**. Some of these concepts are given in **Box 1.3**. Mergers, **acquisitions** and **takeovers** also reduce the number of competing firms in a market and create monopolistic tendencies. Nevertheless, informal anti-

competitive arrangements between firms are difficult to identify and deal with. Most of the countries have legislations to check abuse of monopolistic power and promote fair competition. In the US, Sherman Anti-Trust Act (1890), Clayton Anti-trust Act (1914) and Federal Trade Commission Act (1914) as amended to date exist which deal with the various aspects of anti-competitive practices of large firms. In India MRTP Act (1969) takes care of such aspects, though it has come under controversy now and is being replaced by **Competition Act (2002)**. (See **Chapter 19**).

BOX 1.3

Some basic concepts of competitive environment

Trust. In the US, a trust is a group of firms generally within the same industry group, that continue for mutual business interests and regulate production, prices and related matters in a common arrangement. The concept is similar to that of a *cartel*.

Predatory Pricing. It is a pricing tactic in which a firm charges price which is less than average variable cost or marginal cost initially and drives out smaller competitors. After having gained oligopolistic or monopoly position, it raises prices, sometimes to exploitative level.

Price Discrimination. It is the practice of charging different prices to different customers for the same product. The customers are in different sub-markets separated by need, timing or geographical location and it is generally not possible for the customer to move from higher price sub-market to lower price sub-market.

(For more concepts see **Chapter** 23)

NON-ECONOMIC ENVIRONMENT

Non-economic environment has heterogeneous layers the understanding of which is very important for a business manager. An individual firm is not in a position to bring about a change in this environment, it has to operate and adjust itself to it. The structure of the non-economic environment can be seen in terms of its following constituents.

Political Environment

Business managers must understand the political system and realities of the country in which they operate. Political factors, including international political relations, matter a lot particularly for large multinational firms and export firms operating in a country. For example, no Indian exporting firm can ignore the country's relations with the US and West European countries which provide about 50 per cent of the total market for the country's exports. Within a country, the type of government and its attitude towards business and its various segments matters a lot. Democratic governments preferring market oriented economic system are usually responsive to the problems and issues facing business and encourage private enterprise. In countries having ***absolutist governments*** (like military dictatorship, oligarchies and monarchies), communist, command or socialist economies private enterprise is discouraged and business firms are reluctant to undertake large new investment. In countries like China, free markets exist but only with the permission of the government and the operations of the free markets are constantly monitored by the government. Even in capitalist countries, the design and extent of regulation has been seen to affect business environment and growth.

Political environment has a risk level to which corporate managers adjust their investment decisions. The risk is higher in absolutist and command economies as well as in countries passing

through economic, social or political crises. The main form of risk is the deprivation of ownership through **confiscation, expropriation** or **nationalization (Box 1.4)**. The less reverse form of risk is domestication where the control or ownership of a foreign firm is diluted or shifted partially or fully to nationals. The operations of the firm may also be sealed down or made subservient to national or local interest. The level of risk significantly depends on firm's own perception and analysis of the political situation.

BOX 1.4

Types of political risk

1. *Confiscation.* It results when government or some public authority forcibly possesses ownership of a property without compensation.
2. *Expropriation.* In this case forcible possession of ownership is followed by some compensation which may not equal market value of property.
3. *Nationalisation.* It is also a compulsive process of transfer of ownership and operation of a property from private to public hand. Compensation in this case is more rational. For example, a number of commercial banks were nationalized in India in 1969.
4. *Domestication.* It is a process in which a foreign company is made to transfer, fully or partly, a part of ownership and control to nationals. In India multinational companies under the former **Foreign Exchange Regulation Act (1973)** were required to dilute foreign equity to 40% by issuing/selling shares to Indian nationals.
5. *General Instability Risk.* The risk is perceived when firms think that there is uncertainty with regard to the viability of the existing political system.
6. *Ownership/Control Risk.* Any of the risks (1) to (4) as explained above.
7. *Operation Risk.* The risk arising from the possibility that the government might in future restrict the operations of the firm in marketing, finance, production or in certain geographic locations.
8. *Transfer Risk.* It arises from the possibility of any future act of the government by which it restricts transactions or transfer of funds or profits between the subsidiaries of a firm or from a subsidiary to the parent company. The risk is more important for firm where the parent and its subsidiaries or affiliates are located in different countries.

