Business Administration and Accounting

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Chapter 1

Economia aziendale (Business management): business organizations and firms

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Summary

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1.1. *Economia aziendale* (Business management): definition and purpose

Economia aziendale (business management) is the branch of social sciences that studies the conditions of existence and manifestations of the life of organizations (*aziende*).[1] The founder of *Economia Aziendale* is generally considered to be Gino Zappa, who in 1927 gave a famous inaugural speech defining this new discipline at the Ca' Foscari University of Venice[2] at the ceremony of the opening of the Academic Year 1926-1927.

Business organizations (*aziende*) are economic institutes that are founded to meet human needs and to serve the community. The centrality of the human person and of its needs is fundamental to understand the aims and the premises of *Economia aziendale* (business management).

The spectrum of needs that human beings strive to meet is broad. Maslow was one of the first scholars who tackled the theme by creating a theory of human mo-

[1] Zappa, 1927.

[2] Coronella, Caputo and Leopizzi, 2018.

tivation.[3] According to Maslow, "needs" can be classified into the following hierarchical categories: physiological needs (e.g., water, food, shelter), safety needs (e.g., personal security, employment, health), love and belonging (e.g., friendship, intimacy, family), esteem (e.g., respect, status, recognition) and self-actualization (desire to become the most that one can be).

According to Airoldi *et al.*,[4] needs can be defined as primary or secondary. Primary needs are essential to human dignity and include all the physiological needs and other social needs that are considered essential in human development. Secondary needs are those considered non-essential and are often influenced by social trends. The scope of primary and secondary needs is driven by a community's social, political and economic development: the higher the development of a community, the broader the category of primary needs. When analyzed from this perspective, goods and services can be classified as primary (goods and services fulfilling primary needs) and secondary (goods and services fulfilling secondary needs).

Example 1

Drinking is a physiological need. It can be satisfied as an essential need through primary goods (e.g., drinking still water) or a not essential need through secondary goods (e.g., drinking a fashionable cocktail).

Again, safety is a social need that broadly refers to the need for security, protection from danger, and a familiar, predictable environment.[5] Safety needs can correspond to an essential need (e.g., the safety provided by public safety agencies) or a non-essential one satisfied through secondary goods (e.g., the latest model of antitheft and surveillance system for the home).

This classification of needs has implications regarding business operations and performance. Companies are more likely to focus on sales volume when producing and selling primary goods or services to fulfil essential needs. At the same time, they are more likely to emphasize profit margins concerning goods and services fulfilling non-essential needs.

As we all know from daily experience, human wants exceed what can be produced or achieved. In other words, as resources are scarce, individuals and organizations must choose between alternatives. The concept of scarcity is central in the definition of economic activities: when there is a problem of scarcity, individ-

[3] Maslow, 1943.

[4] Airoldi, Brunetti and Coda, 2005.

[5] https://dictionary.apa.org/safety-need.

uals and organizations face an economic problem that requires an economic activity.

More specifically, there are two categories of economic activity: production and consumption. Production refers to the process of obtaining goods and services, while consumption is using such goods and services to meet human needs. Economic activities generate value if the value of outputs (thus the results obtained) is greater than inputs (thus the production factors employed to obtain the results).

In the context of economic problems, the decision-making process can occur at the individual or organizational level.

In the field of neoclassical economics, the individual decision-making process has been traditionally assumed to be perfectly rational. This means that the individual can weigh marginal benefits against marginal costs of each activity and decide accordingly. This model assumes that the individual: knows the objective and the variables to be maximized; has all the relevant information readily available; knows all the different alternatives; is not biased by others' judgement or opinion; always chooses the best alternative.

More recently, behavioural economics combined elements of economics and psychology to understand how and why people behave the way they do in the real world. This field of study, differently from neoclassical economics, does not assume that individuals have well-defined preferences and make well-informed, self-interested decisions based on those preferences. Rather, it recognizes the existence of several biases that lead people to make suboptimal judgements.

When the decision-making is performed at the group level, further sources of complexity arise. Business organizations have different stakeholders, requiring their decisions to maximize multiple objectives. Besides, different organizational units within the same organization may maximize their performance to the detriment of the business organization's overall performance. Sometimes, organizational units adapt to the environment rather than proactively forecasting its evolution, making the decision-making process less effective.

