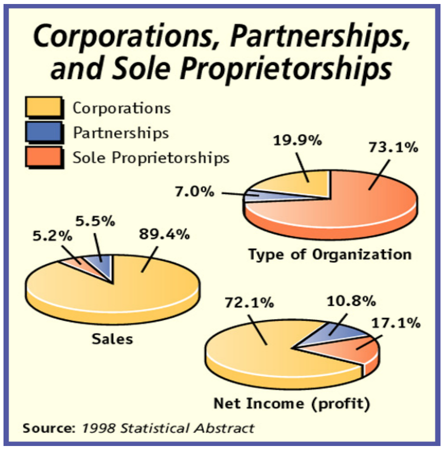
Economics - Chapter 3 Notes

Section 1:
Forms of Business Organizations

- There are three main forms of business organizations in the economy today–the sole proprietorship, the partnership, and the corporation.
- Each offers its owners significant advantages and disadvantages.



- The most common form of business organization in the United States is the **sole proprietorship** or **proprietorship**–a business owned and run by one person.
- Although relatively the most numerous and profitable of all business organizations, proprietorships are the smallest in size.
- Proprietorships earn almost one-fifth of the net income earned by all businesses, even though they make only a fraction of total sales.

Sole Proprietorships

- The sole proprietorship is the easiest form of business to start because it involves almost no requirements except for occasional business licenses and fees.
- The advantages of a sole proprietorship include:
  - ease of starting up
  - relative ease of management
  - owner enjoys the profits of successful management
  - no separate business income taxes
  - psychological satisfaction
  - ease of getting out of business

- The disadvantages of a sole proprietorship include:
  - owner has **unlimited liability**–full and personal responsibility for all losses and debts of the business
  - difficulty in raising financial capital
  - size and efficiency–the business may have to carry a large **inventory**, or stock of finished goods and parts in reserve

- limited managerial experience
- difficulty of attracting qualified employees
- **limited life**–firm ceases to exist when owner dies, quits, or sells the business

Partnerships

- A **partnership** is a business jointly owned by two or more persons.
- Partnerships are the least numerous form of business organization, accounting for the smallest proportion of sales and net income.

Types of Partnerships

- The most common form of partnership is a *general* partnership, one in which all partners are responsible for the management and financial obligations of the business.
- In a **limited partnership**, at least one partner is not active in the daily running of the business, although he or she may have contributed funds to finance the operation.
- Because more than one owner is involved, formal legal papers called ***articles of partnership*** are usually drawn up to specify arrangements between partners.

- The advantages of a partnership include:
  - ease of establishment
  - ease of management
  - lack of special taxes
  - attract financial capital easily
  - slightly larger size, increased efficiency
  - easier to attract top talent

- The disadvantages of a partnership include:
  - each partner is fully responsible for the acts of all other partners
  - limited partners have limited liability
  - limited life
  - potential for conflict between partners
  - offer increased access to financial capital, but do not always work out
  - A business may have to file for **bankruptcy**, a court-granted permission to an individual or business to cease or delay debt payments.

Corporations

- Corporations account for approximately one-fifth of the firms in the United States and about 90 percent of all sales.
- A **corporation** is a form of business organization recognized by law as a separate legal entity having all the rights of an individual.

Forming a Corporation

- Unlike a sole proprietorship or partnership, a corporation is a very formal and legal
  arrangement.

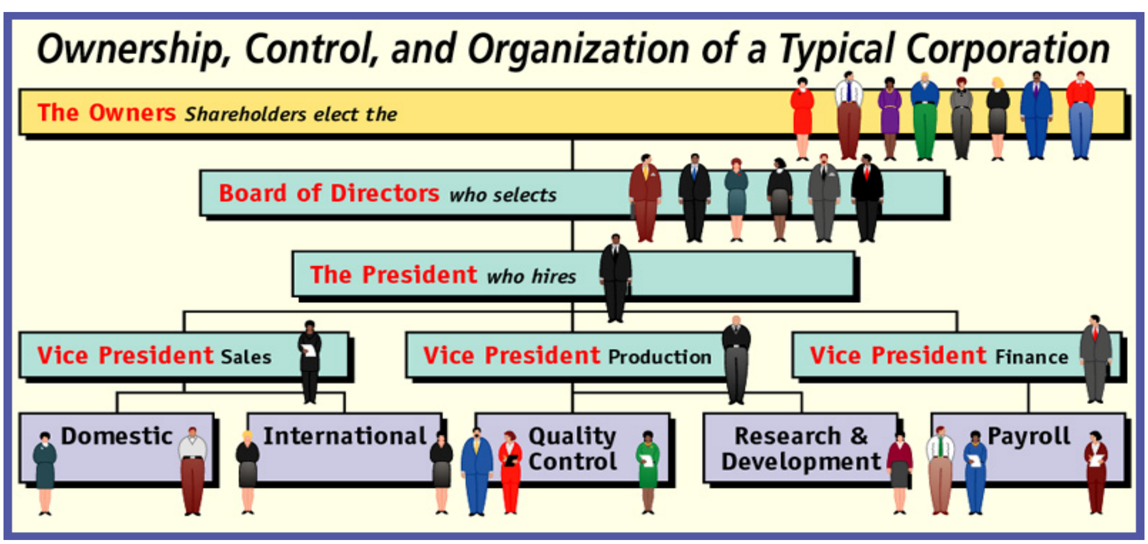
- People who would like to *incorporate*, or form a corporation, must file for permission from the national government or the state where the business will have its headquarters.
- If approved, a **charter**–a government document that gives permission to create a corporation–is granted.

