Economics

Chapter 7: Business Operations

Section 1: About Business Firms

Why Do Business Firms Exist?

A **business firm** is an _______________________ that uses _____________________ to produce __________ and __________________________________________ that are _________ to consumers, other firms, or the government. Most businesses exist because a group of people working _______________ can be more effective than a group of people working _______________________.

Three Types of Firms

1) **SOLE PROPRIETORSHIP**
   - A **sole proprietorship** is a business that is owned by _______ individual.
   - This owner makes all the business ____________________, receives all the  _________ or _________ of the firm, and is ______________________ responsible for the debts of the firm.
   - About __________ million proprietorships operate in the United States.
     - **Advantages**
       - Easy to ________ and to ______________
       - All decision-making power resides with the sole proprietor
       - The profits are ______________ only once
     - **Disadvantages**
       - ______________ - The sole proprietor’s personal assets may be used to pay off the debts of the firm
       - There are challenges raising funds for __________________
       - Usually ends with the ______________ or __________ of the owner

2) **PARTNERSHIP**
   - A **partnership** is a business that is owned by two or more ______________________, called partners.
   - The partners ___________ profits and are legally responsible for debts.
   - About ______________ million partnerships operate in the United States.
     - **Advantages**
       - ___________________________ - If one partner has a talent that goes well with the other partner’s talent, the partners can separate the responsibilities of the business.
       - Taxes are assessed only at the ______________ level.
     - **Disadvantages**
       - Unlimited liability - If one partner incurs a substantial business-related debt, ________ partners are responsible for the debt.
       - **One exception is the ______________ partnerships.** Limited partners do not ______________ in the management of the firm or enter into contracts so they are only liable for the amount he or she ______________ in the firm.
       - ______________ making can be complicated in a partnership. Each partner may want to take different risks or operate the business in a different way.

3) **CORPORATION**
   - The corporation is a business type familiar to most people. A **corporation** is a ______________________ that can conduct business in its own name in the same way that an individual does.
   - A corporation is owned by its _________________________. Stockholders are people who buy shares of stock in a corporation.
   - A share of stock represents a claim on the ______________ of a corporation. Assets are anything of ______________ to which the firm has a legal claim.
   - All corporations have a **board of directors**. The board of directors decides corporate ______________ and ________________, and much more.
All firms can raise money by ____________________ from banks and other lending institutions. Corporations can also raise money from the ______ of bonds, of statements of debt, and of stocks. If you buy a bond from a corporation, you are a ___________. If you buy stock, you are an _____________.

About ____ million corporations operate in the United States and account for about _____ % of all business receipts.

**Advantages**
- **Limited liability** - An owner can lose ______ the amount that she or he has invested in the firm. Suppose a person spends $100 purchasing stock in a business firm. She is at risk of losing only her $100 investment, even if the firm performs poorly and accumulates millions in debt. Any ______ accumulated by a corporation are the sole responsibility of the _________.
- The corporation will continue to _______ even if one or more owners sell their shares or die. A corporation is a legal entity, and its existence does not depend on the existence of its owners.
- Corporations are able to raise large amounts of __________ by selling more stock, providing _____________ for expansion.

**Disadvantage**
- First, the corporation is taxed on its _____________. Later, when the corporation distributes profits to stockholders in the form of _____________, the stockholders are taxed on their dividends.
- Corporations are more _______________ to set up than proprietorships or partnerships.

<table>
<thead>
<tr>
<th>Type of business firm</th>
<th>Examples</th>
<th>Advantages</th>
<th>Disadvantages</th>
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</table>
| Sole proprietorship   | • local barbershop  
                      | • Many restaurants  
                      | • Family farm  
                      | • Carpet-cleaning service | • Easy to form and to dissolve.  
                      | • All decision-making power resides with the sole proprietor.  
                      | • Profit is taxed only once. | • Proprietor faces unlimited liability.  
                      |                      |                         | • Limited ability to raise funds for business expansion.  
                      |                      |                         | • Usually ends with retirement or death of proprietor. |
| Partnership            | • Some medical offices  
                      | • Some law offices  
                      | • Some advertising agencies | • Benefits of specialization can be realized.  
                      |                      |                         | • Profit is taxed only once. | • Partners face unlimited liability (one partner can incur a debt and all partners are legally responsible for payment of the debt).  
                      |                      |                         |                         | • Decision making can be complex and frustrating. |
| Corporation            | • Hewlett-Packard  
                      | • Intel  
                      | • Walt Disney | • Owners (stockholders) have limited liability.  
                      |                      |                         | • Corporation continues if owners sell their shares of stock or die.  
                      |                      |                         | • Usually able to raise large sums of money. | • Double taxation.  
                      |                      |                         |                         | • Corporations are complicated to set up. |
A Fourth Type of Business Firm: The Franchise

- A franchise is a _______________ that lets a person or a group use a firm’s name and sell the firm’s goods in _______________ for certain payments and requirements. A famous example is the franchises of the McDonald’s Corporation.