One of the first models developed to describe the organizational decision-making process under conditions of limited rationality is the "garbage can model" by Cohen *et al.*.[6] According to the authors, "organized anarchies" are organizations characterized by problematic preferences, unclear technology, and fluid participation. Such organizations can be viewed as: collections of choices looking for problems; issues and feelings looking for decision situations in which they might be aired; solutions looking for issues to which there might be an answer; and decision makers looking for work. The model predicts that the three elements for the organizational decision (people, problems and solutions) need to converge for the business organization to be able to make a decision.

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[6] Cohen, March and Olsen, 1972.

These preliminary considerations and the approach of *Economia aziendale* lead to some premises of our analysis. [7]

First, economic activities are performed to meet human needs. Consequently, profits or other configurations of financial value should be intended as the mean rather than the end of such activities. According to Masini, one of the most prominent scholars within *Economia aziendale,* "*an observant reader… cannot fail to notice how mistaken it is to assert that the company's goal is 'revenue'. Revenue is a complex element of the economic dynamic of the non-profit organization, of the business, and of the state-owned company, but it is not the ultimate goal*". [8]

Second, as *Economia aziendale* is part of the social sciences, its theories and knowledge cannot always be expected to explain the behaviour of humans and business organizations.

Third, human beings do not generally pursue the fulfilment of their needs alone but tend to aggregate, creating social groups. Therefore, economic activities are performed within different stable business organizations (*aziende*). The following paragraph will describe the different types of business organizations that are studied by *Economia aziendale (Business management)*.

1.2. Business organization types

Before defining the different types of business organizations (*aziende*), it is essential to discuss the distinction between institutions and organizations. To satisfy their needs, human beings create partnerships that become institutions when rules and behavioural patterns become relatively stable. Institutions can be defined as *"systems of established and prevalent social rules that structure social interactions*". [9] Examples of institutions include, among others: firms, non-profit organizations, public sector organizations, and families.

Every institution performs economic activities benefiting its founders or partners. In fact, every institution performs production or consumption of goods or services. When institutions are studied and analysed from this economic perspective, they are defined as business organizations (*aziende*). In other words, the difference between an institution and a business organization is the same difference that exists between human activity and economic activity.

There are many other perspectives from which institutions can be studied, such as sociological, political, ethical, religious, juridical, cultural, anthropological,

[7] Mancin, Russo and Vaia, 2019.

[8] Masini, 1970, p. 52.

[9] Hodgson, 2006, p. 2.

technological, and others. *Economia aziendale* studies institutions from an economic perspective (thus, it studies business organizations).

Business organizations studied by *Economia aziendale* can be further classified into four broad categories. Each category will be analysed in detail in the following paragraphs:

– firms, devoted to the production of private goods and services;
– households, where the processes of consumption of private and public goods take place;
– public sector organizations, committed to the production of public goods;
– non-profit organizations, which carry out part of the economic activity that is at the intersection of the other three organizational categories.

The economic perspective is also essential for business organizations founded mainly to achieve social, ethical, cultural, and other objectives. Regardless of their mission, business organizations need to be able to exist and operate in the long term, requiring them to be effective and efficient in their economic activities. *Economia aziendale* provides valuable knowledge and theories for this to happen.

1.3. Household

The main aims of families and, more broadly, households are, for the most part, non-financial and not directly related to economic activities. Usually, families are created to fulfil social, ethical, religious or affective aspirations. Nevertheless, to achieve these objectives, households must engage in economic transactions and perform economic activities.

The most apparent economic activity performed by households is the consumption of goods and services produced by firms. From this perspective, households demand goods and services while firms supply them. In a money economy (as opposed to a barter economy), households pay firms in exchange for goods and services, and firms deliver them. In other words, firms and households are generating a market which can be defined as the coming together of buyers and sellers.

The relationship between firms and households also flows in the other direction, as some household members are workers, owners of the firms or their production factors. Therefore, from this second perspective, firms need (demand) production factors owned by households, such as labour and capital. Money flows accordingly from firms to households.

This twin demand and supply relationship allows households to earn income from firms and firms to earn incomes from households. [10]

[10] Sloman, Garratt, Guest and Jones, 2016.

Besides the consumption of goods and services, households also engage in a second relevant activity: wealth management. Families need to manage most efficiently their assets (coming from income, inheritance or other sources) and find the right balance between savings and consumption.