- The charter also specifies the number of shares of **stock**, or ownership certificates in the firm.
- These shares are
  sold to investors,
  called **stockholders** or **shareholders**.
- The money is then used to set up the corporation.

- If the corporation is profitable, it may eventually issue a **dividend**–a check representing a portion of the corporate earnings–to each stockholder.

Corporate Structure

- When an investor purchases stock, he or she becomes an owner with certain ownership rights.



- The advantages of a corporation include:
  - ease of raising financial capital
  - gain capital by selling additional stock
  - borrow money by issuing bonds
- A **bond** is a written promise to repay the amount borrowed at a later date.
- The amount borrowed is known as the **principal**.
- While the money is borrowed, the corporation pays **interest**, the price paid for the use of another's money.

- The advantages of a corporation also include:
  - professional managers run the firm
  - limited liability for owners
  - unlimited life
  - ease of transferring ownership
- The disadvantages of a corporation include:
  - difficulty and expense of getting a charter
  - owners have little say in how the business is run
  - **double taxation** of corporate profits, stockholders' dividends are taxed twice–once as corporate profit and again as personal income
  - more government regulation

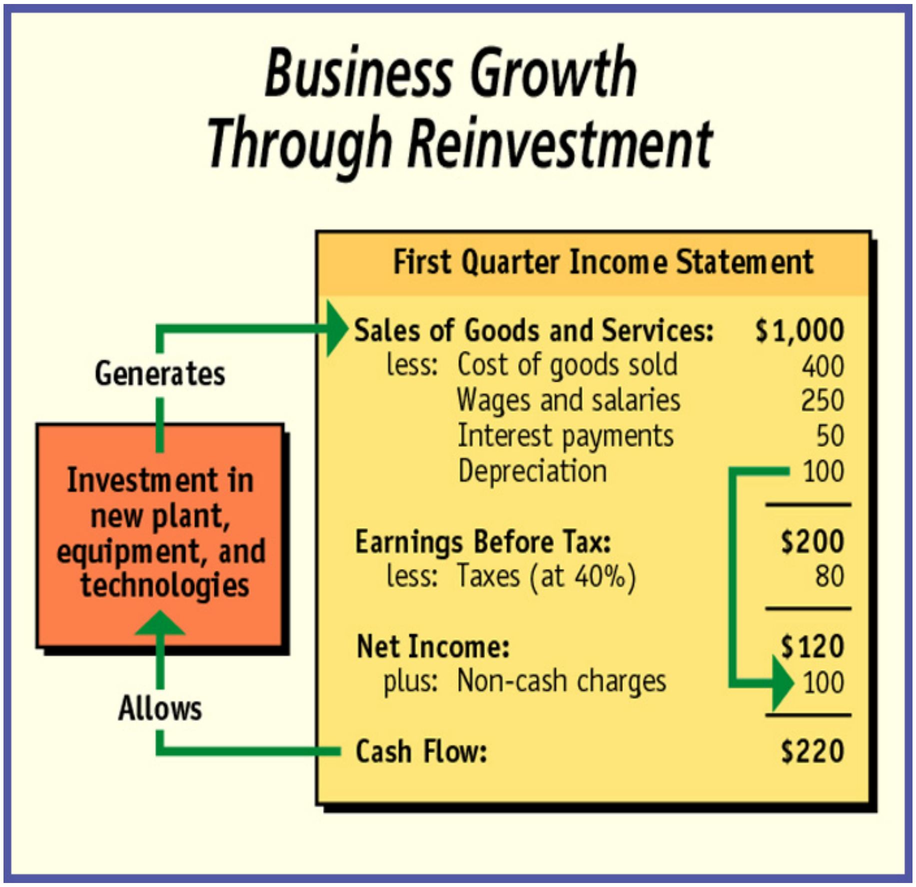
Business Development

- State governments are very active in trying to attract new industry.
- Governors often travel throughout the country or even to foreign countries to draw new business to their states.
- A state may offer an incentive such as a tax credit, or a reduction in taxes, in return for the creation of new jobs or new business investment.

Section 2:
Business Growth and Expansion

- A business can grow in one of two ways.
- It can grow by reinvesting some of its profits.
- A business can also expand by engaging in a **merger**–a combination of two or more businesses to form a single firm.

- Most businesses use some of the revenue they receive from sales to invest in factories, machinery, and new technologies.
- We can use the **income statement**–a report showing a business's sales, expenses, and profits for a certain period–to illustrate the process.
- The business first records its total sales for the period.
- Next, it finds its **net income** by subtracting all of its expenses, including taxes, from its revenues.
- These expenses include the cost of goods and **depreciation**, a non-cash charge the firm takes for the general wear and tear on its capital goods.