Legal Environment

Legal system of a country has a profound impact on decisions concerning both investment and operations in business as it touches the very existence and legality of business firms. It gives permanent effect to economic policies and provides a sense of security and safety to business enterprises. It establishes codes and procedures for various types and aspects of business and deals with deviations or infringement law like bribery, product counterfeiting, gray markets, black markets, consumer deception and tax evasion. The coverage, efficiency and efficacy of the legal system determine adequacy, cost and speed of economic justice and these factors are of great importance for the growth of business. Most countries, apart from the formal judicial system, maintain commercial ***arbitration*** for quick and impartial decisions by acknowledged experts. At the international level, multilateral agreements on arbitration exist which are availed by firms engaged in international business. International arbitral awards are provided under New York convention which has the membership support of more than 80 countries all over the world.

Apart from the general legal system which is derived and is in consonance with the constitution of the country, there exist specific pieces of business legislation which together

guide, control and regulate business activity. The broad areas covered by business legislation include:

- ***Industrial development and regulation,*** covering licensing and registration of industries; price and output regulation; mergers **acquisitions** and **takeovers** of industries; location of industries;
- ***Foreign exchange management,*** covering transactions in foreign currency and security, current account transactions, capital account transactions, foreign exchange realization, foreign currency accounts, foreign trade and investment transactions, borrowings and lending in foreign exchange;
- ***Consumer protection,*** covering consumer rights, consumer disputes and complaints and grievance redressal system;
- ***Essential commodities,*** covering their supply, prices and quality;
- ***Weights, measures and packaging,*** covering standard units, packaging norms and declaration; and inspection.
- ***Patents,*** covering application procedure, life of a patent; rights of patentee, exclusive marketing rights, infringement of patents, claim procedure and settlement.
- ***Copyright,*** covering ownership and licenses of copyright, rights of copyright owners and others, registration procedure and infringement.
- ***Labour,*** covering apprenticeship, employees' insurance, payment of **gratuity**; disputes, bonus, employees' **provident fund**, compensation and disciplinary matters.
- ***Corporate management,*** covering formation of companies, management of companies, governance of companies, raising of capital and liquidation of companies.

Changes in legal environment are caused by legislative changes and amendments and introduction of new economic laws. Business firms are equally concerned with the speed and efficiency with which justice is delivered. ***Professionally managed companies give importance to legal conformity to their business operations as this is important to protect their goodwill assets. Changes in legal environment are often associated with changes in government and social movements. The firms which are not aware of such changes could face crises in the usual course of business and could be driven out of the market in competition.***

Cultural Environment

Culture is a set of socially accepted and shared set of traditional beliefs, norms, values and customs. It differs among various population sub-groups causing differences in the perception of society and consumers towards various product and service groups. Culture is enduring and cumulative and often serves as an identity of the society that preserves it. ***Cultural changes are slow to occur but the changes can accelerate with social movements and campaigns as well as by external influences.*** The culture of a country, particularly the large one, are rarely homogenous, it is a mix of various sub-cultures, which can be quite heterogeneous.

Culture has a profound impact on the language, literature and communication process within a society and business firms have to adjust their marketing communication to the cultural

characteristics. Often firms find it useful to segment their total market on the basis of cultural divisions among their customer base. This is so because culture is an important determinant of consumer tastes and preferences. It particularly affects food habits and attaches values to certain kinds of products and services. In many societies, non-vegetarian food, horse races, alcoholic drinks, beauty parlours and massage houses, fashion shows and adult movies are despised whereas in others these are part of normal life. It also affects work culture and employee productivity in business firms. Firms with cross-cultural environment face challenges in internal communication and keeping team spirit and motivation at desired levels. Culture also determines living styles and standards, which a marketing organisation must understand to be successful. ***The products, in order to be acceptable in society, have to be culturally conforming. Cultural factors play an important role in such areas as front office management enquiry handling, public relations, after sale services, industrial relations, customer relationships, business negotiations and overall human resource management.***

Demographic Environment

Demographic characteristics of a country have an important influence on business environment. Apart from the size and growth rate of population, demography includes **population density** (population per square km of area), **sex ratio** (male-female ratio), **fertility and mortality rates**, age composition, **life expectancy** and geographical distribution of population. The size of population determines the supply of human resources in a country which alongwith demand for it, determines the wage and salary structure. In overpopulated countries like India and China, wage and salary structures are low and induce business firms to go in for labour intensive technologies. Cheap labour is one of the important attraction for foreign direct investment through MNCs in such countries as it offers them cost advantages. The geographical distribution of population and population density in different regions affects urbanization and labour migration. Markets with high population concentrations are attractive to firms as here marketing costs per unit of sale are low. The age structure of population and sex ratio are good guides for a firm to decide the product mix as the types of products demanded substantially vary according to age and sex. ***Demographic factors are important bases for market segmentation and product positioning for marketers.***

At the macro level, population is closely linked to poverty and development, which determine economic environment of business. The countries which are not able sustain economic growth in relation to population growth experience poverty, malnutrition, decline in social and public services including housing, transport and sanitation and deterioration of the overall quality of life. ***Such factors affect the size of the market and discourage private investment particularly in regions of low per capita income.*** In countries where **birth rate** is high, **dependency burden** (number of dependent persons per earning member) increases and lowers the quality of labour and of family life. Many other problems are unemployment morbidity, illiteracy and urbanization which are associated with population explosion.