1.4. Firms and market production

A firm is an economic organization that coordinates the production and distribution of economic goods and services. [11]

Although its primary goal is economic, namely the production of monetary remuneration for financial capital providers and workers, a firm has non-economic goals as well (e.g., environmental, social and governance). Among these, we may enumerate the production of goods and services that contribute to the improvement of society, the arrangement of an organizational environment in which employees can develop themselves personally and professionally, the creation of wealth and its fair distribution, the respect of the natural environment and sustainable development.

Pursuing the economic goal involves producing goods and services to be exchanged through the market. The sale of products made by a firm is feasible in a lasting and autonomous way only if the value recognized in these products by the market is higher than the value of the production factors used to produce them. The profit thus generated will subsequently be distributed through remuneration among the firm members who have contributed to creating this wealth.

However, market economies can enter in crisis when firms excessively prioritize the economic interests of financial capital providers to the detriment of other stakeholders or the community. This may regard, for example, production choices that cause severe environmental damage, failure to recognize reasonable remuneration due to employees or other input suppliers; and tax evasion, based on a narrow perspective focusing on short-term financial performance while excluding the firm's long-term economic sustainability, as well as neglecting its social significance. [12] Porter and Kramer [13] emphasize that firms should create shared value, pursuing financial success and making profits while simultaneously addressing societal and environmental needs and challenges, yielding societal and environmental benefits.

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[11] Sloman, Garratt, Guest and Jones, 2016.

[12] Costa and Ramus, 2012.

[13] Porter and Kramer, 2011.

Treedom mission and shared value creation

Treedom is an e-commerce website founded in Florence, Italy in 2010, where people and organizations can purchase trees to plant and follow their progress online. Treedom directly funds non-governmental organizations (NGOs) working with farmers worldwide. After being planted and cultivated by a local farmer, each tree is individually geolocated and photographed, has a page online, and can be kept or virtually gifted to others, allowing users to receive updates and photos of the project.

Treedom's mission is "*to allow everyone to contribute to the well-being of the planet in a simple, transparent, and fun way*" [14]. The firm's goal is to generate social and environmental benefits by promoting agroforestry and tree-planting activities, which are implemented by supporting rural communities.

Treedom may be regarded as an example of shared value creation since the environmental and social concerns are directly integrated into the firm's core business.

From the economic perspective, the firm generates profits and economic value by selling trees to plant through an online platform. It created a new market space by creating new demand.

Planting trees benefits the environment in different ways: absorbing CO_2 (carbon dioxide) from the atmosphere, respecting the biodiversity of the different territories, combating soil erosion and protecting soil fertility. The agroforestry practice also integrates tree-planting in an agricultural system, facilitating a virtuous interaction between the species.

Further, Treedom activities have social benefits. First, the rural communities involved in the projects, often in countries that need to increase agricultural production and job opportunities, are financed and trained with good results regarding farmers' empowerment. Then the trees and their fruits belong to the farmers, enabling them to diversify and supplement their income and, sometimes, to launch micro-entrepreneurship initiatives. Again, financing the planting of new trees supports the trees' care in the first years of life when they are not yet productive.

Between 2010 and 2021 over 3 million trees were planted in 17 countries in Africa, South America and Italy, supporting more than 180,000 beneficiaries.

Further, firms are often the primary vehicle through which scientific and technological innovations are conceived and implemented with relevant impacts on human life (e.g., benefits derived from the introduction of new drugs, the use of technologies to overcome the difficulties generated by some forms of disability, the reduction of environmental impacts deriving from new production processes,

[14] Treedom, 2021.

etc.). Through their activities, firms participate in the progress of society and the achievement of the common good. [15]

In addition to the goals they pursue, firms can be described in terms of their stakeholders and the economic activity they carry out (firm types).

Stakeholders are groups and individuals who can affect and are affected by the firm's economic activity and achievement of objectives. In the traditional view of the firm, "*the shareholders or stockholders are the owners of the company and the firm has a binding financial obligation to put their needs first, to increase value for them*". [16] In the Italian theoretical framework of *Economia aziendale*, the firm prioritizes the interests of the financial capital providers and the employees. These subjects have economic interests consisting of the achievement of remuneration and, to a lesser extent, also non-economic interests, mainly linked to the satisfaction of social needs, and personal and social affirmation.

