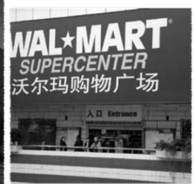


Business Types, Market Types, & Market Strategies

Coach Burnett

AP Macroeconomics

Normal Profit vs. Economic Profit

- Normal profit is the payment for (cost of) the entrepreneurs' contributions
- Whereas Economic Profit is an above-normal profit, and is what lures other producers to a particular industry

The Invisible Hand

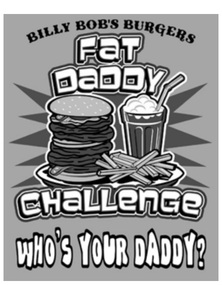
- The tendency of firms and resource suppliers that seek to further their own self-interest in competitive markets to also promote the interest of society
  - "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."

    - Adam Smith - "The Wealth of Nations

The Three Business Structures

- Sole-Proprietorship
- Partnership
- Corporation

Sole Proprietorship



Sole Proprietorship

- Sole proprietorship is a type of business owned by an individual entrepreneur
- This person also manages the operations of the business and assumes all the risk and keeps all the profits (or endures it losses)
- It is the oldest, most common, and simplest form of business organization

Sole Proprietorship

- The most important characteristic of a sole proprietorship is that the owner is inseparable from the business
- The term that describes a sole proprietorship is "unlimited personal liability"
  - This is because the entrepreneur is, in a sense, the business, he/she has complete control over operations and is legally responsible for all debts and legal actions taken against the business

Sole Proprietorship

- About 75 percent of all businesses are sole proprietorship, but they account for <u>only about 6 percent of all revenues taken in by all business types</u>
- As small businesses, they are relatively easy to form and operate
- Due to their scale of operation and the fact the owner has unlimited liability, they experience difficulty in raising revenue in the form of loans, and are not permitted to issue stock or bonds

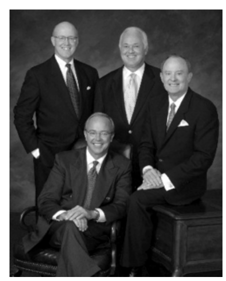
Sole Proprietorship

- Taxes on the business are determined at the personal income tax rate of the owner
- A sole proprietorship does not pay taxes as a business, only the owner needs to pay personal income tax on this annual profits (or declare and income loss)

Recap:

- Think Mom and Pops Diners
- Small size, unlimited liability
- Accounts for most of the marketplace, but smallest margin of profits

Partnership



Partnership

- A partnership is defined as an association of two or more persons to carry on as co-owners of a business for profit
  - In other words, if two or more individuals do nothing more than verbally agree to conduct business as owners, a general partnership is formed

Partnership

- Two types:
  - Limited
  - Limited Liability

Limited Partnership

- In a limited partnership, one or more of the partners may be "silent partners." At least one person must be a general partner
- The difference is that the general partner(s) operate the business while the "silent partner(s)" have only a financial interest in the first and are not normally involved in day-to-day operations

Limited Partnership

- As with sole proprietorships, members of general and limited partnerships have unlimited personal liability
- The debts and legal obligations of the first are the personal responsibility of the partners

Limited Partnership

- A partnership is a popular form of business among professional groups (doctors, lawyers, engineering firms)
- Because of this, if the personal liability of the firm is shared, a mistake or misdealing of one partner could bring the whole partnership to collapse
- So we also have…

Limited-Liability Partnership

- The error of one partner does not affect the other partners
- If one partner is sued for malpractice, for example, the other partners and the firm are insulated from the legal action

Partnership

- Although a verbal commitment is sufficient to form a general or limited partnership, it is prudent and for the protection of all involved, to have a partnership agreement formally called articles of partnership
  - AKA → **GET IT IN WRITING!**
- Partnerships account for about 7 percent of all businesses in the United States and generate about 10 percent of total income of all business types

Pros/Cons of Partnerships

Advantages

- Ease of start-up
- Shared decision making and specialization of tasks
- The business itself is not taxed

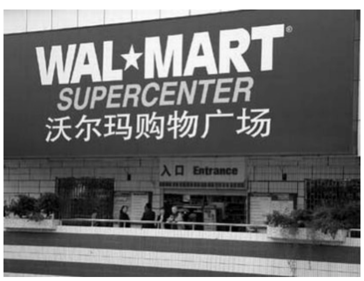
Disadvantages

- Potential for conflict among the partners

Recap:

- Comprised of two or more people working together
- Often seen with professions like doctors and lawyers working together
- More stable than Sole Proprietorship but has the potential for conflict
- About 7% of the marketplace and make up about 10% of total profits

Corporation



Corporations

- A corporation is the most complex form of business organization.
- It is an association of individuals created by law with powers and liabilities independent of its stock holders whose shares of stock represent ownership of the firm.
  - AKA → The corporation owns all property, owes the corporate debt, and is the debtor that gets sued or the creditor who sues another.