  *McDonald’s Corporation.*

- The entity that ____________ the franchise is the **franchiser**. In this case, McDonald’s Corporation is the franchiser.

- The person or group that ____________ the franchise is the **franchisee**.

- A franchise begins when a franchisee pays an initial __________ to use the name and sell the goods (in 2005, the initial fee for a McDonald’s franchise was $45,000). The franchisee will pay a royalty, or a percentage of __________ to the franchiser (in 2005, the McDonald’s royalty rate was 12.5%), and follow guidelines established by the franchiser. In return, the franchisee receives __________ in training employees, advertising, and other benefits.

  *Advantages*
  - Use of national ________________ helps all franchises.
  - ________________ in the product (all Big Macs are made exactly the same).
  - Less _______ (the failure rate is about ____ times higher for independently owned businesses than for franchises).

  *Disadvantage*
  - Sometimes the financial and training support is not ________________ for success.
  - The franchisee may not provide the ________________ of service and product that the franchiser expects.

What Is the Ethical and Social Responsibility of Business? (Differing Points of View)

- Ralph Nader, a consumer advocate, thinks that businesses have _______________ and ______________ responsibilities. He also believes that businesses should treat their _______________ well. And he believes that businesses should _______________ funds to meet social needs in the community.

- Milton Friedman, winner of the 1976 Nobel Prize in Economics, believes that a business has only ____________ social responsibility: to use its resources and increase its profits without ________ or ________. He believes that a business should earn as much as possible by selling the public something it wants to buy. Any other use of resources is outside the business’s social responsibility.
Applying the Principles
Chapter 7, Section 1 - About Business Firms

Identify the type of firm (sole proprietorship, partnership or corporation) that best answers the question.

1. Which type of firm has limited liability? ________________________________

2. Which type of firm is likely to have the greatest number of owners? ________________________________

3. Which types of firms have unlimited liability? ___________________________ and ___________________________

4. Which type of firm suffers from double taxation? ___________________________

5. Which type of firm has only one owner? ________________________________

6. Which type of firm is likely to have the shortest life span? ___________________________

7. Which type of firm is the easiest to form and to dissolve? ___________________________

8. Which type of firm is owned by stockholders? ______________________________

9. In which type of firm does a board of directors make the important decisions?________________________

10. In which type of firm is decision making often the easiest? ___________________________

11. Barbershops and restaurants are examples of which type of firm? ___________________________

12. Law firms and medical offices are examples of which type of firm? ___________________________

13. Wal-Mart, Best Buy and General Electric are examples of which type of firm? ___________________________

14. Which type of firm accounts for the greatest number of firms? ___________________________

15. Which type of firm accounts for the greatest number of receipts (sales)? ___________________________

Double taxation is considered to be a disadvantage of corporations. Write your answers to the next three questions in the space provided.

16. Explain double taxation.

17. Is it fair to tax corporate profits twice? Why or why not?
18. Some people argue that either the corporate income tax or the income tax on dividends should be reduced or eliminated. What might be some of the effects of reducing or eliminating one or both of these taxes? (Hint: Consider the circular flow diagram of economic activity in the U.S. economy on page 60 of your textbook.)

Corporations, like all firms, can raise money by borrowing from banks and other lending institutions. However, corporations also can raise money by selling bonds or issuing additional shares of stock. Answer the following questions by identifying the type of financing (stock or bond) that best answers the question.

19. In which form of corporate financing is the investor a lender to the corporation? _____________

20. In which form of corporate financing is the investor also an owner? _______________

21. Which form of corporate financing involves more risk for the investor? ________________

22. Which form of corporate financing involves the potential for greater returns for the investor? ________________

Franchises have become more common in the last 25 years. What are the advantages and disadvantages of buying a franchise?

23. Advantages:
________________________________________________________________________
________________________________________________________________________

24. Disadvantages:
________________________________________________________________________
________________________________________________________________________

Ethical and Social Responsibilities of Business

25. Do you agree or disagree with Milton Friedman’s opposition to businesses donating funds to charitable organizations? Answer in the space below and give reasons for your answer.