Alongside the financial capital providers and the employees who are institutional stakeholders being that they are part of the firm, there are several non-institutional stakeholders such as customers, suppliers, competitors, banks and other credit institutions, the State and members of the community in which the company operates. Even non-institutional stakeholders have economic interests and non-economic interests.

Stakeholder theory posits that "*whatever the ultimate aim of the corporation or other form of business activity, managers and entrepreneurs must take into account the legitimate interests of those groups and individuals who can affect (or be affected by) their activities*". [17] According to stakeholder theory, managers and entrepreneurs must develop relationships and create communities with stakeholders where everyone strives to give their best to deliver the value that the firm promises. Shareholders are an essential constituent, and profits are a critical feature of the economic activity in firms, a sort of prerequisite; however concern for profits should be the result rather than the driver in the value creation process.

Firm types will be described in section 1.5.3, while the next section proposes an overview of the transaction costs theory, which explains why firms exist and operate in the market.

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[15] Mancin, Russo and Vaia, 2019.

[16] Freeman, 2015.

[17] Freeman, Wicks and Parmar, 2004, p. 365.

1.5. The nature of the firm

1.5.1. Transaction costs theory

A firm coordinates the conversion of inputs (different types of resources) into outputs (economic goods and services) through managing a series of processes (e.g., governance, operations, marketing, planning and control).

A different production organization would involve individuals or households producing goods and services on their own, establishing a separate contract with suppliers in the market at each production stage. As clarified by Sloman *et al.*,[18] let us assume that an individual wants to produce a woollen jumper. He/she would need "*to enter a series of separate contracts: to have the jumper designed, to buy the wool, to get the wool spun, to get it dyed, to have the jumper knitted. There are many other stages in the production and distribution process that might also be considered. With each contract a price will have to be determined, and that price will reflect current market conditions. In most cases, such a form of economic organization would prove to be highly inefficient and totally impractical*". Further, it would be impossible to produce more complex goods such as cars or smartphones for which specific technology, assets and knowledge need to be used.

Coase,[19] who is widely regarded as the father of transaction cost theory, argued that the key advantage of organizing production and distribution through firms is that it leads to lower transaction costs; as opposed to a market where buyers and sellers establish several contracts.

According to Williamson,[20] a transaction occurs when a good or service is transferred across a technologically separable interface. One stage of activity terminates, and another begins. Transaction costs are costs of undertaking a transaction, including search (e.g., search for sellers or products) and information costs, bargaining costs, contracting costs, monitoring costs of implementing a transaction and opportunity costs of non-fulfilment of an efficient transaction.[21]

Thus, transaction costs theory explains the existence of firms positing that market transactions entail various costs which may be reduced if transactions occur within a firm. The actions of managers within firms replace the need to use the market by independent contractors and overcome many of the associated transaction costs. Further, Williamson also argues that transactions requiring a

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[18] Sloman, Garratt, Guest and Jones, 2016, p. 36.

[19] Coase, 1937.

[20] Williamson, 1981.

[21] Rao, 2003.

substantial degree of specific assets, both physical and human, occurring frequently and/or facing a high degree of future uncertainty, have higher costs because economic factors act and make decisions under bounded rationality and may behave opportunistically. [22]

1.5.2. Economic specialization

The production and consumption of economic goods are characterized by economic specialization. Economic specialization generally involves different actors developing different and specific parts of the economic activity based on their unique skills and competencies. [23]

Economic specialization can be observed at different levels. At a higher level, specialization refers to the distribution of economic activity across the four major organizational categories (firms, households, public sector organizations and nonprofit organizations, see section 1.2).

At a second level, specialization refers to the distribution of the economic activity within each organization category. This is especially evident in the context of firms and public sector organizations, where different business organizations specialize in producing different categories of goods and services for different categories of customers; for example, car manufacturers and clothing manufacturers, or healthcare and public security as different public services.

At a third level, specialization can be observed within each business organization and manifests in two interconnected ways: functional specialization and division of labour. Functional specialization refers to business organizations structured in departments according to function, such as sales or finance, where individuals are grouped because of their specialisms and technical expertise to facilitate the development of the function they offer. [24] Division of labour involves breaking down a job into a range of separate, more specialized tasks, allowing workers to acquire high efficiency.

Further, specialization can be observed at the country-level as well. A country "*is said to specialize in a particular product when the product's share in its overall exports is higher than the corresponding share in exports of other countries*". [25] This has implications for trade (e.g., the law of comparative advantages).