Corporations

- Stockholders and company officials have limited personal liability. They are almost always protected from personal loss, other than their own investment in the company's stock.

Corporations

- Two types:
  - Closely held private corporation
  - Publicly held corporation

Corporation types

- Privately held
- Small number of shareholders with restrictions on trading stock shares, and holders are usually board members and officers who work for the company.
- Publicly held
- Shareholders are part of the general public
- Demand for public shares is broader using easily accessible stock exchanges
- There are generally no stock transfer restrictions
- Major shareholders are often elected to the Board of Directors

Pros/Cons of Corporations

- Pros
- Limited personal liability
- Longevity through establishment of a corporate structure
- Specialized management
- Relative ease of raising capital (as a corporate entity, the firm may issue stock and sell bonds in order to raise capital).
- Cons
- Corporations face double taxation.
  - This means a corporation pays a tax on its income when it is earned, and its shareholders pay a tax on their income when it is distributed to them in the form of dividends, and when they sell the stock for a capital gain.
- Corporations are complex and rather expensive to start and continue to operate.

Corporations

- The procedure to incorporate starts with choosing a proper name for the first, (which is not used by another company).
- Articles of Incorporation and Bylaws that describe precisely how the business is to be run must be filed with the state (and sometimes federal and even foreign governments).

Corporations

- Profits, losses, and distributions must be reported periodically
- Methods of capitalizing and financing must also be made to government agencies and stockholders.
- There are a number of filing fees and costs to attorneys, advertising and publishing firms also associated with the incorporating process.

Recap:

- Largest business structure and greatest potential for large amounts of income
- Limited liability is a perk, but taxes are higher than any other business model we learned
- The incorporation process includes choosing a name for the business

Standardized Product

- A product whose buyers are indifferent to the seller from whom they purchase it as long as the price charged by all sellers is the same; a product all units of which are identical and thus are perfect substitutes
  - Ex: paper plates/cups, plastic silverware, etc

Non-price competition

- Competition based on distinguishing one's product by means of product differentiation and then advertising the distinguished product to consumers

Product Differentiation

- A strategy in which one firm's product is distinguished from competitors products by means of its design, related services, quality, location, or other attributes (except price)

Perfect Competition Markets

- Also known as 'pure competition markets' in the textbook
- A market structure in which a very large number of firms sells a standardized product, into which entry is very easy, in which the individual seller has no control over the product price, and in which there is no non-price competition; a market characterized by a very large number of buyers and sellers

Monopolistic Competition Markets

- A market structure in which many firms sell a differentiated product, into which entry is relatively easy, in which the firm has some control over its product price, and in which there is a considerable non-price competition
- AKA →
  - Many sellers → just like perfect competition
  - Differentiated products → like monopoly
  - No barriers to entry → like perfect competition

Oligopoly

- A market structure in which a few firms sell either a standardized or differentiated product, into which entry is difficult, in which the firm has limited control over product price because of mutual interdependence (except when there is collusion among firms), and in which there is typically non-price competition

Oligopoly [cont.]

- <u>Collusive Oligopoly</u>

- Cartels
  - Act like a monopoly (think OPEC)
- Price leadership
  - One firm sets the price and others follow

Monopoly

- A market structure in which the number of sellers is so small that each seller is able to influence the total supply and the price of the good or service
- AKA
  - One single seller, many buyers
  - Product has no close substitutes
  - Barriers to entry

Spillover Benefits

- A benefit obtained without compensation on third parties by the production or consumption of sellers or buyers.
  - Ex: A beekeeper benefits when a neighboring farmer plants clovers
    - •(The bees pollinate)

Spillover Costs

- A cost imposed without compensation on third parties by the production or consumption of sellers or buyers.
  - Ex: a manufacturer dumps toxic chemicals into a river, killing the fish sought by sport fishers
    - •(The fish die from the shortcut taken by the company)

Externalities

- Another name for Spillover costs/benefits is an <u>Externality</u>
- Positive Externalities (spillover benefits)
  - Education
  - Research
  - A well-kept yard
- Negative Externalities (spillover costs)
  - Pollution
  - Noise
  - An un-kept yard

The Government’s basic role in the simple circular flow model