SECTORAL ENVIRONMENT

This is the external microeconomic environment of a firm which closely envelopes the firm. Every firm operates within a broad group of firms which constitute a particular industry. For

example, a firm manufacturing steel belongs to the metallurgical sector, automobiles to the mechanical engineering sector and radio receivers to the electrical engineering sector. The business conditions of a firm are largely circumscribed by the conditions prevailing in the sector as a whole. ***The business conditions in a particular industrial or service sector are determined by the nature and level of demand, tax structure, state of competition, technological and supply factors and government policy relating to that sector.*** Within a particular sector, however, some firms are more competitive and successful than others because of differences in the quality of internal environment which is described in the succeeding sections.

The sectoral environment too has its sub sets and is not internally homogenous. The different sectors of industry are broadly organized and classified and each sector has a number of industry groups which are widely different from one another in terms of product lines and each group and segment has its own environment. ***For example, diesel engines and bicycles belong to the mechanical engineering sector but their business environment conditions are widely different. Similarly, cement and tyres belong to the chemical and allied industries sector but their business conditions are almost independent.*** However, in certain industries like electric motors, electric fans and electric lamps, all belong to the electrical engineering sector where business conditions are closely related and interdependent.

PUBLIC RELATIONS ENVIRONMENT

This is the enterprise-level external macro environment constituted by the business relations of an organisation with outside parties. Every organisation depends upon, and is in relationship with, a number of outside groups, organisations and individuals. These are intermediaries, consumers, suppliers, consultants and advisers, advertising agencies, competitors and the government. In most cases, the relationship is continuous, two way and valuable for the business enterprise. In typical public relations framework, these entities are called 'publics'. The field of business relations is narrower as compared to public relations since in the former case the relation is with the entities with which it has 'direct or indirect', business relations. ***In a wider framework, a firm operates within its own public relations environment and generates such assets as reputation, goodwill and credibility which are key factors in the long run success of the enterprise.*** Some of the main entities with which a firm has business relations are discussed below:

SUPPLIERS

Suppliers provide capital equipment, intermediate inputs and raw materials on a regular basis. Supplier relations are important for a firm. Good supplier relations ensure reasonable price, appropriate quality, fairness in dealing, rational delivery terms and timely schedules. Not only that, a firm is able to obtain the supplies on soft credit terms, which eases pressure on the liquidity of the firm. Where supplies are regular and in time, the firm need only smaller inventories of raw materials, which reduces the cost of holding inventory stocks. These advantages add to the firm's competitiveness in the market.

CUSTOMERS

A business organisation basically exists for the customer and all its activities have to be customer-focused. Firms cherish to have a large and growing base of loyal customers. This is possible only through proper customer relations management. Firms that rapidly lose old customers and gain new ones operate in risky and uncertain marketing environment. Firms seek to build and maintain good customer relations by maximising consumer satisfaction and customer-care services. Customer relations are especially important in service organisations like commercial banks and insurance companies and those producing consumer durables like TVs, refrigerators and cars with product life spanning over a number of years. Firms serve their customers through product guarantees, maintenance and replacement, consumer information and consumer satisfaction surveys. These are also the components of a customer relation strategy.

Creditability is the kingpin of good firm-customer relations. A firm must enjoy credibility among customers regarding its claims on product quality, safety and genuineness. Any firm enjoying customer confidence can economize on advertising and needs smaller promotional expenses on new products and models. Singer, Philips, Samsung, GKW, Bajaj, Hindustan Levers, Cipla and Proctor & Gamble are some such brands which command a high level of customer confidence.