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[22] Rindfleisch, 2020.

[23] Airoldi, Brunetti and Coda, 2005.

[24] Worthington, Britton and Rees, 2005.

[25] Timmer, Miroudot and de Vries, 2019, p. 4.

Economic specialization has advantages and disadvantages. Focusing on specialization as a division of labour, workers can become highly efficient in their particular job, less training is needed, and there is less time lost in workers switching from one operation to another. Further, task repetition improves performance, requires easier supervision, and managers can allocate tasks according to the individual workers' skills. Similar advantages are also found in the division of managerial tasks. These advantages derive from learning processes related to task repetition, which may also facilitate problem-solving and new idea generation, and may improve both output quality and employee empowerment and motivation. The same advantages of specialization may reveal in capital employment at high output volumes (e.g., equipment dedicated to individual productive tasks).

As a result, economies of specialization arise when the cost of producing a good by a specialized firm is lower than the cost of the same good made by a firm which produces two or more goods together.[26] They are one of the sources of economies of scale.

However, economic specialization may have some drawbacks (diseconomies of specializations), such as higher coordination costs due to potential poor coordination of the tasks and functions performed by different employees, or communication of misleading information among employees;[27] employee demotivation stemming from task repetition; disadvantages in capital becoming too specialized as this might not allow the firm sufficient flexibility in production to meet changing market demands (with higher costs and longer times needed for a change).

1.5.3. Firm types

Different authors classify firms according to their legal structure, which influences their conduct within the marketplace and affects their performance. Based on the legal structure, there are sole proprietors, partnerships, companies, consortia of firms, cooperatives and public corporations (see Sloman *et al.*[28] for an overview).

Firms can also be classified into different categories according to their size. For this purpose, different criteria may be used, such as the number of employees or the value of some economic variables.

[26] Daraio, Bonaccorsi and Simar, 2015.

[27] Becker and Murphy, 1992.

[28] Sloman, Garratt, Guest and Jones, 2016.

Example 2

Two of the most relevant classifications of firms based on their size are the OECD and the EC classification. According to OECD classification, [29] small and medium-sized enterprises (SMEs) employ fewer than 250 people. SMEs are further subdivided into micro enterprises (less than 10 employees), small enterprises (10 to 49 employees), and medium-sized enterprises (50 to 249 employees). Large enterprises employ 250 or more people.

The European Commission [30] classifies firms according to staff headcount and turnover/balance sheet total. Micro companies have less than 10 employees and either turnover lower than 2 million euros, or balance sheet total lower than 2 million euros. Small companies have less than 50 employees and either turnover lower than 10 million euros, or balance sheet total lower than 10 million euros. Medium sized companies have less than 250 employees and either turnover lower than 50 million euros, or balance sheet total lower than 43 million euros.

Further, firms can be described in terms of their core business. [31] In this sense, there are manufacturing firms, service firms and trading firms. Further, platform firms are an emerging and fast-growing group of firms based on digital technologies and internet diffusion.

Manufacturing and service firms use various inputs such as capital, labour and information to create, respectively, goods or services through one or more transformation processes (e.g., storing, production work, assembly, transporting, repairing). [32] To ensure that the desired outputs are obtained, firms take measurements at various points in the transformation process (feedback) and then compare them with previously established standards to determine whether corrective action is needed (control).

Generally, manufacturing firms involves physically transforming goods and results in tangible outputs, such as an automobile, eyeglasses, a chemical product, or anything we can see or touch (a material artefact). The traditional manufacturing methods required a large amount of raw materials and parts inventories to support the production, but the increased adoption of flexible manufacturing systems, which use automated techniques and robotics, has reduced this requirement. [33]

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[29] https://data.oecd.org/entrepreneur/enterprises-by-business-size.htm.

[30] https://single-market-economy.ec.europa.eu/smes/sme-definition_en.

[31] Airoldi, Brunetti and Coda, 2005.

[32] Stevenson, 2015.

[33] Worthington, Britton and Rees, 2005.

Differently, providing a service generally implies an act; for example, a physician's examination, goods home delivery, a movie projection in a cinema, a bank transfer, an insurance contract.