Reinvesting Cash Flows

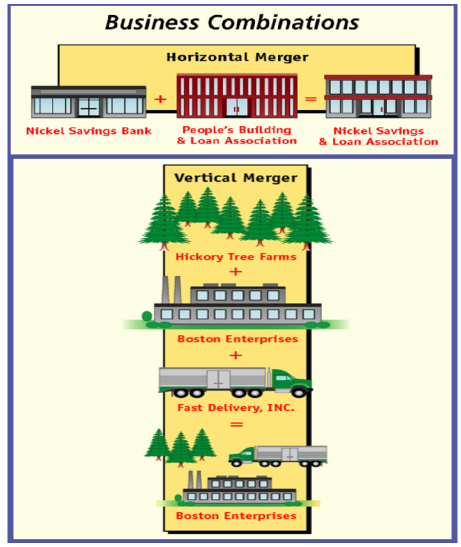
- Depreciation is called a non-cash charge because, unlike other expenses, the money is never paid to anyone else.
- Cash flow, the sum of net income and non-cash charges such as depreciation, is the bottom line, or real measure of profits for the business.
- The cash flow represents the total amount of new funds the business generates from operations.
- Business owners decide how the cash flow will be allocated.
- When cash flows are reinvested in the business, the firm can produce additional products.
- As long as the firm remains profitable, and the reinvested cash flow is larger than the wear and tear on the equipment, the firm will grow.

Growth Through Mergers

- When firms merge, one gives up its separate legal identity.
- The name of the new company may reflect the identities of the merged companies.
  - A firm may seek a merger to grow faster, to become more efficient, to acquire or deliver a better product, to eliminate a rival, or to change its image.
  - Some companies merge in order to grow faster.
  - Efficiency is another reason for mergers.
  - Some mergers are driven by the need to acquire new product lines.
  - Sometimes firms merge to catch up with, or even eliminate, their rivals.
  - A company may use a merger to lose its corporate identity.

Types of Mergers

- Economists generally recognize two types of mergers:
  - The first is a **horizontal merger**, which takes place when two or more firms that produce the same kind of product join forces.
  - When firms involved in different steps of manufacturing or marketing join together, it is a **vertical merger**.



- A corporation may become so large through mergers and acquisitions that it becomes a conglomerate.
- A **conglomerate** is a firm that has at least four businesses, each making unrelated products, none of which is responsible for a majority of its sales.
- Other large corporations have become international in scope.
- A **multinational** is a corporation that has manufacturing or service operations in a number of different countries.
- They are important because they have the ability to move resources, goods, services, and financial capital across national borders.

Section 3: Other Organizations

- Most businesses use scarce resources to produce goods and services in hopes of earning a profit for their owners.
- Other organizations operate on a “not-for-profit” basis.
- A **nonprofit organization** operates in a businesslike way to promote the collective interests of its members rather than to seek financial gain for its owners.
- Examples of nonprofit institutions include organizations such as schools, churches, hospitals, welfare groups, and adoption agencies.
- Most of these organizations are legally incorporated to take advantage of unlimited life and limited liability.
- They are similar to profit-seeking businesses, but do not issue stock, pay dividends, or pay income taxes.
- They use scarce factors of production to serve many needs.

Cooperatives

Types of CO-OP'S

- Consumer cooperative:
  - The consumer cooperative is a voluntary association that buys bulk amounts of goods such as food and clothing on behalf of its members.
- Service cooperative:
  - A service cooperative provides services such as insurance, credit, and baby-sitting to its members, rather than goods.(Ex. Credit Union)
- Producer cooperative:
  - A producer cooperative helps members promote or sell their products.

Labor Unions

Professional Associations

- Many workers belong to professional societies, trade associations, or academies.
- One such organization is a **professional association**–a group of people in a specialized occupation that works to improve the working conditions, skill levels, and public perceptions of the profession.
- These associations also seek to influence government policy on issues that are important to them.

Business Associations

- Businesses also organize to promote their collective interests.
- Most cities and towns have a **chamber of commerce** that promotes the welfare of its members and of the community.
- Many business organizations represent specific kinds of businesses and are called industry or trade associations.
- Some business associations help protect the consumer.
- The **Better Business Bureau**, a nonprofit organization sponsored by local businesses to provide general information on companies, is one of these.

Government

- **Direct Role of Government:**
  - Many government agencies produce and distribute goods and services to consumers, giving government a direct role in the economy.
  - The role is "direct" because the government supplies a good or service that competes with private businesses.
  - Many federal agencies are organized as government-owned corporations.

Government

- **Indirect Role of Government:**
  - The government plays an indirect role when it acts as an umpire to make sure the market economy operates smoothly and efficiently.
  - One such case is the regulation of **public utilities**, investor- or municipal-owned companies that offer important products to the public, such as water or electric service.
  - The government also plays an indirect role when it grants money to people in the form of Social Security, veterans' benefits, financial aid, and unemployment compensation.