DISTRIBUTION CHANNEL MEMBERS

These are the marketing middlemen or intermediaries which, either independently or on behalf of the firms, act as conduits for moving the products from firms to the final customers. The channel members are interdependent or interconnected, joining the firms with their customers. Firms have to carefully plan the length, breadth and depth of the channels so as to control cost, adequacy and efficiency of the distribution system. Channel relation is one of the important factors behind the selection of channel members. ***In contemporary times of multi-brand dealerships, a company competes with its rivals right within the dealer showrooms before the product reaches the final consumer. This underscores the vital significance of channel relations. The channel members must thoroughly understand the product's competitive advantages and values and convey the right message down the channel up to the customer. To accomplish this, most companies, apart from having lucrative reward systems for distribution, lay stress on dealer information, education, motivation and loyalty building. A good firm-distribution relation has a symbiotic character.***

RIVALS

In a competitive environment, a firm is in relation with its rivals as well. A firm competes with its rivals on price, quality, packaging, delivery, credit and after – sale services. A firm in a non-monopoly situation is either in a competitive or collusion relationship with rivals. In a competitive relationship, a firm's strategy and tactics depend on those of the rivals particularly in oligopolistic situations. The firms whose market shares remain more or less constant in spite of heavy expenditure on competitive market campaigns, often discover the wisdom of joining hand, collude, divide the market and fix higher prices acting as a monopolist. ***Even in competition, aspects of cooperation can be seen. Leading competitors often form associations and set the rules of the competitive game. As members of the same industry associations, they together prepare policy papers highlighting industry problems for presentation to the government particularly at the time***

of the budget. Confederation of Indian Industry (CII), Federation of Indian Chambers of Commerce and Industry (FICCI), Associated Chambers of Commerce and Industry (ASSOCHAM) and Federation of Indian Exporters' Organisations (FIEO) are the leading industry and trade associations in India.

In a competitive environment, the relationship between firms keeps on changing. In competition, some firms emerge as market leaders and set the trends for other competitors. Prices set by market leaders are generally taken as benchmark prices, which other firms tend to follow with marginal variations. Such pricing by market-following firms is called **parity pricing**. It reduces competition and competition tends to shift to non-price areas. The firms, which get marginalized in the competitive process, often face threats of **takeovers** by other firms. Even in normal situations, firms develop relations with one another which eventually lead to **mergers** to gain market dominance or to neutralize the threat emerging from third rivals. A number of firms in the normal course of operations develop relations to have common or shared training infrastructure, research facilities, marketing intermediaries and export channels. Many firms participate in cross-promotional and cooperative advertising and obtain marketing economies.

OTHER ENTITIES

There are a number of other entities with whom a firm may not have direct business relations but with which good relations are important for the growth of business. A firm must have social acceptance among the local population groups. For this purpose it may develop local infrastructure, provide development and welfare programmes, provide small-time, causal or low skill employment to the local youth and generate small business opportunities. Firms need to have good media relations for publicity and projecting good image of the firm and its products among the masses. This also economises on advertising costs.

Similarly, good relations with such action groups as human rights activists, anti-pollution campaigners, social and welfare workers, consumer protection groups and campaigners for women's rights are important for a firm to gain better image in society. Finally, a firm must have good relations with the government and the local civic bodies. Firms that have good relations with the government are those which pay taxes and various user charges for water, electricity etc. in full and on time. They supply the requisite information from time to time in connection with official surveys. Good government relations make firms' transactions with the government easier and smoother.

INTERNAL ENVIRONMENT

The spirit of the internal environment of a firm is derived from its mission that states as to why and for whom does it exist. This provides the basic purpose of a firm's existence and operations. To fulfil the mission, the firm has a vision which lays down its basis philosophy and approach. Top management of the firm executes the mission through a strategy which is based on thorough planning in terms of clearly identified objectives to be achieved over a period of time. Most of the objectives are transcripted into quantified goals and tasks. The entire process takes place within the framework of a value system and corporate culture and the persons occupying different line and staff positions have to fit themselves into the value and culture framework. These factors establish the broad internal environment within which different departments of the firm operate in an interrelated manner. The ethical and governance standards and codes which a firm sets for it have a profound impact on the quality of internal environment.

The internal environment is critically dependent on **line and staff relations, industrial relations**, job design and coordination, team spirit, quality of internal communication, work and productivity standards, compensation systems and employee motivation. Firms adopting accredited quality control systems have standardized environments. Firms have a high level of concern for internal environment as it affects external microenvironment and the image of the firm. Top management strives to have full control over the environment so that the goals of the firm could be achieved within stipulated timeframes. Internal environment has tremendous impact on employee motivation, work efficiency, product quality, customer services, public relations and eventually its competitiveness. Major determinants of internal environment of a firm are listed in **Box 1.5**.