There are several differences between manufacturing and service firms in terms of what is done (based on the degree of consumer contact, labour content of jobs, uniformity of inputs, inventories, productivity measurement, quality assurance, employee wages and ability to patent). At the same time, there are many similarities regarding how it is done, primarily related to management processes.[34] Further, manufacturers are increasingly offering services tightly coupled to their products. Servitization is "*the innovation of an organization's capabilities and processes to shift from selling products to selling integrated products and services that deliver value in use*".[35] Customers are not just provided with products but broader, more tailored "solutions" (e.g., Alstom maintenance, upgrade and operation of trains and signalling systems). Xerox is an example of a photocopier manufacturer offering advanced services such as document publishing and production services, document management and business process outsourcing.

Trading firms are businesses that buy goods and sell them to customers. They do not operate a transformation of products but typically manage the different activities of the selling process, including logistics, marketing, promotion, commercial relations and technical assistance. They may operate in large geographical areas or in smaller areas, importing and exporting goods. In Italy, most trading companies are small in size, have high product specialization and operate in specific geographical areas.[36]

Platform firms exploit information and communication technologies to facilitate interactions between users, including commercial transactions; collection and use of data about these interactions; and network effects that make the use of the platforms with most users most valuable to other users.[37] Platform firms may cover a wide range of activities, "*including online marketplaces, social media, creative content outlets, app stores, price comparison websites, platforms for the collaborative economy as well as search engines. They increase consumer choice, improve efficiency and competitiveness of industry and can enhance civil participation in society*".[38]

Many platform firms have adopted an asset-light model, where the scope of the platform firm is so narrow that it excludes core assets and most workers.

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[34] Stevenson, 2015.

[35] Baines, Lightfoot, Benedettini and Kay, 2009, p. 547.

[36] Treccani, 2012.

[37] Gawer, 2021.

[38] European Commission, 2018.

These firms (e.g., Airbnb, Uber) focus on data capture, aggregation and analysis, with little necessity to invest in physical resources. Other platform firms, such as Amazon or Google whose scope has expanded over time, not only own considerable assets and employ many workers, but have also recently made several acquisitions to diversify revenue sources.

1.6. Public sector organizations

In all countries, whatever their economic and political systems, it is the State which owns assets in various forms and performs several functions, providing certain goods and services felt beneficial to its citizens. The public sector is the State or government sector of the economy which includes a wide range of heterogeneous organizations.[39] Public functions are acts or activities generally carried out by public sector organizations on a territorial basis, and according to their legal duties and powers, to coordinate various interventions required to meet a given citizen's need.[40] Public functions, for example, are the administrative activities performed by central government bodies such as Ministries, departments or agencies, local governments at different levels (such as Regions or municipalities), justice, health or education administration departments, National Social Security Institute, Authorities.

Public services are services provided by public sector organizations to benefit all the citizens in a particular society or community; such as health care in hospitals, education in schools, transport, job centres, water management or waste removal.

Accordingly, public sector organizations may be broadly categorized as organizations providing public functions or public services.[41] However, boundaries between the two categories are blurry. For example, a municipality can perform both functions (city administration) and services (e.g., registry office, street cleaning, social services).

Both public function and public service are ways to perform public policies, which refer to a series of decisions and actions taken by public authorities to resolve public problems identified as priority on the political agenda.[42] For example, pollution, unemployment, price instability, urban violence and gender inequality).

[39] Borgonovi, 1984; Worthington, Britton and Rees, 2005.

[40] Landi, 2021.

[41] Rea, 1998.

[42] Anderfuhren-Biget, Varone and Giauque, 2014.

According to the tasks performed, public sector organizations are generally categorized as whether they perform classical functions based on government authority, welfare state activities (health services, education, housing) or economic market-based activities. [43] Business organizations with market-based activities, which closely approximate firms' activities, are usually referred to as state-owned enterprises (e.g., Poste Italiane, municipally-owned companies).

There are different reasons why the State intervenes in the economy through its organizations, and they are explained in the next section.

1.6.1. The State intervention in the economy

The State intervention in the economy refers to the deliberate actions the State takes to influence resource allocation and market mechanisms.

Generally, the State intervention in the economy has two primary objectives: social efficiency and equity. [44] Social efficiency relates to the efficiency of resource allocation (i.e., whether society gets a maximum out of its scarce resources) and has to do with the ability of the economy to make use of given resources. The concept of equity has two facets. There is horizontal equity, which broadly means the absence of discrimination, and vertical equity, which regards income distribution between individuals with different abilities or making different efforts. While horizontal equity is endorsed almost universally, vertical equity is a contentious issue, as it is not clear to what extent an equal distribution of income is desirable and depends on political views. [45]

Markets generally fail to achieve social efficiency and do not provide the goods and services individuals demand in desired quantities. There are various types of market failure providing motivation for State intervention in the economy (see Sloman *et al.* [46] for a thorough discussion):

– monopoly. A monopoly is a market structure in which there is only one supplier of a product or service, no substitutes for the product, and barriers to entry and exit. The monopolist firm has the power to set the price of the product (it is a price maker) or the quantity offered for sale. The monopolist will produce less than the socially efficient output. As Stigler [47] notes, "*When the monopolist raises prices above the competitive level in order to reap his monopo-*

[43] Meyer and Leixnering, 2015.

[44] Sloman, Garratt, Guest and Jones, 2016.

[45] Blomqvist and Lundahl, 2002.

[46] Sloman, Garratt, Guest and Jones, 2016.

[47] Stigler, 2014.

ly profits, customers buy less of the product, less is produced, and society as a whole is worse off".

Further, "*if the entire demand within a relevant market can be satisfied at lowest cost by one firm rather than by two or more, the market is a natural monopoly, whatever the actual number of firms in it*".[48] This typically manifests in industries with significant initial costs associated with setting up the infrastructure for production and distribution, such as electric power, natural gas, water, telecommunications and transportation. Markets with natural monopoly may present a range of economic performance problems: excessive prices, production inefficiencies, costly duplication of facilities, poor service quality, and to have potentially undesirable distributional impacts.[49]

Where there is a monopoly or a natural monopoly, the State may choose to intervene through antitrust policies, public regulation (such as ex-ante price controls) or public ownership;

- externalities. Generally, externalities are costs or benefits experienced by people other than the producers and consumers directly involved in the market transaction/s that generated them.[50] For example, firms may use some of the natural environment in the production processes (e.g., through air pollution) without paying the price. In this case, whereas the true full production costs are the costs of the priced inputs (e.g., materials, labour, overhead) plus some unpriced environmental services, the market price only tends to represent the former.[51] Thus, the full costs to society from the production (in the pollution example, worse air quality) may differ from the costs that the firm bears. These external effects, which are not necessarily costs but may be benefits as well, are called production externalities.

  There are also consumption externalities, occurring when the level of consumption of a good/service directly affects another consumer's welfare. For example, renovating an old house, an individual may increase the value of neighbouring properties;
- public goods. They are economic goods or services showing two main features: non-excludability and non-rivalry in consumption. If an individual's consumption of a good or service does not prevent anyone else from consuming it, then the good is said to be non-rival in consumption (e.g., street lighting). Conversely, a good is rivalrous if and only if an individual's consumption diminishes others' ability to consume it (if someone is eating a pizza, someone else cannot eat that pizza).

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[48] Posner, 1968, p. 548.

[49] Joskow, 2007.

[50] Sloman, Garratt, Guest and Jones, 2016.

[51] Worthington, Britton and Rees, 2005.

Further, a good is excludable if and only if it is possible to prevent individuals from consuming it. Differently, if it is impossible to prevent people from consuming or benefiting from a good and it is not easy to get people to pay to consume it, the good is said to be non-excludable.
Thus, while non-rivalrous and non-excludable goods are defined as public goods, rivalrous and excludable goods are private goods. National defence is a typical example of a public good. Further, some goods may be rivalrous and non-excludable, while others may be non-rival and excludable.[52] Table 1 provides some examples of economic good types to highlight their differences.

Table 1.1 – *Different kinds of economic goods*

Characteristic	Rivalrous	Non-rivalrous
Excludable	Private goods (homesteads, bathroom cleaner)	Club goods (sports clubs, movie theatres)
Non-excludable	Common resource goods (fish stocks)	Public goods: local (fire protection), national (national defence), global (climate mitigation measures), partial (parades)

Source: Reiss (2021), https://plato.stanford.edu/entries/public-goods/.