BOX 1.5

Determinants of internatinal environment of an organisation

- Mission and vision of the organisation
- Management philosophy and strategy
- Industrial relations
- Corporate culture and values
- Line and staff relations
- Governance standards and codes
- Quality control system
- Team spirit among employees
- Work culture and socio-economic background of employees
- Job design and coordination
- Quality of internal communication
- Compensation system and career progression of employees
- Control system of the organisation

There are always a number of factors polluting the internal environment. There is an inherent conflict between the owners (shareholders) and the managers of a firm. While the former seek to maximize return on investment, the latter seek to maximize compensation and accelerate career progression at the expense of each other. In this context, the role of the Board of Directors is both sensitive and important. There are also antagonist groups within the same organisation. There are conflicts between workers and managers, finance department and purchase department, production department and marketing department and so on. To a good extent these conflicts are resolved through standard management accounting practice. Competition among employees for career progression generates a lot of office politics in which inter-personal factors, attitudes and relations plays an important role. Further, absenteeism, corruption, misuse of office position money laundering, nepotism, disloyalty, sabotage, espionage and sexual harassment (**Box 1.6**) mar the internal environment. Top managements are acutely conscious of such vitiating factors but are unable to eliminate these altogether.

BOX 1.6

Major pollutants of internal environment

- Conflict between different owner groups.
- Conflicts between workers and managers.
- Inter-departmental conflicts and mistrust.
- Unhealthy competition and conflict between employees.
- Office politics and discrimination at workplace.
- *Absenteeism* and *moonlighting*.
- Corruption and *money laundering*.
- Nepotism and misuse of office position.
- Disloyalty and espionage for outsiders.
- Sabotage.
- Sexual harassment at workplace.

CONCLUSION

An effective business manager must understand the nature of business environment in its structured form. This understanding helps him to visualise a framework in which he can understand the extent and seriously of the likely impact of a given change in business environment on the business of his organisation. He must also be to understand how changes in one layer of business environment affect other layers and with what lag of time. This requires continuous meritoring and processing of business environment information so that rational and effective business planning and decision-making is facilitated.

Key Terms

Absenteeism
Acquisition
Arbitration
Booms
Confiscation
Corporate governance
Cost of capital
Counterfeiting
Country risk
Cultural risk
Debt-equity ratio
Deflating
Direct taxes
Disposable income
Economic liberalization
Euro
European union
Expropriation
Fiscal Federalism
GDP deflator
Globalisation
Gray market
Gross domestic product
Import substitution
Indirect taxes
Industrial relations
Inflation
Life expectancy
Line and staff relations
Liquidity
Lorenz curve
Macroeconomic policy
Market potential
Merger
Monetary policy
Money laundering
Moonlighting
Mortality rate
Multilateral economic institutions
NAFTA
National income
Nationalisation
Oligofolisitc collusion
Parity pricing
Political risk
Population density
Predatory pricing
Price discrimination
Price fixing
Privatisation
Recession
Synergy
Takeover
Tax evasion
Tie-in arrangements
Transfer payments

Supplementary Readings

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Long Questions

1. Discuss the nature and dynamism of business environment. What factors trigger changes in the business environment?
2. What are the constituents of domestic macroeconomic environment? How do changes in international economic environment affect the domestic environment?
3. What is the significance of domestic economic policies in business environment? How do economic policies affect economic stability and competitive conditions in an economy?
4. Discuss how:
   (a) International economic environment affects domestic macroeconomic environment.
   (b) Domestic macroeconomic environment affects sectoral environment.
   (c) Non-economic environment affects domestic economic environment.
5. What is public relations environment of a firm? How is it important for the existence, viability and growth of the firm?
6. What constitutes internal environment of a firm? How is this environment affected by non-economic factors? What factors generally pollute the internal environment?

Short Questions

1. What factors account for the complexity of business environment?
2. Why should a business manager be concerned with business environment?
3. What do you understand by the term dynamism of business environment?
4. What constitutes the international business environment?
5. How is macroeconomic stability important for domestic macroeconomic environment?
6. How does legal environment affect business decisions?
7. Does domestic macroeconomic environment affect all business segments alike?
8. List five leading factors or internal environment.

Practical Assignments

1. Hold a group discussion on "*The Impact of Recent Conflict in Iraq on the Business Environment in India.*"
2. Select a medium or large scale firm and assess the sectoral environment for it. (3-4 students can make a group presentation)
3. Select 3-4 business firms in your region and study how inter-departmental conflicts and office politics pollute the internal environment. Make a team presentation followed by class discussion with the aims to suggest measures or how to clean the internal environment.
4. Collect news clippings for the last one quarter which show how changes in international economic environment affect domestic macroeconomic environment. A team of 3-4 students can make a group presentation.