Worthington *et al.*[53] explain why non-rivalrous and non-excludable goods or services tend to be provided by the State and funded by the taxation system: "*Take the well-known example of street lighting which is provided communally by local authorities. If, instead of this public provision, street lighting had to be purchased in a free market, then one person's purchase would allow others to enjoy the product free of charge as they could not be denied the benefits of the lights being switched on for the buyer. This is known as the 'free rider problem'. Moreover, one person's consumption of street lighting would not reduce the supply available to anyone else (as when you bought this book or ate your sandwich). Given these characteristics it becomes difficult to get people to pay to consume such a good and this is clearly a disincentive for anyone to provide them. In effect they are unlikely to be provided at all if left to market forces*";

– information asymmetries. Generally, different actors in a market transaction may have different amounts of information. Thus, in some markets, it can be difficult for consumers to be sure about the characteristics or the quality of a

[52] Reiss, 2021.

[53] Worthington, Britton and Rees, 2005, p. 345.

good or service before purchasing it (e.g., food, financial products). In this case, the State may intervene (e.g., through mandatory labelling and consumer education initiatives) to help overcome these problems and empower consumers to make informed choices; [54]

- merit goods. These are goods which the State feels that firms may underproduce in the free market or citizens will under consume and whose consumption should be encouraged, subsidized or provided free as beneficial to the community (e.g., sports facilities, vaccines, libraries);
- the State may also intervene to pursue specific social objectives and protect people's interests. For example, the State may undertake actions to discourage the consumption of harmful goods (such as tobacco, alcohol, and unhealthy food), promote sustainable development and combat climate change, or implement countermeasures to cyclical downturns or economic crises.

The State can choose among different types of intervention, which may be grouped into three main categories: [55] the direct provision of public goods and services, laws and regulations, and taxes and subsidies.

First, the State may intervene in the economy to provide public goods and services that free markets would be unlikely to provide at a socially efficient level (e.g., streets, infrastructure, public illumination, national defense), or goods and services that are not strictly public, as they are not non-excludable and non-rivalrous (e.g., education, health). The latter are provided free or below cost for different reasons: [56] social justice and equity; significant positive externalities (e.g., free health service helps to combat the spread of disease); dependants (e.g., if education was not free, then low-income families could not ensure the education of decent quality to children); and lack of information, as people may not be fully aware of benefits deriving from the consumption of such goods and services. The State is also a purchaser of goods and services, typically through competitive tendering processes, to carry out its functions and deliver public services [57], and can influence firms' production.

Second, according to Sloman *et al.*, [58] laws can be of three main types: "*those that prohibit or regulate behaviour that imposes external costs; those that prevent firms providing false or misleading information; and those that prevent or regulate monopolies and oligopolies*". Government can also choose to intervene as the regulator of business activity, for example, through consumer protection laws and employment laws to ensure minimum health and safety standards.

[54] OFT, 2009.

[55] Airoldi, Brunetti and Coda, 2005.

[56] Sloman, Garratt, Guest and Jones, 2016.

[57] OFT, 2009.

[58] Sloman, Garratt, Guest and Jones, 2016, p. 356.

Third, all public sector intervention is basically funded through the taxation of individuals and businesses. Some taxes and subsidies may help correct market distortions, such as the presence of monopolies and externalities, changing the costs of goods and services. Through taxes and income support, the State may redistribute income and wealth, providing benefits to households. Additionally, through aid to businesses and cultural and scientific institutions it may play a role as a promoter of economic development. [59]

Further, the State sets the legal and institutional frameworks within which markets operate, protecting competition and ensuring that consumers can make choices and are not coerced or defrauded. [60]

The State intervention has advantages and drawbacks (see Sloman *et al.* [61]).

1.6.2. New public management

In the modern sense, public sector organizations were founded on the principles of bureaucracy, which focus on formalized internal organizational structures and processes. [62] Bureaucratic organizations entail structured hierarchies, emphasis on rules and procedures, law application, formalized decision-making processes and advancement based on administrative expertise. [63]

New public management (NPM) is "*a set of assumptions and value statements about how public sector organizations should be designed, organized, managed and how, in a quasi-business manner, they should function*". [64] The basic idea of NPM is to make public sector organizations and their employees much more 'business-like', oriented to performance, efficiency and audit, shifting the emphasis from process accountability towards results accountability. [65] NPM advocates for public sector organizations to be split into units whose managers are held accountable for assigned performance targets. Table 2 displays the basic assumptions and core elements of NPM.

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[59] Worthington, Britton and Rees, 2005.

[60] OFT, 2009.

[61] Sloman, Garratt, Guest and Jones, 2016.

[62] Borgonovi, 2020.

[63] Bozeman, 1979.

[64] Diefenbach, 2009, p. 893.

[65] Hood, 1995.